

# Briefing on Retail Sales Tax Structure for Nebraska Tax Modernization Committee

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## Three Basic Rules for Tax Design (BBLR)

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- ❑ Sensible capacity measure
  - ❑ Broadest logical legal definition
  - ❑ Lowest possible statutory rate
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## Kaldor Principle, Measuring Ability, and the Consumption Base

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- "...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
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## Consumption Base Advantages

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

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- ❑ 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
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## Issue 1: Treatment of Business Purchases

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- ❑ 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
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Test is sometimes easy...

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Test is sometimes harder (“mixed use”)...

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## The problem if business purchases are taxed..

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- ❑ 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.
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# The Reality of State Retail Sales Taxation

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- ❑ 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
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## Pyramiding – static analysis

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- ❑ 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
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## Pyramiding– dynamic analysis

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- ❑ 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
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## Tax Collected in Supply Chain is Considerable Share of Total Sales Tax

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- 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.
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## What's the problem with pyramiding?

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- ❑ 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
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## Why do business purchases remain in tax base?

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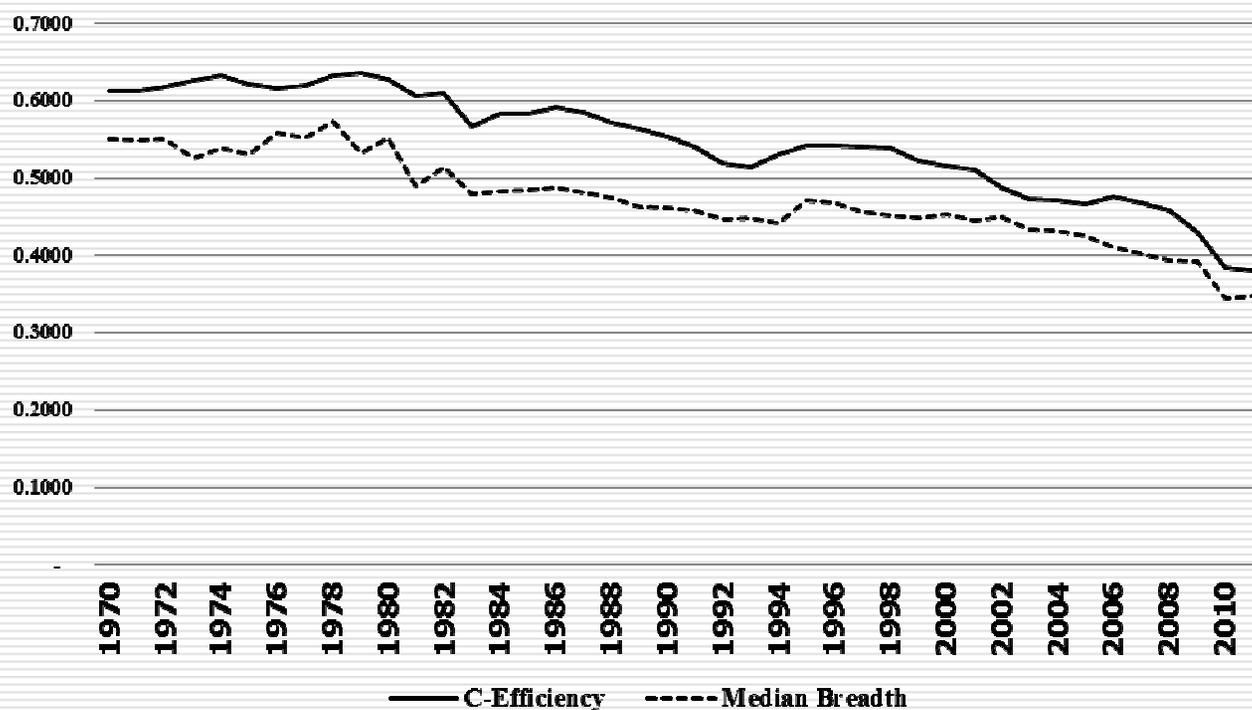
- ❑ Revenue from sales tax paid by businesses = 20 % of all state – local tax paid by businesses
  - ❑ Some politicians like to hide taxes
  - ❑ Lawmakers like to behave like Soviet planners – dole out selective tax benefits. “good businesses v. bad businesses”
  - ❑ Exemption looks like tax break for business – look at tax expenditure budget...
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## Issue 2: The Disappearing Base

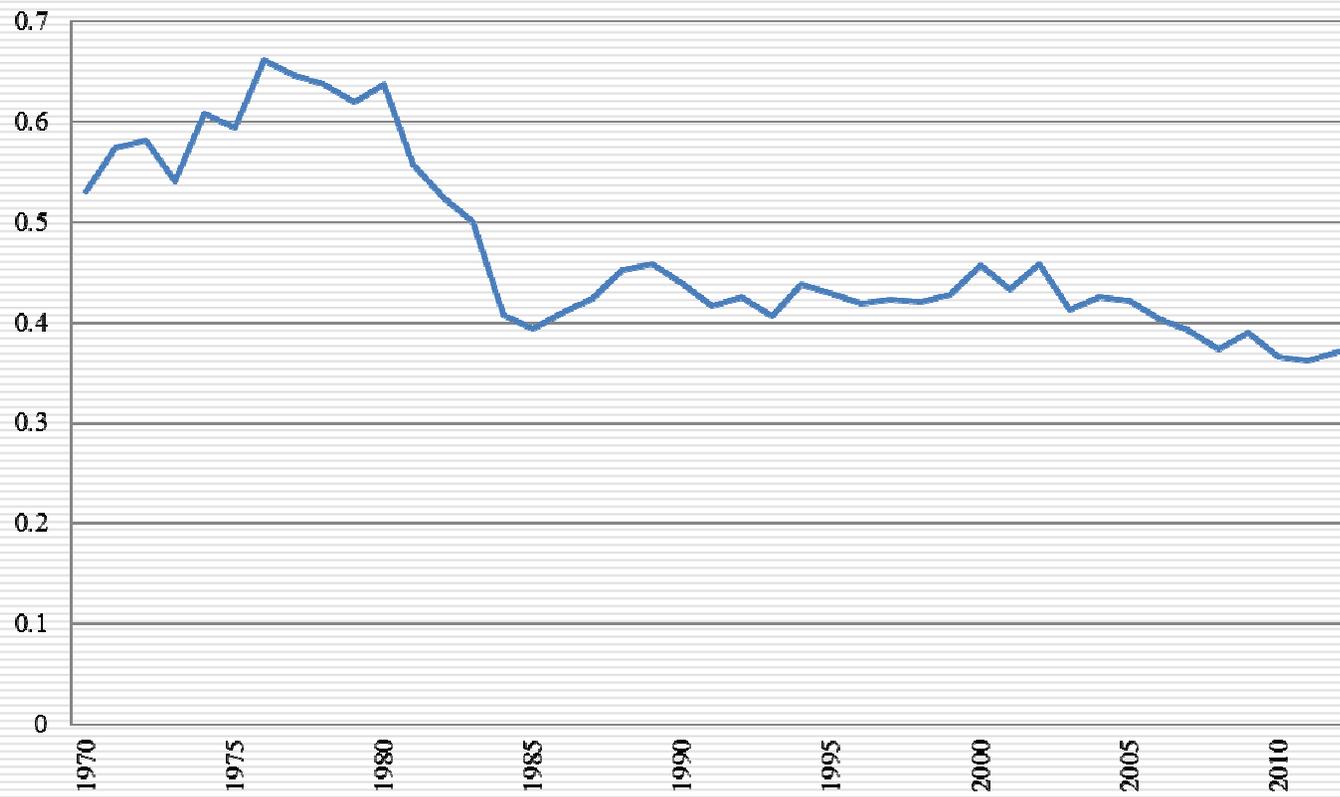
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- Sales tax base in secular decline
  
  - Five graphs:
    - National phenomenon: Exhibit 4
  
    - Nebraska phenomenon: Exhibit 5
  
    - National Consumption and Services Share: Exhibit 6
  
    - National Share – Health Care: Exhibit 7
  
    - National – Untaxed Services Share: Exhibit 8
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**Exhibit 4. National Sales Tax Base Is Narrowing: C-Efficiency and Median Breadth, 1970 - 2011**

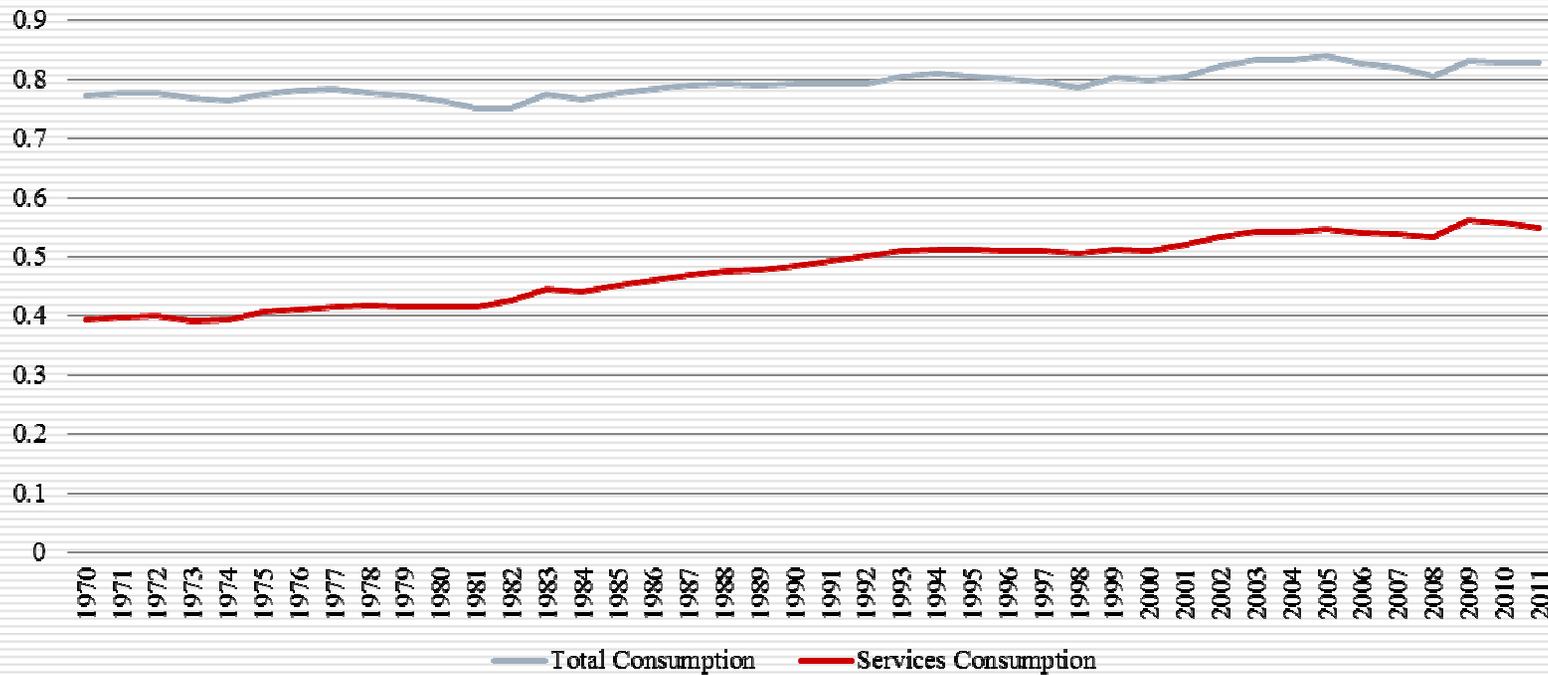


**Exhibit 5. Nebraska's Disappearing Sales Tax Base (Base / Personal Income)**



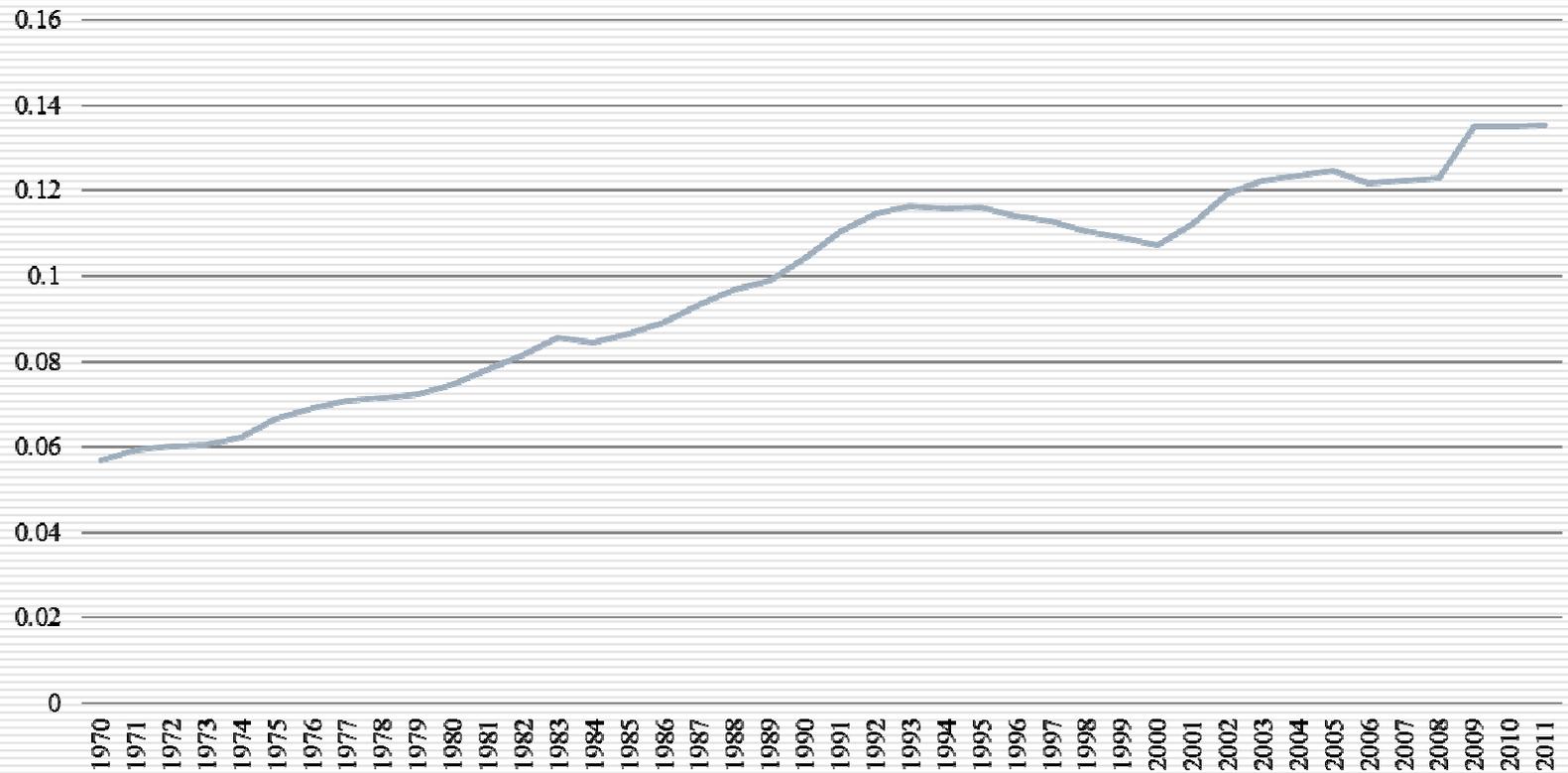
# Consumption Share of Personal Income Relatively Stable, Services Share Has Increased Considerably

Exhibit 6 . Total Consumption and Services Consumption as Share of Personal Income, 1970 - 2011



# Health Care is significant factor in increase in services share

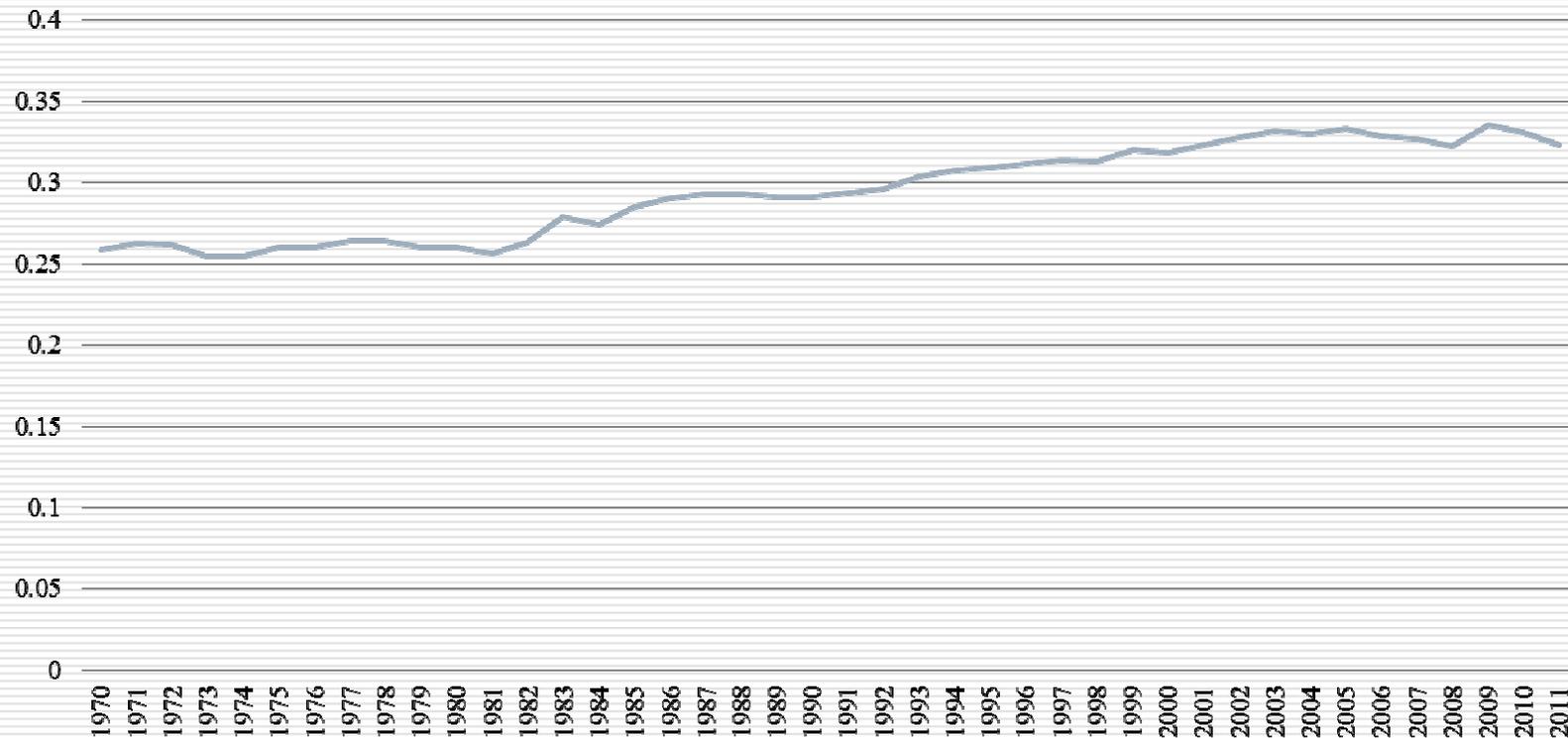
**Exhibit 7. Health Care Services as Share of Personal Income, 1970 - 2011**



# But Share from Other Services Has Increased As Well

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**Exhibit 8. Adjusted Services Share of Personal Income, 1970 - 2011**



## Household Services and the Base

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- ❑ Base disappearance closely related to absence of services from base
  - ❑ Services are part of consumption expenditure
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## Why Tax Service Purchases?

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

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- 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)
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