Briefing on Retail Sales Tax Structure for Nebraska Tax Modernization Committee

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Three Basic Rules for Tax Design (BBLR)

- Sensible capacity measure
- Broadest logical legal definition
- Lowest possible statutory rate
“...each individual performs this operation [revealing ability to pay] for himself when, in the light of all his present circumstances and future prospects, he decides on the scale of his personal living expenses. Thus a tax based on actual spending rates each individual’s spending capacity according to the yardstick which he applies to himself.”

Private market, self-determination, all-encompassing
Consumption Base Advantages

- Reasonable capacity measure
- Less harmful for economic growth than income base
- No anti-saving bias
Retail Sales Tax – American Approximation of General Consumption Tax

- Not income tax proxy
- Not selective excise
- Not gross receipts / turnover
- BUT: not truly general consumption tax
- General consumption tax would tax every household consumption purchase and would exempt every business purchase
Issue 1: Treatment of Business Purchases

- Tax last exchange in supply chain to household.

- Test is not whether item is “finished”

- Test is whether purchase is an input for business use. (RST administers through suspension certificates)

- Tax purchases that are components of household consumption spending
Test is sometimes easy...
Test is sometimes harder ("mixed use")...
The problem if business purchases are taxed..

- Tax becomes part of business cost
- Business cost becomes part of price charged
- Final purchaser (household) pays tax on final purchase and also earlier embedded tax
- Pyramiding: one tax applied multiple times in supply chain causes high tax rate on consumer, considerably higher than advertised statutory rate.
The Reality of State Retail Sales Taxation

- Some business purchases get excluded from taxation: inventory for resale, component parts

- Some business purchases get excluded from taxation usually but far from always: equipment and machinery used on the production line

- Some business purchases get excluded from taxation sometimes: fuels, energy, consumables

- Some business purchases get excluded from taxation almost never: office and retail fixtures
Pyramiding – static analysis

- Exhibit 1: static analysis (no adjustments to tax in supply chain)

- Tax collected on business-to-business purchases adds to state revenue

- Effective rate > statutory rate
Pyramiding– dynamic analysis

- Exhibit 2: dynamic analysis (supply chain adjustment to tax paid on purchases)

- Tax on business-to-business purchases adds to state revenue and adds to price and tax paid by household

- Effective rate > statutory rate
Tax Collected in Supply Chain is Considerable Share of Total Sales Tax

- Exhibit 3: business shares of sales tax base by state (Ernst & Young data)

- Typical: business purchases – 40% of base; effective rate paid by households > statutory rate.

- Nebraska share > national average business share.
What’s the problem with pyramiding?

- Violates consumption tax idea – retail sales tax becomes hybrid turnover / consumption tax
- Transparency: much of tax burden is hidden, may contribute to inflated government
- Disincentive for business expansion
- Discourage improvement in machinery, investments in productivity
- Reduce international and domestic competitiveness
- Tax paid by business not strongly related to economic capacity or use of government services
- Horizontal inequity
- Distorts business behavior
- Exempt purchasers and purchases bear tax burden
Why do business purchases remain in tax base?

- Revenue from sales tax paid by businesses = 20% of all state – local tax paid by businesses

- Some politicians like to hide taxes

- Lawmakers like to behave like Soviet planners – dole out selective tax benefits. “good businesses v. bad businesses”

- Exemption looks like tax break for business – look at tax expenditure budget...
Issue 2: The Disappearing Base

- Sales tax base in secular decline

- Five graphs:
  - National phenomenon: Exhibit 4
  - Nebraska phenomenon: Exhibit 5
  - National Consumption and Services Share: Exhibit 6
  - National Share – Health Care: Exhibit 7
  - National – Untaxed Services Share: Exhibit 8

- C-Efficiency
- Median Breadth
Exhibit 5. Nebraska's Disappearing Sales Tax Base (Base / Personal Income)
Consumption Share of Personal Income Relatively Stable, Services Share Has Increased Considerably

Exhibit 6. Total Consumption and Services Consumption as Share of Personal Income, 1970 - 2011
Health Care is significant factor in increase in services share
But Share from Other Services Has Increased As Well

Household Services and the Base

- Base disappearance closely related to absence of services from base

- Services are part of consumption expenditure
Why Tax Service Purchases?

- Yield: avoid higher statutory rates
- Horizontal equity
- Avoid silly distinctions
- Vertical equity
- BUT: need distinction between business and household purchase of services.
Summarizing...

- Retail sales tax works as indirect consumption expenditure tax.

- If objective is something other than general consumption tax, then use some other tax.

- For retail sales tax to succeed as uniform consumption tax with equity and efficiency effects of such a tax:
  - Exempt all business purchases
  - Tax all household consumption purchases (even food for at home consumption and motor fuels)