

# THE RETAIL SALES TAX IN A NEW ECONOMY

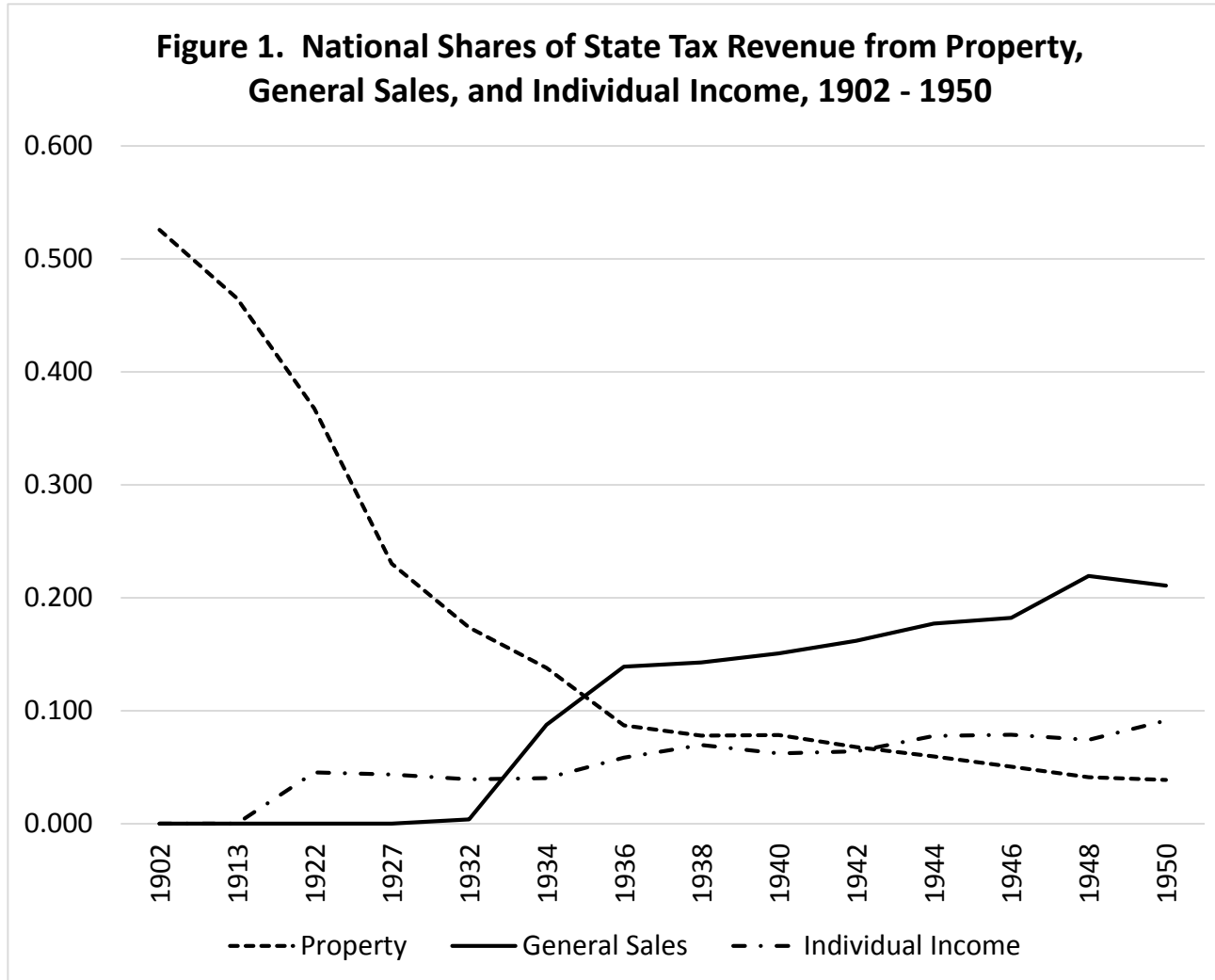
Municipal Finance Conference  
Washington, D. C.  
July 16, 2018

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# Some Retail Sales Tax Background

- **Great Depression Desperation**– property tax was largest state tax source, fell by 11.4 % from 1927 to 1932, by another 16.8 % from 1932 to 1934.
- **The Innovators:** Mississippi converted gross receipts tax (GRT) to retail sales tax in 1932, West Virginia adopted free-standing retail sales tax in 1933.
- **If you can make it there, you can make it anywhere:** Produced revenue even in poorest states. Ten more adopted in 1933.

# Early History of State General Sales, Individual Income, and Property Tax Reliance, 1902 - 1950



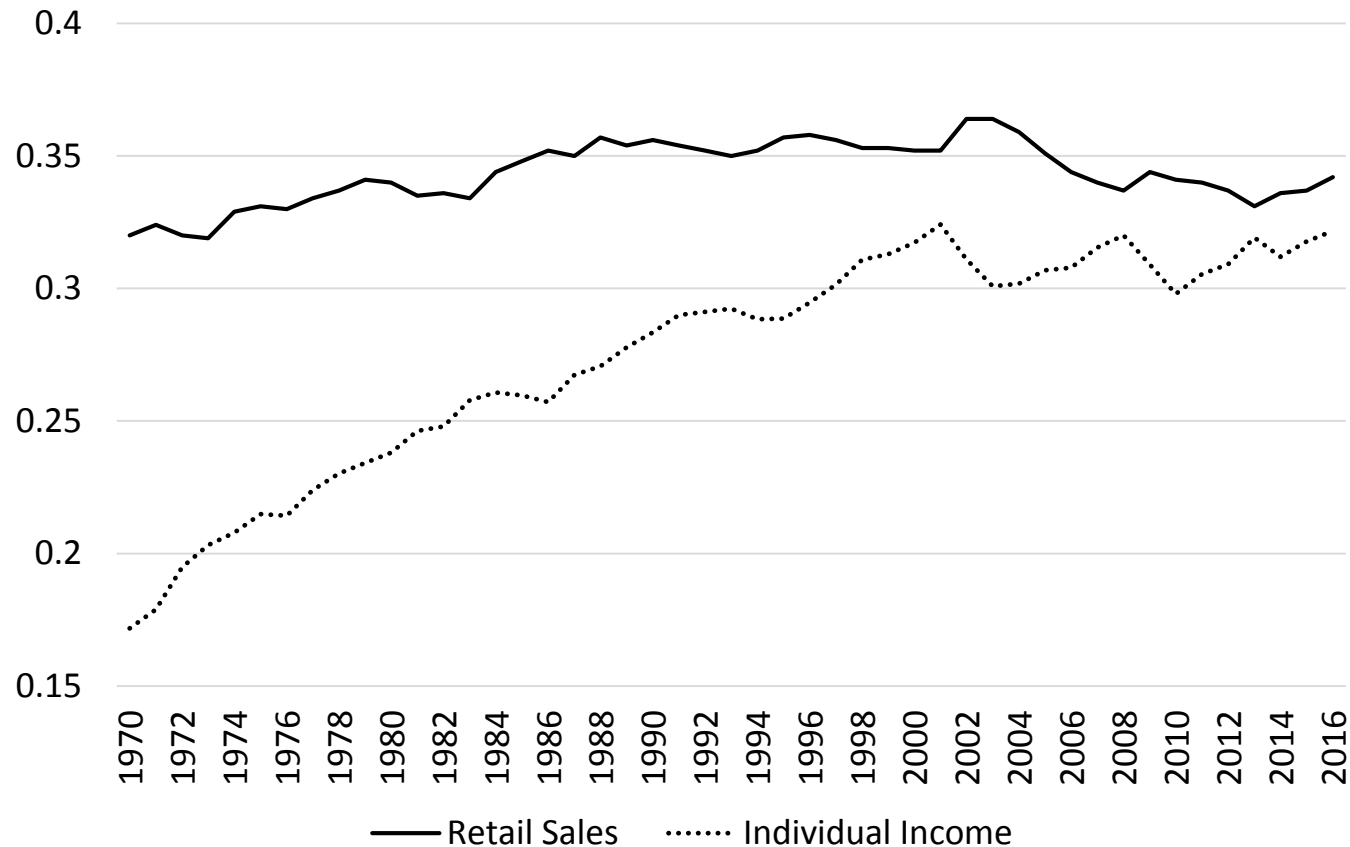
- Five states levied individual income taxes before first general sales taxes, but trivial revenue. Revenue surpassed property tax in early 1940s but still behind general sales.
- Property tax reliance consistently declined.
- General sales reliance jumped from 1933, rapidly to 1936, then somewhat more gradually through the period as more states adopted the tax and the economy improved.
- General sales tax reliance exceeded property tax reliance in 1936.
- But these general sales tax data include both RST and GRT data and there is no feasible way to separate. But it is possible for 1970 and onward.

# Some Structural Carry-Overs from the Early Adoptions

- Tax base is mostly goods, not services
- Retail focus on finished products; exempt inventory purchases but less attention to exempting other input purchases
- Tax added on purchase, not embedded in sticker price

## Important Stuff for State Finances: Retail Sales Tax (RST) and Individual Income Tax (IIT) Across the Individual States Since 1970 (Standardized RST Data)

Figure 2, Mean State Retail Sales and Individual Income Tax Reliance Across the 45 Sales Tax States, 1970 - 2016



- National Aggregate: Individual income tax (IIT) collections in FY 2016 \$333.5 B vs. RST collections \$288.5 B.
- **BUT:** At individual state level, mean retail sales tax reliance is greater than individual income tax reliance (although individual income tax reliance has been increasing).
- **State fiscal policy is made by individual states, not as a cohesive national whole.**
- Political and economic obstacles to greater use of alternative revenue sources (CIT, IIT, PIT, sel exc, user charges)

# Challenges Endogenous to State Policy Makers

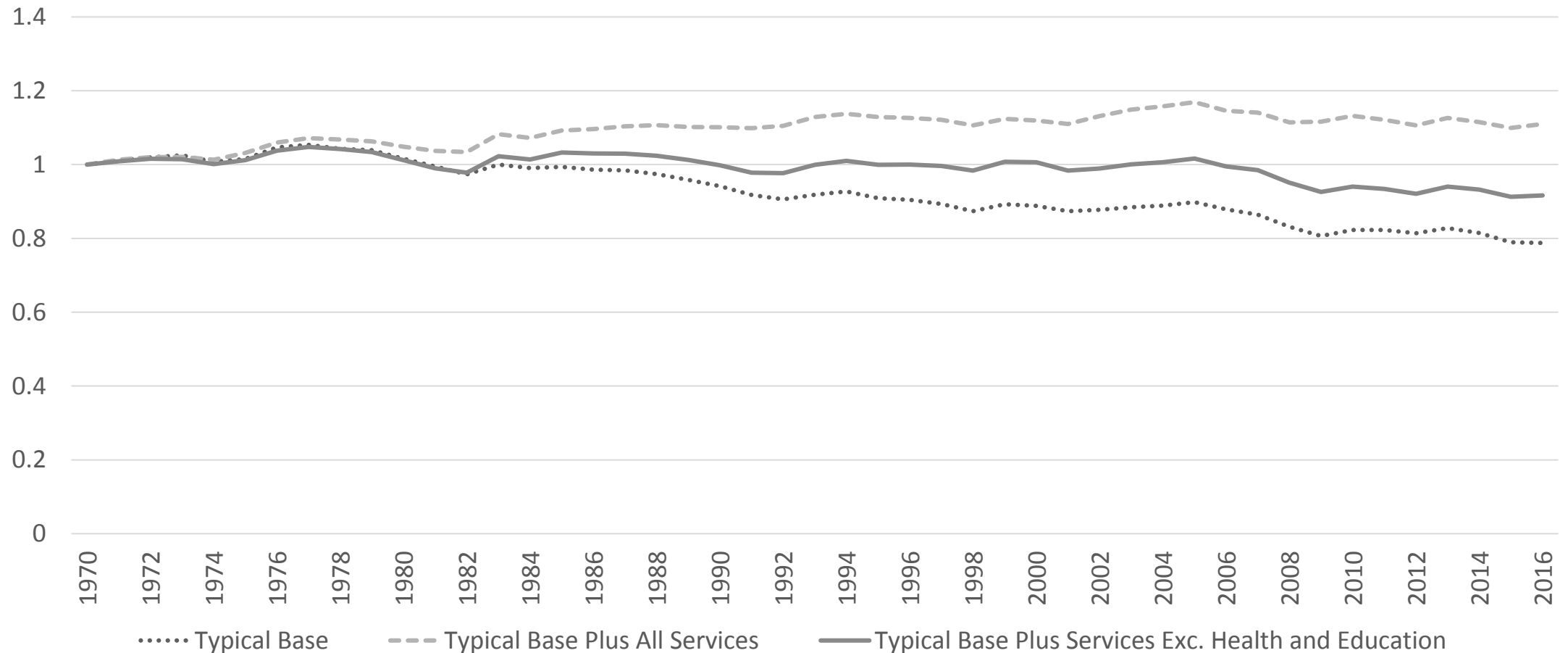
- **Exclusions:** base definitions that omit important portions of household consumption expenditure, purchases of services notably
- **Exemptions:** freeing from taxation of identified transactions because of their nature, usage, buyer, or seller.
- **Over-reach:** inclusion of transactions that are not household consumption expenditure in the taxable base.
- To coincide with ideal consumption base standard for transparency, efficiency, growth, and non-discrimination: tax all household consumption purchases and exempt all business input purchases

# The Big Exclusion: Services Purchased by Households

- State sales tax statutes often exclude services from definition of taxable transactions. Some services may be added selectively to general coverage of purchases of tangible personal property.
- Some States Have Expanded Service Coverage, But Not Broadly
  - 1971: 26 states exclude, 17 selectively tax, and 2 generally tax services
  - 2018: 3 states exclude, 38 selectively tax, and 4 generally tax services
- Problems
  - Selective coverage of minor service classes
  - Coverage of services almost exclusively purchased by businesses
  - And even selective coverage is difficult to add (e.g., Kentucky in 2018 over veto)

# Taxing Services Could Mitigate Some of the Disappearing Base Problem (BEA Data)

Sales Tax Base Relative to Personal Income: Current Typical Base, Current Base Plus Untaxed Household Service, and Base Plus Services Except Health Care and Education (Relative to 1970)





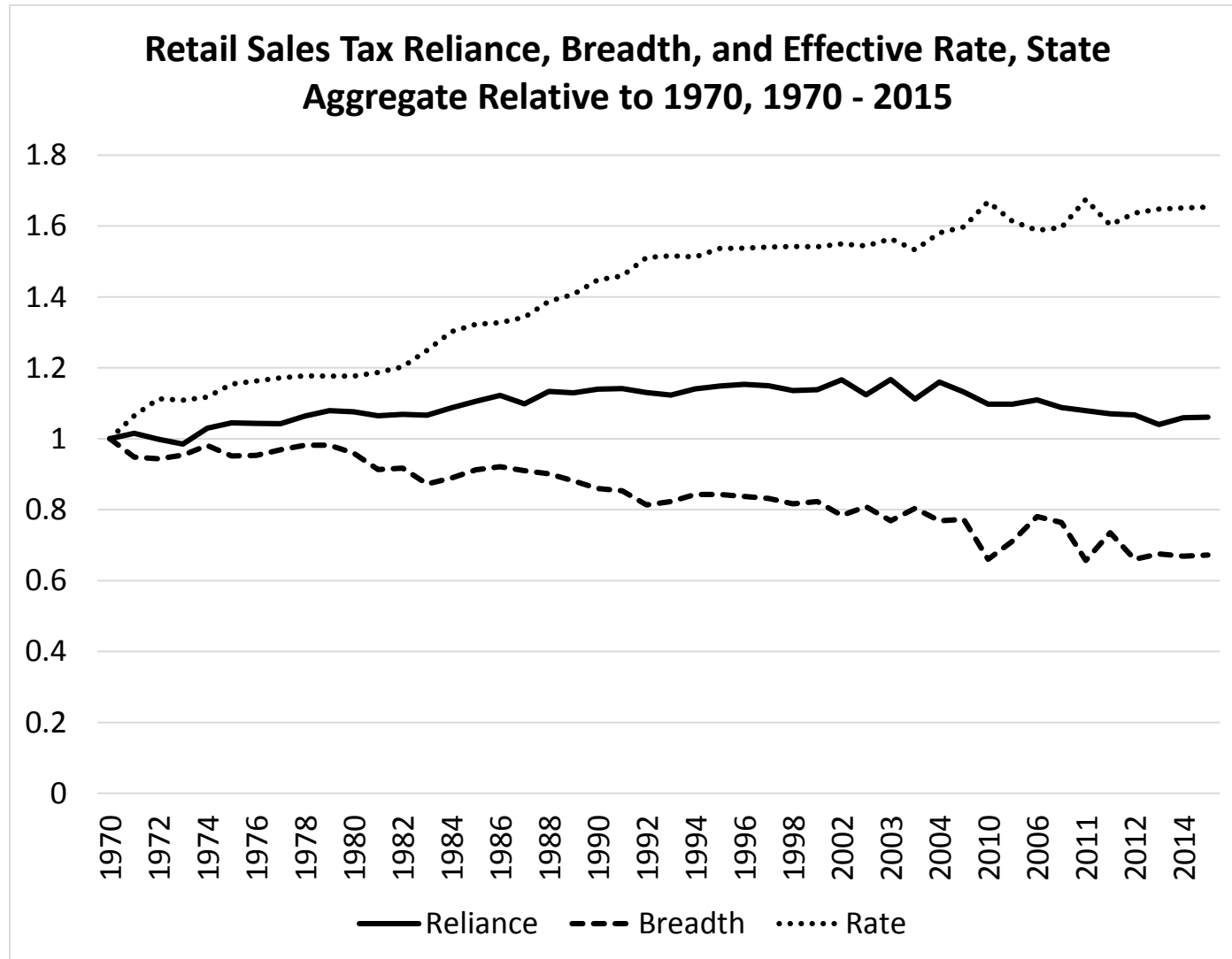
## **Adding Exemptions: 1971 - 2018**

- States have narrowed coverage of goods purchased by households
- States have not flocked to the better targeted, more efficient, and less expensive credit / rebate approach
  - Now appearing as Maine Sales Tax Fairness Credit, Kansas Food Sales Tax Credit, Oklahoma Sales Tax Relief Credit, Idaho Grocery Credit Refund, Hawaii Refundable Food / Excise Tax Credit, and Wisconsin Child Sales Tax Rebate.
- Expanding exemptions contributes to the implicit “narrow base – high rate” tax policy

Household Consumption Exemptions in Individual States, 1970 and 2018  
*(E = category is exempt; RR = category is taxed at reduced rate; T = category is taxed at standard rate)*

	<b>Status in 1970</b>	<b>Status in 2018</b>
<b>Food for at-home consumption</b>	E: 16; RR: 1; T: 28	E: 32; RR: 6; T: 7
<b>Clothing</b>	E: 4; E-children: 1; T: 40	E: 7; T: 38
<b>Prescription medicines</b>	E: 26; RR: 2; T: 17	E: 44; RR: 1
<b>Gasoline</b>	E: 38; T: 7	E: 36; RR: 6; T: 3
<b>Cigarettes</b>	E: 15; RR: 6; T: 24	E: 2; RR: 3; T: 40
<b>Sales tax holiday</b>	No states	One holiday: 10 states; two holidays: 5 states; 3 holidays: 1 state; 4 holidays : 1; zero holidays: 28

# The Heart of the Retail Sales Tax Dilemma: Maintaining Reliance With Disappearing Base and Means Rising Rates



- Continued retail sales tax reliance
- Sales tax base has persistently declined as portion of economy (measured by personal income). 1970 mean = 0.544; 2016 mean = 0.373
- Sales tax rates have persistently increased to maintain yield in face of declining base. Mean increase 1970 – 2016 is 2.06% (Range from 0 to 5%).
- **Implicit narrow base / high rate** strategy not part of anyone’s tax policy program, but that’s what we have

Breadth – Rate Trade-off:

$$RT = 0.044 + 0.170 \text{ REL}^{***} - 0.114 \text{ BR}^{***}$$

AdjRSq = 0.96

$$BR = 0.376 + 1.350 \text{ REL}^{***} - 8.293 \text{ RT}^{***}$$

AdjRSq = 0.95

## **Endogenous Challenges are Substantial**

- But dealing with them is within the power of state lawmakers.
- Fixing the regular base should be the first step in preparing state retail sales taxes for the new economy.

# New Economy Challenges Exogenous to State Policy Makers

- Internet and Remote Vendors
- Sharing Economy
- Zappers and Phantomware

# New Economy Challenge 1: The Remote Vendor - SCOTUS to the Rescue or Creating New Battles?

- ***South Dakota v. Wayfair* (2018) changed the rules for non-resident vendors to register and collect state sales (use) taxes.**
  - Earlier cases [*National Bellas Hess v. Department of Revenue* (1967) and *Quill v. North Dakota* (1992)] had used a physical presence standard for registration and collection.
- Implications of Ruling:
  - **States can legislate registration / collection requirements based on economic presence;** physical presence no longer required. Some states have already done so, but many have yet to do so or have delayed implementation dates.
  - **How much new revenue?** Nobody knows: Fox and friends, 5.2%; GAO, 2 – 4%; NCSL, 9%. Highest estimate is only around 3.5% total state tax revenue nationwide.
  - **BUT Court warned against “discrimination against or undue burden upon interstate commerce.”** Particularly (i) noted need for safe harbor for small vendors doing little business in the state, (ii) warned against applying tax retroactively, and (iii) noted the need to reduce compliance and administrative costs (e.g., court noted favorably the Streamlined Sales and Use Tax Agreement. However, current full members constitute less than 20 percent of national sales tax base).
  - **Next battle: Marketplace facilitators.** Individual vendors too small to be required to register / collect, but sell product through a marketplace (Amazon, Etsy, etc.) and total sales through the marketplace exceed the threshold. Marketplace facilitator must collect on all sales. Laws enacted in Alabama, Arizona, Oklahoma, Pennsylvania, Rhode Island, Washington, Minnesota. Certain to be tested in court.
  - **Will Congress act helpfully?** Any action now looks more like tax reduction and might have political popularity. States now hope that Congress does nothing. “Stop Taxing Our Potential Act of 2018” introduced in Senate shortly after *Wayfair* ruling to require physical presence alone as requirement for registration / collection and reporting by remote vendors. (4 Senators from no-sales-tax-states)

## New Economy Challenge Number 2: The Sharing Economy

- **Sharing economy: economic structure in which there are peer-to-peer transactions via an on-line platform.** Notable categories: lodging (Airbnb, VRBO), auto/taxi (Uber, Lyft) (vendors are not remote, platforms are), car rental (Turo, Getaround). Probably no nexus issue up front because actual vendors appear to be local.
  - Problems: small businesses with irregular operating profiles make enforcement difficult, business selling the service may be violating zoning or other regulations and will be reluctant to register with tax authorities, service being sold isn't always subject to state sales tax so taxing the shared provision only would be discriminatory.
  - Airbnb arranges tax collection in over half the states – collects from guests, remits to jurisdiction. (see next slide); Illinois requires for motor vehicle rental facilitators (2018 legislation).
  - Uber treatment differs across states: sometimes adds tax to bill and remits (Rhode Island); sometimes disputes any responsibility for tax because it does not provide transportation services (Ohio); sometimes appears to be deducted from the fare otherwise owed the driver (New York); sometimes leaves tax entirely up to the driver (Hawaii).
  - Turo and Getaround claim they are platforms only and shouldn't be involved in any of this.
- Sales tax has always had collection issues with small, informal, irregular vendors, so administration promises to be a pain. Collection through platform would be most effective approach.
  - Casual sales exclusion should be applied if platform does not collect.

## From Airbnb Terms of Agreement (2018):

“In certain jurisdictions, Airbnb may decide in its sole discretion to facilitate collection and remittance of Occupancy Taxes from or on behalf of Guests or Hosts, in accordance these Terms ("**Collection and Remittance**") if such jurisdiction asserts Airbnb or Hosts have an Occupancy Tax collection and remittance obligation. In any jurisdiction in which we decide to facilitate direct Collection and Remittance, you hereby instruct and authorize Airbnb (via Airbnb Payments) to collect Occupancy Taxes from Guests on the Host's behalf at the time Listing Fees are collected, and to remit such Occupancy Taxes to the Tax Authority. The amount of Occupancy Taxes, if any, collected and remitted by Airbnb will be visible to and separately stated to both Guests and Hosts on their respective transaction documents. Where Airbnb is facilitating Collection and Remittance, Hosts are not permitted to collect any Occupancy Taxes being collected by Airbnb relating to their Accommodations in that jurisdiction.”



## New Economy Challenge Number 3: Supercharged Skimming

- **Zappers** (hardware), **phantomware** (software) make transactions disappear
  - Cash is easy to make disappear with Z&P -- pocket the cash and use the computer link with the electronic cash register to make all tracks in the accounting system disappear. Perpetual issue in bars and restaurants. (“Cashless” economy may reduce this problem.)
  - Newer system run transactions with credit or debit cards through off-shore accounts to make their tracks disappear as well.
  - 21 states have legislated to make possession of Z or P illegal
  - Adds a new step in audits.

## But Some Technology Helps

- **Bar coding** in mid-1970s made all the difference – no longer clerk dependent application of tax
- **Online compliance systems** from certified vendors in Streamline system, sometimes provide by state at no charge; Electronic records, electronic filing, electronic compliance

# A Way Forward in the Economy of the 21<sup>st</sup> Century

- Retail sales tax revenue critical to finances of states, requires individual state actions
- Move the traditional part of the retail sales tax from its Great Depression roots! Does anyone believe that household purchases of services will become less significant in upcoming years and that taxing business input purchases improves prospects for economic growth and development or reduces economic distortions?
  - Fix old economy base problems that are in tax authority control – stop base disappearance
  - Use targeted relief via credit / rebate system to replace exemptions
  - Avoid “narrow base / high rate” policy for maintaining reliance
- Engaging the New Economy:
  - Beware of state overreach that may trigger court challenge (burden can't be excessive)
  - Use platforms to collect from shared economy and possibly marketplace facilitators for remote vendors;
  - Keep small, irregular vendors out of the system;
  - Keep new economy businesses within the regular sales tax structure to prevent distortions and inequities.