Chapter Nine
National Retail Sales Tax

The Panel considered a number of proposals to reform the income tax, including replacing the entire income tax system with a broad-based national retail sales tax. A retail sales tax is perhaps the most obvious form of consumption tax because it is imposed on the final sales of goods and services to consumers. Like other consumption taxes, the retail sales tax does not tax normal returns to saving and investment and thus may lead to greater economic growth than our current tax system.

After careful evaluation, the Panel decided to reject a complete replacement of the federal income tax system with a retail sales tax for a number of reasons. Two considerations were particularly important to the Panel's decision:

- Replacing the income tax with a retail sales tax, absent a way to ease the burden of the retail sales tax on lower and middle-income Americans, would not meet the requirement in the Executive Order that the Panel's options be appropriately progressive.

- Although a program could be designed to reduce the burden of a retail sales tax on lower-income and middle-income taxpayers by providing cash grants, such cash grants would represent a new entitlement program – by far the largest in American history. Adjusting the distribution of the burden of the retail sales tax through a cash grant program would cost approximately $600 billion to $780 billion per year and make most American families dependent on monthly checks from the federal government for a substantial portion of their incomes. The Panel concluded that such a cash grant program would inappropriately increase the size and scope of government.

The Panel also had additional concerns with replacing the current tax system with a retail sales tax:

- Even with favorable assumptions, a retail sales tax on a broad base with a cash grant program would require a tax rate of at least 34 percent, and likely higher over time if the base erodes, creating incentives for significant tax evasion. A discussion of the range of potential estimates of the tax rate is provided later in this chapter.
- The federal administrative burden for a retail sales tax may be similar to the burden under the current system. A federal agency, such as the IRS, would be required to administer the tax in order to ensure adequate collection of federal revenues and uniform enforcement of the rules and regulations underlying the tax. Indeed, two types of administrations would be required – one to collect the tax and another to keep track of the personal information that would be necessary to determine the size of the taxpayer's cash grant.
- Taxpayers likely would continue to file state income tax returns, which would limit the potential simplification gains from replacing the federal income tax system with a retail sales tax.

Box 9.1. Comparing "Tax-Exclusive" and "Tax-Inclusive" Rates

The 34 percent tax rate mentioned in the introduction to this chapter is a tax-exclusive rate. Sales tax rates are typically quoted on a tax-exclusive basis, while income tax rates typically are quoted on a tax-inclusive basis. If a good costs $100 and bears an additional $34 sales tax, the tax-exclusive sales tax rate is 34 percent. The tax-inclusive rate is 25 percent – $34 (the tax paid) divided by $134 (the total amount the consumer paid). An individual who earns $134 and pays $34 in income taxes would think of themselves as paying approximately 25 percent ($34/$134 = 0.254) of their income in taxes.

Although tax-exclusive and tax-inclusive rates are both valid ways of thinking about tax rates, the easiest way to compare the retail sales tax rate to the state sales taxes paid by most Americans is to consider the tax-exclusive rate. On the other hand, it is appropriate to compare the retail sales tax rate with current income tax rates by utilizing the tax-inclusive rate. For ease of understanding, this chapter uses tax-exclusive rates unless otherwise specified in the text. Tax-inclusive rates are provided in the Appendix.

As explained in Chapter Three, the retail sales tax and the VAT represent similar ways to tax consumption of goods and services. A VAT and a retail sales tax that share the same tax base, tax rate, and compliance rates would generate the same amount of tax revenue. The Panel, therefore, analyzed a full replacement VAT at the same time it considered a full replacement retail sales tax. Although the Panel concluded that the full replacement VAT might mitigate some of the compliance challenges encountered with a retail sales tax, the Panel's primary objections to a retail sales tax applied equally to a full replacement VAT. As a result, the Panel does not recommend the full replacement VAT as a tax reform option.

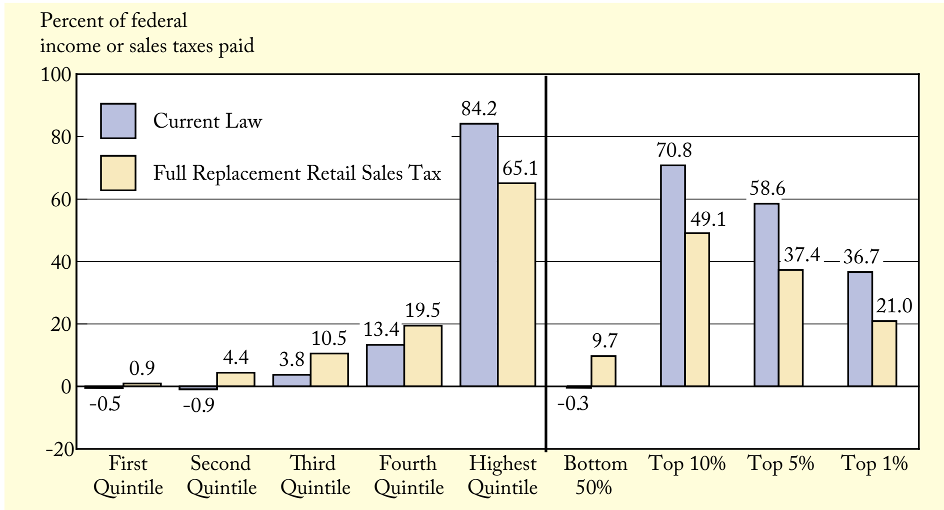
Retail Sales Tax with No Cash Grant

Forty-five states and the District of Columbia currently have retail sales taxes. Many states use multiple sales tax rates and exempt many goods and services from tax. The Panel, however, considered a single-rate tax that would be imposed on a broad tax base because such a tax would be simpler to administer and create fewer economic distortions. The Panel's broad tax base would apply to sales of goods and services to consumers, but, to prevent multiple taxation or "cascading," it would not apply to purchases of goods or services by business that are used to produce other goods or services for sale to households.

The Panel initially evaluated the federal retail sales tax using the broad tax base described by advocates of the "FairTax" retail sales tax proposal. That tax base (the "Extended Base") would exempt only educational services, expenditures abroad by U.S. residents, food produced and consumed on farms, and existing housing (or what economists refer to as the imputed rent on owner-occupied and farm housing). The long-term likelihood of maintaining this broad tax base is addressed later in this chapter.

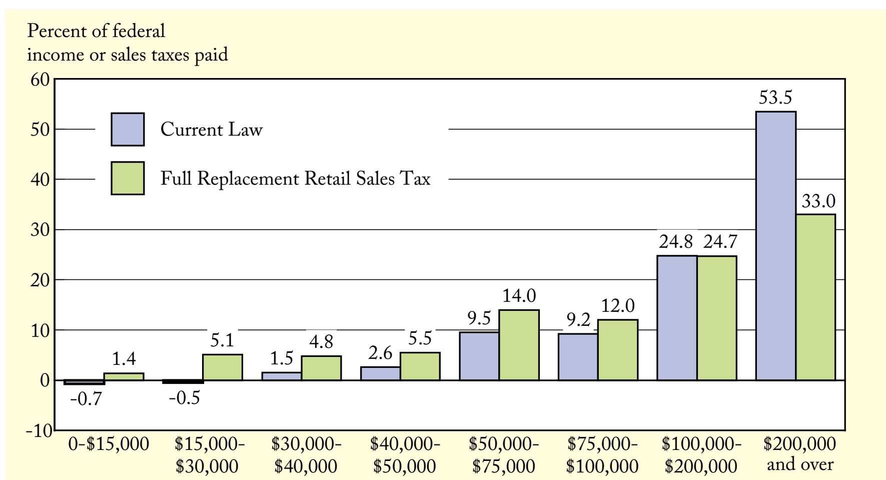
Using the Extended Base and assuming low rates of evasion, the Treasury Department calculated that the tax rate required to replace the federal income tax with a retail sales tax would be 22 percent on a tax-exclusive basis. This tax rate, however, does not include a program designed to ease the burden of the tax on lower-income Americans. Moreover, unless the states repealed their existing sales taxes, most consumers would pay both federal and state sales tax on many goods. The weighted average state and local sales tax rate is approximately 6.5 percent on a tax-exclusive basis. Thus, for sales subject to both federal retail sales tax and state and local sales taxes, the weighted average combined tax-exclusive sales tax rate would be approximately 28.5 percent.

Figure 9.1. Distribution of Federal Tax Burden Under Current Law and the Full Replacement Retail Sales Tax Proposal without Prebate by Income Percentile (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $45,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907. Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 9.2. Distribution of Federal Income Tax Burden Under Current Law and the Full Replacement Retail Sales Tax Proposal without Prebate by Income Level (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

Figures 9.1 and 9.2 compare the current distribution of federal taxes paid with the distribution that would exist under a "stand-alone" retail sales tax at a 22 percent tax rate. Adopting this retail sales tax would impose a larger tax burden on lower-income households than the current system because a retail sales tax is imposed directly on consumption and does not provide deductions, exemptions, or credits to reduce the tax burden on lower-income Americans. Replacing the current income tax with a stand-alone retail sales tax would increase the tax burden on the lower 80 percent of American families, as ranked by cash income, by approximately $250 billion per year. Such families would pay 34.9 percent of all federal retail sales taxes, more than double the 15.8 percent of federal income taxes they pay today. The top 20 percent of American taxpayers would see their tax burden fall by approximately $250 billion per year. Such families would pay 65.1 percent of all federal retail sales taxes, compared to the 84.2 percent of federal income taxes they pay today.

Lower- and middle-income families would be especially hard hit by a stand alone retail sales tax. For example, the Treasury Department estimates that a hypothetical single mother with one child making $20,000 per year currently pays $723 in total federal taxes (including both the employee and employer shares of the Social Security and Medicare taxes). Under the stand-alone retail sales tax, her tax bill would go up to $6,186 – a tax increase of over 750 percent. A hypothetical married couple with two children making $40,000 per year would pay an additional $6,553 in taxes, an increase of more than 110 percent of total federal tax liability. In contrast, a hypothetical married couple with two children and $300,000 of income currently pays about $89,000 in total federal taxes. Under the stand-alone retail sales tax, this hypothetical family would pay about $72,000, a tax cut of 19 percent. Further discussion of the Treasury Department's hypothetical taxpayer analysis appears in the Appendix.

The Panel concluded that the distribution of the tax burden under a stand-alone retail sales tax would not meet the requirement in the Executive Order that the Panel's tax reform options be appropriately progressive.

Retail Sales Tax with a Cash Grant Program

Universal Cash Grant Program

Retail sales tax proposals generally recognize the distributional effects of a stand-alone retail sales tax. For this reason, such proposals usually include a cash grant program to relieve the burden of the retail sales tax on lower and middle-income families.

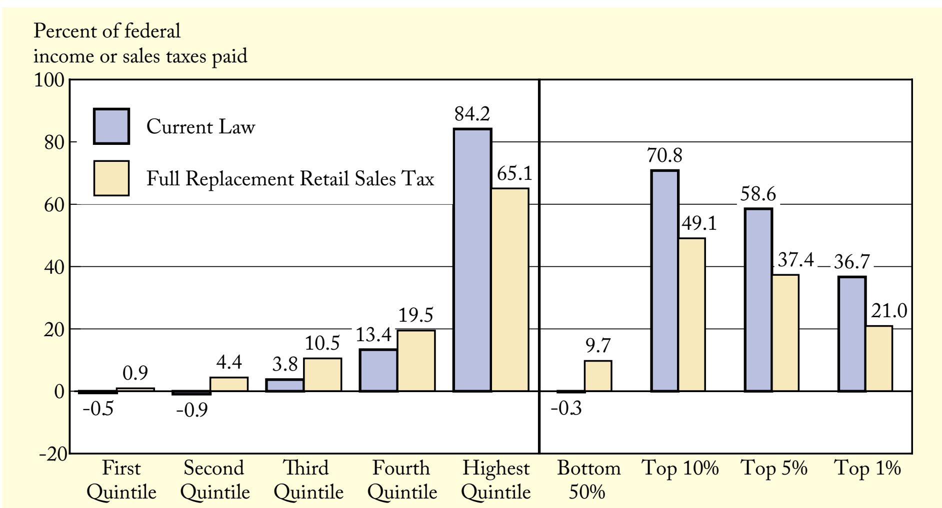
The Panel considered the cash grant program advocated by proponents of the FairTax. This program (sometimes called a "Prebate") would provide a monthly monetary grant to all U.S. citizens and residents. The goal of the program would be to provide families with cash sufficient to pay retail sales tax on all their spending up to the poverty level. The program would not be income based so there would be no need to have a federal agency to keep track of personal income. Nevertheless, it would require a federal agency to keep track of family characteristics, such as family size, on which the cash grant would be based.

This cash grant program would be expensive, and would require raising the retail sales tax rate. To pay for the cash grant program and remain revenue-neutral, the required tax rate, assuming evasion rates somewhat lower than those under the income tax, would be 34 percent. Using a higher evasion rate assumption, discussed further below, the tax rate would be 49 percent. If a narrower tax base were used instead of the Extended Base, the tax rate would be even higher.

How would the cash grant program work? The federal government would be required to send monthly checks to every family in America, regardless of their income level. If the tax rate was 34 percent and the before-tax poverty level for an individual was $10,000, all single individuals would receive $3,400 a year from the government. The cash grant would also be adjusted for marital status and family size. For married couples with two children, the cash grant amount in 2006 would be $6,694 per year.

The Prebate-type program would cost approximately $600 billion in 2006 alone. This amount is equivalent to 23 percent of projected total federal government spending and 42 percent of projected total federal entitlement program spending, exceeding the size of Social Security, Medicare, and Medicaid. The Prebate program would cost more than all budgeted spending in 2006 on the Departments of Agriculture, Commerce, Defense, Education, Energy, Homeland Security, Housing and Urban Development, and Interior combined.

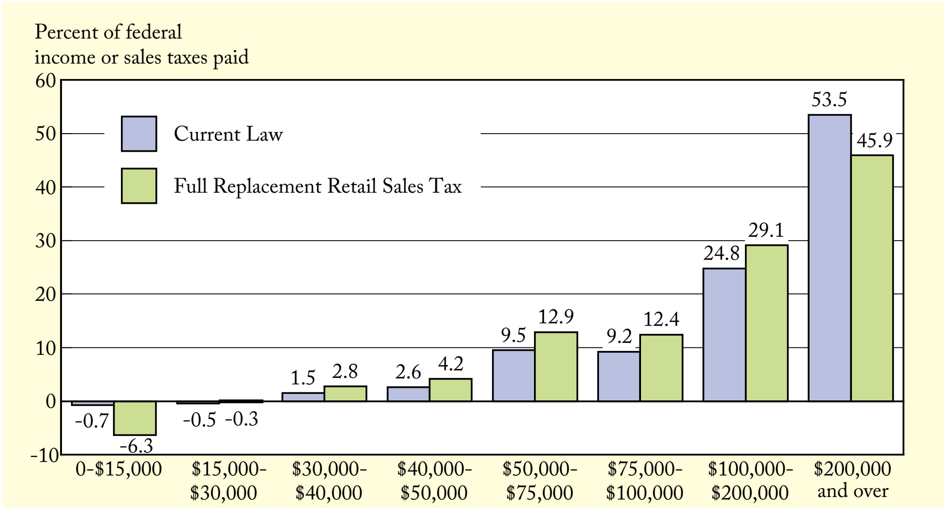
Figure 9.3. Distribution of Federal Tax Burden Under Current Law and the Full Replacement Retail Sales Tax Proposal with Prebate by Income Percentile (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461 Fourth $45,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907; Bottom 50% below $36,738.

Source: Department of the Treasury, Office of Tax Analysis.

Figure 9.4. Distribution of Federal Income Tax Burden Under Current Law and the Full Replacement Retail Sales Tax Proposal with Prebate by Income Level (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

Figures 9.3 and 9.4 show that low-income and high-income Americans would benefit from the retail sales tax with a Prebate, while middle-income Americans would pay a larger share of the federal tax burden. Separate figures with distributional estimates for 2015 law are not provided because the distribution of the retail sales tax burden in these estimates was identical to the distribution shown in Figures 9.3 and 9.4. American families with the lowest 20 percent of cash incomes currently pay negative 0.5 percent of total federal income taxes because the tax credits they claim exceed their total positive tax liability. Under the retail sales tax with a Prebate, this group would pay negative 5.6 percent of the federal sales tax burden because the amount they would receive in monthly checks from the government would exceed what they would pay in retail sales tax at the cash register. In total, the bottom quintile would bear 5.1 percentage points less of the tax burden. Families with the top 10 percent of cash incomes would also benefit substantially from the retail sales tax. Their share of the tax burden would fall by 5.3 percentage points – from 70.8 percent to 65.5 percent.

Middle-income Americans, however, would bear more of the federal tax burden under the retail sales tax with a Prebate. The Treasury Department's analysis of hypothetical taxpayers shows that married couples at the bottom 25th percentile, 50th percentile, and 75th percentile of the income distribution for married taxpayers would see substantial tax increases under a full replacement retail sales tax. A typical married couple at the bottom 25th percentile of the income distribution earns $39,300 per year and would pay $5,625 dollars in federal taxes in 2006. Under the retail sales tax with a Prebate, the same family would pay $7,997 in net federal taxes after subtracting the Prebate of $6,694, resulting in a tax increase of $2,372, or 42 percent. A typical married couple at the 50th percentile of the income distribution making $66,200 would pay an additional $4,791, a tax increase of 36 percent, and a typical married couple in the 75th percentile, making $99,600 would pay an additional $6,789, a 29 percent tax increase. A typical single mother at the bottom 25th percentile of the income distribution for head of household taxpayers has $23,100 of income per year and, compared to current law, would pay $5,866 more under the retail sales tax with a Prebate.

Targeted Cash Grant Program

The Panel requested that the Treasury Department develop a more targeted cash subsidy program to alleviate the burden of a retail sales tax on lower- and middle-income American families. The resulting program required a cash grant of up to $7,068 to married couples, plus $2,570 per dependent per year, with a phase-in and a phase-out. Further details regarding the program are provided in the Appendix, as well as a brief discussion of an alternative targeted subsidy program.

The Treasury Department's proposed targeted cash grant program would cost $780 billion in 2006. It would represent 30 percent of total federal government spending, and would dwarf all other federal entitlement programs and exceed the combined size of Social Security and Medicaid. To implement the program, the government would need to collect 34 percent more revenue and redistribute an additional 6 percent of GDP. The Panel concluded that this substantial increase in the amount of revenue collected from taxpayers and redistributed by the federal government was undesirable. Some Panelists were also concerned that the precedent set by the large cash grant program could set the stage for further growth in the size and scope of the federal government. To pay for the targeted cash grant program and remain otherwise revenue-neutral, the tax rate would need to increase to at least 37 percent, assuming low evasion and using the Extended Base.

Administration of a Cash Grant Program Would be Complex

The proposed cash grant programs would require all eligible American families to file paperwork with the IRS or another federal government agency in order to claim their benefits under this new entitlement program. A federal agency would need to manage the program, verify individuals' marital status and number of eligible children, and write checks to every family in the United States. Eligibility rules would be necessary, for example, to ensure that a child claimed as a dependent could not also file for his or her own separate cash grant.

Substantial additional complexity would be imposed by a targeted cash grant program because determining eligibility would require additional information. For example, a program based on annual income would require the IRS or another federal government agency to make many of the same determinations now made under the current income tax.

Evasion, the Tax Base, and the Required Tax Rate Revisited

The tax rate necessary to replace the revenues from the current individual and corporate income taxes is one key consideration in evaluating a retail sales tax. The two major factors that determine the tax rate are the size of the tax base and the level of evasion. The tax rates and rebate program cost estimates presented thus far have been based on relatively optimistic assumptions about the breadth of the tax base and the evasion rate. As explained above, even under these optimistic assumptions, the Panel does not recommend a full replacement sales tax at the resulting 34 percent tax rate.

The Panel also had substantial concerns that a base as broad as assumed above would not be viable and that evasion rates could be higher than under the present income tax. The Panel believed that in evaluating the retail sales tax it was important to consider the tax rate required under less favorable assumptions regarding the tax base and evasion. Accordingly, the Panel requested that the Treasury Department estimate the required retail sales tax rate using the same tax base as the Partial Replacement VAT described in Chapter Eight and using a base equal to the average state sales tax base.

The Partial Replacement VAT base described in Chapter Eight is slightly narrower than the Extended Base – primarily because it excludes the value of state and local government services. The Extended Base would require state and local governments not only to pay retail sales tax on their purchases from businesses, but also to pay tax at the retail sales tax rate to the federal government on the total value of the salaries that state and local governments pay their employees – this would be equivalent to the value of services provided by state and local governments to their citizens. The Panel concluded that it may be inappropriate for the federal government to directly assess a tax of this sort on state and local government in our federal system. For this reason, the Panel excluded state and local government services from the Partial Replacement VAT base discussed in Chapter Eight.

Existing state sales tax bases are substantially narrower than either of the broad bases studied by the Panel. Most states exempt a variety of specific products and many services from their sales taxes. For example, every state sales tax exempts prescription drugs, most states do not tax health care, approximately 30 states exempt food for home consumption or tax it at a preferential rate, and many states exempt clothing. These exemptions are often justified as a means to ease the burden of a sales tax on basic necessities, but are not well targeted because they often decrease the tax burden on higher-income taxpayers as much or more than they decrease the tax burden on lower or middle-income taxpayers. To illustrate the impact of extensive base erosion on a retail sales tax, the Panel requested that the Treasury Department estimate the tax rate using the average state sales tax base. The Panel acknowledges there are structural differences between state tax systems and a federal tax system that would rely on a retail sales tax instead of an individual and corporate income tax, and that these differences would affect the nature of any base erosion. Nevertheless, the Panel believes that estimating the tax rate using a base equal to the average state sales tax base is illustrative of the impact of base erosion on the tax rate.

Table 9.1. shows the Treasury Department's estimates of the tax-exclusive retail sales tax rates required to replace the federal income tax using the alternative assumptions regarding evasion rates and the breadth of the tax base. The Extended Base and Partial Replacement VAT Base estimates include the Prebate-type universal cash grant program (calculated to provide all families with cash sufficient to pay a 34 percent retail sales tax on a poverty level amount of spending). The average state sales tax base estimate includes no cash grant program, because exclusions from the base are assumed to fulfill the burden-easing function of the cash grant. These tax rates should be compared both to each other and to the overall burden an individual faces under both the corporate and individual income tax today. Tax-inclusive rates are provided in the Appendix.

Table 9.1. Retail Sales Tax Rate Estimates – Range of Tax-Exclusive Rates

Evasion Rate	Extended Base	Partial Replacement VAT Base	Median State Sales Tax Base
Low Evasion (15%)	34%	38%	64 %
Higher Evasion (30%)	49%	59%	89%

Source: Department of the Treasury, Office of Tax Analysis.

Box 9.2. Comparing the Treasury Department's Revenue-Neutral Rate Estimate with Estimates Made by Retail Sales Tax Proponents

In their submission to the Panel, proponents of the FairTax claimed that a 30 percent tax exclusive sales tax rate would be sufficient not only to replace the federal income tax, but also to replace all payroll taxes and estate and gift taxes and fund a universal cash grant. In contrast, the Treasury Department concluded that using the retail sales tax to replace only the income tax and provide a cash grant would require at least a 34 percent tax-exclusive rate.

Some may wonder why the tax rate estimated by FairTax advocates for replacing almost all federal taxes (representing 93 percent of projected federal receipts for fiscal year 2006, or $2.0 trillion) is so much lower than the retail sales tax rate estimated by the Treasury Department for replacing the income tax alone (representing 54 percent of projected federal receipts for fiscal year 2006, or $1.2 trillion).

First, it appears that FairTax proponents include federal government spending in the tax base when computing revenues, and assume that the price consumers pay would rise by the full amount of the tax when calculating the amount of revenue the government would obtain from a retail sales tax. However, they neglect to take this assumption into account in computing the amount of revenue required to maintain the government's current level of spending. For example, if a retail sales tax imposed a 30 percent tax on a good required for national defense (for example, transport vehicles) either (1) the government would be required to pay that tax, thereby increasing the cost of maintaining current levels of national defense under the retail sales tax, or (2) if the government was exempt from retail sales tax, the estimate for the amount of revenue raised by the retail sales tax could not include tax on the government's purchases. Failure to properly account for this effect is the most significant factor contributing to the FairTax proponents' relatively low revenue-neutral tax rate.

Second, FairTax proponents' rate estimates also appear to assume that there would be absolutely no tax evasion in a retail sales tax. The Panel found the assumption that all taxpayers would be fully compliant with a full replacement retail sales tax to be unreasonable. The Panel instead made assumptions about evasion that it believes to be conservative and analyzed the tax rate using these evasion assumptions.

Evasion

Tax evasion occurs when taxpayers do not pay taxes that are legally due. Analysts agree that some evasion is inevitable in any tax, and that evasion rates for any tax tend to rise as the tax rate rises. At the request of the Panel, the Treasury Department estimated the revenue neutral retail sales tax rate assuming evasion rates of 15 and 30 percent of personal consumption spending. The Treasury Department assumed no evasion by state and local governments. By comparison, for 2001 the IRS estimates that the evasion rate for the individual income tax was between 18 and 20 percent and the evasion rate of the entire U.S. tax system was about 15 percent.

The retail sales tax would rely on retail businesses to collect all federal tax revenue and eliminate federal individual income tax filing. Therefore, the number of federal tax return filers would fall significantly under the retail sales tax. Further, the complexity of filing a business tax return would decline dramatically as compared to corporate income tax returns. Retail sales tax returns would indicate only total sales, exempt sales (sales to businesses with exemption certificates plus export sales) and tax liability. From an enforcement perspective, both the reduced number of tax return filings and the simple nature of the retail sales tax return represent substantial advantages.

Nevertheless, the Panel concluded that a number of features of the retail sales tax would make it difficult to administer and enforce at the high tax rate necessary to be revenue-neutral. A federal retail sales tax assessed at a rate of at least 34 percent, added on to state retail sales taxes, would provide a substantial inducement for evasion at the retail level. Retailers and shoppers could use a number of techniques to evade a retail sales tax. For example, unregistered cash sales to a consumer would allow a transaction to escape taxation. Retailers facing a high retail sales tax might also misapply exemption criteria, whether intentionally or unintentionally, and fail to tax goods that should be taxed. Or, the retailer might collect the tax from customers, but keep the money rather than remit it to the government. At high tax rates, the gain to retailers from evasion is high.

Empirical evidence suggests third-party reporting substantially improves tax compliance, particularly when tax rates are high. For the portion of income from which taxes are not withheld and there is no third-party reporting, income tax evasion rates are estimated to be around 50 percent. There is no third-party reporting in a retail sales tax. Retailers would add their retail sales tax to the pre-tax price for their goods and would remit that amount to the government, but shoppers would not separately report what they bought, and at what price, to the government. The government would rely on retailers alone to report their own taxable and exempt sales.

To obtain exemption from tax, retail purchasers might try to fabricate exemption certificates or otherwise masquerade as tax-free buyers of retail products. For example, individuals might create "paper" businesses solely to obtain business exemption certificates and avoid taxes on purchases for personal use. A related problem involves individuals with legitimate businesses using their business exemptions for personal purchases or for goods or services to give to employees in lieu of cash compensation. Using their business purchase exemption would provide a discount equal to the retail sales tax rate.

With a retail sales tax, retailers would have the responsibility to determine whether the ultimate use of a good or service would be for a business purpose, and therefore would be deserving of the business purchase exemption. Retailers are often ill-equipped to carry out this role. State experience suggests that abuse of exemptions is common, in part because distinguishing between business and individual consumer purchases of so-called "dual use" goods and services – goods and services that are commonly purchased by both businesses and final consumers, such as a plane ticket – can be difficult and costly.

Box 9.3. Dual-Use Goods and the Problem of "Cascading"

The difficulty of identifying whether dual-use goods are used for business or individual purposes is one reason that states typically include a significant number of business-to-business transactions in their sales tax base. For example, states often do not ask retailers to determine whether a buyer will use a computer for entertainment at home (taxable) or to run a business (exempt). Instead, many states treat sales of computers as taxable unless the buyer certifies that they are purchasing the computer for resale. Thus, many businesses pay sales tax when purchasing computers. That tax then "cascades" into the cost of the goods and services the purchasing business sells to consumers. Taxing goods and services bought by businesses to produce other goods and services is economically inefficient because it haphazardly imposes double (or triple or quadruple) taxation on some consumer goods and services.

Cascading taxes create incentives for business to produce fewer goods or services, shift resources into tax-favored activities, or adopt tax-driven business structures. Cascading taxes also may have a negative impact on U.S. competitiveness because they impose some tax liability on exports and result in less tax being assessed on imports relative to competing domestically-produced goods.

Comparison with State Sales Tax Evasion and Administration

Retail sales tax advocates often note that evasion rates with sales taxes are lower than evasion rates with the income tax. However, state sales tax evasion rates are not likely to be representative of the evasion rate of a full replacement retail sales tax for several reasons.

First, state sales tax rates are a fraction of the tax rates required to replace the federal income tax. Among states that impose sales taxes, tax rates range from 3.5 percent in Virginia to 7.0 percent in Mississippi, Rhode Island, and Tennessee. When combined with local sales taxes, the highest sales taxes are found in Alabama (11.0 percent), Arkansas (10.625 percent), Oklahoma (10.5 percent) and Louisiana (10.5 percent).

Higher tax rates provide greater incentives for taxpayer evasion and avoidance. Those incentives also make administration and enforcement more expensive – and any failure to effectively administer the tax requires a higher tax rate to compensate for lost revenue. No state or country has ever levied a retail sales tax at a tax rate that even approaches the 34 percent required to replace the federal income tax system. State tax administrators told the Panel that they would expect significant compliance problems at such rates.

State sales taxes also do not broadly tax service providers, often because they are difficult to tax. For example, all U.S. state sales taxes exempt most financial services. Other dual-use services, such as utilities, transportation, and communication services are also difficult to tax properly and often are exempt from state sales taxes. It is reasonable to assume that trying to tax these services through a retail sales tax likely would result in more extensive evasion and higher compliance and administrative costs than existing state sales taxes. Although it is difficult to know with any measure of certainty what the evasion rate would be under the RST, the Panel believes that it would likely be at least as high as evasion under the current income tax and that a 30 percent rate of evasion would not be an unreasonable assumption.

Other Concerns

Response of the States to a Retail Sales Tax

Although some retail sales tax proposals claim the administration of the retail sales tax could be left to the states and the IRS could be eliminated, such a system would likely be unworkable. Existing state sales tax bases are both narrow and varied and it may be difficult to persuade the states to adopt the federal retail sales tax base.

The experience of Canada, which tried to federalize its provincial sales taxes, may be instructive. Canada considered adopting a unified federal and provincial sales tax base in 1987, but intergovernmental discussions failed to produce an agreement to standardize the existing provincial sales tax bases with the base for Canada's federal goods and services tax.

Variation in local sales tax rates within the United States could further complicate any effort to standardize U.S. sales tax bases and rates. As of 2001, Texas alone had 1,109 separate city tax rates, 119 county tax rates, and 67 other special tax jurisdictions. Texas is not atypical in having numerous local sales tax jurisdictions. While some states might bring their sales taxes into conformity with a federal retail sales tax, it is unlikely that all would do so. States have not adopted identical definitions, standards, and rules in their own income tax regimes as those that exist for the federal income tax, even though there would be many administrative and compliance advantages to such an approach.

Given the tremendous variance in the current taxation of retail sales across the United States, the IRS or another federal agency with substantial personnel and resources would almost certainly have to define, administer, and enforce a federal retail sales tax. For example, detailed rules would be necessary to ensure that exemption certificates were issued uniformly and only provided to legitimate businesses for use in purchasing actual business tools, materials, and other inputs. Further, the IRS or another federal agency would likely need to administer the retail sales tax directly in the five states that do not currently impose a sales tax. The same might be true in those states that do not bring their sales tax bases into conformity with the federal retail sales tax base. Finally, because failure to effectively enforce the sales tax would lower federal revenues, Congress might decide that the IRS should maintain a significant enforcement function as a backup mechanism to state tax administration efforts.

State Income Tax

At the Panel's public meetings, state and local tax officials suggested that a federal retail sales tax would encroach on a tax base that traditionally has been left exclusively to states and localities. Currently sales and gross receipts taxes account for about 37 percent of state general tax collections and about 17 percent of local revenues. However, if a federal retail sales tax were put in place at a rate of 34 percent or more, it could become unattractive for states to add their own rates on top of the federal retail sales tax.

If the federal government were to cease taxing income, states might choose to shift their revenue-raising to the income base from the sales base. State income taxes could rise, while state sales tax rates could fall. In any event, unless states found a substitute source of revenue, they likely would maintain their income taxes. For that reason, it is reasonable to expect that taxpayers would need to continue to keep track of income-related information and file income tax returns, regardless of whether the federal government eliminates the federal income tax. Furthermore, with an income-based cash grant program, tracking income at the federal level would remain a necessity.

Today, 45 states and the District of Columbia have state income taxes. Most states use federal adjusted gross income as the starting point in determining the state individual income tax base. Eliminating the federal income tax would remove the common basis upon which most state income taxes are now structured. State and local income tax returns would likely become much more complex if they could not be based on a pre-existing federal income tax return that includes a calculation of annual income. Greater disparities among state income tax systems and potential distortions would likely develop as state income tax structures diverge from each other over time in the absence of a common federal income tax base as a starting point.

State income tax compliance initiatives currently rely in large measure on information that the states receive from the third-party reporting structure created by the federal income tax – such as W-2 and 1099 forms as well as other standard tax forms that report income. In the absence of the federal third-party reporting system, states would need to impose information reporting requirements on individuals, employers, financial institutions, and others in order to maintain their income tax systems. States might bind together to coordinate enforcement of state income taxes and impose those reporting requirements. But if states chose to impose reporting requirements independently, multi-state businesses could face many different sets of reporting obligations. Simplification of the federal tax system through a retail sales tax might be achieved at the expense of greater overall complexity in the combined system of state and federal taxation.

Compliance Burden on Small Business

A retail sales tax also likely would place a disproportionate burden on small retail businesses. Few statistical studies exist on the compliance costs for retailers of different sizes. However, a well-regarded study conducted by the State of Washington Department of Revenue in 1998 suggests that, although such costs are low overall, they are disproportionately high for small retailers. In Washington, the cost of collecting sales tax for retailers with annual gross retail sales of between $150,000 and $400,000 was 6.5 percent of sales tax collected. By comparison, firms with annual gross retail sales greater than $1.5 million spent less than 1 percent of sales tax collected on compliance.

Small vendors, particularly those operating on a cash basis, account for a significant share of the noncompliance in many state sales taxes as well as our current income tax. A retail sales tax would cover all retailers, including small service providers, such as dentists, car mechanics, or beauticians, as well as small retail stores. Small service providers would likely find retail sales tax compliance costly and would have noncompliance incentives that would be similar to those for small retail stores.

Macroeconomic Effects of Transition

Some observers have worried about potential macroeconomic disruptions associated with moving from an income tax to a retail sales tax. Although there may be some such disruptions, those considerations were secondary in the Panel's decision not to recommend a retail sales tax.

Full Replacement of the Income Tax with a VAT

The Panel considered replacing the income tax with a VAT at the same time it analyzed a replacement retail sales tax because of the similarities between the two taxes. The Panel concluded that fully replacing the income tax with a VAT would be substantially more administrable than fully replacing the income tax with a retail sales tax. The advantages of a VAT over a retail sales tax with respect to enforcement and compliance are described in Chapter Eight. However, the Panel's objections regarding the increased tax burden on the middle class and increased size of government resulting from the full replacement retail sales tax apply equally to a full replacement VAT. Because of these concerns, the Panel did not recommend a full replacement VAT.

Conclusion

Like other consumption taxes, the full replacement retail sales tax has pro-retail growth features. Nevertheless, the Panel does not recommend a full replacement retail sales tax. Without a large cash grant program to ease the burden of the tax, a retail sales tax would not be appropriately progressive. A cash grant program to make the tax appropriately progressive would cost at least $600 billion per year – which would make it America's largest entitlement program. The Panel concluded that it was inappropriate to recommend a tax reform proposal that required the federal government to collect and redistribute this amount in additional revenue from taxpayers. The Panel also was concerned with administrative and compliance issues associated with a retail sales tax, as well as difficulties involving coordination with existing state sales taxes.