History and Economic Impact

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March 13, 2002

This chapter focuses on two basic issues, the history and the economic impact of sales taxes. The chapter is divided into five sections. The first is a brief review of sales taxes and their implementation throughout history. The second discusses the general sales tax's role in current U.S. state government finance. The third is an examination of the sales tax as a consumption tax, and the other means of taxing consumption. The next section addresses trends in the sales tax base and the factors that have been altering the base. The final section is a discussion of the likely direction of sales taxes in the future.

1. Sales Tax History

The imposition of transactions taxes can be found through much of modern civilization (see Buehler, 1940). Tomb paintings depict tax collectors in Egypt at least as early as 2000 BC, and sales taxes on individual commodities, such as cooking oil, can be traced to that time. Egypt, Athens, and Rome were all known to have general sales taxes. Indeed, the Romans were responsible for taking sales taxes to the rest of Europe, including to both Spain and France. Later, Spain had a national sales tax in place from 1342 until the 18th century, with rates that ultimately reached 10 to 15 percent. Specific commodity taxes were so broadly imposed during the U.S. civil war, that when combined, they nearly formed a general sales tax.[1]

The use of sales taxes by U.S. states dates back at least to the Pennsylvania mercantile license tax that was initially introduced in 1821, though this and other early taxes were not broad-based. Buehler attributes development of modern state sales taxes to the depression era. He credits Kentucky with the first tax levied exclusively on retailers. The initial tax, passed in 1930, was progressive, but was replaced in 1934 with a 3 percent flat rate tax and then was eliminated in 1936. The current Kentucky sales tax was adopted in 1960. Commerce ClearingHouse credits Mississippi with the first sales tax, in 1930. Forty-five states and the District of Columbia currently impose sales taxes (see Table 1). Twenty-four of the states first levied the tax during the 1930s, six in the 1940s, five in the 1950s, and eleven in the 1960s. In 1969, Vermont was the last state to impose a sales tax. Alaska, Delaware, New Hampshire, Montana and Oregon do not levy general sales taxes.

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[1] Two characteristics normally distinguish general sales taxes from selective sales taxes. First, general sales taxes have a broad base, including a wide variety of goods and potentially of services. Second, general sales taxes are imposed at ad valorem rates and selective sales taxes are often, though not always, levied at specific rates. Cigarettes, alcohol, and gasoline are examples of goods normally taxed at specific rates but cigars and other tobacco products are often taxed at ad valorem rates.

Table 1. Date of Adoption of General Sales Tax

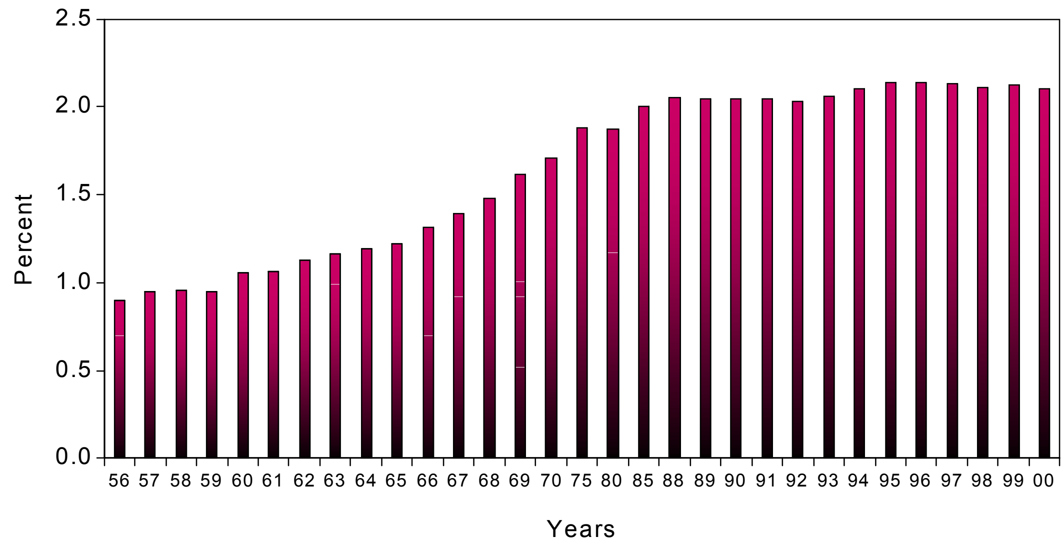
State	Year	State	Year
Alabama	1936	Missouri	1934
Arizona	1933	Nebraska	1967
Arkansas	1935	Nevada	1955
California	1933	New Jersey	1966
Colorado	1935	New Mexico	1933
Connecticut	1947	New York	1965
District of Columbia	1949	North Carolina	1933
Florida	1949	North Dakota	1935
Georgia	1951	Ohio	1934
Hawaii	1935	Oklahoma	1933
Idaho	1965	Pennsylvania	1953
Illinois	1933	Rhode Island	1947
Indiana[1]	1933	South Carolina	1951
Iowa	1933	South Dakota	1933
Kansas	1937	Tennessee	1947
Kentucky	1960	Texas	1961
Louisiana	1938	Utah	1933
Maine	1951	Vermont	1969
Maryland	1947	Virginia	1966
Massachusetts	1966	Washington	1933
Michigan	1933	West Virginia	1933
Minnesota	1967	Wisconsin	1961
Mississippi	1930	Wyoming	1935

[1]Gross income tax. In 1963, Indiana enacted a 2% retail sales and use tax.
Source: U.S. Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, Volume 1. Budget Processes and Tax Systems, February 1993.

2. Role of Sales and Use Taxes in U.S. Government Finance

State sales taxes raised $164.4 billion in 1999 while local sales taxes raised an additional $36.2 billion, for combined collections of $200.6 billion. The combined sales tax collections represented 2.58 percent of personal income in 1999, about the same percentage that was raised through most of the decade. A longer term look shows state sales taxes rising as a share of personal income during the 1960s through 1980s, but stabilizing during the 1990s (see Figure 1).

FIGURE 1
General Sales Taxes as a Percent of Personal Income, Selected Years



The sales tax was the largest source of state government finance from 1970 until 1998 when it was supplanted by the personal income tax (see Figure 2). Still, the sales tax provides nearly one-third of state government finance and ranks second to the income tax in importance as a source of state finance. Reliance on the sales tax varies widely by state. Sales taxes are much more important in the south and west than in New England and the industrial Midwest (see Figure 3). Florida, Washington, Tennessee, and Texas all generate more than 50 percent of their tax revenue from the sales tax, and several of these states raise nearly 60 percent from the sales tax. New York, on the other hand, only raises about one-fifth of its revenues from the sales tax.

Faster natural revenue growth is the primary reason that the personal income tax has overtaken the sales tax as the largest state tax revenue source. Income taxes are buoyed by tax bases that are normally broad and by progressive rates. Sales taxes, on the other hand, normally have a single rate for most commodities.[2] State sales taxes tend to rise about 85 to 90 percent as fast as the economy (measured by personal income), while state income taxes normally grow much faster than the economy.

[2] Twenty-six states and the District of Columbia have more than one sales tax rate, but the additional rates are normally applied to a small set of specific commodities and need not affect the overall growth rate.

FIGURE 2
U.S. Total Tax Collections, 2000

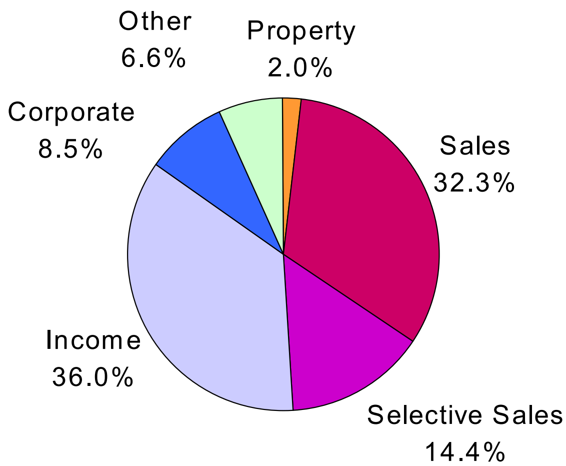
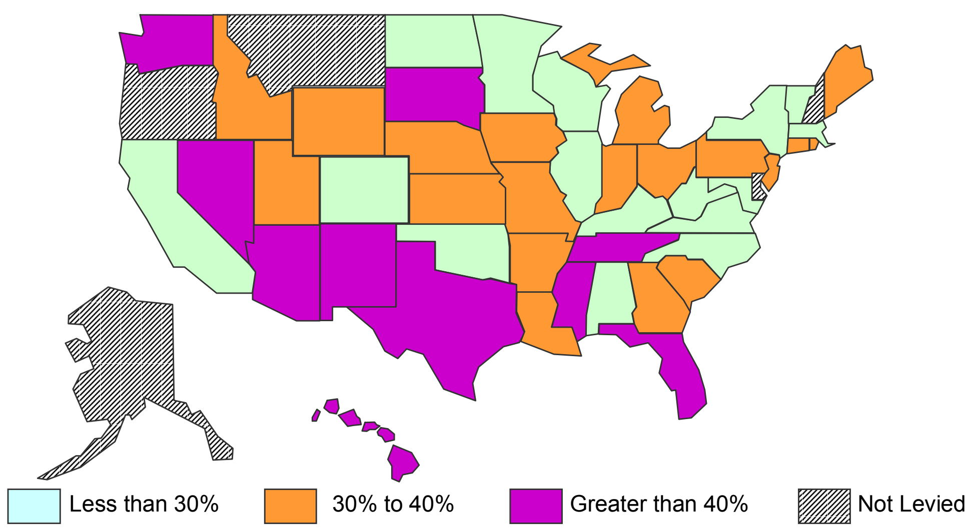
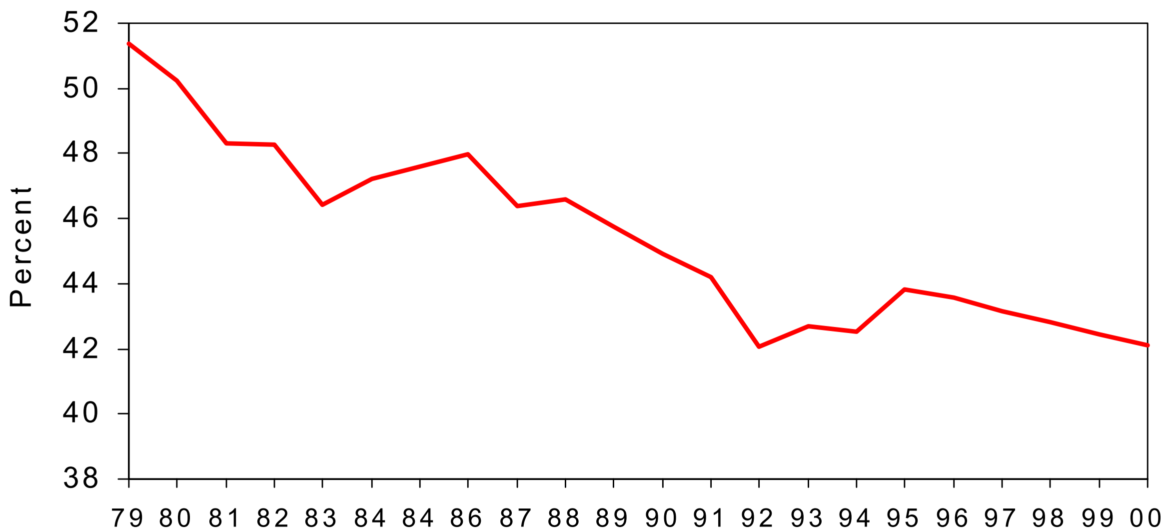


FIGURE 3
State General Sales Taxes as a Percent of Total Taxes, 2000



The sales tax base has fallen from 51.4 percent of personal income in 1979 to 42.1 percent in 2000 (see Figure 4), meaning that sales tax base expansion was not the reason for revenues growing as a percent of personal income. Higher tax rates are the primary reason for the rising share of GDP paid in sales taxes. The median state sales tax rate was 3.25 percent in 1970, 4.0 percent in 1980, and 5.0 percent in 1990, where it remains today (see Table 2). Rates have been increased much less frequently since the 1990 recession, causing the share of personal income paid in sales taxes to fall slightly. Higher sales tax rates have allowed the sales tax to maintain or increase its share of the economy, but the sales tax will shrink relative to the economy without a continued pattern of rate increases. Combined state/local rates vary from 1.05 percent in Alaska (which has no state tax) to 8.35 percent in Louisiana and Tennessee (see Table 2).

FIGURE 4
U.S. Sales Tax Base as a Percent of Personal Income, 1979-2000



Property tax revenues dominate local tax finance. Still, local governments in 34 states use sales taxes, allowing for some revenue diversity. All local sales taxes together generate only 11.1 percent of local tax revenues versus the nearly three-fourths provided by property taxes. Local sales taxes are generally more important in the southeast and southwest (see Figure 5). Local income taxes by comparison are used in only 13 states and generate only 5.2 percent of local tax revenue.

Table 2: State Sales Tax Rates and Combined Average City and County Rates

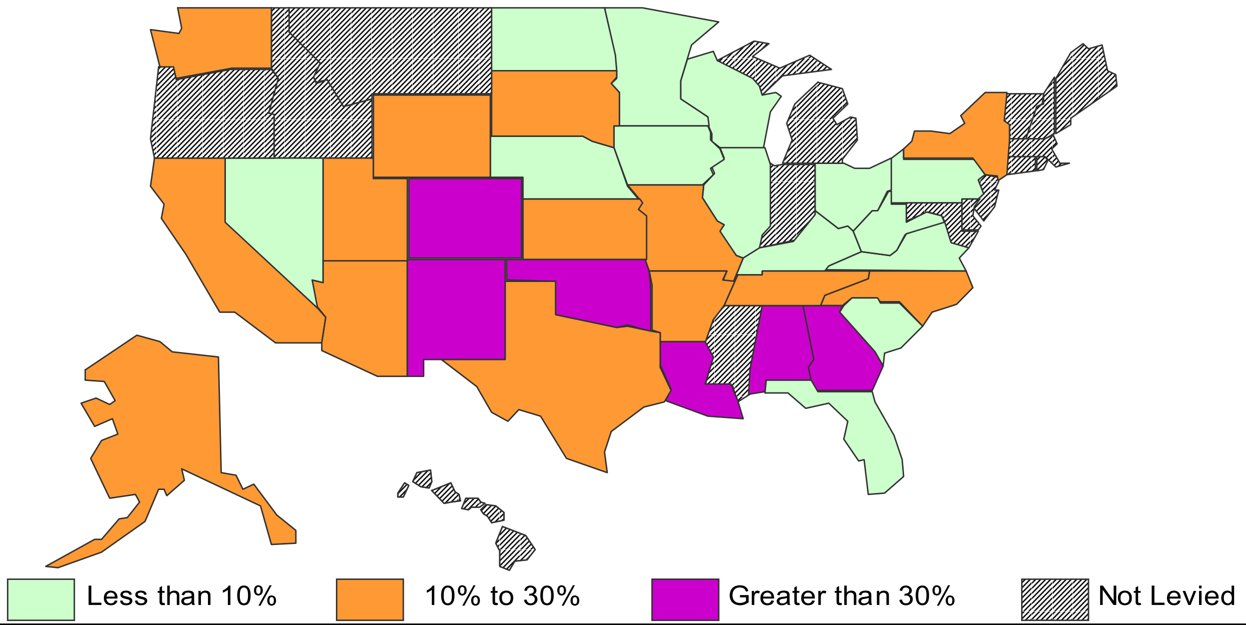
	State Sales Tax Rates	Combined Average City and County Rates		State Sales Tax Rates	Combined Average City and County Rates
Alabama	0.04	0.0745	**Montana**	--	
Alaska	--	0.0105	**Nebraska**	0.05	0.0575
Arizona	0.056	0.076	**Nevada**	0.065	0.0715
Arkansas	0.05125	0.0675	**New Hampshire**	--	
California	0.0575	0.079	**New Jersey**	0.06	0.0595
Colorado	0.029	0.058	**New Mexico**	0.05	0.0595
Connecticut	0.06		**New York**	0.04	0.0795
Delaware	--		**North Carolina**	0.045	0.0655
Dist. of Columbia	0.0575		**North Dakota**	0.05	0.0545
Florida	0.06	0.065	**Ohio**	0.05	0.0615
Georgia	0.04	0.0655	**Oklahoma**	0.045	0.0755
Hawaii	0.04		**Oregon**	--	
Idaho	0.05	0.0505	**Pennsylvania**	0.06	0.0625
Illinois	0.0625	0.0735	**Rhode Island**	0.07	
Indiana	0.05		**South Carolina**	0.05	0.0555
Iowa	0.05	0.0605	**South Dakota**	0.04	0.051
Kansas	0.049	0.062	**Tennessee**	0.06	0.0835
Kentucky	0.06		**Texas**	0.0625	0.078
Louisiana	0.04	0.0835	**Utah**	0.0475	0.064
Maine	0.055	0.05	**Vermont**	0.05	
Maryland	0.05		**Virginia**	0.035	0.045
Massachusetts	0.05		**Virgin Islands**	0.04	
Michigan	0.06		**Washington**	0.065	0.0825
Minnesota	0.065	0.0665	**West Virginia**	0.06	
Mississippi	0.07		**Wisconsin**	0.05	0.054
Missouri	0.04225	0.0655	**Wyoming**	0.04	0.0525

Source: The Sales Tax Clearinghouse, 2001

3. Mechanisms for Taxing Consumption

It is unlikely that the original sales taxes were designed based on a precisely developed conceptual framework. Nonetheless, both analysts and legislators normally evaluate the tax in light of a general expectation that they are trying to tax consumption. A consumption tax should be levied in the place where the consumer enjoys the good or service (called the destination) rather than the place where goods are manufactured or sold (called the origination). Further, a consumption tax would be levied on the final consumption of goods and services. In addition to a sales tax, consumption can also be taxed through a value added tax (VAT) and a consumable income tax. The three mechanisms will have identical bases if they are properly structured, but they are often very different in practice.

FIGURE 5
Local General Sales Taxes as a Percent of Total Local Taxes, 1999



Value Added Tax

Consumption taxation through a VAT has a much shorter history than general sales taxes (see Ebrill, et al, 2001). France introduced the first VAT in 1948, though with a different structure than the consumption VATs that are imposed today. France converted the VAT to a consumption variety VAT in 1954. At least 123 countries, and essentially every developed country except the U.S., levies a VAT today. VATs are infrequently imposed at the sub-national level, but Canada, Brazil, and India are countries where a VAT is levied by sub-national governments.

The VAT is remitted both by firms selling to final consumers and by firms selling to other businesses. Each firm calculates its VAT liability by multiplying its gross revenues by the VAT rate and taking a credit for VAT that was previously paid by suppliers. Effectively this means that the tax is paid on the value added (equal to the difference between a firm's receipts and its purchases from other firms) by each firm.[3] The VAT is a consumption tax when aggregated across the entire country, because credits are taken for tax paid on all business-to-business transactions. The net effect is credits for all taxes except for those paid on sales to final consumers. This means the overall tax is a levy only on purchases by final consumers. Further,

[3] There are exceptions, such as would occur if the VAT imposed on suppliers was at a different rate than the firm's VAT.

the tax is converted to a levy on all consumption by not collecting VAT on exports[4] and imposing it on imports.[5] In principle, the tax is collected on all goods and services (though in practice there are frequent exemptions) sold to final consumers in the domestic economy (whether manufactured inside or outside the country) and is not levied on any goods for use outside the country (or state).

Consumable Income Tax

Consumable income taxes are based on the notion that there are only two ways to use income, it can be saved or it can be consumed. Thus, the tax base is defined as annual income minus net additions to savings during the year. A consumable income tax would be paid through filing of forms by individuals or families, much like the current U.S. income tax. This structure allows the tax burden to be more easily geared to individual circumstances than with the other means of taxing consumption since the tax would be collected from individuals rather than vendors. This characteristic makes the consumable income tax a more effective structure for achieving desired degrees of horizontal and vertical equity.[6] The VAT and sales taxes are collected from vendors so achieving specific equity goals in relationship to people's income or some other demographic criteria can at best only be approximated. Also, business purchases are easily exempted from a consumable income tax. Consumable income taxes are seldom used, but the subtraction of contributions to 40lK, IRA and other pension programs in calculating taxable income means the U.S. income tax is a hybrid of a general income tax and a consumable income tax.

Sales Tax

Sales taxes were used in many countries prior to the adoption of a VAT, and they continue to be used in some countries besides the U.S.[7] But, no developed country imposes sales taxes to the extent they are levied in the U.S. Though sales taxes are normally evaluated both by analysts and legislatures as consumption taxes, their use by U.S. states (and other governments as well) differs in two significant ways from a tax on consumption. First, the sales tax base is much smaller than consumption since many exclusions and exemptions are allowed in nearly every state except Hawaii. Exemptions are granted for many reasons, including a) concerns about fairness, b) administrative difficulties in collection, and c) concerns that other states fail to tax the same good or service and that loss of sales tax base and other economic activity could result if the tax was imposed. The justifications for exemptions have differing degrees of

[4] VAT paid on earlier stages in the production process is rebated to the exporter.
[5] Michigan and New Hampshire levy quasi-VATs but the taxes are intended as replacements for business taxes and not as consumption taxes. These taxes are production-type rather than consumption-type VATs and are levied on goods and services produced for domestic and foreign use (the taxes are levied on exports from the state and not imports into the state). See Fox, Luna, and Murray (2002) for further discussion of application of state VATs in the U.S.
[6] Horizontal equity refers to comparisons of the tax burden for people with a similar capacity to pay tax and vertical equity refers to comparisons of the tax burden for people with different capacities to pay tax. Progressive, proportional, and regressive taxation are terms applied to vertical equity.
[7] For example, regions in Russia and in Bosnia and Herzegovina use sales taxes. Russian sales taxes, first permitted in 1998, will no longer be permitted after 2003.

validity, but the bottom line is the exemptions result in a base that is much smaller than consumption. The resulting overall tax base in the average state is only equal to about 42 percent of personal income. Exemptions that violate the intent to tax all consumption include those for:

- purchases financed with certain forms of preferred income, such as exemptions for food stamp purchases
- food, clothing, prescription drugs, and other transactions that are not taxed because of equity
- many services
- sales by certain types of vendors, such as governments and not-for-profit businesses

Second, sales taxes are levied on many business-to-business transactions with no tax credit allowed when goods or services are sold to final consumers (as would exist with a VAT). State revenue departments and legislatures often distinguish between intermediate purchases that become component parts of produced goods and other intermediate goods. So, most states allow exemptions for sales for resale, for manufacturing equipment, for raw materials that become component parts of a manufactured product and for select other business-to-business transactions, but impose the tax on a wide range of business purchases. But, businesses are not final consumers, even for items that are not component parts of a businesses' output. All business purchases, including office desks, computers for accounting, and stationary are inputs necessary to operate a business and to produce the firms' goods and services, and should be exempt from a consumption-based tax. Economists argue that only final purchases by individuals represent consumption. Purchases by business are seen as inputs. This point is obvious when a component part of a manufactured good or a purchase for resale is being considered. At first blush, the point seems less appropriate when other purchases are made, such as computers for accounting, stationary, and desks. But, these items are just as important to production of the firm's output and operation of the business, so they are best regarded as inputs as well.

No direct estimates are available on the share of the tax base that is comprised of business-to-business transactions because states collect data according to reports filed by vendors selling taxable goods and services, not by the purchasers. Ring (1999) estimates that the business component of the tax base could be as much as 40 percent of the total tax base. Combined with the base being only 42 percent of personal income, this suggests that the tax base comprised of final consumption by individuals represents only 25.2 percent of personal income in the average state. This indicates a very narrow tax base in the average state.

Taxation of business-to-business transactions has several perverse effects. First, the overall structure is inconsistent with a tax base equal to consumption, which would exempt all business-to-business purchases. Second, businesses have an incentive to vertically integrate. That is, firms are encouraged to bring the production of intermediate products into the corporate structure so that the inputs are not taxed. Smaller firms are likely to be disadvantaged since they are least able to vertically integrate and are often the suppliers of outsourced services. Third, the total tax actually implicit in goods depends on the degree of cascading. Taxes on intermediate products cascade into final product prices, with the degree of cascading depending on how many intermediate transactions are taxed. The varying degrees of taxation will distort important considerations such as how much of a product gets purchased and the tax structure's vertical and horizontal equity.

In theory, the sales tax can be structured closely to a consumption tax by exempting all business-to-business transactions through use of exemption certificates. However, it is difficult to ensure that the certificates are used only for business purchases, since an incentive exists to create businesses simply to get sales tax exemptions or to make household purchases through legitimate businesses. Also, much higher statutory tax rates would be necessary to raise the same revenue, and this is politically difficult for elected officials. The existing system allows the effective tax rates to be much higher on many goods than the legislated rate, and this is hidden from taxpayers.

4. Determining the Sales Tax Base

The sales tax base, as with all taxes, should be structured to tax the intended target. As previously noted, the sales tax is normally viewed as a tax on consumption. Accordingly, the broadest sales tax base would include all household purchases, regardless of how they were paid for and where or how they were purchased. The base would exclude all business purchases. In practice, the base differs dramatically from this ideal. Attempts to increase fairness, stimulate economic development, encourage the purchase of certain items, conform with constitutional restrictions, and allow certain organizations to sell free from tax are among the reasons that the base differs from the conceptual target.

Economic restructuring and policy decisions have worked together to change the base radically in recent years. Some of the factors leading to this outcome include:

- Attempts to tax services
- Frequently legislated exemptions
- Cross-border shopping
- Technological change

The remainder of this section examines these factors and how they are influencing the tax base.

<u>Attempts to tax services</u>

States differ widely in the way their sales tax is structured, but there is a general similarity in approach. State tax legislation is normally written so that all tangible goods are taxable unless they are otherwise exempted, and no services are taxable unless they are specifically enumerated. Starting with this basic structure, the net effect of recent policy decisions has been to narrow the base. Taxation of services has been one focus of policy discussions during the past two decades.

The existing taxation of services varies widely across states, with some, such as Hawaii, New Mexico and South Dakota, taxing services relatively broadly, and others, such as California and Nevada, taxing few services (see Due and Mikesell, 1995). Many state legislatures have engaged in discussions on the desirability of broadening the sales tax to selected services. The debates were particularly intense during the late 1980s and early 1990s as states were looking to raise revenues during the 1990 recession and to design structures that included the rapidly growing service sector. Florida was the most aggressive state as it passed and implemented broad based taxation of services in 1987 (see Fox and Murray, 1988), but Florida retracted the base expansion after six months. Massachusetts enacted broad base expansion as well, but repealed the legislation before it became effective. The base was expanded in many other states to selected small services, but states have not extended the tax to services that can generate significant revenue including health care, construction and professional services. The bottom line is that no state has successfully extended its sales tax to a wide set of services during the past several decades.

The case for taxation of services is not as simple as it appears to be at first glance, and ultimately the question is not whether services should be taxed, but which services to tax. Services belong in the tax base to ensure that the tax burden on commodities and services is similar. Imposing the same tax burden on goods and services increases the horizontal equity of the tax and lessens the role that taxes play in affecting people's choices between goods and services.[8] Taxation of services may make the tax base less regressive, though the consumption of most goods and services is regressive (consumption as a percent of income falls as people's income rises). Taxation of services will allow more rapid tax revenue growth than taxation of goods because U.S. consumers are dramatically increasing their consumption of services relative to goods. Consumption of services has grown from 47.4 percent of total consumption in 1979 to 58.4 percent in 2000. Further, taxation of services could allow the same revenue to be collected with a lower tax rate. Lower rates reduce the extent to which the economy is distorted by people seeking to make non-taxable purchases, who engage in cross-border shopping, and so forth.

Taxation of services also offers certain disadvantages. Many services, such as legal and accounting services, are primarily purchased by businesses and expansion of the base to include these services could increase the extent to which the sales tax base is composed of business-to-business transactions. Administrative and compliance costs will rise as more services are taxed, because service vendors tend to be smaller on average than goods vendors. Also, taxation of services that can be remotely provided can be difficult to enforce, increasing the chance that the tax will disadvantage in-state service providers relative to out-of-state providers. Concerns about equity also arise with taxation of some services, such as some forms of health care. As a result of these advantages and disadvantages, some services belong in the tax base and others do not.

[8] Merriman and Skidmore (2000) concluded that failure to tax services accounted for one-eighth of the service sector's growth during the 1980s and 1990s.

Legislated exemptions

State sales taxes often started with relatively inclusive taxation of goods. In subsequent years, however, most states have exempted many otherwise taxable goods from their base. Discussion of the desirability of these exemptions should be separated into exemptions of consumer goods and exemptions of business-to-business transactions. The arguments for consumer goods exemptions have often focused on making the sales tax less regressive or otherwise less unfair. Exemption of food for consumption at home, which is now done by 30 states, is an obvious example. Non-prescription drugs are another good that has been exempted by some states in recent years. Other consumer goods are sometimes exempted because the selling industry makes an impassioned plea that exemption will stimulate the economy. Sales tax holidays, which have been enacted in nearly 10 states since 1997, are an example that has been justified on both grounds[9].

The case against exemption of consumer goods is similar to the arguments above in favor of taxing services. Nearly every good and service is regressive in consumption so it is very difficult to design a sales tax that is not regressive, even if the base is narrowed. Further, these exemptions raise the costs for administering and complying with the tax (for example, because of the problems of defining the exempt transactions), increase the chance that consumers will select non-taxed alternatives over taxed ones, and require higher tax rates for any given amount of revenue to be raised (which makes taxes more important factors in business location decisions, consumer choice decisions, and so forth).

Exemptions of many business purchases have been enacted in recent years as well. Exemption of business transactions generally receives high marks from economists who believe that all business-to-business transactions should be free from taxation. Generally, economists would support significant restructuring of the sales tax to exempt more business-to-business transactions.

Taxation of inputs often affects how business is done, and thereby hampers efficient operation of the U.S. economy[10]. It can affect where business occurs, as it makes the taxing states more expensive places to do business. Taxation of business purchases raises the costs of operating in a state – a selling point that has been widely recognized by state legislators and in some cases has led to successful arguments for exemptions. Further, imposition of the tax on business purchases distorts business costs and makes it more attractive to vertically integrate. That is, firms have the incentive to bring activities in house to avoid the tax burden of buying from other vendors.

For these reasons, exemption of business purchases is a good idea unless the effect is to create very uneven tax burdens across firms. Uneven tax burdens can result when exemptions are

[9] Opponents of sales tax holidays argue that the benefits are poorly targeted to the intended beneficiaries and may simply supplant discounting that otherwise would occur, increase compliance costs, and reduce tax revenue.

[10] A stronger case can be made for imposing taxes on many inputs used in production of services that are untaxed. Taxation of the inputs is an indirect way to tax the output. However, input taxes as proxies for output taxes are levied in the origination or production location of the product rather than the destination of the consumer.

very narrowly construed so that all firms do not similarly benefit. Manufacturing capital (equipment and buildings for production) and some types of software and computers used in research are examples of exemptions that have often been granted. These exemptions are often available to all firms and should not create serious unevenness in tax burdens. Many other specific transactions have also been exempted, on a nearly annual basis, by each state legislature. Often the exemptions are for specific firms, even if they are codified directly into tax law. These exemptions are much more likely to create different tax burdens across firms.

Cross-border shopping

The rapidly growing extent of cross-border shopping has altered purchasing patterns around the U.S. Today, cross-border shopping is much more than the old concept of people and businesses occasionally traveling across state lines to make purchases at lower tax rates. Internet, telephone, and mail order purchases have become very important means of cross-border shopping because they have significantly reduced the transactions costs associated with remote purchasing. Indeed, one analyst has gone so far as to argue that the Internet effectively eliminates the existence of borders and allows all shoppers the chance to make purchases without having the sales tax withheld and remitted by the vendor (Goolsbee, 2000). The same tax burden is normally levied regardless of whether taxable goods or services are purchased in-state or out-of-state, as a result of the use tax that is a companion to the sales tax in every state. The issues become whether vendors have a collection responsibility and whether the revenues can be collected from the purchaser if there is no collection responsibility. Experience has demonstrated that use tax compliance is significantly poorer than sales tax compliance.[11]

Many researchers have analyzed the extent to which consumers purchase out of state to evade the sales tax.[12] A general conclusion of the research is a tendency for the location of some purchases to be altered to evade the sales tax. The result is lost tax revenues and reductions in economic activity in states with higher sales taxes. Future research is expected to uncover a rapidly growing pattern of tax evasion because widespread access to the Internet and mail order sales allow a dramatic expansion in the ability to purchase remotely and evade sales taxes.

Technology Changes

Recent technologies have had profound influences on the sales tax. First, new technologies provide the mechanism through which many of the remote transactions described above can occur. Second, the technologies have fostered a new set of services including e-mail, on-line information, and on-line games. Third, digitization allows a set of goods, such as books and music, to be accessed in different formats.

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[11] For example, the State of Washington analyzed tax compliance by registered businesses. The study found use tax non-compliance was the greatest of all taxes, and at 20 percent was more than 10 times worse than sales tax non-compliance. Also, the Federation of Tax Administrators surveyed states that have a place on their individual income tax returns to report and remit use tax liability. The maximum received by any of the 10 states was only about $1.5 million.

[12] See Fox (1986) and Fisher (1980) for examples.

These trends can affect the sales tax significantly. They encourage businesses to structure themselves to minimize tax liabilities. Thus, multiple corporations are created for operations in a state, in hopes that nexus can be avoided for some types of sales. Operation of a corporation's on-line business and bricks and mortar business through separate corporations is an example. The way that these corporations relate to each other can be affected as well. The corporations want the contacts to be sufficiently minimal so that nexus is not established. This may preclude the business from maximizing the benefits of cross inventorying, advertising, distributing products and so forth. Another outcome is for firms to carefully choose their operating locations (particularly for remote sales) to limit sales tax collection responsibilities. All of these avoidance behaviors can reduce the sales tax base and harm efficient operation of the U.S. economy.

Digitization can also change the taxability of transactions. Canned software is taxable in every state when sold via diskettes but is exempt in about one-third of the states when downloaded via the Internet. Books and music are normally taxable in states but are not taxable in some states when digitized. Thus, the sales tax base will shrink unless states modernize their structures.

5. Future Prospects for the Sales Tax

The sales tax's demise has been told over the years, but only recently has there been some evidence of lesser reliance on the sales tax; and, at this point, the change is very limited. The Tax Reform Act of 1986 was expected to reduce states' reliance on sales taxes because it increased the cost of raising sales tax relative to income tax revenue by eliminating deductibility of the sales tax from federal income tax while maintaining deductibility of state income taxes. Failure to tax services was also portended to lower reliance on the sales tax because it lessened the sales tax's growth. Now, difficulties in collecting sales and use taxes on remote transactions are a growing factor that can cause states to shift towards income taxes. Put together, these factors suggest that the likely scenario is for falling emphasis on the sales tax as the tax base continues to diminish in relative terms, both from policy decisions and economic patterns. The relative decline in the tax base can only be overcome from higher tax rates. But, as before, the tax structure will only change slowly, so no radical difference in the sales tax's role should be anticipated in the next five years.

Pressure for Higher Tax Rates

Some states have responded to the political pressure that arises from high income and property tax rates by cutting the rates. The cuts suggest that an upper limit has been found in the acceptability of income and property tax rates. There is no evidence that the upper limit to sales tax rates has been reached even with some combined state and local rates at about 10 percent. A continued pattern of the sales tax base growing more slowly than the economy will put fiscal pressure on states to raise sales tax rates. Higher rates may be sought both to balance the revenue structure (which otherwise will be increasingly income tax based) and to offset the base decline and maintain sales tax revenues as a share of the economy (although legislators may not directly examine the issue in these terms). The extent of this pressure will vary between states depending on the desired expenditure growth pattern and the growth of other state revenue sources. The propensity to raise rates will be highest in or immediately after recessions, when state fiscal conditions are tightest.

Several forces will counterbalance the propensity to raise the rates. First is the general anti-tax sentiment that exists in the U.S. Second is tax competition from lower tax places. The ability to cross-border shop in neighboring states or via remote means such as the Internet and mail order will exert much stronger downward pressure on state rates than has historically been true. The pressure will cause states to focus on taxing items that are less able to escape taxation. So the tax structure will slowly shift away from taxation of business profits and sales and towards taxation of labor (such as through state income taxes).

<u>Pressure for base cuts</u>

Lobbyists will continue to approach state legislatures with pleas for additional exemptions from the tax. The case for exemptions will become easier to make as the base gets narrower and the rates get higher because the inequities and distortions from the tax system will become more apparent and troublesome. Inability to effectively collect taxes on remote sales will be an important part of the political discussion and will allow vendors to make a more compelling case that they should be exempted as well. As in the past, the case for exempting consumer goods will be based on arguments such as reducing the sales tax's regressivity or increasing the state's economy. Arguments for exempting producer goods will primarily focus on economic development. The base exemptions will occur with opposite timing from the rate increases – during economic expansions. The net effect over the business cycle will be higher rates and narrower bases, just the opposite of the tax structure that economists would encourage.

<u>Simplification</u>

States are feeling pressure to simplify their tax structures because of the Quill Court finding that the tax compliance burden for remote vendors is excessive and because of an expectation that Congress will be more amenable to granting nexus if states have lowered their compliance burdens. State departments of taxation, through the Federation of Tax Administrators, and state legislatures, through the National Conference of State Legislatures, have been working for several years to develop a structure that lowers both compliance and administration costs. The goal is to develop greater similarity in the overall tax system across states and to develop provisions that are less burdensome within each state. The technical work is still underway, and it may take a number of years to reach agreement and have many states enact new structures. The considerable independence of states in setting fiscal policy makes it unlikely that uniformity will result. But, the signs are good that significant steps will be taken that should lessen compliance burdens in many states.

<u>Federal role in sales taxation</u>

The federal government imposes a limited number of selective sales taxes, such as on gasoline and telecommunication, but has no broad taxation of consumption. There have been occasional discussions in Washington about altering the federal tax structure to include a consumption tax, but no serious attempts have been made as yet.[13] Reliance of countries around the world on a VAT will increasingly focus attention on differences between the U.S. tax structure and that used by the rest of the world and will focus greater attention on the issue. The ability to rebate VAT taxes but not corporate income taxes on exports will be one factor motivating future discussions.

No movement towards federal consumption taxation should be expected for many years. General aversion to broad changes in tax structures is one reason. Taxpayers are often suspicious that their tax burden will rise with a new tax, and they are normally more comfortable with the known devil. Fears will be expressed that the VAT rate will rise once it is in place, and there is evidence that some countries have responded with higher rates. State objection of federal forays into consumption taxation, which has traditionally been left to the states, will be another reason. States have had little competition in the use of consumption as a tax source, and they can be expected to object to federal incursions.

[13] See Auten and Toder (1997) for a discussion of some recent federal proposals.

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