



**Tax Policy Center**  
Urban Institute and Brookings Institution

## THE TAX POLICY

### BRIEFING BOOK

*A Citizens' Guide for the  
2008 Election and Beyond*

# NATIONAL RETAIL SALES TAX

What is it? .....	III-4-1
What would and would not be taxed?.....	III-4-2
What would the tax rate be?.....	III-4-4
Why wouldn't the rate be 23 percent? .....	III-4-6
What is the difference between a "tax-exclusive" and "tax-inclusive" sales tax rate?.....	III-4-8
Who would bear the burden? .....	III-4-9
How much avoidance and evasion would there be? .....	III-4-12
What would be the effect on economic growth? .....	III-4-14
What transition rules would be needed? .....	III-4-16
Would it simplify the tax code? .....	III-4-18
What did the President's Advisory Panel on Tax Reform say?.....	III-4-20
What has been the state and local experience? .....	III-4-22
What is the experience of other countries? .....	III-4-24



## National Retail Sales Tax: What is it?

The national retail sales tax is a proposed 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 retail sales from businesses to households.

- 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 intends to rent it to others is not a retail sale, nor is the sale of an existing home from one occupant to another.
- A pure national retail sales tax would represent a sharp break from the current tax system. The tax base would shift from income to consumption. Rates would be flat. All special exemptions, deductions, and credits would be eliminated. Tax administration, enforcement, and points of collection would be radically altered.
- No country in the history of the world has enacted a retail sales tax at anywhere near the rates that would be required to replace the U.S. tax system. Whether such a tax could be implemented effectively is therefore an open question.

### See Also

National Retail Sales Tax: What would and would not be taxed?

National Retail Sales Tax: What would the tax rate be?

National Retail Sales Tax: Who would bear the burden?

Authors: William Gale and Benjamin Harris  
Last Updated: December 14, 2007

### Further Reading

Gale, William G., "The National Retail Sales Tax; What Would the Rate Have to Be?" *Tax Notes* 107, no. 7 (2005): 889-991.

## National Retail Sales Tax: What would and would not be taxed?

Under a pure national retail sales tax, all consumption expenditures by individuals and by federal, state, and local government agencies would be subject to the tax. (Purchases by businesses are, by definition, not retail sales and so would not be subject to tax.) However, no sales tax in history has come close to such an ideal tax base. Some items, such as imputed financial services, are quite difficult to tax. Other items might not be taxed for reasons of social policy, such as child care, rent, food, housing, and health care. Powerful political influences also often successfully lobby for exemptions from the sales tax, just as they do from the income tax. As a result, very few of the state sales taxes currently in existence tax many of the items listed above, and none tax all of them. Hence there is no precedent for a broad-based national retail sales tax that would include all consumption expenditures by individuals and government.

Exempting selected sectors, however, would cause serious problems for a national retail sales tax. The broader the tax base, the lower the tax rate can be and still raise the same amount of revenue. As discussed elsewhere, the required tax rate under a national retail sales tax would have to be very high to replace existing federal taxes, even with a broad tax base. But health, food, and housing make up about half of all personal consumption, so that exempting even one of these sectors would cut deeply into the sales tax base, forcing the required rate even higher.

- Even with extreme political discipline in avoiding subsidies, it would be difficult to tax more than 80 percent of personal consumption. Retaining some of the major preferences in the income tax could reduce the private consumption base to about 60 percent of personal consumption.
- A national retail sales tax would need to tax all consumption and investment purchases made by state and local governments. Leaving these transactions out of the tax base would reduce the base substantially, which would in turn raise the required tax rate for a given amount of revenue. Taxation of government transactions would also be necessary to ensure that private industry is not placed at a disadvantage when competing with public suppliers of goods and services. Taxing government transactions would likely add complexity to a system that its advocates laud for its simplicity.
- Although the details of the various national retail sales tax proposals vary, they generally maintain several similar tax base characteristics. Exemptions would be provided for business purchases and education, both of which are considered investment. Domestic purchases by foreigners would be taxed; foreign purchases by U.S. residents would not.
- Employer-provided health insurance would be taxed. Economists Jonathan Gruber and James Poterba have calculated that this tax change would boost the price of health insurance by an average of 21 percent. They estimate that this price increase would reduce both the number of people insured (by between 6 million and 14 million) and the amount of insurance that each remaining insured person would choose to carry.
- The existing deductions for mortgage interest and property taxes would disappear with the income tax. This would reduce the value of all residential housing. Newly constructed houses sold to occupants would be subject to the sales tax. But already existing houses would generally not, because sales of a house from one household to another would be exempt since they do not rep-

resent a retail sale (i.e. a sale from a business to a household). This would boost the cost of buying a new house relative to existing houses.

### See Also

National Retail Sales Tax: What is it?

National Retail Sales Tax: Who bears the burden?

National Retail Sales Tax: What would the tax rate be?

National Retail Sales Tax: Why wouldn't the rate be 23 percent?

### Further Reading

Gale, William G., "The National Retail Sales Tax; What Would the Rate Have to Be?" *Tax Notes* 107, no. 7 (2005): 889-991.

Gruber, Jonathan, and James Poterba, "The Impact of Fundamental Tax Reform on Employer-Provided Health Insurance," *Insurance Tax Review* 11, no. 1 (1996): 41-44.

President's Advisory Panel on Tax Reform, *Final Report* (Washington, 2005).

Authors: William Gale and Benjamin Harris  
Last Updated: December 14, 2007

## National Retail Sales Tax: What would the tax rate be?

Perhaps the most controversial aspect of the national retail sales tax has been its rate: how high would it have to be to replace all revenue from the current tax system? Determining the revenue- and budget-neutral tax rate for such a tax requires making assumptions about three things: the rates of tax evasion and tax avoidance; the extent to which deductions, exemptions, and credits would be retained in the tax base; and the impact on economic growth. Under the optimistic assumption of a very broad base, and extremely conservative assumptions about evasion and avoidance, the tax rate would have to be 44 percent (on a tax-exclusive basis, or 31 percent on a tax-inclusive basis) to replace existing federal taxes in revenue-neutral fashion over the next ten years. Other analysts have estimated even higher required rates.

Range of Tax Rates Under a Retail Sales Tax		
Evasion rate	Extended base <sup>a</sup>	Median State Sales Tax Base
Lower evasion (15%)	34%	64%
Higher evasion (30%)	49%	89%

Notes:  
 (a) The extended base refers to the tax base described by advocates of the FairTax proposal, which includes all sales of goods and services to consumers except educational services, expenditures by U.S. residents abroad, food produced and consumed on farms, and existing housing.

Source: President's Advisory Panel on Tax Reform (2005).

Range of Tax Rates Under a Retail Sales Tax		
Evasion rate	Extended base <sup>a</sup>	Median State Sales Tax Base
Lower evasion (15%)	34%	64%
Higher evasion (30%)	49%	89%

Notes:  
 (a) The extended base refers to the tax base described by advocates of the FairTax proposal, which includes all sales of goods and services to consumers except educational services, expenditures by U.S. residents abroad, food produced and consumed on farms, and existing housing.

Source: President's Advisory Panel on Tax Reform (2005).

- A key issue in determining the required tax rate is how to define the tax rate. Suppose a good costs \$100 before tax 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. The tax-inclusive rate would be about 23 percent, which is obtained by dividing the \$30 tax by the total cost to the consumer (\$100 + \$30). Sales tax rates are typically quoted in tax-exclusive terms, but income tax rates are typically quoted as tax-inclusive rates. For example, a household that earns \$130 and pays \$30 in

income taxes would normally think of itself as facing roughly 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—a 17-percentage-point difference.
- The total sales tax rate that households would face would likely be significantly higher than the federal rates indicated above, 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 state income tax systems depend on the federal system for reporting of income and other information. Today's state income taxes would likely be converted to sales taxes, adding considerably to the combined sales tax rate.
- The President's Advisory Panel on Tax Reform, using different but reasonable assumptions about tax evasion and the breadth of the tax base, estimated the required tax-exclusive tax rate to be in the range of 34 to 89 percent. Their highest estimate assumes that tax evasion would be moderate and that the federal tax base would equal the median state sales tax base.
- Other reforms would serve to further raise the required rate. Transition relief provided to households would reduce the tax base and raise the required rate even higher. And if major consumption items such as food, housing, or health care were exempted from the base (the assumptions above do not allow for such large exemptions), the rate on the remaining goods and services would rise still higher.

### See Also

National Retail Sales Tax: What is it?

National Retail Sales Tax: Why wouldn't the rate be 23 percent?

National Retail Sales Tax: What is the difference between a tax-exclusive and a tax-inclusive sales tax rate?

### Further Reading

Gale, William G., "The National Retail Sales Tax; What Would the Rate Have to Be?" *Tax Notes* 107, no. 7 (2005): 889-991.

President's Advisory Panel on Tax Reform, *Final Report* (Washington, 2005).

Authors: William Gale and Benjamin Harris  
Last Updated: December 14, 2007

## National Retail Sales Tax: Why wouldn't the rate be 23 percent?

Advocates of a national retail sales tax have suggested that such a tax at a 23 percent rate would be sufficient to replace the entire federal tax system. This estimate is misleadingly low for a variety of reasons, in part because it assumes that there will be no evasion or avoidance of the tax and no exclusion of hard-to-tax items from the tax base. Furthermore, the 23 percent rate they cite is a "tax-inclusive" rate, which corresponds to a 30 percent tax-exclusive rate. Besides all this, the 23 percent rate advocates cite is based on a mathematical error in the way they compute the changes in consumer and producer prices that would occur under the proposed tax. For all these reasons, the 23 percent tax rate can be considered unrealistic given plausible and accurate assumptions about how a national retail sales tax would be implemented.

- The 23 percent tax rate cited by advocates of the NRST is a tax-inclusive rate; the mark-up at the cash register under a 23 percent tax-inclusive rate would be 30 percent.
- Proponents assume that there will be no evasion, no avoidance, no erosion of the statutory base due to political pressure to exempt certain goods and services, and no exceptions for hard-to-tax items. This makes the effective tax base in their calculations much larger than it would be likely to be in a real-world implementation; hence the required tax rate in their calculations is much lower than it would be in a real-world setting.
- Advocates also made a mathematical mistake in calculating their required tax rate. An analysis of the required rate in a sales tax requires a consistent set of assumptions about what how consumer and producer prices will change relative to the current system. Producer prices could either remain constant in nominal terms, fall by the entire amount of the previously embedded taxes, or fall by an amount somewhere in between. Consumer prices are just producer prices plus the sales tax. (So, for example, if producer prices remained constant in nominal terms after the transition to a sales tax, consumer prices would rise by the full amount of the sales tax.) In calculating their required rate, advocates assumed that producer prices would remain constant when they calculated the revenue the government would obtain from the tax, but they then 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 likely revenue, or both. Making a consistent assumption about producer prices-whichever of the three above options one chooses-leads to a significantly higher rate than advocates assumed.

**See Also**

National Retail Sales Tax: What is it?

National Retail Sales Tax: What would the tax rate be?

National Retail Sales Tax: What and would not be taxed?

National Retail Sales Tax: What is the difference between a tax-exclusive and a tax-inclusive sales tax rate?

**Further Reading**

Gale, William G., "The National Retail Sales Tax; What Would the Rate Have to Be?" *Tax Notes* 107, no. 7 (2005): 889-991.

Paull, Lindy L., "Budget Neutral Tax Rate for H.R. 2525," reprinted in Martin A. Sullivan, "The Rise and Fall of the National Sales Tax," *Tax Notes* 105, no. 8 (2004): 916-21.

President's Advisory Panel on Tax Reform, *Final Report* (Washington, 2005)

## National Retail Sales Tax: What is the difference between a “tax-exclusive” and “tax-inclusive” sales tax rate?

A tax-exclusive tax rate refers to the amount of tax paid as a proportion of the pretax value of whatever is taxed; sales tax rates are typically expressed in tax-exclusive terms. A tax-inclusive rate, conversely, refers to the amount of tax paid as a proportion of the after-tax value; income tax rates are often expressed in tax-inclusive terms. Thus the difference between the two definitions is whether or not the tax paid is included in the denominator when calculating the tax rate.

- Although there is no single correct way to report a 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—a 17-percentage-point difference.
- As an example, suppose a good costs \$100 before tax 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. The tax-inclusive rate would be about 23 percent, which is obtained by dividing the \$30 tax by the total cost to the consumer (\$100 + \$30).
- Sales tax rates are typically quoted in tax-exclusive terms, but income tax rates are typically quoted as tax-inclusive rates. For example, a household that earns \$130 and pays \$30 in income taxes would normally think of itself as facing roughly a 23 percent (30/130) income tax rate.

### See Also

National Retail Sales Tax: What is it?

National Retail Sales Tax: Why wouldn't the rate be 23 percent?

National Retail Sales Tax: What would the tax rate be?

### Further Reading

Gale, William G., “The National Retail Sales Tax; What Would the Rate Have to Be?” *Tax Notes* 107, no. 7 (2005): 889-991.

President's Advisory Panel on Tax Reform, *Final Report* (Washington, 2005).

Authors: William Gale and Benjamin Harris

Last Updated: December 14, 2007

## National Retail Sales Tax: Who would bear the burden?

Under a national retail sales tax, the wealthiest households in the country would receive stunningly large tax cuts. Households in the top 1 percent of the income distribution have an average income of about \$475,000. Their average tax cut would be \$79,000, or more than the incomes of all but about 8 percent of households. Put another way, the roughly 1.1 million taxpayers in this top 1 percent would save a total of \$87 billion on their taxes each year. This cut would be financed by tax increases on the bottom 92 percent of households. Households with income between \$5,000 and \$50,000 would face an average tax increase of over \$1,000.

- The existing tax system, which includes income, corporate, estate, and payroll taxes, is generally progressive. Households with incomes between \$5,000 and \$10,000 pay an average effective tax rate—defined as taxes actually paid divided by income—of under 9 percent. The average effective tax rate rises with income to about 25 percent for households with incomes between \$100,000 and \$200,000, and then to about 32 percent for the fewer than 1 percent of households with incomes above \$200,000. The current system is not completely progressive, however. Households in the lowest income group, those with incomes less than \$5,000, pay an average effective rate of almost 12 percent, which is higher than households in the next group.
- The proposed national retail sales tax has been shown to be a relatively proportional tax for much of the population; that is, effective rates would vary little with income. Average effective tax rates would at first rise modestly as incomes rise, from about 20 percent for households with incomes between \$5,000 and \$10,000 to 23 percent for households in the \$20,000 to \$40,000 range, and would then fall back to 20 percent as income rises to \$100,000 to \$200,000. At the extremes, however, the national retail sales tax would be quite regressive. The average rate for the lowest income group would exceed 33 percent, while the average for the top group would fall to less than 16 percent. These results suggest that converting to a national retail sales tax would be a highly regressive shift when measured against annual income.
- A common claim is that a reform that includes a national retail sales tax would be "pro-family." Advocates usually point to the proposed demogrant as proof of this assertion. However, the demogrant is only one policy that affects children and families with children. Families with children would likely be hurt both by the elimination of current deductions for health insurance, mortgage interest, and state and local income and property taxes (which finance schools and other government services) and by the elimination of various tax credits (the earned income credit, child care credits, education credits, and child credits). Moreover, at any given income level, families with children have higher consumption requirements than couples without children, so that switching to a consumption tax would present an inherent disadvantage for families with kids.

Distributional Implications of Replacing  
Total Personal Income Tax (TPIT) with a National Sales Tax

Income (\$)	Tax units (millions)	PIT	TPIT	Retail sales tax exempt-			Retail sales tax with demogrant based on family size and poverty
				None	Food	Food, medical housing	
Average taxes per tax filing unit							
0 - 5,000	9.8	-30	60	1,763	1,705	1,804	452
5,000 - 10,000	13.2	-91	51	2,106	1,930	2,031	936
10,000 - 15,000	12.4	132	410	2,608	2,459	2,478	1,614
15,000 - 20,000	11.7	649	1,004	3,103	3,010	2,960	2,375
20,000 - 30,000	19.4	1,462	1,869	3,861	3,806	3,800	3,445
30,000 - 40,000	13.9	2,739	3,183	4,829	4,814	4,767	4,814
40,000 - 50,000	10.7	3,905	4,432	5,732	5,739	5,750	6,031
50,000 - 75,000	15.4	6,001	6,561	7,129	7,246	7,230	8,084
75,000 - 100,000	5.8	10,290	11,185	9,064	9,326	9,069	11,057
100,000 - 200,000	4.0	19,410	22,703	11,836	12,454	12,411	15,516
Less than 200,000	1.2	105,279	139,624	30,185	31,984	31,175	44,645

Income (\$)	Tax units (millions)	PIT	TPIT	Retail sales tax exempt-			Retail sales tax with demogrant based on family size and poverty
				None	Food	Food, medical housing	
Average taxes as a percentage of							
0 - 5,000	9.8	-1.3	2.7	79.4	76.8	81.2	20.4
5,000 - 10,000	13.2	-1.2	0.7	27.8	25.5	26.8	12.3
10,000 - 15,000	12.4	1.1	3.3	20.9	19.7	19.8	12.9
15,000 - 20,000	11.7	3.7	5.7	17.7	17.2	16.9	13.6
20,000 - 30,000	19.4	5.9	7.6	15.7	15.4	15.4	14.0
30,000 - 40,000	13.9	7.9	9.2	13.9	13.9	13.7	13.9
40,000 - 50,000	10.7	8.7	9.9	12.8	12.8	12.8	13.5
50,000 - 75,000	15.4	9.9	10.8	11.8	12.0	12.0	13.4
75,000 - 100,000	5.8	12.1	13.1	10.6	10.9	10.6	13.0
100,000 - 200,000	4.0	15.1	17.6	9.2	9.7	9.6	12.0
Less than 200,000	1.2	22.2	29.4	6.4	6.7	6.8	9.4
Tax rate on retails sales				17.2	19.8	30.3	27.3

Notes:

Authors' tabulations using Tax File CPS-CES merged file as described in text. Food exemption relates only to food consumed at home. Income concept used includes the imputed value of owner occupied housing and medical expenses that are not out of pocket.

Source: Feenberg, Mitrusi, and Poterba (1997).

**See Also**

National Retail Sales Tax: What is it?

National Retail Sales Tax: What would the tax rate be?

National Retail Sales Tax: How much avoidance and evasion would there be?

**Further Reading**

Feenberg, Daniel R., Andrew W. Mitrusi, and James M. Poterba, "Distributional Effects of Adopting a National Retail Sales Tax," in *Tax Policy and the Economy*, vol. 11 (Cambridge, Mass.: MIT Press, 1997).

Authors: William Gale and Benjamin Harris

Last Updated: December 14, 2007

## National Retail Sales Tax: How much avoidance and evasion would there be?

Advocates of the national retail sales tax claim that tax avoidance and tax evasion on legally generated income would decline and that tax revenue collected from the underground economy would rise significantly. Critics view these claims as somewhere between overoptimistic and nonsensical. The President's Advisory Council on Tax Reform noted in its final report that "A federal retail sales tax assessed at a rate of at least 34 percent, added on to state retail sales taxes, would provide substantial inducement for evasion at the retail level."

- By eliminating the current tax system, the national retail sales tax would eliminate the use of current avoidance and evasion schemes, but that does not mean it would eliminate avoidance and evasion. It would simply change the locus and nature of such activities.
- The overall rate of evasion of the U.S. income tax is estimated at around 15 percent, or possibly a bit higher. But this figure masks great heterogeneity in evasion by form of income. At one extreme, for income where taxes are withheld and reported to government by a third party (predominantly wages), the evasion rate is about 5 percent. At the other extreme, where taxes are not withheld and there is no cross reporting, the evasion rate is as high as 50 percent. A national retail sales tax would feature no withholding and no cross reporting, and so the possibility of high rates of evasion needs to be taken quite seriously.
- Individuals might engage in tax avoidance under a national retail sales tax in several ways. They might misreport personal consumption as business activity, for example using the company car for personal use. The treatment of property that involves mixed consumer and business use would also be a problem, as would the verification of retail goods purchases by business representatives for personal use (think of a bar owner purchasing a television or a restaurant manager buying cooking supplies).
- Previous studies have found a 13 percent "delinquency" rate for state sales taxes. This rate of evasion is lower than what would be expected under a national retail tax, since the tax rate under a national plan would be significantly higher than the rates applied by the states. Underreported sales would be much higher under a national retail tax than under current sales taxes, for two reasons: enforcement currently relies on cross verification with federal and state income taxes, and the effective state sales tax rates are currently quite low. Under a national retail sales tax, both of these conditions would change.
- One of the major claims of national retail sales tax advocates is that it would be more effective than the current system at raising revenue from the underground economy. The example frequently offered is that of a drug dealer who does not pay income tax on his earnings today but would be forced to pay the national retail sales tax if he took the funds and bought, say, an expensive car. The problem with this argument was laid out by former Congressman Dick Armey: "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 them to the government. In the end, neither system taxes the drug trade.

**See Also**

National Retail Sales Tax: What is it?

National Retail Sales Tax: What would the tax rate be?

National Retail Sales Tax: Why wouldn't the rate be 23 percent?

National Retail Sales Tax: What is the experience of other countries?

Authors: William Gale and Benjamin Harris

Last Updated: December 14, 2007

**Further Reading**

Armey, Richard K., "Caveat Emptor: The Case against the National Sales Tax," *Policy Review* 73 (1995): 31-35.

Due, John F., and John L. Mikesell, *Sales Taxation*, 2nd ed. (Washington: Urban Institute Press, 1994).

Gale, William G., and Janet Holtzblatt, "The Role of Administrative Issues in Tax Reform: Simplicity, Compliance, and Administration," in *United States Tax Reform in the 21st Century*, edited by George Zodrow and Peter Mieszkowski (Cambridge, U.K: Cambridge University Press, 2000).

President's Advisory Council on Tax Reform, *Final Report* (Washington, 2005).

## National Retail Sales Tax: What would be the effect on economic growth?

In theory, moving to a national retail sales tax would provide additional avenues for economic growth. Estimates using plausible assumptions suggest that if a relatively pure version of such a tax were effectively implemented, the growth effects would be positive but modest, especially over the first ten years or so.

- Changing the tax base from income to consumption enhances the after-tax return to saving and investment. More saving and investment results in a larger capital stock, which improves workers' productivity and raises output. The double taxation of previously existing assets during the transition to a national retail sales tax would allow for lower rates on the rest of the tax base, and thus would encourage additional growth.
- However, the world is not that simple. Many forms of saving—including all pensions and 401(k) plans and most Individual Retirement Accounts—already receive consumption tax treatment, and many forms of corporate income are not taxed at all. Moreover, under a national retail sales tax the transitional rules governing existing assets could reduce the effect on saving further.
- A number of analysts have constructed models capable of generating realistic estimates of the impact of fundamental tax reform on growth. The most complete model, developed by David Altig and colleagues, shows the effects of moving from the current system to a flat-rate consumption tax. Their analysis of such a reform, which assumes a less generous demogrant than proposed by national retail sales tax advocates, transition relief for existing assets, and no avoidance or evasion of the new tax, finds that the economy would be 0.6 percent larger than otherwise after two years, 1.8 percent larger after ten years, and 3.6 percent larger in the very long run. Plausible allowances for avoidance, evasion, and the incorporation of a more generous demogrant would reduce these already modest estimates.
- It appears on both conceptual and empirical grounds that switching to a national retail sales tax would raise consumer prices, with several economic effects. First, anyone holding nominal (that is, non-inflation-protected) financial assets—such as balances in saving accounts, CDs, or bonds—would see a drop in the value of those assets. Conversely, issuers of nominal debt, including the government, would see a reduction in the real burden of their debt outstanding.

**See Also**

National Retail Sales Tax: What is it?

National Retail Sales Tax: What transition rules would be needed?

Authors: William Gale and Benjamin Harris  
Last Updated: December 14, 2007

**Further Reading**

Altig, David, Alan J. Auerbach, Laurence J. Kotlikoff, Kent Smetters, and Jan Walliser, "Simulating U.S. Tax Reform," Working Paper 6248 (Cambridge, Mass.: National Bureau of Economic Research, 1997).

## National Retail Sales Tax: What transition rules would be needed?

Any tax reform that seeks to collect the same amount of revenue in a new way may redistribute tax burdens among taxpayers, affect asset values, and change price levels. Those who stand to lose often seek to prevent the reform or to secure "transition relief," which avoids or delays the full brunt of the new law. The national retail sales tax proposal illustrates these issues starkly, because it would impose a single tax rate on all consumption, with limited, or no special provisions and only limited transition relief. A practical question is whether such a proposal can withstand the inevitable political pressures to restore preferential treatment or introduce transition relief. The issue is pivotal, because adding these changes would fundamentally alter the character of the reform.

Determining how to handle these transition issues creates an interesting dilemma. At one extreme, the pure sales tax would allow no adjustments. At the other logical extreme, policymakers could choose to grant extensive "transition relief," by adjusting Social Security benefits, allowing consumption to be tax-free if financed by assets existing at the time of the reform, and so forth. In practice, the transition relief that has accompanied much smaller tax reforms has tended to turn into a bonanza of hidden tax breaks and subsidies.

- The economic case for transition relief depends on the impact of such relief on the simplicity, efficiency, and equity of the tax system. Not providing transition relief is, in a sense, simpler. Transition rules could prove very complex, and the transition period could stretch out for years. However, not providing relief would also cause complexity by instituting strong incentives for individuals to adjust their behavior before the tax takes effect.
- Not providing transition relief would also be more efficient. Because future consumption can be financed only from future wages or existing assets, a consumption tax is a tax on those wages and assets. A consumption tax that exempts old assets is just a tax on future wages. Whereas a pure consumption tax (one that taxes all old capital) is usually found to be more efficient than a pure income tax, a wage tax (which exempts all old capital) is usually found to be less efficient than a pure income tax. The reason is that not taxing existing assets requires higher tax rates on the rest of the tax base to raise the same revenue, and this creates more distortions of people's work decisions.
- Surely the strongest argument for transition relief is fairness. The assets that people own today were priced, purchased, and used under the current tax system. Is it fair to them to change the rules in midstream? But the answer may not be as obvious as it seems. First, a one-time implicit tax on existing capital would be very progressive. The distribution of such capital is more skewed toward wealthy households than is the distribution of overall wealth, which in turn is more skewed than the distribution of income. Second, within any age group, wealthy households do most of the saving. Since these households will benefit most from eliminating the double taxation on future saving, it is reasonable that they should pay for some of the costs. Third, older households tend to have more assets than younger ones, and therefore taxing existing capital places heavier burdens on older generations. But those older households have received transfers through Social Security and Medicare that far exceed what they have put in. And the vast majority of the income and wealth of most elderly households is in the form of earnings (which have not yet been taxed), housing (which receives extraordinarily preferential treatment under the current tax system), pension income (which already receives consumption tax treatment), Social Security benefits (which everyone agrees would be indexed for inflation with tax re-

form), and Medicare benefits (which are not taxed). Relatively few elderly households finance much of their living expenses from other assets, and those that do tend to be very well off.

- Ultimately, the political case for transition relief would determine whether such relief occurs. And political factors overwhelmingly suggest that it would. Even in much smaller tax reforms, the losers-households or businesses made worse off by the reform-have been compensated. Transition relief would therefore almost surely be needed to garner sufficient support for major tax reform.

### See Also

National Retail Sales Tax: What is it?

National Retail Sales Tax: What did the President's Advisory Panel on Tax Reform say?

Authors: William Gale and Benjamin Harris  
Last Updated: December 14, 2007

### Further Reading

Esenwein, Gregg A., and Jane G. Gravelle, "The Flat Tax, Value-Added Tax, and National Retail Sales Tax: Overview of the Issues," Congressional Research Service Report for Congress (Washington, December 14, 2004).

Gale, William G., "The National Retail Sales Tax: What Would the Rate Have To Be?" *Tax Notes* 107, no. 7 (May 16, 2005).

President's Advisory Panel on Tax Reform, *Final Report* (Washington, 2005).

## National Retail Sales Tax: Would it simplify the tax code?

As a flat-rate consumption tax with a universal demogrant for families, the proposed national retail sales tax contains many of the features that make taxation simpler. Most individuals would no longer need to keep tax records, know the tax law, or file returns. Only those who own sole proprietorships, partnerships, or S or C corporations that make retail sales would have to file. And even for these taxpayers the complexity of filing a return would decline dramatically. But a national retail sales tax could create new areas of complexity, for example in administering the proposed demogrant, in enforcing the tax code to ensure that personal and business consumption are not mixed, and in monitoring exemptions for the importation of foreign goods.

- The demogrant that, in many proposals, would accompany a national retail sales tax would likely be based on the existing poverty line, which rises less than proportionally with the number of family members. For example, in 1998 the poverty line was \$8,050 for a single individual and rose by \$2,800 for each additional family member. Thus the poverty level for a family of four in that year was \$16,450, just over twice the level for an individual. Basing the demogrant on the poverty line would thus create incentives to conceal family relationships so as to claim the demogrant for more than one individual in a family. It is also not obvious how the demogranths would be administered, or even which agencies would be responsible for determining eligibility and monitoring claims. Thus compliance and administrative costs could be significant.
- Another area of potential complexity stems from the threat of tax avoidance and evasion. The most likely way that people would try to avoid the tax would be by disguising personal consumption as business activity, since business-to-business transactions would not be taxed. For example, individuals might seek to register as firms, or to purchase their own consumption goods using a business certificate; or employers might buy goods for their workers in lieu of paying wages. Ensuring that all business purchases are not taxed and that all consumer purchases are taxed would require all businesses to keep records of their transactions, even though only retailers would actually have to remit the tax. Certain proposals deviate from a pure retail sales tax by requiring that taxes be paid on many input purchases, and that vendors file explicit claims to receive rebates on their business purchases. This would raise compliance costs further.
- Imports would be another potential source of tax avoidance and evasion. Under some proposals, each year a certain amount of imported purchases would be exempt from the tax. This feature would likely be exploited fully by many taxpayers, even those who do not travel abroad: it would be simple for firms to set up offshore affiliates, warehouses, or mail order houses, ship goods from them to domestic customers, and claim that the goods are tax-exempt imports. It would be very difficult to monitor such arrangements, and it seems quite likely that taxpayers could end up importing more than their annual exemption. Some related evidence on the potential extent of these problems comes from the experience with state-level "use" taxes, under which taxpayers voluntarily make tax payments on goods purchased in other states. One analyst described enforcement of such taxes as "dismal at best." The development of electronic commerce could amplify avoidance and evasion problems.

**See Also**

National Retail Sales Tax: What is it?

National Retail Sales Tax: What would and would not be taxed?

National Retail Sales Tax: What transition rules would be needed?

Authors: William Gale and Benjamin Harris  
Last Updated: December 14, 2007

**Further Reading**

Murray, Matthew N., "Would Tax Evasion and Tax Avoidance Undermine a National Retail Sales Tax?" *National Tax Journal* 50, no. 1 (1997): 167-82.

General Accounting Office, "Potential Impact of the Alternative Taxes on Taxpayers and Administrators" (Washington, January 1998).

## National Retail Sales Tax: What did the President’s Advisory Panel on Tax Reform say?

The President’s Advisory Panel on Tax Reform rejected replacing the current tax system with a national retail sales tax on the grounds that the tax would be too regressive and difficult to administer. The report noted that "lower and middle-income families would be especially hard hit by a stand-alone retail sales tax." The panel was also concerned that although the proposed demogrant program to provide relief for families would make the retail tax system less regressive, it would be a massive program to administer, "by far the largest in American history," and would "inappropriately increase the size and scope of government." The panel’s estimates also showed that, with the demogrant, a national retail sales tax sufficient to replace the current tax system would require a tax rate somewhere between 34 and 89 percent. The panel’s estimated tax rates are "tax-exclusive," which means that the tax rate is equal to the tax paid as a percent of the pre-tax price of the good or service.

- The panel found that a national retail sales tax would not provide substantial tax simplification. Taxpayers would still be required to complete state income tax returns (unless states abolished income taxes as a result of a switch to a national retail sales tax), which would limit the potential simplification gains from abolishing the federal income tax. In addition, a new government agency would be required to monitor both the collection of the tax and the proposed allocation of demogrants to families.
- The panel estimated the necessary tax rate under a variety of different scenarios using alternate assumptions about the frequency of evasion. Under the most optimistic scenario, which assumed no taxpayer evasion and the broadest feasible base, and excluded demogrants to low- and middle-income families, the required rate would be 22 percent (in tax-exclusive terms). And taxpayers would continue to pay state sales taxes, at rates currently averaging 6.5 percent. Under scenarios that did include a demogrant, the required rate ranged from 34 percent to 89 percent (in tax-exclusive terms).
- The panel’s report expressed concern about the level of evasion, stating, "A federal retail sales tax assessed at a rate of at least 34 percent, added on to state retail sales taxes, would provide substantial inducement for evasion at the retail level." The report stated that third-party reporting, notably absent from the proposal, would significantly improve the likelihood of compliance. In circumstances where there is no third-party reporting, "evasion rates are estimated to be around 50 percent."
- The panel voiced several concerns about the ability of the federal government to administer the tax, and of small businesses to collect it. It noted that the states would lack the ability to collect the tax, and that an agency analogous to the Internal Revenue Service would be required for administration. The panel also observed that state income taxes, whose administration relies on the federal income tax system, would become much more difficult to administer if that system were to disappear. Lastly, the report cited concern that the burden of collecting the tax would disproportionately fall on small businesses and small service providers.

**See Also**

National Retail Sales Tax: What is it?

National Retail Sales Tax: Who would bear the burden?

National Retail Sales Tax: What would the tax rate be?

National Retail Sales Tax: What is the difference between a tax-exclusive and a tax-inclusive sales tax rate?

Authors: William Gale and Benjamin Harris  
Last Updated: December 14, 2007

**Further Reading**

President's Advisory Panel on Tax Reform, *Final Report* (Washington, 2005).

## National Retail Sales Tax: What has been the state and local experience?

The first sales tax in the United States was a tax of last resort, established in Mississippi in the 1930s to raise revenue during the Depression. Today sales taxes are relatively common in the United States, used by 45 states, the District of Columbia, and over 6,000 localities. State sales tax rates currently range from 3 percent to 7 percent (in tax-exclusive terms). The tax base used varies widely across states. The states with higher-yielding sales taxes tend to have tourist economies, so that taxes in these states are collected in large measure from nonresidents.

The state sales taxes appear to be poor models for broad-based federal tax reform, for several reasons. States show little inclination to exempt producers completely. But without a much more complete exemption of producer purchases in a national retail sales tax, cascading would present a significant problem. Furthermore, states make little effort to tax services, and they exempt broad categories of purchases for reasons relating to social and economic policy, tax administration, and political pressure. The federal base would have to be much broader than the typical state base, or else rates would skyrocket. The states offer only limited and varied experience in taxing government, but the federal proposals envision taxing every dollar of government purchases and investment. Finally, in state systems relief for low-income households is provided through product exemptions, as opposed to the demogrants proposed for a national tax.

- A uniform retail sales tax would cover consumption of all goods and services. State sales taxes, however, deviate from this norm in numerous ways. About twenty-five states exempt food, twenty exempt electricity, seventeen exempt telephone service, and six exempt at least some type of clothing. The most commonly exempted good is prescription medicine. Commodities subject to excise taxes—motor fuel, alcohol, and cigarettes—are usually exempt, even though this at least partly defeats the purpose of imposing separate excise taxes.
- Product exemptions raise important issues. Family cash allowances would be simpler to administer, would induce fewer distortions of household behavior, and—according to some studies—would be at least as progressive as specific product exemptions. Yet product exemptions are quite popular. State legislatures may find them attractive because they appear progressive, and industry groups that benefit from them may effectively advocate their continuance.
- The taxation of services is even more problematic. Although many states do tax some services, only three—Hawaii, New Mexico, and South Dakota—attempt to place all services in the tax base. Twenty-three states make no real effort to tax services at all.
- The taxation of purchases by state and local governments varies significantly across states; only eight states generally apply the sales tax to such purchases. (The federal government is exempt under the Constitution.) Sales to nonprofits and to educational, hospital, religious, charitable and similar organizations are exempted in twenty-seven states, and another fifteen exempt certain purchases by these groups. Sales of goods by nonprofits are usually subject to tax.
- Enforcement of sales taxes on services has proved difficult. These taxes are hard to administer and easy to evade, since there are fewer records to audit. This raises several red flags for a national retail sales tax. Besides the obvious erosion of the tax base, the state experience suggests that items that are difficult to tax are simply excluded from most retail sales tax systems and, again, that political pressures can easily affect the form and substance of a retail sales tax.

- A retail sales tax should exempt all business purchases, but most state-level sales taxes do not come close to this ideal. A variety of estimates indicate that, on average, between 20 and 40 percent of state sales tax revenue comes from business-to-business sales. Estimates for individual states range as high as 70 percent.

### See Also

National Retail Sales Tax: What is it?

National Retail Sales Tax: What is the experience of other countries?

National Retail Sales Tax: What would and would not be taxed?

### Further Reading

Due, John F., and John L. Mikesell, *Sales Taxation*, 2nd ed. (Washington: Urban Institute Press, 1994).

Ring, Raymond J., Jr., "The Proportion of Consumers' and Producers' Goods in the General Sales Tax," *National Tax Journal* 42, no. 2 (1989): 167-79.

Schwartz, Jordan A., "John Nance Garner and the Sales Tax Rebellion of 1932." *Journal of Southern History* 30, no. 2 (1964):162-80.

Authors: William Gale and Benjamin Harris

Last Updated: December 14, 2007

## National Retail Sales Tax: What is the experience of other countries?

Many other countries have attempted to implement a national retail sales tax or variants of such a tax, such as wholesale-level taxes or "ring" taxes (retail sales taxes with business exemptions certificates for businesses "in the ring"). Almost all of these countries have ended up with value-added taxes (VATs). The general lesson from these countries is fairly clear, if perhaps often overstated. In 1967 nineteen OECD countries had some form of wholesale, retail, or turnover tax. By 1995 all nineteen had converted to VATs. Developing countries as well have largely abandoned retail sales taxes in favor of VATs.

- Retail sales tax rates are generally lower than VAT rates. According to Ken Messere, countries that have relied on retail sales taxes "tend to charge around 4-6 percent of the tax exclusive value of goods...whereas standard VAT rates tend to vary between 14 percent and 25 percent."
- The typical retail sales tax rate is also much lower than the rate advocated by proponents of the national retail sales tax. Only a few countries-Iceland, Norway, South Africa, Sweden, and Zimbabwe-have ever instituted a retail sales tax with a rate in excess of 10 percent. And none of this select group currently maintains such a tax.
- A retail sales tax with a rate in excess of 10 percent is difficult to administer, in large part because of the increased incentive for evasion. One tax policy expert, Vito Tanzi, noted, "The general view among experts, a view obviously shared by most governments, is that 10 percent may well be the maximum rate feasible under an RST."
- There are good reasons why retail sales taxes get replaced with VATs, namely, cascading and evasion. Cascading occurs when taxed inputs are used to produce taxed outputs, so that the total tax on the goods compounds beyond what was intended. This can be avoided by exempting all business purchases from taxation, but it is difficult administratively, and possibly politically as well, to enforce this provision. Moving to a VAT removes the problem, since businesses receive tax credits for the taxes they paid on their input purchases.
- Evasion is higher under a retail sales tax than under a VAT for several reasons. First, retailing is the weakest enforcement link in the entire production chain. Second, if a retailer evades the tax, the full tax on the sale is lost under a retail sales tax, but only the tax on value added at the retail level is lost under a VAT. Third, there is no paper trail with a sales tax.

**See Also**

National Retail Sales Tax: What is it?

National Retail Sales Tax: What has been the state and local experience?

National Retail Sales Tax: What would and would not be taxed?

Authors: William Gale and Benjamin Harris  
Last Updated: December 14, 2007

**Further Reading**

Bartlett, Bruce, "Replacing Federal Taxes with a Sales Tax," *Tax Notes* 68, August 21, 1995.

Messere, Ken, *Tax Policy in OECD Countries: Choices and Conflicts* (Amsterdam: IBFD Publications, 1993).

Tait, Alan A., *Value Added Tax: International Practice and Problems* (Washington: International Monetary Fund, 1988).

Tanzi, Vito, *Taxation in an Integrating World* (Washington: Brookings Institution, 1995).