How Sales Taxes Work

Sales taxes apply to items we purchase every day, including goods (such as furniture and automobiles) and services (such as car repairs and dry cleaning). To compute the sales tax on a taxable item, the cost of the item is multiplied by the tax rate. For example, in Michigan, where the sales tax rate is six percent, the sales tax on a $10 book is sixty cents. The cost of the book to the consumer, after tax, is $10.60. The sales tax base is the total amount paid for all the goods and services subject to the tax. The sales tax is an example of an ad valorem tax—that is, a tax based on the price of the item sold.

In theory, the sales tax applies to all retail transactions—or sales to the final consumer—but most states tax only a fraction of household consumption. Some items that can be thought of as “essentials” are often exempted from the sales tax, including rent, medicine, utilities, and groceries. But not all sales tax exemptions apply to “essentials.” Politically powerful business groups often carve out exemptions for their products, and in many states, the tax base does not include personal services such as haircuts and car repairs. A large number of Internet transactions are also currently untaxed by the states.

States often have more than one sales tax rate. Some states apply lower tax rates to items such as groceries or utilities, as a means of providing low-income tax relief. Other states apply a higher tax rate to goods and services consumed primarily by tourists, such as hotels or rental cars, with the goal of “exporting” part of the sales tax to residents of other states.

Many states also have local sales taxes. These usually (but not always) apply to the same items as the state sales tax. Thus, calculating the total state and local sales tax is generally simply a matter of adding the state rate to the local rate and multiplying it by the cost of taxable items.

Every state with a sales tax also has a use tax, which applies to items that are bought outside a state for use within a state. The use tax is designed to prevent state residents from avoiding the sales tax by purchasing goods in other states. Residents who purchase such goods are legally required to report and pay tax on those purchases, though that requirement is rarely enforced. Many states are now attempting to boost use tax compliance, both by passing so-called “Amazon laws” (discussed on page 19) and by allowing residents to pay the tax through their regular income tax forms—but enforcement remains a serious problem.

Most states have more than one type of sales tax. They have a general sales tax (which is what most people mean when they talk about their state’s “sales tax”), and selective sales taxes on particular goods or services. A typical selective sales tax—which may have a different rate than the general sales tax—is a tax on the purchase of alcohol, tobacco or gasoline, or a tax on utilities, such as electricity and telephone service. Selective sales taxes, also known as excise taxes, are discussed later in this chapter.
Sales Taxes and Fairness

Sales taxes are inherently regressive because the lower a family’s income, the more of its income the family must spend on things subject to the tax. According to estimates produced by ITEP based on Consumer Expenditure Survey data, low-income families typically spend three-quarters of their income on things subject to sales tax, middle-income families spend about half of their income on items subject to sales tax, and the richest families spend only about a sixth of their income on sales-taxable items. Put another way, a 6 percent sales tax is the equivalent of an income tax with a 4.5 percent rate for the poor (that’s three-quarters of the 6 percent sales tax rate), a 3 percent rate on the middle-class (half of 6 percent) and a one-percent income tax rate for the rich (one-sixth of 6 percent).

Obviously, no one could get away with proposing an income tax that looked like that. The only reason this pattern is tolerated in consumption taxes is that their regressive nature is hidden in a harmless looking single rate, and the amount families pay is hidden in many small purchases throughout the year.

The sales tax violates the basic tax fairness principle of taxing according to one’s ability to pay: low-income families are actually made to pay a larger share of their incomes in tax than their wealthier neighbors. Sales taxes also violate this principle in their insensitivity to fluctuations in taxpayer income: families will always need to spend money on sales taxable basic necessities, no matter how little they earn in a given year. A middle-income taxpayer who loses his job will still have to spend much of his income just to get by—and will still pay a substantial amount of sales tax even though his ability to pay these taxes has fallen dramatically.

The “Equal Tax on Equal Purchases” Fallacy

Despite the regressivity of the sales tax, some people claim that sales taxes are fair. After all, it is said, no one can completely avoid paying sales taxes since they apply to things that everyone—rich and poor alike—needs to buy. Supporters of this position argue that the sales tax affects everyone “equally,” since the tax on a tube of toothpaste, for example, is the same no matter who buys it.

Is the Sales Tax “Voluntary”? 

Occasionally, the argument is made that sales taxes possess a fairness advantage over other forms of taxation because they are “voluntary”—that is, they are only paid by people who choose to spend, rather than save their income.

In reality, however, many kinds of spending are far from voluntary. Clothing, toiletries, school supplies, and furniture are just a few examples of important everyday items usually subject to the sales tax. Individuals who purchase these items are rarely making a truly voluntary “choice” between saving and consuming their income.

The purpose of branding the sales tax as “voluntary” is to portray it as having some relationship to the taxpayer’s ability to pay the tax. But in fact, income taxes do a much better job of targeting tax liabilities in proportion to what individual taxpayers can afford to pay. Chapter Five examines the workings of state income taxes in detail.
But this so-called “equality” is precisely why sales taxes fail the test of fairness. The cost of toothpaste, and therefore the sales tax on it, is the same for a rich person as for a poor person. But since the rich person has many times more income, the amount that he or she pays in tax on that tube of toothpaste is a much less significant expense—that is, a much smaller share of his or her income—than the same tax on a middle- or low-income family.

Of course, a rich family does consume more and thus pays more sales tax in dollars than does a less well-off family. But in terms of what those dollars mean to rich families—as a portion of their income and how it affects their standard of living—the sales tax has a much less significant effect on the rich than it does on middle- and low-income families.

Sales Taxes on Business—Who Pays?
Most state sales taxes are designed to exempt purchases made by businesses, on the theory that the sales tax is supposed to be a tax on final personal consumption. But the distinction between business and individual purchases is often difficult to make, and as a result every state applies its sales tax to some business purchases. These business-input sales taxes add to the cost of producing goods and services, and therefore mostly passed forward to consumers in the form of higher retail prices. In other words, taxing business inputs through the sales tax is generally akin to taxing the consumer more than once on the same retail sale. As a result, expanding the sales tax base to include business inputs will usually hurt low-income taxpayers.

Because some of the sales tax paid by businesses is exported to out-of-state consumers, lawmakers may find it politically appealing to apply the sales tax to business purchases. A manufacturer will likely be able to pass through most of the sales tax it pays on its inputs to consumers in other states, which means only a little of the tax will hit state residents.

For more on the issues associated with sales taxes on businesses, see page 20.

Revenue and Stability
Sales taxes are a mainstay of state budgets nationwide. But during times of economic uncertainty, sales tax collections can be volatile. When the most recent economic recession began in 2008, for example, state sales tax collections were the first major revenue source to suffer. Sales tax revenues can also decline when people are simply afraid a downturn may be coming. If a family thinks it may face hard times soon, it may delay some spending in anticipation of the worst. Purchases of big-ticket

The “Fair Tax”: Anything But Fair
Some national and state-level policymakers have unfortunately become enamored with the idea of replacing existing sales, income and corporate taxes with a single high-rate sales tax on virtually everything we consume. This approach is referred to as the “Fair Tax” by its supporters. But its name is only one of the misleading features of this regressive plan.

For example, “fair tax” advocates generally give absurdly low estimates of the sales tax rate that would be necessary to replace existing state taxes. A plan considered in Missouri in 2009 would have created a “fair tax” at a 5.11 percent rate—but an ITEP analysis found that the rate would actually need to be more than twice as high to raise the advertised amount of revenue.
items like new cars are particularly likely to be postponed. As a result, sales tax revenues can fall during periods of economic uncertainty—even before a recession has set in.

Even in good economic times, the sales tax usually is not a fast-growing tax. In large part, this is due to the antiquated sales tax base used in most states. In 2007, services represented about 65 percent of individual spending nationally, and are currently the fastest-growing area of consumption.2 But services remain largely untaxed by the vast majority of states, and sales tax collections have noticeably suffered as a result. Furthermore, failing to tax services also has the potential to increase the volatility of the sales tax, as the consumption of services is generally a more stable tax base than sales of big-ticket items, which make up a significant share of total sales taxes on goods.

The slow growth nature of sales tax revenues frequently forces lawmakers to increase the sales tax rate just to keep tax revenues growing with inflation over the long-term. The chart on the preceding page shows how North Carolina’s declining sales tax base (fueled both by the increasing prominence of services and the addition of new exemptions for items like groceries) has resulted in a higher sales tax rate over time.

Federal Deductibility
Heavy reliance on sales taxes brings with it a big disadvantage for states: the uncertain future of the federal itemized deduction for sales taxes. Ever since the enactment of the Tax Reform Act of 1986, sales taxes, unlike income and property taxes, have not been available as an itemized deduction on federal tax forms. Federal legislation enacted in 2004 temporarily changed this fact for tax years 2004 and 2005, and since then the deduction has been repeatedly extended on a temporary basis. Because the structure of the deduction forces one to choose between deducting sales taxes and deducting income taxes, this break generally only benefits itemizers living in states that lack an income tax.

Unfortunately for states lacking an income tax, the sales tax deduction is not nearly as useful as the income tax deduction. As ITEP recently found in a report titled Leaving Money on the Table, the handful of states without an income tax could reduce their residents’ federal tax bills by billions of dollars in the aggregate by shifting away from sales taxes and toward income taxes.3 This is because such a shift would raise taxes mostly on the high-income earners best able to take advantage of the federal deduction for state tax payments.

But as bad a deal as the sales tax deduction is today, states lacking an income tax could find themselves in an even worse situation if the deduction is allowed to lapse entirely. As of this writing, the deduction has been temporarily extended through the end of 2011, though the bleakness of the federal budgetary outlook increases the possibility that the deduction may disappear at some point in the not-so-distant future. For more detail on the “federal offset” effect, see page 9.

Gross Receipts Taxes: Sales Taxes by Another Name
Before moving on to discuss the major issues confronting sales taxes, it is worth noting that some states levy a variation of the sales tax, known as a gross receipts tax (GRT). The main difference is that sales taxes apply (in theory, anyway) only to retail sales, while a GRT applies to the sales made by companies at every stage of the production process, including manufacturing companies, wholesalers, and retailers. In other words, a GRT is a sales tax that applies to more types of transactions. From the consumer’s perspective, the major distinction between gross receipts taxes and retail sales taxes is that gross receipts taxes are not necessarily itemized on customers’ bills—though they are nonetheless paid by customers in the form of higher prices.

The gross receipts taxes currently used by states typically only apply to the sales receipts from certain types of products, with utilities and insurance being the most common targets. In fiscal year 2008, state and local governments raised more than $40 billion in gross receipts taxes on utilities and insurance—about twice as much as what the states raised from excise taxes on alcohol and tobacco.

When state policymakers propose a gross receipts tax as a proposal for comprehensive tax reform, what they usually have in mind is something very different from the single-item gross receipts taxes that most states currently use. These proposals typically would impose a very low tax rate on a very broad base of economic activity. For example, in 2005 Ohio enacted a “tax swap” that, among other things, replaced its corporate income tax with a gross receipts tax of 0.26 percent on all business revenues over $150,000 a year.

This sort of gross receipts tax is quite rare on the state level. The most comprehensive current GRT is the Washington State Business and Occupation Tax, which taxes the gross receipts of most companies doing business in Washington at rates ranging from 0.47 percent to 1.8 percent.

There are three main problems with GRTs. First, like any sales tax, a GRT hits low-income taxpayers the hardest. Second, because GRTs are based on the amount that a business sells
rather than on its profit, a GRT is not sensitive to a business’ ability to pay. In fact, some of the strongest opposition to Washington’s GRT comes from businesses that engage in high-volume, low-profit-margin activities—and those that frequently don’t turn a profit at all. And third, GRTs lead to severe pyramiding problems, because the tax applies not just to retail sales but to all stages of the production process. As a result of this last problem, it doesn’t make much sense to compare the tax rate of a broad-based GRT to the tax rate of a general sales tax: a GRT is a multi-stage tax, whereas the sales tax is a single-stage tax. So, for example, if a GRT of 0.25 percent applies to four stages in the production of a product, that’s roughly equivalent to a retail sales tax of one percent.

Perhaps worst of all, many lawmakers erroneously view GRTs as replacements for state corporate income taxes, simply because businesses are responsible for remitting these taxes to the state. But since GRTs are levied on sales, rather than profits, they are ultimately passed through to consumers like a sales tax, with all the same regressive effects.

Sales Tax Reform: Issues and Options

As lawmakers struggle to modernize the sales tax, they face two general problems: how to define the tax base, and how to make the sales tax less unfair. This section surveys a variety of specific issues falling under these two headings, with special emphasis on the solutions those issues demand.

Applying the Sales Tax to Services

Most state sales taxes were enacted early in the twentieth century, at a time when most of the things people purchased were tangible goods like cars, furniture and books. But in the past fifty years, American consumer purchases have changed dramatically, shifting toward consumption of services like gym memberships and cable television subscriptions. Few states have extended their sales tax to include services in their tax base. Only Hawaii, South Dakota, and New Mexico have a comprehensive service tax, and, according to a recent survey done by the Federation of Tax Administrators (FTA), a large majority of states still apply their sales tax to less than half of 168 potentially taxable services identified by the survey that are taxed in at least one state—such as rental services, repairs, installations, cleaning services, and a wide variety of entertainment options. Though it can be politically difficult to accomplish, there are sound tax policy reasons for seeking to modernize the sales tax base by expanding it to include some—but not all—services.

The basic rule of thumb for which services should be taxed is very similar to the way states seek to tax goods: services consumed by individuals should be taxed, while services consumed by businesses in the process of producing goods and services of their own should be exempt. Taxing business services may seem tempting to lawmakers because of the potentially high revenue yield—but doing so will actually make sales taxes more unfair in the long run, since business sales taxes are mostly passed through to consumers in the form of higher prices. Because these passed-through taxes are built into the prices of the goods we buy every day, the consumer doesn’t see these hidden taxes, and the amount of this hidden tax that is included in any particular retail purchase will vary depending on the number of taxed stages in the production process for a given retail item. But consumers will, in general, be the ones most affected by efforts to impose sales taxes on business services.
Taxing personal services, in contrast, can make the sales tax more fair in two ways. First, taxing services helps ensure that the amount of sales tax anyone owes will depend primarily on how much they spend—not what they spend it on. There is nothing inherently better (or worse) for society in spending money on services as opposed to goods. Taxing goods but not services discriminates in favor of consumers who prefer services, and discriminates against those who prefer goods.

Second, if done carefully, expanding the tax base to include more services typically thought of as “luxuries” has the potential to make the sales tax less regressive. This is because these services tend to be purchased more frequently by higher-income households. Of course, the sales tax will still be regressive overall no matter how broad the tax base is made. But taxing services, in combination with the types of income tax credits discussed on page 39, could represent an important step towards tax fairness.

More fundamentally for state lawmakers facing long-term fiscal crises, taxing services will also increase the amount of sales tax revenue collected at any given tax rate—which makes it less likely that lawmakers will be forced to raise the sales tax rate to balance budgets. And broadening the tax base makes sales tax revenues more stable in the long run, because declines in one area of taxable consumption will be offset by gains in another.

Addressing Sales Tax Exemptions
Every state’s sales tax allows targeted exemptions. These exemptions are usually intended to make the sales tax less unfair. Sales taxes can be made less regressive by taxing more of the things the wealthy consume the most and fewer of the things on which middle- and low-income families spend their money (e.g. taxing restaurant meals, but not groceries). Of course, every state and local general sales tax is regressive. But the degree of unfairness ranges substantially—from moderately regressive in states like Vermont to extremely regressive in states like Tennessee.

The most important factor affecting regressivity is whether groceries are taxed. Taxing food is extremely regressive because such a high portion of the income of poorer families goes to mere sustenance.

But there are reasons to be concerned about the long-term impact of sales tax exemptions. Economists generally argue that the sales tax base should be as broad as possible, for several reasons:

- **Exemptions are poorly targeted.** The poorest 40 percent of taxpayers typically receive about 25 percent of the benefit from exempting food. The rest goes to wealthier taxpayers.
- **While exemptions can make the sales tax less regressive,** they also create a new source of unfairness: different treatment of taxpayers who earn similar amounts of income. By exempting food while taxing other retail sales, lawmakers are discriminating against taxpayers who spend more of their money on things other than food.
- **Exemptions tend to make sales tax collections fluctuate more,** because changes in particular economic sectors can have a larger effect on tax collections. A broader tax base will allow tax revenues to be less sensitive to sudden swings in retail purchases of particular items since those swings will generally be offset by changes in purchases of other items.

Because they offer tax relief to everyone regardless of their individual need, exemptions are very costly. Exempting groceries, for example, has the potential to reduce the revenue yield of each penny of sales tax by nearly twenty percent. This requires that lawmakers increase tax rates in order to offset the reduction in the tax base.

Exemptions are an administrative challenge to policymakers, tax administrators, and retailers because any exemption requires a way of distinguishing between taxable and exempt products. For example, in some states, a particular food item may be taxed based only on whether or not the seller provides eating utensils with the item. Exemptions require policymakers and tax administrators to make countless decisions of this sort, and retailers must be familiar with all of these rules.

In states that allow local sales taxes, lawmakers must decide whether exemptions should apply to...
local taxes as well. Doing so can be costly to local
governments, but not doing so creates more complication
for retailers and tax administrators.

In addition to each of these problems, many states offer
a variety of poorly-conceived sales tax exemptions with no
purpose other than to assist favored special interests. While
the sales tax is well enough understood that special interest
loopholes in the tax law tend to get noticed (especially
compared to some of the more complex tax breaks that are
sometimes hidden in the income tax), that doesn't mean that
special interests don't work hard to win preferential sales tax
treatment. In some cases, these exemptions cross into the
absurd, such as the exemption for products made from trees
infested by pine beetles in Colorado, or the Arkansas exemption
for vehicles purchased by blind veterans.

With few exceptions, exemptions of personal consumption
items from the sales tax are not necessary. At best, exemptions
for necessities can be described as a second-best option
to income tax credits for reducing regressivity. At worst,
unwarranted exemptions can be described as expensive,
 wasteful, inefficient, unfair, and overly complex.

Sales Tax Holidays—Boon or Boondoggle?
In recent years, lawmakers in over a dozen states have sought to
lessen the regressive impact of sales taxes by enacting “sales tax
holidays.” These are temporary sales tax exemptions for clothing,
computers, school supplies, and other “back to school” expenses.
Most sales tax holidays last only a few days.

Virtually any sales tax cut will provide larger benefits, as a
share of income, to low-income taxpayers than to the wealthy.
But sales tax holidays are a problematic way of achieving low-
income tax relief, for several reasons:

■ A three day sales tax holiday for selected items still forces
taxpayers to pay sales tax on these items during the
other 362 days of the year, leaving a regressive tax system
basically unchanged.
■ Sales tax holidays are poorly targeted, providing tax breaks
to both wealthy taxpayers and nonresidents.
■ Sales tax holidays do not stimulate the economy. The
increased consumption observed during such holidays has
been shown to be primarily the result of consumers shifting
the timing of their purchases.
■ Many low-income taxpayers don't have the luxury of timing
their purchases to coincide with brief sales tax holidays. By
contrast, wealthier taxpayers are likely to be able to time
their purchases appropriately.
■ Retailers know that consumers will shift their spending
toward sales tax holidays to take advantage of the
temporary tax exemption. Savvy retailers can take
advantage of this shift by hiking prices during the holiday.
■ Any sales tax exemption creates administrative difficulties
for state governments, and for the retailers who must
collect the tax. But a temporary exemption requires retailers
and tax administrators to wade through a sheaf of red tape
for an exemption that lasts only a few days.
■ Perhaps most important for cash-strapped lawmakers, sales
tax holidays are costly. Revenue lost through sales tax holi-
days will ultimately have to be made up somewhere else.

Sales tax holidays do have advantages, of course. The
biggest beneficiaries from a sales tax cut are the low- and
middle-income families affected most by sales taxes. And
the heavily-publicized manner in which sales tax holidays are
typically administered means that taxpayers will be very aware
of the tax cut they receive—and will know that state lawmakers
are responsible for it.

But in the long run, sales tax holidays are simply too insig-
nificant to change the regressive nature of a state's tax system—
and may lull lawmakers into believing that they have resolved
the unfairness of sales taxes. Ultimately, sales tax holidays are
much more political gimmick than reasoned tax policy.

Sales Tax Credits
Lawmakers seeking to make the sales tax less unfair without
breaking the bank do have an increasingly popular alternative
to broad-based exemptions of the “essentials”: targeted sales
tax credits. Usually administered through the income tax,
these credits generally provide a flat dollar amount for each
member of a family, and are available only to taxpayers with
income below a certain threshold. These credits are also
usually refundable, meaning that the value of the credit does
not depend on the amount of taxes a claimant pays (for more
on refundability, see page 40). This approach offers several
advantages over sales tax exemptions, among them: credits
can be targeted to state residents only, and they can be
designed to apply to whichever income groups are deemed
to be in need of tax relief. The chart on the next page shows
the details of one such program, the Kansas food sales tax
refund. Low-income Kansas taxpayers over 55 years old, and
non-elderly Kansans with children, can claim up to $90 for each
family member. In 2010, Kansans with incomes up to $31,900 were eligible for the credit.

The precise targeting of credits means that they are much less expensive than exemptions. Credits do not affect the sales tax base, so the long-term growth of sales tax revenues is more stable (credits do, however, reduce the yield of the income tax). And credits are easier for tax administrators to manage. Because of these advantages, state lawmakers have shown an increasing willingness to pair sales tax (and excise tax) increases with the creation or expansion of low-income credits.

However, sales tax credits have one important disadvantage: they must be applied for. All of the states that allow sales tax credits require taxpayers to fill out a form every year. Taxpayers who do not know about the credit—or who do not have to file income tax forms—may not claim the credit even if they are eligible. This means that an effective outreach program must be a central part of any effort to provide sales tax credits. By contrast, exemptions are given automatically at the cash register—so consumers don’t need to apply or even to know about them.

Many states interested in mitigating the regressive effects of the sales tax have decided to rely on a state Earned Income Tax Credit (EITC) in lieu of a formal sales tax credit. While this approach offers state lawmakers less flexibility in deciding on the credit’s eligibility criteria and amount, it is preferable from a tax simplicity perspective and can potentially enhance the ease with which taxpayers can claim the credit. For more on state EITCs, see page 40.

It is also important to recognize that sales tax credits (or state EITCs) will never be able to eliminate the regressivity of sales taxes. As the chart on this page shows, the Kansas sales tax remains quite regressive, even after the food sales tax refund is taken into account. It would take a very large tax credit to eliminate the disproportionate effect that the sales tax has on low-income taxpayers. And while a state may technically be able to relieve the sales tax load on low-income families through a credit, there is no practical way to make sales taxes on middle-income families equal to the light sales taxes borne by the wealthy. Since a substantial share of sales tax revenue currently comes from low- and middle-income families, a sales tax and rebate system that ended up

<table>
<thead>
<tr>
<th>INCOME LEVEL</th>
<th>REFUND</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 to $15,950</td>
<td>$90 per person</td>
</tr>
<tr>
<td>$15,951 to $31,900</td>
<td>$45 per person</td>
</tr>
<tr>
<td>$31,901 or more</td>
<td>no refund</td>
</tr>
</tbody>
</table>

taxing the middle class at the same low rate as the rich wouldn’t be worth the trouble of collecting (and rebating).

To be sure, rebates or credits can be valuable to poor families. But no one should think that they can solve the problem of sales tax regressivity entirely.

### Applying the Sales Tax to Internet Transactions

A large and growing share of retail purchases are now being made on the Internet—and a substantial portion of these are not being taxed by states. This is not a totally unfamiliar problem, as states have long struggled with how to tax “remote sales” (e.g. catalog, telephone, and internet sales). With the growth of the Internet, however, this once marginal issue has evolved into a serious problem. The most commonly cited estimate of the revenue loss associated with Internet transactions, by researchers at the University of Tennessee, is that state and local governments lost $8.6 billion in sales tax revenue in 2010, and will lose as much as $11.4 billion in 2012. If expanded to include mail and telephone orders, these figures would be significantly larger. Left unchecked, this revenue loss will sap the vitality of state sales taxes.

From a tax fairness perspective, Internet-based transactions should be treated in the same manner as other retail transactions.
transactions. That is, retail transactions that are taxable when sold by conventional “bricks and mortar” retailers should also be taxable when sold over the Internet, for several reasons:

- Exempting e-commerce transactions is unfair to “bricks and mortar” retailers. Retailers who choose to sell their wares primarily in a “brick and mortar” setting rather than making sales over the Internet are unfairly disadvantaged by a policy that exempts e-commerce.
- Exempting e-commerce transactions is also unfair to consumers. Consumers who are unable to access the Internet are unfairly disadvantaged by having to pay sales taxes on their purchases. Exempting Internet retail sales has the potential to increase the regressivity of sales taxes as better-off taxpayers are able to avoid these taxes through Internet purchases.
- In addition to being unfair, allowing Internet transactions to go on tax-free also violates the principle of ‘neutrality’, discussed in Chapter Two. A sales tax that treats Internet sales differently from “bricks and mortar” sales creates an inefficient economic incentive for consumers to shop online, and for retailers to accommodate that demand with an increased online presence. This results in an overabundance of online transactions, relative to what the market would normally allow.
- Exempting e-commerce transactions will become increasingly costly in terms of lost state and local revenues as the importance of the Internet continues to grow.

Unfortunately, a series of U.S. Supreme Court decisions, most recently Quill Corp. v. North Dakota, have found that states cannot require retailers to collect sales taxes on items purchased from remote sellers (that is, sellers based in other states). As a rationale for this decision, the Court cited the complexity of state and local sales tax systems. The Court argued that with so many states, counties, and municipalities levying different taxes at different rates with different tax bases, forcing retailers to figure out the appropriate tax to collect on sales to each jurisdiction would impose an unacceptable administrative burden on these sellers.

However, the Court also indicated that this problem could be solved, noting that there are good reasons to try to collect taxes on remote sales: even businesses that engage only in mail-order or Internet sales in a state still benefit from the public services that make these transactions possible—and should help to pay the cost of providing these services. The Court also noted that Congress could pass legislation allowing states to require sales tax collection on remote sales, and hinted that Congress would be more likely to pass such legislation if state lawmakers took immediate steps to simplify the current maze of tax bases and tax rates.

States have responded to the Supreme Court’s suggestion by cooperating to simplify their sales tax rules. The Streamlined Sales Tax Project (SSTP) was formed in April of 2000 by representatives of most states to develop a plan to simplify sales tax structures. In 2002, these representatives agreed on model legislation, called the Streamlined Sales and Use Tax Agreement (SSUTA), designed to be enacted by each state legislature. The agreement became legally binding (in states enacting it) in 2005. As of 2010, twenty states are full members of the agreement, and three states have associate member status. However, the states remain largely powerless to require the collection of sales taxes on remote sales until Congress acts to enable them.

Bills have recently been introduced in Congress that would

A New Method forTaxing Internet Sales?

A number of states, led by New York, are refusing to wait for permission from Congress to tax internet sales, and have taken some controversial steps to expand the number of internet retailers subject to its sales tax.

Under legislation enacted in New York in early 2008, internet retailers based in other states are required to collect sales tax on purchases made by New Yorkers if those internet retailers use the services of advertisers located in New York. This is an important change to existing law, and has the potential to increase the state’s sales tax revenue significantly, especially in the long-term.

Major internet retailers such as Amazon and Overstock have filed lawsuits challenging the law, claiming that the companies New York is attempting to tax are in fact untaxable “remote sellers”, despite any agreements made with New York advertisers.

Arkansas, Connecticut, Illinois, North Carolina and Rhode Island have followed New York’s lead in expanding their authority to tax internet sales in this manner, and legislation containing similar provisions has been introduced in over a dozen other states. If New York’s law is upheld in court, more states can be expected to follow suit.
allow states to collect sales tax on remote sales, but these bills have failed to advance due to the anti-tax attitudes of many in Congress, as well as a more general apathy toward this uniquely state-level problem.

**Tax Treatment of Sales Made to Businesses**

Unlike the special exemptions enjoyed on sales made by internet retailers, the service sector, and various other favored businesses, the exemption from the sales tax of most purchases made by businesses is actually good policy. For example, nobody thinks that retailers should pay sales tax when they buy goods at wholesale. If they did, the goods would be taxed twice—once at the wholesale transaction and once at the retail sale—with the ultimate consumer bearing much of the burden of this double-taxation.

But the same principle applies when, for example, furniture-making companies buy wood to make into tables and chairs. If they must pay sales tax on the wood, then the wood will, in effect, be taxed twice—one when it is bought by the manufacturer, and again when it is bought by the consumer as part of the furniture. When sales taxes from earlier stages of the production process pile up on the final consumer, economists call it “pyramiding” or “cascading.”

Cascading sales taxes can create serious economic problems. For example, suppose one furniture manufacturer chops down trees, does all the wood machining, shaping and assembly itself, and runs its own retail stores. In contrast, a second furniture manufacturer buys semi-finished wood from a lumber company, which in turn bought it from a timber company. And suppose that the second manufacturer sells its furniture at wholesale to unrelated retail stores. Only the final retail furniture sales of the first, integrated manufacturer will be taxed, since until then, the furniture and its components never change ownership. But under a “cascading” sales tax system, the products of the second manufacturer would be taxed four times: first when the wood is purchased by the lumber company, second when purchased by the furniture manufacturer, third when bought by retailers, and finally when sold to consumers at retail. Such a strange tax system would give the products of the integrated company a huge competitive advantage over those of the second manufacturer—even though the multi-company approach to furniture making and sale might be just as economically efficient. As with many of the sales tax issues discussed in this section, this is a clear violation of the “neutrality” principle, discussed in Chapter Two.

Taxing business inputs can also undermine the methods used to make the sales tax less unfair. For example, if grocery stores pay sales tax on the smocks they buy for their clerks or the fees they pay their lawyers, and these taxes are passed on to their customers in the form of higher retail food prices, the benefit of exempting food from the sales tax is partially undermined.

One often overlooked result of taxing business inputs is that the effective sales tax rate on income (that is, sales taxes as a percentage of income) may actually end up higher than the nominal sales tax rate. In other words, a state can have a 5 percent sales tax rate but there may be families that have 6 percent of their income going to sales taxes. This is caused by two related phenomena. First, families pay a higher price for a product because the tax on the purchases by businesses increases the cost of making, wholesaling andretailing the product. Second, the retail sales tax applies to this added increment in the price, compounding the problem.

---

**What is the Role For The “Benefits Principle”?**

In general, the appropriate measure for evaluating the fairness of any tax policy is its adherence to the “ability-to-pay” principle, described on page 1. In some limited instances, however, it may make sense to also consider the “benefits principle” in evaluating tax fairness. Under the benefits principle, the tax one pays should be linked to the benefit one receives from relevant government services. This principle is most commonly applied to user fees, discussed on page 3, but can also be expanded to include the gasoline tax.

Unlike a public education system, which produces enormous “spillover” benefits and should therefore be funded by society as a whole, the benefits gained from an efficient transportation system are often more localized. For this reason, relying on gasoline taxes to fund transportation can actually improve tax fairness by ensuring that those individuals who do not own cars, or who only drive very short distances, do not have to subsidize the behavior of long-distance commuters and other road-trippers. Of course, since gasoline taxes are still regressive, additional progressivity should be built into the tax system in other ways—such as through the use of low-income credits—in order to avoid disproportionately affecting low-income families.
With only a few minor exceptions, a sales tax on business inputs is no more fair than any other kind of regressive sales tax, with the added drawback that it distorts the economy.

How Excise Taxes Work
Excise taxes are sales taxes that apply to particular products. Compared to income, property, and general sales taxes, excise taxes constitute a fairly small portion of state revenues. This is because excise taxes lack a broad base, and are instead levied on only a few specific products—typically tobacco, fuel, and alcohol. In part because of its narrow base, the tobacco tax in particular has become a popular source of revenue even among politicians that are generally opposed to raising taxes—though health concerns have also contributed to this popularity.

Unlike general sales taxes, excise taxes are usually applied on a per-unit basis instead of as a percentage of the purchase price. For instance, cigarette excise taxes are calculated in cents per pack. And most gasoline excise taxes are imposed in cents per gallon. As is explained in the next section, this structure contributes to the extreme regressivity of excise taxes.

Because excise taxes are generally not itemized on consumer receipts, they tend to be invisible to the taxpayer. Nonetheless, while most states levy general sales taxes, every state levies excise taxes on tobacco, alcohol, and gasoline.

Excise Taxes and Fairness
Like sales taxes, excise taxes as a share of personal income fall more heavily on middle- and low-income families than on the rich, and thus violate the principle of “vertical equity,” explained on page 5. In fact, excise taxes tend to be even more regressive than general sales taxes. This is because excise taxes are unrelated to the price of the item purchased. Under a typical sales tax, a wealthy person purchasing an expensive Mercedes would pay more—in dollars—than a middle-income family purchasing a less expensive Chevrolet. But excise taxes do not work this way because of their per-unit basis. The excise tax paid on premium wine, beer, and cigarettes is the same as that paid on less expensive brands.

The regressivity of cigarette excise taxes is especially pronounced due to an additional factor: lower-income individuals are far more likely to smoke than are wealthy individuals. Unlike most categories of products and services—where wealthier individuals tend to spend more than lower- and middle-income families—cigarette consumption is actually concentrated among the less wealthy members of society. Taxes on cigarettes, therefore, are particularly regressive.

Why Levy Excise Taxes?
In addition to violating the principle of “vertical equity,” excise taxes on their face also appear to violate the principle of “horizontal equity” (explained on page 5) by singling out those taxpayers who chose to spend a portion of their income on items subject to excise taxes. In reality, however, the rationale for levying most excise taxes is that consumers of these products are in some way not similar to other consumers, and are thus deserving of differential treatment under the tax law. The following three reasons for levying excise taxes are each based on this assumption.

Levy “Sin Taxes” to Discourage Consumption
Excise taxes are commonly referred to as “sin taxes” because they are applied to items whose consumption is deemed to be detrimental to society (e.g. alcohol, tobacco, and gasoline). By singling out these products for excise taxation, their price can be increased in order to discourage both their consumption and the societal ills associated with such consumption—including drunk-driving, second-hand smoke, vehicle emission pollution, etc. Extending this idea further, proposals to impose excise taxes on soda in order to reduce obesity, and its associated strain on the nation’s health care system, have recently received attention at both the state and federal levels.

While pursuing social policy goals such as these through the tax code can be controversial, this strategy has proven effective in some circumstances. Cigarette taxes, for example, have been shown to have a meaningful impact on reducing smoking, especially among younger people. But even under a cigarette tax levied at a high rate, the vast majority of smokers will simply pay the higher tax and continue in their habit. This is even more true of gasoline taxes, which at current levels have been shown to be relatively ineffective at reducing consumption.

Levy “Sin Taxes” to Pay for Societal Costs
Because some individuals will always continue to consume certain products despite the presence of “sin taxes,” such taxes can also provide revenues with which to compensate society for the burdens imposed by these goods. A smoker whose second-hand smoke affects the health of current or future Medicare recipients, for example, is necessitating higher spending on the part of government due to her decision to smoke. A similar argument can be made regarding the plethora of environmental costs associated with gasoline consumption—and in fact, a
number of states dedicate a portion of their gasoline tax revenue to funding environmental cleanups of gasoline spills and leaks. Excise taxes can ensure that consumers of these products help pay for the full range of costs associated with their use.

**Levying Gas Taxes as a User Fee Proxy**

The most important rationale for levying a gasoline excise tax differs from the two reasons discussed above. Gasoline taxes are usually dedicated to funding the maintenance and expansion of a state’s transportation infrastructure, and are therefore widely understood as an approximation of a “user fee” on drivers for their enjoyment of the nation’s roadways. Those who drive the furthest distances (or the heaviest vehicles) produce more wear-and-tear on the roads, and therefore generally pay more in gasoline taxes.

As the discussion of user fees on page 53 makes clear, however, gasoline taxes are not quite a true user fee. Moreover, with new fuel-efficient technologies allowing some drivers to purchase significantly less gasoline while deriving the same benefit from the nation’s roads (and producing the same wear-and-tear on those roads), the usefulness of this tax as an even-handed user charge has been diminished. Until other methods, such as tolls or “vehicle miles traveled taxes” become more widespread, however, the gas tax remains the most realistic method for charging users in rough proportion to the benefit they receive from the nation’s transportation infrastructure.

**Revenue and Stability**

Excise tax revenues tend to grow very slowly, which makes them an inadequate source of revenue over the long run. Nonetheless, states have increasingly turned to excise taxes—particularly the cigarette tax—in recent years as a more politically expedient alternative than broad-based tax increases for shoring up their budgets. As a result, the slow-growth, unsustainable nature of these taxes is likely to be an issue of importance for years to come.

**Unprepared for Inflation’s Inevitable Effect**

The unsustainable nature of excise taxes results primarily from their per-unit rate. Because of their per-unit structure, excise tax revenue grows only when the volume of sales subject to the tax grows. General sales tax revenue, by contrast, also grows when the price of the products subject to tax rises as a result of inflation.

Under a general sales tax, for example, if the price of a product increases by 3 percent as a result of inflation, tax revenues from the sale of that product (all else being equal) will increase by 3 percent as well. Of course, this isn’t a real gain in revenue for the government, since those extra revenues will simply go to paying the higher, inflation-adjusted prices associated with providing government services. This “gain” is instead a bare minimum requirement for keeping government running at a stable level over time.

But excise taxes fail to live up to this bare minimum requirement. Under a gasoline excise tax of twenty cents per gallon, the government will always receive twenty cents on each gallon sold, regardless of what happens to the price of gasoline and the price of government services over time. As inflation erodes the value of that twenty cents, government’s ability to provide a consistent level of services will suffer.

Virginia provides one example of a state suffering from this flawed arrangement. Though Virginia has collected 17.5 cents on each gallon of gasoline sold within its borders since 1987, the real value of its gasoline excise tax has declined considerably as a result of inflation. The 17.5 cent tax Virginians pay on each gallon purchased today is, in inflation-adjusted terms, really about 16 cents lower than what they paid when the rate was set at that level in 1987. Put another way, 17.5 cents today has the same purchasing power that 33.5 cents had in 1987. Inflation has effectively provided Virginians with an unintended, 16 cent per-gallon tax cut which has, in turn, had a stark effect on state revenues—as well as on the (already limited) ability of the gas tax to deter consumption.

That effect on revenues can be seen by looking at Virginia’s gas tax revenues as a share of its economy over time. As seen in the graph on this page, the spike in revenues that occurred in 1987 is the result of the legislature’s action to increase the per-gallon excise tax rate from 11 to 17.5 cents per gallon. Before
and after that spike, however, are predictable revenue declines brought about by inflation's effects on the real tax rate. A similar story could be told in most states around the country.

Declining Consumption of Goods Subject to Excise Taxes
In some cases, the slow-growth of excise tax revenues can also be attributed to changes in the demand for products subject to excise taxes. Cigarette consumption, for instance, has been steadily declining as a result of increased awareness of tobacco's negative health effects, as well as the higher prices created by cigarette excise taxes. This decline has already had a marked effect on state cigarette tax revenues. In time, gasoline consumption will decline as well as alternative energy sources and more fuel-efficient technologies continue to improve.

Inevitably, if excise taxes succeed in deterring consumption, they will fail to produce sustainable revenue growth. These two goals of excise taxation are completely incompatible.

Federal Deductibility
Unlike income taxes and property taxes (and, at least temporarily, general sales taxes), excise taxes are not deductible in computing federal taxable income. As a result, every dollar in excise tax paid is a dollar out of that taxpayer's pockets. There is no offsetting reduction in federal income taxes for those who itemize deductions. For a more detailed discussion of the "federal offset" effect, see page 9.

Excise Tax Reform: Issues and Options
Though there are persuasive reasons for levying excise taxes, their regressive and unsustainable nature demands careful attention from policymakers. This section surveys the options available forremedying these problems associated with excise taxes.

Reducing Regressivity
As explained earlier, excise taxes are more regressive than general, percentage based sales taxes. One obvious way of reducing this regressivity is to levy excise taxes in a manner more akin to how general sales taxes are levied. Unlike a flat, per-gallon tax on premium and regular liquors, a percentage based tax would take account of the difference in price between these two products, and would collect more tax from those consumers able to afford premium brands. This method would reduce, but by no means eliminate the regressivity of excise taxes.

But levying an excise tax in this manner does have its problems. Expensive and inexpensive brands of liquor, for example, are equally capable of producing societal ills, and should therefore be treated equally by an excise tax aimed at discouraging their consumption or to offsetting their social costs. Moreover, with gasoline in particular, tying excise tax revenues to the often wild and unpredictable price of gasoline can have unfortunate implications for state revenues.

Rather than altering the structure of the tax itself, a more targeted approach with fewer side-effects is to rely on low-income credits to offset the effects of excise taxes on those individuals least able to afford them. This could be accomplished by bolstering the types of sales tax credits discussed on page 17, or by enhancing (or enacting) a state Earned Income Tax Credit (EITC). In 2009, Minnesota temporarily offered a refundable tax credit—dubbed the "lower income motor fuels tax credit"—specifically as a means of offsetting a recent increase in the state's gasoline excise tax.

Improving Revenue Growth
Aside from regressivity, the other principal disadvantage of excise taxes is the unsustainable nature of the revenue they produce, as explained on page 22. Fortunately, options do exist for mitigating this disadvantage—though it is neither possible nor desirable to eliminate it entirely. Indeed, as is noted above, poor revenue growth is an inevitable side-effect of any excise tax that is effective in deterring consumption.

Levying excise taxes as a percentage of the item's sales price, rather than at a flat per-unit rate, can result in additional revenue growth over time as inflation raises the item's sales price. Some state gasoline and alcohol excise taxes are already levied in this manner. But while this strategy may result in additional revenue over the long-term, it does somewhat reduce the predictability of the revenues generated by the tax, since variations in the item's price can have significant effects on the amount of revenue collected. In the case of tobacco and alcohol—products with prices that are not particularly volatile—this is a fairly minor issue, and a strong case can in fact be made for levying these taxes in this way. With gasoline taxes, on the other hand, tying the state's revenues too closely to the product's price can cause a serious problem. As the graph on the preceding page shows, gasoline prices over the past three decades have been quite variable, sometimes changing by 30 or 40 percent in a single year. This aspect of gasoline prices is especially troubling because gas tax revenues, rather than being intermingled with other types of revenue in a state's general
The ITeP Guide To Fair State and Local Taxes

fund, are often dedicated to a separate transportation trust fund. Needless to say, when gas prices plummet, a trust fund reliant on a percentage-of-price gas tax can be expected to suffer as a result. Many states that previously levied their gasoline taxes in a percentage-based manner have since abandoned this method precisely because of this threat.

So if a percentage-of-price levy is not a good fit for the gasoline tax, what is? The most obvious answer is to index the per-unit rate based on the economy’s overall rate of inflation. As the above graph shows, inflation provides a much more stable and predictable measure than the price of gasoline itself. Maine and Florida currently index their gas tax rates to the general inflation rate, and the idea has been discussed in many other states.

For states not interested in indexing, there is one other alternative. Nebraska regularly adjusts its gasoline tax rate based on a number of factors, including most notably the budget the legislature has authorized for the Department of Roads. When the legislature decides that the Department needs additional funding to adequately maintain Nebraska’s roads, this linkage provides a straightforward way for securing the necessary revenue without having to reduce spending on education, public safety, or other priorities. This is arguably the best option available for avoiding unforeseen shortfalls in the transportation budget, though it can create a reluctance among lawmakers to spend adequately on transportation since their spending decisions translate directly into sometimes politically unpopular gas tax increases.

Conclusion

Despite all their flaws, sales and excise taxes are an important component of state and local tax systems. Sales and excise tax reform should focus both on improving the sustainability of the revenues generated by these taxes, as well as on reducing the inevitable regressivity associated with these forms of taxation. But while much can be done to improve sales and excise taxes in these respects, policymakers must recognize that neither of these characteristics is the strong suit of these taxes, and for that reason, no state tax system should ever come to rely too heavily upon them.

---

1 In many states, a small portion of this tax is actually pocketed by retailers through programs known as “vendor discounts.” These “discounts” are ostensibly designed to compensate retailers for the costs associated with collecting and remitting sales tax payments, though in many states the compensation provided arguably exceeds the actual costs to retailers. For more information see: Good Jobs First, “Skimming the Sales Tax.” November 2008. http://www.goodjobsfirst.org/pdf/skimming.pdf
2 This figure represents household consumption expenditures for services as a share of personal consumption expenditures, as found in the Bureau of Economic Analysis’ National Income and Product Account Tables (NIPA), available at: http://www.bea.gov/national/nipaweb/index.asp
4 This is not to be confused with taxing internet access itself, which the Internet Tax Freedom Act (ITFA) prohibits in most states through 2014 based on the dubious claim that exempting internet access encourages more households to purchase high-speed internet service.
7 For more information see Michael Mazorov, Amazon’s Arguments Against Collecting Sales Taxes Do Not Withstand Scrutiny,” Center on Budget and Policy Priorities, November 2010. http://www.cbpp.org/cms/index.cfm?fa=view&id=2990
8 This has been shown in numerous studies, including: Carpenter, Christopher and Philip J. Cook, “Cigarette Taxes and Youth Smoking: New Evidence from National, State, and Local Youth Risk Behavior Surveys.” Journal of Health Economics, Vol. 27(2), March 2008.