How Could We Improve the Federal Tax System?

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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 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,

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.

Data Sources

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