How Does the Depression-Designed Retail Sales Tax Cope With the New Economy of the 21st Century? A Tax for the New and the Old.

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The state retail sales tax was a desperation revenue measure that emerged in the depths of the Great Depression of the 1930s. But it was an almost instant fiscal success. For the second half of the 20th century, the retail sales tax was the largest single source of tax revenue to state government and the second largest tax source to local governments. In recent years, the individual income tax has replaced it as the largest state tax source but it remains an important contributor to state and local government finances, including being the largest single tax source for a number of states. Any significant share of the sales tax would be difficult to replace in manner that is equitably, fiscally, economically, and politically feasible.

The retail sales tax is important because household consumption has strong status as an ability-to-pay standard for dividing the cost of government, as a tax without some incentive issues raised by income taxation, and as a tax that provides some relief from the substantial reliance on the income base in American revenue systems. Lawmakers in some states have even proposed expanded reliance on the tax because of concerns with economic or social difficulties, not to mention political concerns, created by income or property taxes. The problem is that the retail sales tax faces challenges to its continuing productivity, efficiency, and equity. Some are endogenous, in that they have been created by the states themselves. Others are exogenous, in that they have emerged from changes in technology, economy, and demography. Both challenges are critical and, interestingly enough, some are direct carry-overs from sales tax structure that emerged as a product of the Great Depression of the 1930s.

The paper has three main sections. The first tracks the fiscal development of the state retail sales tax and its path of reliance in state finances. The second examines the challenges to the retail sales tax in the new (and old) economy that are endogenous to choices made by state lawmakers. The tax has been characterized as being both too narrow (excluding too much personal consumption expenditure) and too broad (taxing too many business inputs). Political forces emerging in recent years make it difficult to achieve the standard of broad coverage of all consumption expenditure, in particular consumer behavior moves spending toward frequently untaxed purchase of services but also the contagion of purchase-class exemption emerging from political forces, while surmounting the challenge of preventing the pyramiding and anti-growth impact of including business inputs in the tax base. Resurgence of the political value of a “hidden” tax can be seen in recent reemergence of the almost universally despised gross receipts tax in state tax policy and proposals. The paper tracks how the state tax structures have changed from the 1970s to the present. The third examines exogenous challenges coming from technology and the new economy. States have been constrained in their capacity to collect the tax owed on transactions consummated from remote vendors, usually internet sales, and those sales represent a growing component of the potential tax base. (The results of the Wayfair case will be integrated into the conference presentation, examining options and impacts from whichever way the case is decided.) But the remote vendor issue is not the only exogenous change coming from the new economy and it likely is not even the most important one for the long term. The development of the sharing economy
in which a large platform dramatically increases the market scope of small independent vendors challenges compliance. The use of zappers and phantomware dramatically complicates the enforcement process. Possible emergence of a cashless economy may make some administration simpler. And there are other complexities emerging from the use of services from the cloud. If the retail sales tax is to provide the reliable revenue states have come to expect for the 21st century, they will need to take important legislative and administrative actions. Each challenge impacts the equity, efficiency, productivity, and transparency of the retail sales tax and, because of the fiscal significance of the tax to subnational governments, those challenges ripple throughout the American revenue systems.

There are difficult issues in devising a robust retail sales tax for the environment of the 21st century. Some of these emerge from the unfinished business of implementing a sales tax appropriate for the 20th century (old economy). All can be surmounted with structural changes in tax laws and their administration. The problems are often political because solutions may impact members of organized interest groups, but some states have had modest success at fruitful restructuring and these episodes merit detailed study. The sales tax future much depends on the design of strategies to enact identified solutions to structural, behavioral, and administrative threats and this represents the greatest challenge for the future of the tax. The sales tax needs to be simultaneously adapted to the needs of the old and new economy. This paper provides restructuring proposals for meeting the existing and emerging challenges.