Does the sales tax have a future?

The sales tax has fallen on hard times. Designed to capture payment on every purchase meant for general use, state sales taxes often miss transactions that should be taxed and apply to ones that shouldn’t, experts tell us.

For years, consumers’ spending preferences have shifted to shopping online rather than in stores and to buying more services than tangible goods. Since many states don’t tax such purchases, these changes have undoubtedly contributed to the currently anemic state of sales tax revenues.

In NCSL’s “Fall 2015 State Budget Update,” 22 states reported that general sales tax revenues fell below estimates or that revenue targets had been lowered. In Wyoming, for example, total taxable sales in the third quarter of 2015 were 18.2 percent lower than a year earlier.

And it’s not looking much brighter this year. In Kansas, retail sales tax revenues were $12.2 million below estimates in February 2016, contributing to an overall $53 million shortfall that prompted cuts to higher education. In March, Maryland lowered estimates for sales tax collections by a total of $127 million for fiscal years 2016 and ’17.

Past Its Peak?

Nationally, the tax is growing slightly slower than other forms of revenue. U.S. Census Bureau data show that, from 2008 to 2015, state and local income tax revenues grew by 26 percent in nominal terms, property tax revenues grew by 23 percent and sales tax revenues grew by 19 percent.

Economist John Mikesell, professor of public finance at Indiana University, points out that sales tax difficulties have been a long time coming. He has found that consumption growth has been consistently outpacing growth in the sales tax base for decades. In other words, consumers are buying more and more things that are not taxed.

In the report “Georgia’s Incredible Shrinking Sales Tax Base,” Robert Buschman of Georgia State University noted that the state’s sales and use tax revenues peaked in FY 2001 on an inflation-adjusted basis. Although the state’s economy was much larger in 2014 than in 2001, sales tax revenues fell by 31 percent in real terms.

Although some of the drop can be explained by legislated tax exemptions, the report cited changes in consumption as a major factor. Had the sales tax kept pace with growth in state gross domestic product growth, it would have generated an extra $2.2 billion in FY 2014.

A Big Chunk of the Revenue Pie

In many states, the sales tax makes up a significant chunk of total tax revenue. On average, it accounted for 31.2 percent of state tax collections in 2014, and more than 50 percent in a few states. It is commonly criticized for its regressivity—low-income people lose a greater percentage of their income to the tax than the wealthy do—but its historical stability relative to the income tax makes it an appealing revenue-raisers.

In fact, the struggles of the sales tax are occurring as a number of states attempt to place more responsibility for funding government on

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its back, often by reducing income or business taxes. From 2008 to 2015, seven states combined income tax cuts with higher sales tax rates, and 10 raised sales tax rates only. The trend has continued in 2016, with Louisiana and South Dakota lawmakers approving sales tax increases.

As the challenges of the 21st century marketplace mount, many states are looking for ways to ensure the sales tax remains a strong component of state revenues.

Case for E-Fairness

The sales tax has not kept pace with the rise of electronic commerce. In 1992, the U.S. Supreme Court reaffirmed in Quill v. North Dakota that, in order for a state to have the authority to require a business to collect and remit sales taxes, the business must have a sufficient physical presence—or “nexus”—in the state.

The ruling did not prevent states from collecting taxes on online purchases, just those made from out-of-state retailers. It also left room for Congress to address through legislation the issue of what constitutes a physical presence in the digital age—something it has declined to do. In the meantime, there has been a dramatic shift toward electronic commerce.

States lost an estimated $23.3 billion in 2012 in uncollected taxes to online and catalog purchases, according to University of Tennessee economist William F. Fox. The losses are becoming more pronounced as a greater number of consumers opt to shop online.

“What is the same exact product, being sold at the same exact price, to the same individual, who will consume or use it in the same place, being taxed differently depending on how or where it was bought,” Utah Senator Curt Bramble (R) asked during a congressional hearing on the Nexus issue.

“Every business should be afforded the right to compete but should do so by playing by the same rules. Nothing more, nothing less,” he said.

The retail analysis company ShopperTrak notes that brick-and-mortar sales on Black Friday dropped from $11.6 billion to $10.4 billion from 2014 to 2015. Online sales increased 14 percent during that period, bringing in a total of $2.7 billion. It would be inaccurate, however, to call these purchases “tax free,” because they’re not.

What’s the Use?

Every state that levies a sales tax also has an accompanying use tax. A use tax typically applies to goods that an individual buys out of state (online or in person), but brings back or uses at home.

The use tax, however, is notoriously difficult to administer and is almost never collected. In addition, auditing individuals is costly and time consuming, and many people don’t even know they’re obliged to pay the tax. In a survey of states, a Minnesota House report found that only 1.6 percent of taxpayers paid use taxes on their 2009 income tax returns.

Stuck between not being able to effectively collect sales and use taxes and inaction in Congress, states have attempted to address the issue themselves. Since 2008, 20 states have enacted affiliate nexus laws, known as “Amazon laws” for the online retail giant.

They require out-of-state retailers to collect and remit sales taxes if they have in-state, independent partners who post links to the out-of-state retailer’s website. These measures target only a piece of the e-commerce pie, however, and many online retailers simply terminate their agreements with affiliates in such states to avoid liability, diminishing potential revenue gains.

This year, 16 states have considered legislation that allows them to be more aggressive in their attempts to require out-of-state companies to collect taxes on online sales, regardless of whether they have in-state affiliates. So far, bills have passed in Louisiana and South Dakota.

South Dakota Senator Deb Peters (R) hopes these laws motivate Congress to act.

“We have spent years working to convince Congress to restore our sovereign
Holiday Jubilee

In addition to exemptions, many states also carve out periods of time (typically two to seven days) in which the sales tax is temporarily suspended, either for a few select items or all taxable goods. Seventeen states had a sales tax holiday in 2014, and 18 had at least one in 2015. The goal of these holidays is to stimulate economic activity while reducing the regressive impact of the tax, but think tanks from both sides of the political spectrum agree they do neither.

The evidence suggests that these measures simply encourage consumers to shift the timing of their purchases and retailers to raise prices in anticipation of bargain-hunting shoppers. One obvious effect these measures produce is less sales tax revenue. According to Georgia State University’s Tax Expenditure Report, the state lost about $41 million in revenue from its back-to-school sales tax holiday in 2013.

authority and have been continually frustrated,” Peters says. “All of my colleagues in states across the country are equally as frustrated and are working on the admittedly imperfect approach of state-by-state solutions to this nationwide problem.”

Legislators are hoping these bills will be challenged and heard by the U.S. Supreme Court. South Dakota’s law has already been challenged and is headed to state court. The American Catalog Mailers Association and Netchoice filed suit in late April claiming the new state law is an unconstitutional expansion of state tax powers and directly conflicts with the precedent set by the Supreme Court.

Justice Anthony Kennedy, however, suggested in a ruling last year (Direct Marketing Association v. Brohl) that it might be time to rethink the concept of nexus in the digital age.

Congressional Effort

At the federal level, the NCSL-supported Remote Transactions Parity Act would create a framework to allow states to tax out-of-state online retailers and eliminate the 5 percent to 10 percent price advantage online retailers enjoy over their box-store competitors. It could lead to lower tax rates overall because of the revenue increase.

Critics argue that such requirements will place an undue collection burden on small businesses and lead to job losses. The parity act seeks to mitigate opponents’ concerns by phasing in smaller sellers, by ensuring those sellers aren’t subject to out-of-state audits and by making states responsible for the costs of installing and using software to determine the tax rates in customers’ jurisdictions.

Some Services Required

Remote transactions are not the only threat to the sales tax base. Consumers have shifted a lot of their spending away from tangible goods to services, which many states don’t tax.

The California Legislative Analyst’s Office found that consumer spending on taxable goods peaked in 1979, when Californians spent 53 cents of every dollar on taxable items. Since then, growth of the state’s sales tax base has lagged behind that of the overall state economy by 1.4 percent annually. By 2013, consumers were spending only 33 cents of each dollar on taxable items.

Most states tax at least a few services, but only five tax them broadly. Often, the services that would bring in the most revenue—legal, health care and construction services, for example—are not included in the tax base.

Adding a range of taxable services could bring in billions to state coffers. The California Board of Equalization estimated, for example, that the state could have generated $122.6 billion in FY 2016 by taxing all currently nontaxable services. The state’s general fund would have captured about $57.6 billion, with the remainder accruing to local governments and special districts.

The case for taxing services is strengthened when some untaxed services bear an uncanny resemblance to taxed goods. Non-taxable digital goods, in particular, are increasingly contributing to base erosion.

For example, a movie purchased as a DVD or through a cable provider like Comcast is taxable, but a movie streamed online from a company like Netflix is not. Netflix generated more than $2.7 billion in revenue from its domestic streaming segment in 2013, a 26 percent increase over 2012.

The tax base shrinks when such service providers gain a greater share of the market.

At least six states expanded their sales taxes to include more services in the last three years and at least four have so far this year.

There are, of course, reasons why states have been slow to tax services, just as they have with taxing out-of-state remote transactions. Many Americans aren’t enthusiastic about the idea of expanding taxes, and well-organized, vocal groups oppose any legislative action to accomplish that. They are not prone to welcome any effort that will inflate the cost of popular digital goods, entertainment, and other consumer services. Furthermore, businesses account for a large share of service purchases, taxing their services would exacerbate the existing problems associated with taxation of business inputs.

According to a special report by the Council on State Taxation, “the sales tax on professional services should be considered principally a state business tax.”

Florida began applying the sales tax to services in 1987, only to abandon the effort after six months in the face of fierce oppo-
sition. In 2007, Michigan similarly repealed a measure to tax services after just two months following a substantial public outcry that included recall threats.

The fervent opposition to service taxation suggests that progress in this realm will be difficult. Even if more states choose to expand taxes to services, the growing market for digital goods could present additional revenue concerns—digital goods may be cheaper than similar tangible goods, which would still mean lower sales tax collections.

**Other Exemptions**

In addition to online and service purchases, states also exclude a number of goods from taxation. Such exemptions usually exist for reasons related to fairness, collection troubles and tax competitiveness. It is common for states to exempt food, utilities, medicine and clothes, for example.

Of the 45 states that have a sales tax, 39 exempt food for eating at home entirely or tax it at a reduced rate. This can be costly; groceries account for about 20 percent of sales tax revenues in the states that tax them at the full rate. The food-at-home exemption is meant to reduce the unequal impact of the tax, but whether it accomplishes this is still being debated.

Exemptions also can lead to a surprising amount of complexity. If you exempt food but tax candy, for example, decisions must be made about what does and does not qualify as “food,” and vendors need to be able to keep up with how the two are distinguished, lest they be subject to state audits or penalties.

The debate around deciding which products receive exemptions recently received a lot of attention after Ohio Representative Greta Johnson (D) questioned why feminine hygiene products were categorized as taxable luxuries.

“Essential feminine hygiene products are a necessity, not a luxury,” she says, claiming the sales tax on them represents “yet another unfair economic barrier to full equality” for women.

Whatever the reason for exempting a product, as tax policy expert David Brunori has pointed out, “excessive exemption forces a state either to raise the sales tax rates or forgo revenue.”

**What’s Old Is New Again**

Concerns about the sales tax are not new. In 1998, NCSL released a publication with the National Governors Association and the National League of Cities on the hurdles state and local tax structures would face in the 21st century. They correctly predicted “an economy...dominated by personal services” ... using "electronic media for purchasing goods and services.”

Debate over what will provide the better boost in revenues—taxing remote transactions and services or eliminating exemptions—continues in statehouse around the country.

Although the proactive approach states have taken recently regarding sales tax nexus may finally allow them to tax online purchases, after decades of trying, nothing is certain. As tax expert Billy Hamilton, a former Texas deputy comptroller remarked recently, “I’m beginning to think maybe a 10,000-year wait isn’t impossible.”

State sales tax bases continue to shrink while revenues under-perform. With little or no progress in strengthening the sales tax, it remains in a weakened position. Unless states dare to experiment with a new type of consumption tax, the future of the tax is uncertain.