What can state and local sales taxes tell us about a national retail sales tax?

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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 Great 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). State sales tax rates vary widely (from 2.9 percent in Colorado to 7.25 percent in California, not counting local rates), 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. 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. Without a uniform exemption of producer purchases in a national retail sales tax, cascading taxes and market distortions would present a significant problem.

A uniform national retail sales tax would cover consumption of all goods and services. State sales taxes, however, deviate from this norm in numerous ways. General sales taxes typically apply to most tangible goods. One notable exception is food purchased for use at home: only 13 states tax such purchases, and six of these states tax food at a lower rate than their general sales tax rate. Five of the 13 states that tax food for home consumption provide income tax credits to low-income residents to help offset the tax. Almost all states also exempt prescription drugs and some also exempt nonprescription drugs, textbooks, and clothing from general sales taxes.

Further, most states struggle to tax services—from old services like dry cleaning to professional services such as lawyers and new services such as digital products—for reasons relating to social and economic policy, tax administration, and lobbying. 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. As a result, states exempt broad categories of purchases from their tax. This challenge raises red flags for a national retail sales tax. States also offer only limited experience in taxing government entities while most proposals for a national retail sales tax envision taxing every dollar of government purchases and investment.

How Could We Improve the Federal Tax System?

What can state and local sales taxes tell us about a national retail sales tax?

Product exemptions intended to make the tax more progressive could also be deeply problematic. 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 at the state level, pleasing policymakers because they appear progressive even as they serve the interests of producers looking for exemptions.

It is reasonable to conclude that if a national retail sales tax is meant to replace the federal income tax, the federal sales tax base would have to be much broader than the typical state base or the tax rate needed would be sky-high.

Updated May 2020

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