# How Could We Improve the Federal Tax System?

What is a national retail sales tax?



## Q. What is a national retail sales tax?

## A. A national retail sales tax is a consumption tax collected as a flat-rate tax on all sales from businesses to households.

Retail sales are business sales to households; neither business-to-business nor household-to-household transactions qualify. 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 home to a business that intends to rent it to others is not a retail sale, nor is the sale of an existing home by one occupant to another.

A pure national retail sales tax would represent a sharp break from the current tax system, shifting the tax base from income to consumption. Rates would be flat; no goods or services would be exempted or favored; and 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 rate anywhere near as high as what would be required to replace the US tax system. Whether such a tax could be implemented effectively remains an open question.

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## Q. What would and would not be taxed under a national retail sales tax?

## A. In theory, all consumption would be taxed. In practice, there would be great pressure to narrow the base.

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 would not be subject to tax.) However, no sales tax in history has come close to this ideal. Some items, such as imputed financial services, are quite difficult to tax. Taxing others, such as child care, rent, food, housing, and health care, might undermine popular (and arguably desirable) social policies.

State experiences demonstrate that interest groups often succeed in carving out preferences, just as they do from the income tax. As a result, few state sales levies tax many of the items listed above, and none tax all of them. Hence, a pure broad-based national retail sales tax has no precedent.

However, the path of least political resistance—exempting selected sectors—would be problematic. The broader the tax base, the lower the tax rate can be and still reach the revenue target. But health, food, and housing make up more than 40 percent of all personal consumption; exempting even one of these sectors would cut deeply into the sales tax base, forcing the required rate higher. Moreover, even with a broad base, the required tax rate would have to be very high to replace existing federal taxes.

Consider, too, that a national retail sales tax would need to tax all purchases by state and local governments. Exempting them would narrow the base substantially, which in turn would raise the tax rate needed to generate 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.

Although the various national retail sales tax proposals differ in details, they generally maintain similar tax-base characteristics. Business purchases and education, both of which are considered investments, would be exempt. Domestic purchases by foreigners would be taxed; foreign purchases by US residents would not.

Employer-provided health insurance would be taxed, but economists Jonathan Gruber and James Poterba estimate that this tax change would boost the price of health insurance by an average of 21 percent. This price increase would reduce both the number of people insured (by 6 million) and the amount of insurance each remaining insured person would choose to carry.

The existing deductions for mortgage interest and property taxes would disappear along 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 existing houses would generally not because such transactions would not constitute retail (business-to-household) sales. This change would lower the market value of new houses relative to old ones.

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# How Could We Improve the Federal Tax System?

What would the tax rate be under a national retail sales tax?



## Q. What would the tax rate be under a national retail sales tax?

**A. It depends on assumptions about the breadth of the tax base, tax evasion and avoidance, and the effects on economic growth. It also depends on how the tax rate is measured. Estimates for a tax that would replace revenues from the current federal tax system range from 31 percent to 65 percent. However, these estimates are dated, since revenue levels have recently changed, in part due to the 2017 Tax Cuts and Jobs Act.**

Perhaps the most controversial aspect of the national retail sales tax has been how high the tax rate would need to be to replace all revenue from the current tax system. The answer depends on four things: (1) whether the quoted rate is in tax-exclusive or tax-inclusive terms; (2) the rates of tax evasion and tax avoidance; (3) the extent to which deductions, exemptions, and credits would be retained in the tax base; and (4) 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

TABLE 1

### Range of Average Tax Rates under a Retail Sales Tax
2006–15

| Avoidance, evasion, and legislative erosion rate | Tax-exclusive rate | Tax-inclusive rate |
|---|---|---|
| None | 44% | 31% |
| 10% | 53% | 34% |
| 20% | 65% | 39% |

**Source:** Gale (2005).
**Note:** Estimates assume a baseline of current law revenue projections.

# How Could We Improve the Federal Tax System?

## What would the tax rate be under a national retail sales tax?

Estimates from the President's Advisory Panel on Federal Tax Reform span an even wider range. Using reasonable assumptions about tax evasion and the breadth of the tax base, the Advisory Panel estimated the required tax-exclusive rate to be between 34 and 89 percent. Their highest estimate assumes (1) an evasion rate consistent with the current income tax for income on which taxes are not withheld and there is no third-party reporting and (2) a federal tax base equivalent to the median state sales tax base.

Note, however, that these estimates are dated. Revenue levels have changed since the 2005 report, partly from the 2017 Tax Cuts and Jobs Act.

TABLE 2

### Range of Tax Rates under a Retail Sales Tax

| Evasion rate | Extended base[a] | Median state sales tax base |
|---|---|---|
| Lower evasion (15%) | 34% | 64% |
| Higher evasion (30%) | 49% | 89% |

**Source:** President's Advisory Panel on Federal Tax Reform (2005).
**Note:** Tax exclusive rates.
(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 US residents abroad, food produced and consumed on farms, and existing housing.

### TAX EXCLUSIVE OR TAX INCLUSIVE

A key issue in determining the required tax rate is how to define the tax rate. Suppose a product costs $100 before tax and has a $30 sales tax. The "tax-exclusive" tax rate would be 30 percent, because 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 rate rises. 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.

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## What would the tax rate be under a national retail sales tax?

### OTHER FACTORS WOULD RAISE THE RATE EVEN HIGHER

Households' total sales tax rate would be significantly higher than the federal rates indicated above, after existing state sales tax were added. In addition, most or all state income taxes would probably be abolished in the absence of a federal income tax system because state income tax systems depend on the federal system for reporting income and other information. Today's state income taxes would likely be converted to sales taxes, adding considerably to the combined sales tax rate.

Other reforms would further raise the required rate. Transition relief for 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.

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# How Could We Improve the Federal Tax System?



## Q. What is the difference between a tax-exclusive and tax-inclusive sales tax rate?

## A. It depends on whether the tax is reported relative to the pre-tax or post-tax price.

Suppose an item costs $100 before tax and is subject to a $30 sales tax. The tax-exclusive tax rate would be 30 percent, as 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). 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 increases 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, which is a big difference.

Sales tax rates are typically quoted in tax-exclusive terms, but income tax rates are typically quoted as tax inclusive. 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.

### Further Reading

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# How Could We Improve the Federal Tax System?



## Q. Who bears the burden of a national retail sales tax?

## A. A revenue-neutral national retail sales tax would be more regressive than the income tax it replaces.

A national retail sales tax would create a wedge between the prices consumers pay and the amount sellers receive. Theory and evidence suggest that the tax would be passed along to consumers via higher prices.

Because lower-income households spend a greater share of their income than higher-income households do, the burden of a retail sales tax is regressive when measured as a share of current income: the tax burden as a share of income is highest for low-income households and falls sharply as household income rises. The burden of a sales tax is more proportional to income when measured as a share of income over a lifetime. Even by a lifetime income measure, however, the burden of a sales tax as a share of income is lower for high-income households than for other households: a sales tax (like any consumption tax) does not tax the returns (such as dividends and capital gains) from new capital investment and income from capital makes up a larger portion of the total income of high-income households.

In contrast, federal income taxes are progressive. The individual income tax is progressive thanks to refundable credits for lower-income households (average tax rates are negative for the two lowest income quintiles), the standard deduction (which exempts a minimum income from the tax), and a graduated rate structure (rates on ordinary income rise from 10 to 37 percent, with an additional 3.8 percent marginal tax on certain investment income of high-income households).

The President's Advisory Panel (2005) concluded that replacing the income tax system with a national retail sales tax would heavily favor high-income households. A sales tax rate of 22 percent (the rate necessary to replace the revenue from the federal income tax at that time) would increase tax burdens on the lower 80 percent of the income distribution by approximately $250 billion a year (in 2006 dollars), if the sales tax were not modified to return some revenue to lower-income households.

Put another way, the lower 80 percent of the income distribution would go from paying 15.8 percent of federal income taxes to paying 34.9 percent of federal retail sales taxes. Conversely, the top 20 percent of the income distribution would go from paying 84.2 percent of federal income taxes to 65.1 percent of federal retail sales taxes (figure 1).

The Advisory Panel also found that offsetting the regressivity by per capita rebates to disadvantaged households would require a 34 percent sales tax rate to sustain revenue.

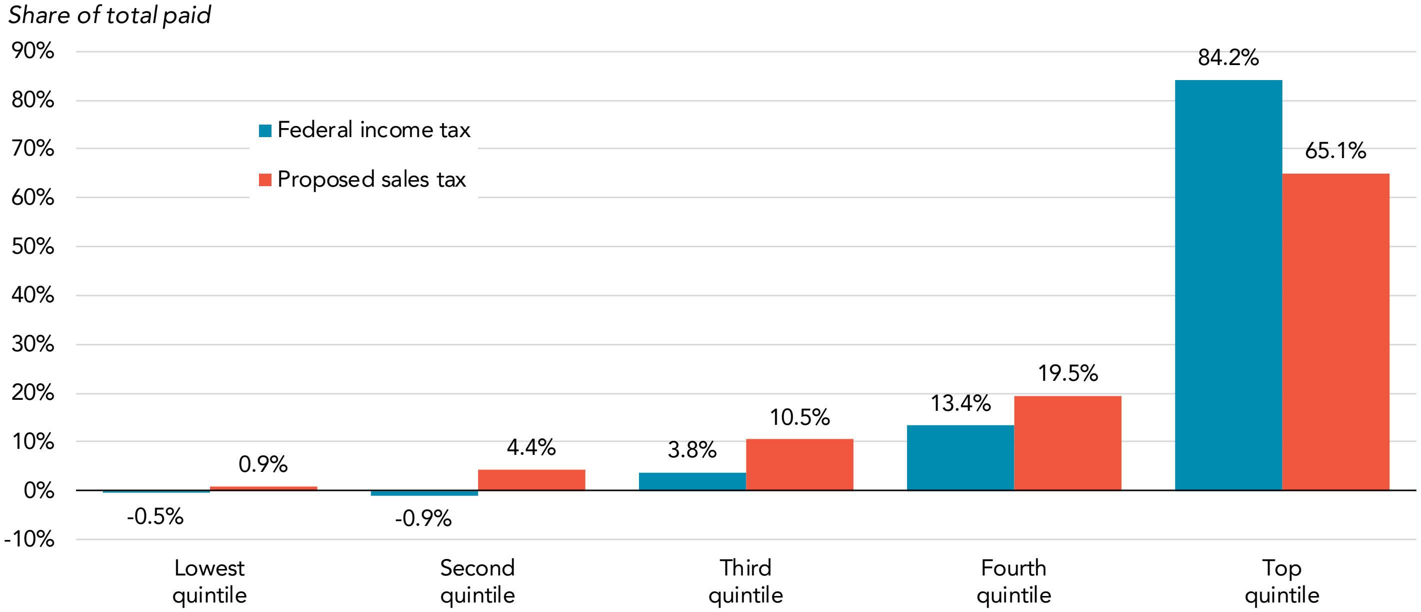
# How Could We Improve the Federal Tax System?

## Who bears the burden of a national retail sales tax?

FIGURE 1

Share of Current Federal Income Tax or Proposed Retail Sales Tax Paid

By income level under 2006 law




**Source:** President's Advisory Panel on Federal Tax Reform (2005).
**Note:** Assumes a 22 percent national retail sales tax without demogrant.

Some claim that a properly modified national retail sales tax would be "pro-family." Advocates usually point to the proposed demogrant—the per capita cash rebates—as proof of this assertion. On the other side of the ledger, though, families with children would likely be hurt by the elimination of both 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 EITC, child care credits, education credits, and child tax credits). Consider, too, that at any given income level, families with children have higher consumption requirements than those without, so switching to a consumption tax would present an inherent disadvantage for families with kids.

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## Q. Would tax evasion and avoidance be a significant problem for a national retail sales tax?

## A. A national retail sales tax would certainly not eliminate tax evasion and avoidance, and might increase it.

Advocates of the national retail sales tax claim that tax avoidance and outright evasion would decline, and that tax revenue collected from the underground economy would rise significantly. But critics view these claims as somewhere between overly optimistic and nonsensical. The President's Advisory Council on Federal Tax Reform (2005, 218) 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 a substantial inducement for evasion."

By eliminating the current tax system, the national retail sales tax would indeed eliminate current avoidance and evasion schemes. But that does not mean it would eliminate avoidance and evasion. It would simply change their locus and nature.

The overall rate of evasion of the US income tax is estimated at around 16 percent, with the net percentage of misreported income equaling 22 percent. But these figures mask great differences in behavior that depend on the source of the income. At one extreme, where taxes are withheld and reported to government by a third party (predominantly wages), the misreporting rate is just 1 percent. At the other, where taxes are not withheld and there is no cross-reporting among government agencies, the misreporting rate averages 63 percent. If the income is subject to reporting but no withholding, about 7 percent is misreported. (Think interest, dividends, unemployment compensation, etc.) A national retail sales tax would feature no withholding and no cross-reporting, and so the potential for evasion needs to be taken seriously.

Individuals might avoid or evade a national retail sales tax in several ways. They might misreport personal consumption as business activity (e.g., using a company car for personal use). Treating property that involves mixed consumer and business use would also be a problem, as would verifying that retail goods were not purchased for personal use by business representatives (e.g., a bar owner purchasing a flat-screen for his or her home).

Previous studies have found a 13 percent "delinquency" rate for state sales taxes. This rate of evasion is lower than the likely rate under a national retail tax, though, since the tax rate under a national plan would be significantly higher than the rates applied by the states, increasing the incentive to cheat. Underreported sales would almost certainly be much higher with a national retail tax for two reasons: (1) enforcing the income tax currently relies on cross-verification between federal and state income taxes, and (2) the effective sales tax rates are currently low. With a tax-regime change, both conditions would change.

# How Could We Improve the Federal Tax System?

## Would tax evasion and avoidance be a significant problem for a national retail sales tax?

Then there's the question of taxing 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 sales tax if he took the funds and bought, say, an expensive car. The flaw in this argument was laid out years ago by former congressman Richard "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 [illegal] drug trade."

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# How Could We Improve the Federal Tax System?



## Q. What would be the effect of a national retail sales tax on economic growth?

## A. The switch from an income tax to a consumption-based tax would probably make a positive difference, but it is far from certain.

A pure retail sales tax without exemptions or transition relief ought to have a positive impact on growth. First, switching from an income tax to a consumption-based tax would lead to greater savings and investment. And that should increase productivity and the pace of output growth.

There's a subtler route, too. The effective double taxation of existing capital during the transition to a national retail sales tax would generate windfall revenues and thus allow a tax-rate reduction that stimulated growth.

However, the world is not quite that simple. Many forms of saving—including pensions, 401(k) plans, and individual retirement accounts—already receive consumption tax treatment, and a significant share of corporate income is currently untaxed. Moreover, under a national retail sales tax, the likely provision of transition relief for existing assets could reduce the effect on saving further (it's hard to imagine that sophisticated lobbies would accept double taxation without a fight).

Several analysts have constructed models capable of generating realistic estimates of how tax reform would affect growth. The most complete model, developed by David Altig and colleagues (2001), simulates the effects of moving from the current system to a flat-rate consumption tax.

Their analysis—which assumes a less generous demogrant (cash rebate) than proposed by national retail sales tax advocates, some 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 10 years, and 3.6 percent larger in the very long run. But here, as almost everywhere, the devil is in the assumptions. Plausible allowances for avoidance, evasion, and erosion of the statutory tax base for political reasons, along with a more generous demogrant, would reduce these estimates.

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## Q. What transition rules would be needed for a national retail sales tax?

## A. The answer depends more on politics than on economics.

Any fundamental tax reform that seeks to collect the same amount of revenue in a new way is almost certain to redistribute tax burdens, affect asset values, and change price levels. Those who stand to lose would try to prevent the reform or secure "transition relief" that delays or blunts the impact.

The national retail sales tax proposal illustrates these issues starkly. Could the proposal withstand the inevitable political pressures to provide some with preferential treatment or to introduce transition relief? The issue is pivotal because backsliding would undermine the logic of pressing the reform in the first place.

The transition to a national sales tax would open a can of worms. At one extreme, the sales tax could include no adjustments. At the other, policymakers could grant extensive relief by adjusting Social Security benefits to reflect higher retail prices, allowing consumption to be tax free if financed by existing wealth, and so forth. In practice, the transition relief that has accompanied much smaller tax reforms has tended to balloon.

The economic case for transition relief depends on how it affects the simplicity, efficiency, and equity of the new tax system. Providing no relief would be simpler, transition rules could prove complex, and the transition period could stretch out for years. However, there are wheels within wheels here. Not providing relief would also be problematic because it would create strong incentives for individuals to adjust their behavior before the tax takes effect.

Not providing transition relief would certainly be more efficient. A consumption tax that exempts old assets is just a tax on future wages. While 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. Not taxing existing assets requires higher tax rates on the rest of the tax base to raise the same revenue, increasing the disincentives to work that plague any tax on wages.

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 their owners to change the rules midstream?

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 the overall distribution of wealth. And the overall distribution of wealth is, in turn, more skewed toward the wealthy than the distribution of income. Second, since wealthy households would benefit most from the switch to a consumption-based tax, it seems reasonable to ask them to pay some of the costs.

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## What transition rules would be needed for a national retail sales tax?

Third, older households tend to have more assets than younger ones, so taxing existing capital places heavier burdens on older generations. But there's rough justice here: those older households, on average, have received transfers through Social Security and Medicare that far exceed what they have put in. And the vast majority of most elderly households' income and wealth is in 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 reform), and Medicare benefits (which are not taxed). Few elderly households finance much of their living expenses from other assets, and those that do tend to be well off.

Ultimately, the political case for transition relief would determine whether it was part of the package. And history strongly suggests that it would be. Even in much smaller tax reforms, the losers—households and businesses made worse off by the reform—have been compensated. A big question, then, is whether imposing what might be called "sales tax lite" would be worth the economic dislocation.

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## Q. Would a national retail sales tax simplify the tax code?

## A. It would for individuals, but not as much for businesses and enforcement authorities.

Constructed as a flat-rate consumption tax with a universal demogrant (cash payment) for needy families, the proposed national retail sales tax contains many features that make taxation simpler. Most individuals would no longer need to keep tax records, learn the fundamentals of tax law, or even file returns. Only sole proprietorships, partnerships, and S or C corporations that make retail sales would have to file. And the complexity of filing a return would decline dramatically, even for these taxpayers.

But a national retail sales tax could create new areas of complexity, for example, in administering the proposed demogrant that returns part of the revenue to millions of households, and in enforcing the tax code to ensure that personal and business consumption are not mixed.

### DEMOGRANTS

In many proposals, the demogrant that would accompany a national retail sales tax would likely be based on the existing federal poverty guidelines, which rise less than proportionally with the number of family members. For example, in 2016, single individuals fell beneath the federal poverty level if their annual incomes were less than $11,880. This number rose by $4,140 for each additional family member. Thus, the federal poverty level for a family of four in 2016 was $24,300, roughly twice the level for an individual. Basing the demogrant on the federal poverty level would thus create incentives to conceal family relationships to claim the demogrant for more than one individual in a family.

### ADMINISTRATION

It is also unclear how the demogrants would be administered or even which agencies would be responsible for determining eligibility and monitoring claims. Thus, compliance and administrative costs could be significant.

### TAX AVOIDANCE AND EVASION

Another area of 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, as business-to-business transactions would not be taxed.

For example, individuals might register as firms or purchase goods for personal use with a business certificate. Or employers might buy goods for their workers in lieu of wages. Ensuring that all business purchases are not taxed and that all consumer purchases are would require all businesses to record their transactions, even though only retailers would actually have to remit the tax. Some proposed tax plans 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. Such requirements would raise compliance costs further.

## EVIDENCE

Some related evidence on the potential extent of these problems comes from the experience with state-level "use" taxes, under which taxpayers are obliged to pay taxes on goods purchased in other states. One analyst described the current enforcement of such taxes as "dismal at best."

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# How Could We Improve the Federal Tax System?

What has been the state and local experience with retail sales taxes?



## Q. What has been the state and local experience with retail sales taxes?

## A. Most states and localities rely heavily on retail sales taxes. But their experiences suggest that administering a national tax would be daunting.

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. Sales taxes are now the rule rather than the exception in states and localities: 45 states, the District of Columbia, and several thousand localities impose them. Only Alaska, Delaware, Montana, New Hampshire, and Oregon abstain (although Alaska allows localities within the state to have them). Sales tax rates vary widely (from 3 percent to 8 percent), as do the goods and services that are exempt.

Nothing in the states' experience suggests that a broad-based, high-rate federal retail sales tax would survive attempts to create preferences or would be easy to administer. For example, states show little inclination to carefully differentiate between producers' and consumers' purchases. But without a uniform exemption of producer purchases in a national retail sales tax, cascading taxes and market distortions would present a significant problem.

Further, 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 plain old lobbying. The federal base would have to be much broader than the typical state base; otherwise, the rate needed to replace the revenue generated by today's income tax would be sky-high. The states offer only limited experience in taxing government entities. But proposals for a national retail sales tax envision taxing every dollar of government purchases and investment.

A uniform retail sales tax would cover consumption of all goods and services. State sales taxes, however, deviate from this norm in numerous ways. According to a 2010 Federation of Tax Administrators survey, 35 states exempted household water usage, 25 household electricity, 21 household natural gas, and 21 household telephone services. Another Federation of Tax Administrators survey in 2015 revealed that 33 states exempted food and almost all states exempted prescription medicines. Taxation of services under state sales taxes is spotty at best.

Product exemptions intended to make the tax more progressive would be deeply problematic. Demogrants (cash rebates for lower-income families) 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 exemptions for "worthy" goods like prescription drugs and heating fuel are quite popular,

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## What has been the state and local experience with retail sales taxes?

pleasing policymakers because they appear progressive even as they serve the interests of producers looking for exemptions.

The state experience suggests that items difficult to tax are sooner or later excluded and, again, that political pressures can easily affect the form and substance of a retail sales tax.

The taxation of services is even more problematic. Although many states tax some services, only Hawaii and New Mexico include almost all services in the tax base. Enforcement of sales taxes on services has proved exceptionally difficult. These taxes are hard to administer and easy to evade because their paper trail is difficult to audit. This challenge raises red flags for a national retail sales tax.

Last, but not least, remember that an efficient retail sales tax should exempt all business purchases, but most state-level sales taxes do not come close to this ideal. Various 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 are as high as 70 percent.

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## How Could We Improve the Federal Tax System?



### Q. What is the experience of other countries with national retail sales taxes?

### A. No country has attempted a truly ambitious retail sales tax. Those that have tried more modest versions have abandoned them in favor of value-added taxes.

Many countries have attempted to implement national retail sales taxes or variants, such as wholesale-level taxes or "ring" taxes (retail sales taxes with exemptions for businesses "in the ring"). But not for long. In 1967, 19 Organisation for Economic Co-operation and Development countries had some form of wholesale, retail, or "turnover" tax (a tax paid when a good is manufactured, rather than when it is sold). By 1995, all had converted to value-added taxes (VATs) that collect revenue at each stage of production. Developing countries have also largely abandoned retail sales taxes in favor of VATs.

Retail sales tax rates are generally lower than VAT rates, running 4–6 percent as opposed to 14–25 percent. These sales tax rates are 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 retail sales taxes with rates in excess of 10 percent. And none of these countries currently maintains such a tax, presumably because high-rate sales taxes invite evasion.

Retail sales taxes got replaced with VATs for good reasons—namely, evasion and "cascading." Cascading occurs when taxed inputs are used to produce taxed outputs, so that the total tax on goods compounds beyond what was intended. This effect can be avoided by exempting all business purchases from taxation. But separating business purchases from consumer purchases is difficult. Moving to a VAT solves the problem because businesses receive credits for the taxes paid on their input purchases.

Evasion is higher under a retail sales tax than under a VAT for several reasons. First, the retail level is the weakest link in the enforcement chain. Second, if a retailer evades a sales tax, the full tax on the sale is lost. But with a VAT, successful evasion by retailers only costs the government the tax on the retailer's value added. Third, sales taxes do not produce a paper trail enforcers can easily follow.

# How Could We Improve the Federal Tax System?

## What is the experience of other countries with national retail sales taxes?

### Further Reading

Bartlett, Bruce. 1995. “Replacing Federal Taxes with a Sales Tax.” *Tax Notes* 68 (8): 997–1003.

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

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Tanzi, Vito. 1995. *Taxation in an Integrating World*. Washington, DC: Brookings Institution Press.

What did the President's Advisory Panel on Federal Tax Reform say about the national retail sales tax?



## Q. What did the President's Advisory Panel on Federal Tax Reform say about the national retail sales tax?

## A. Put simply: a nonstarter.

The President's Advisory Panel on Federal Tax Reform's first objection to replacing the current tax system with a national retail sales tax hinges on the latter's effect on income distribution. The report (2005) noted that "lower and middle-income families would be especially hard hit by a stand-alone retail sales tax" (2005, 211).

The panel was also concerned that, although the proposed demogrant program (which would provide cash rebates to needy households) would make the retail tax system less regressive, it would be a bear to administer. And it would thus "inappropriately increase the size and scope of government" (208). Moreover, the panel concluded that, with the demogrant, the tax rate needed to sustain current federal revenues would exceed— perhaps far exceed—34 percent. Meanwhile, households would still be liable for state and local sales taxes, which currently average 6.5 percent.

Nor was the panel impressed with the tax's value as a tool to simplify the tax system. Taxpayers would still be required to complete state income tax returns unless states abolished their own income taxes. Moreover, a new government agency would be required to monitor both collection of the tax and allocation of demogrants.

The panel also expressed concern about likely evasion: "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" (218). And with third-party reporting—such as W-2 and 1099 forms—notably absent from the proposal, "evasion rates are estimated to be around 50 percent" (218).

There's more glum news here. The panel noted that states would lack the ability to collect the tax and that an agency analogous to the IRS would be needed to enforce compliance. It also pointed out that states currently rely on taxpayers' fears of audits of federal income tax returns to deter state sales tax evasion. If the federal government abandoned income tax enforcement along with the income tax, states would be left hanging. Last, the report cited concern that the burden of collecting the national retail sales tax would disproportionately fall on small businesses and small service providers, raising their costs.

### Further Reading

President's Advisory Panel on Federal Tax Reform. 2005. *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*. Washington, DC: President's Advisory Panel on Federal Tax Reform.