

State and Local Retail Sales Taxes

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1. Purpose

- 1.1. The purpose of this outline is to provide an overview of state and local retail sales and use taxes in the U.S. and their administration.
- 1.2. It examines such issues as the use of the tax among states and localities, general characteristics of the state tax base, tax rates, and common tax policy criticisms of the tax.

2. Prevalence of the Tax at the State and Local Level

- 2.1. Forty-five states and the District of Columbia impose a broad-based general retail sales and use tax at the state level.¹ Those states not levying the tax include Alaska, Delaware, Montana, New Hampshire, and Oregon.²
- 2.2. In FY 2003, states collected about \$185 billion in general retail sales taxes, about 37 percent of total state general tax collections of roughly \$497 billion.³
- 2.3. Local governments in 34 states also impose a sales tax.⁴ In all but four states, local taxes are imposed as an add-on to the state tax and are collected and administered by the state tax administration agency.⁵ In addition, local tax bases as a general matter conform to the state sales tax base. In some states, the local tax is levied in all jurisdictions of a certain type, but the norm is to allow a “local option” tax in which a locality (or certain types of localities) can choose whether or not to impose a tax. This results in quite a patchwork of sales tax utilization and sales tax rates. Approximately 7,500 separate local jurisdictions impose a sales tax in the U.S.

¹ From this point forward, D.C. is treated as a state since its retail sales tax operates identical to those of the other states.

² A number of Alaska local governments are authorized to, and do, impose a sales tax. In addition, Delaware imposes a low-rate gross receipts tax and New Hampshire imposes excise taxes (that operate like sales taxes) on transient lodging, certain restaurant meals and a broad range of communications services.

³ Data from U.S. Bureau of Census. Total tax figure does not include “License Taxes” as categorized by the Census Bureau. For comparison purposes, individual income taxes (\$181 billion) account for 36.6 percent of total taxes, and corporate taxes account for 5.7 percent.

⁴ Those states in which localities do not levy a sales tax include Hawaii, Indiana, Kentucky, Maine, Maryland, Massachusetts, Michigan, New Jersey, Rhode Island, and West Virginia.

⁵ In Alabama, Arizona, Colorado and Louisiana, some local governments are authorized to administer their own sales tax. In these states, there is also somewhat more divergence between the state and local tax base.

- 2.4. For the large part, local sales taxes are levied by general purpose local governments (cities and counties) as opposed to special purpose districts such as school districts. The use of sales taxes for certain special purposes (e.g., transit) is becoming more common.
- 2.5. In FY 2002, general local sales accounted for \$43.3 billion in revenue out of a total of \$369.7 billion in local tax receipts (11.7 percent)⁶

3. State and Local Tax Bases

- 3.1. **Exemptions from the Base.** State and local sales taxes have three types of exemptions: (a) Product-based exemptions in which a product or service is exempt regardless of who purchases it or for what purpose;⁷ (b) Use-based exemptions in which the exemption is dependent on the use to which it is to be put; (For example, a product purchased to be used in producing a subsequent product to be sold at retail may be exempt, but it would not be if purchased for final consumption.); and (c) Entity-based exemptions in which all or certain purchases by particular types of entities (e.g., schools, charities) are exempt.
 - 3.1.1. States vary widely in their exemption practices, but all of them have a variety of exemptions aimed at eliminating the tax on intermediate or wholesale transactions and imposing the tax only on final consumption, e.g., exemptions of sales for resale, ingredient and component parts and the like. Still, states apply their taxes to a wide range of business inputs and intermediate goods, particularly in the service sector where few services are taxed on final consumption. See discussion below.
 - 3.1.2. The most common product-based exemptions are aimed at excluding the tax on what are considered items of necessity, e.g., food for home consumption and prescription drugs. As shown in Table I, every sales tax state exempts prescription drugs from the tax, and about thirty states exempt (or are phasing in an exemption) food for home consumption from the tax. Several others subject food to a rate that is lower than the general sales tax rate.
- 3.2. **Taxation of Services.** State sales and use taxes came into prominence in the Great Depression. More than half of state sales taxes were enacted during the 1930s.⁸ Since the economy was largely one of trade in tangible goods at that time and there was an aversion to imposing tax on personal labor services, most sales taxes were originally applied only to sales of tangible personal property and not services.
 - 3.2.1. Despite the significant change in the U.S. economy and the increasing proportion of economic output that is attributable to services, states have not, for the large part, extended the reach of the tax to services. Only three states – Hawaii, New Mexico and South Dakota – impose their tax generally on transactions involving services.

⁶ Data from the U.S. Bureau of the Census. Property taxes, by contrast, accounted for over 70 percent of all local tax revenue.

⁷ State and local sales taxes are generally imposed on all sales of tangible personal property unless specifically exempted, but only on specifically enumerated service transactions. Thus, most services would be deemed to be excluded, rather than exempted, from the tax. See further discussion below.

⁸ A second wave of adoptions occurred after World War II as state governments expanded their activities. There were also several adopted in the 1960s as states expanded their financing of elementary and secondary education.

- 3.2.2. Another group of about 10 states impose their tax on a fairly wide range of utility, admissions and amusement and labor repair services (when applied to tangible personal property.) These states, however, tend not to impose the tax on professional services (e.g., lawyers, accountants or medical), and they exhibit a mixed pattern in terms of applying the tax to other business and personal services.
- 3.2.3. At the other end of the spectrum, there are a number of states that impose the tax on few, if any, services including utilities, admissions or labor services. In a 1996 survey, there were 16 states that taxed fewer than 30 services from a list of over 160 specific services. Fewer than one-half of the states impose the tax widely on labor and repair services.⁹
- 3.2.4. States have encountered a variety of political, economic and administrative obstacles when they have attempted to extend the sales tax to services. Massachusetts and Florida undertook such efforts in 1990 and 1987, respectively, and repealed the enactments within six months of the time they were passed. Among the reasons for repeal (that also influenced decisions in other states) were extreme opposition among providers of some services being subjected to tax, concern about the taxation of business inputs, and difficulties in effectively and efficiently sourcing transactions where services are provided or consumed on a multistate basis.

3.3. **Breadth of Sales Tax Bases.** States vary widely in terms of the breadth of their sales tax base. Factors contributing to differences across states include the exemption of various household goods such as food, clothing and drugs, treatment of service transactions and the treatment of various business inputs.

- 3.3.1. One recent study found that the implicit state sales tax base (calculated from actual collections) when expressed as a percentage of state personal income ranged from 109 percent in Hawaii (that taxes services and has heavy tourist purchases) to 24.8 percent in Illinois. The median implicit tax base expressed relative to personal income was 43.3 percent.¹⁰
- 3.3.2. There is a fairly strong regional pattern to the breadth of state sales tax bases (and reliance on the tax). States in the Northeast and Mid-Atlantic states rely relatively less on the tax, while those in the Plains, Mountain and Western states rely relatively more heavily on the tax.¹¹

⁹ All data regarding the taxation of services is taken from "Sales Taxation of Services: 1996 Update," Research Report No. 147, published by the Federation of Tax Administrators in April 1997. The survey is currently being updated to 2004 and will be available by June 2005. The details may vary, but the general conclusions remain the same as in the earlier work. The 1996 report is available at <http://www.taxadmin.org/fta/pub/services/services.html>.

¹⁰ John Mikesell, "States of Mind: State Retail Sales Tax Burdens, Reliance and Breadth in Fiscal 2003," State Tax Notes, July 12, 2004, pp. 126-131.

¹¹ *Ibid.* See also, John Mikesell, "States of Mind: A Quality Index for States Sales Tax Structure – Measuring the States Against an Ideal Standard," State Tax Notes, Jan. 26, 2005, pp. 129-136.

4. State and Local Sales Tax Rates

- 4.1. As shown in Table I, state sales tax rates range from a low of 4 percent in several states to a high of 7 percent in Mississippi, Rhode Island and Tennessee. The median rate is 5.75 percent.
- 4.2. Local sales tax rates vary rather widely among the states, but generally fall within a range of 1.0-3.0 percent. As shown in Table II, however, the maximum local rate can exceed that level significantly. The highest maximum combined state and local rate exceeds 8 percent in 16 states; it is greater than 10 percent in 5 states.
- 4.3. The weighted average current state and local sales tax rate in the U.S. is estimated at 6.5 percent.¹²

5. Criticisms of State and Local Retail Sales Taxes

- 5.1. State and local sales taxes as they exist today are generally subjected to three criticisms on tax policy grounds when compared to the normative standard for broad-based consumption taxes. First, the ideal consumption tax would tax all (or nearly all) household consumption which current sales taxes do not. Second, the ideal consumption tax would not tax purchases by business, another area in which current sales taxes fall short. Finally, as a result of these shortcomings and for other reasons, the tax is administratively complex, particularly for a seller operating in multiple states.¹³
- 5.2. **Household Consumption.** As noted, most states do not impose the sales tax on a wide range of service transactions when purchased by households. In addition, a number of states have exempted a variety of “household necessities” from the sales tax as a means of improving the vertical equity of the tax. The consequence of this approach is to make tax rates higher than they would otherwise be and to introduce some distortions into household decisions as untaxed purchases may be preferred over taxed items. In addition, the pattern of exclusions and exemptions introduces administrative complexity for both taxpayers (sellers collecting the tax) and tax administration agencies. The exclusions and exemptions make it necessary to determine whether all or a portion of a transaction is taxable or not and to make judgments as to how tax should be applied to mixed transactions, among other matters.
- 5.3. **Business Purchases.** The ideal consumption tax would not impose tax on business purchases and would instead tax all final household consumption. States deviate from this norm in that they tax many business purchases when the business is the final consumer of the product or service and it is not being incorporated into another product or service that will be sold at retail or used for another exempt purpose. For example, purchases of paper, computers and desks by lawyers, accountants and other businesses

¹² See, Donald Bruce and William F. Fox, “State and Local Sales Tax Revenue Losses from E-Commerce: Estimates as of July 2004,” University of Tennessee, Center for Business and Economic Research, July 2004, p. 4.

¹³ For a more complete description, see either of the Mikesell articles cited earlier. Also, Charles McLure has written widely and well on this topic. See, for example, Charles E. McLure, Jr., “How – and How Not – to Tax Business,” State Tax Notes, April 4, 2005, pp. 29-34.

would be taxable, but the flour, eggs and other ingredients used in making bread would not. The lines are not always easily drawn.

- 5.3.1. Taxation of business inputs leads to a pyramiding of the sales tax which, in turn, decreases the ability to control the actual incidence of the tax. It can also discriminate against smaller firms that cannot provide taxable services on an “in house” basis. Determining which transactions are taxable and which are not also introduces complexity for all parties.
- 5.3.2. Estimates are that taxation of business purchases accounts for about 43 percent of all state sale tax collections on average.¹⁴
- 5.4. **Other Complexities.** Beyond the administrative complexities driven by the above, much of the remaining complexity derives from the existence of multiple sales tax regimes, the large number of local taxing jurisdictions, and certain restrictions on state taxation.
 - 5.4.1. Each of the 45 states and D.C. administer its sales tax independently of other states.¹⁵ Thus, a retailer is obligated to track laws, file returns and make payments to each state in which it operates. A retailer is also subject to potential audit by each state in which it does business.
 - 5.4.2. The existence of 46 sales tax regimes adds complexity for multistate sellers in that the procedures, rules, tax bases and tax rates vary from state-to-state, but the seller is liable for knowledge of the practice in all states.
 - 5.4.3. The existence of over 7,500 localities that impose tax also creates issues for sellers delivering goods into or performing taxable services in multiple local jurisdictions. A seller is responsible for determining the appropriate jurisdiction to which a sale should be sourced and for determining the appropriate tax rate in each jurisdiction.
 - 5.4.4. The U.S. Supreme Court has ruled that states may not require a seller that does not have a physical presence in a state (by virtue of its own activities or those of a representative) to collect tax on goods and services sold into a state. This adds another layer of complexity in that it becomes necessary to determine who is liable for collection in a state.
 - 5.4.5. For the past five years, states have worked with the business community through the Streamlined Sales Tax Project to develop ways that the administration of state and local sales taxes can be simplified and much of this complexity eliminated.¹⁶ The project is intended to reduce complexity for sellers as well as to persuade

¹⁴ Robert Cline, John Mikesell et al., “Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services,” Published by the Council on State Taxation, Washington, D.C., January 25, 2005.

¹⁵ The Multistate Tax Commission to performs joint audits as a service to a number of states. The joint audits supplement the regular state audit staff.

¹⁶ For a complete discussion, see Walter Hellerstein and John A. Swain, “Streamlined Sales and Use Tax,” Research Institute of American, 2004.

Congress to authorize states to require those sellers that do not have a collection responsibility under current law to collect on goods and services sold into a state.

6. Observations on a National Sales Tax

- 6.1. Some of the criticisms and complexities associated with state and local sales taxes would not be relevant to a national sales tax (e.g., multiple regimes and conflicting rules.) In addition, others criticisms and complexities could be overcome with the proper design of a national-level consumption tax, particularly the proper designation of the tax base.
- 6.2. Still, there are certain lessons that can be drawn from the state experience. Primary among these is that each instance in which the base deviates from taxing all final consumption at a single rate will introduce complexity (for sellers and the tax agency) as well as present opportunities and incentives for noncompliance. Put simply, someone has to decide what qualifies for the preferred treatment and people will try to take advantage of the preferred treatment.
- 6.3. Issues of compliance will not be inconsequential in a national sales tax. States devote substantial audit and collection resources to state sales tax administration, and the same will be necessary at the national level. Exempting business purchases (while the right policy) will introduce substantial compliance issues as will the mere fact that there will be a large number of sellers responsible for collecting tax and remitting it to the government.
- 6.4. There are a number of areas in which the coordination of federal and state activities in the administration of a sales tax (or other consumption tax) could be explored. The degree to which they can be coordinated will likely be dependent on the degree of similarity between the federal and state consumption tax bases.¹⁷

7. Conclusion

- 7.1. Despite some sizeable policy flaws and substantial complexity, the retail sales tax has been a workhorse in the state and local tax system for nearly 75 years. It was the single largest source of state tax revenue in 2004 and is often seen as the most widely accepted tax by the general public.
- 7.2. The state experience could be instructive in designing a potential federal consumption tax.

¹⁷ The Federation, along with several other organizations, is sponsoring a forum to examine the implications of federal tax reform for state tax systems on May 18 in Washington, D.C. As part of that effort, we have commissioned several papers that will look at various federal reforms and what they might mean for states and for coordination of federal and state tax administration.

Table I
STATE SALES TAX RATES
AND FOOD & DRUG EXEMPTIONS
(As of January 1, 2005)

STATE	Tax Rate (percentage)	EXEMPTIONS		
		Food (1)	Prescription Drugs	Nonprescription Drugs
ALABAMA	4		*	
ALASKA	none			
ARIZONA	5.6	*	*	
ARKANSAS	6		*	
CALIFORNIA (3)	7.25 (2)	*	*	
COLORADO	2.9	*	*	
CONNECTICUT	6	*	*	*
DELAWARE	none			
FLORIDA	6	*	*	*
GEORGIA	4	*	*	
HAWAII	4		*	
IDAHO	6		*	
ILLINOIS	6.25	1%	1%	1%
INDIANA	6	*	*	
IOWA	5	*	*	
KANSAS (6)	5.3		*	
KENTUCKY	6	*	*	
LOUISIANA	4	* (4)	*	
MAINE	5	*	*	
MARYLAND	5	*	*	*
MASSACHUSETTS	5	*	*	
MICHIGAN	6	*	*	
MINNESOTA	6.5	*	*	*
MISSISSIPPI	7		*	
MISSOURI	4.225	1.225	*	
MONTANA	none			
NEBRASKA	5.5	*	*	
NEVADA	6.5	*	*	
NEW HAMPSHIRE	none			
NEW JERSEY	6	*	*	*
NEW MEXICO	5	*	*	
NEW YORK	4.25	*	*	*
NORTH CAROLINA	4.5	* (4)	*	
NORTH DAKOTA	5	*	*	
OHIO	6	*	*	
OKLAHOMA	4.5		*	
OREGON	none			
PENNSYLVANIA	6	*	*	*
RHODE ISLAND	7	*	*	*
SOUTH CAROLINA	5		*	
SOUTH DAKOTA	4		*	
TENNESSEE	7	6%	*	
TEXAS	6.25	*	*	*
UTAH	4.75		*	
VERMONT	6	*	*	*
VIRGINIA	5.0 (2)	4.0% (5)	*	*
WASHINGTON	6.5	*	*	
WEST VIRGINIA	6		*	
WISCONSIN	5	*	*	
WYOMING	4		*	
DIST. OF COLUMBIA	5.75	*	*	*

* -- indicates exempt from tax, blank indicates subject to general sales tax rate.

Source: Compiled by FTA from various sources.

(1) Some state tax food, but allow an (income) tax credit to compensate poor households.
They are: ID, KS, SD, VT, and WY.

(2) Includes statewide local tax of 1.25% in California and 1.0% in Virginia .

(3) Tax rate may be adjusted annually according to a formula based on balances in the unappropriated general fund and the school foundation fund.

(4) Food sales are subject to local sales taxes.

(5) Tax rate on food is scheduled to decrease to 3.5% on 7/1/05. Statewide local tax is included.

Table II
Comparison of State and Local Retail Sales Taxes

January, 2004

	Food Items [1]	State	Maximum	Maximum
	Taxable (T)	Rate	Local	State/Local
	Exempt (E)		Rate [2]	Rate [2]
Alabama	T	4.00	7.00	11.00
Alaska	T	0.00	7.00 [3]	7.00
Arizona	E	5.60	4.50	10.10
Arkansas	T	5.125	5.500	10.625
California	E	6.00	2.75	8.75
Colorado	E	2.90	7.00	9.90
Connecticut	E	6.00	---	6.00
District of Columbia	E	5.75	---	5.75
Florida	E	6.00	1.50	7.50
Georgia	E	4.00	3.00	7.00
Hawaii	T *	4.00	---	4.00
Idaho	T *	6.00	3.00	9.00
Illinois	T **	6.25	3.00	9.25
Indiana	E	6.00	---	6.00
Iowa	E	5.00	2.00	7.00
Kansas	T *	5.30	3.00	8.30
Kentucky	E	6.00	---	6.00
Louisiana	E [4]	4.00	6.25	10.25
Maine	E	5.00	---	5.00
Maryland	E	5.00	---	5.00
Massachusetts	E	5.00	---	5.00
Michigan	E	6.00	---	6.00
Minnesota	E	6.50	1.00	7.50
Mississippi	T	7.00	0.25	7.25
Missouri	T	4.225	4.125	8.350
Nebraska	E	5.50	1.50	7.00
Nevada	E	6.50	1.00	7.50
New Jersey	E	6.00	---	6.00
New Mexico	T	5.00	2.25	7.25
New York	E	4.25	4.50	8.75
North Carolina	E [4]	4.50	3.00	7.50
North Dakota	E	5.00	2.50	7.50
Ohio	E	6.00	2.00	8.00
Oklahoma	T	4.50	6.00	10.50
Pennsylvania	E	6.00	1.00	7.00
Rhode Island	E	7.00	---	7.00
South Carolina	T **	5.00	2.00	7.00
South Dakota	T *	4.00	2.00	6.00
Tennessee	T	7.00	2.75	9.75
Texas	E	6.25	2.00	8.25
Utah	T	4.75	2.25	7.00
Vermont	E	6.00	1.00	7.00
Virginia	T **	3.50	1.00	4.50
Washington	E	6.50	2.40	8.90
West Virginia	T	6.00	---	6.00
Wisconsin	E	5.00	1.00	6.00
Wyoming	T *	4.00	2.00	6.00

[1] Food purchased for consumption off-premises.

[2] Highest local rate known to be actually levied by at least one jurisdiction. Includes local taxes for general purposes and those earmarked for specific purposes (e.g. transit). Taxes applying only to specified sales (e.g. lodging or meals) are excluded.

[3] Alaskan cities and boroughs may levy local sales taxes from 1% to 7%.

[4] Food exempt from state tax, but subject to local taxes.

** Food taxed at lower rate.

* Income tax credit allowed to offset sales tax on food.

Source: Compiled by the Federation of Tax Administrators from various sources.