How Could We Improve the Federal Tax System?

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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NATIONAL RETAIL SALES TAX

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Further Reading

Gale, William G. 2005. "The National Retail Sales Tax: What Would the Rate Have to Be?" *Tax Notes*, May 16.

Gruber, Jonathan, and James Poterba. 1996. "The Impact of Fundamental Tax Reform on Employer-Provided Health Insurance." *Insurance Tax Review* 11 (1): 41–44.

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