Will the Decline in Sales Tax Revenue Continue?

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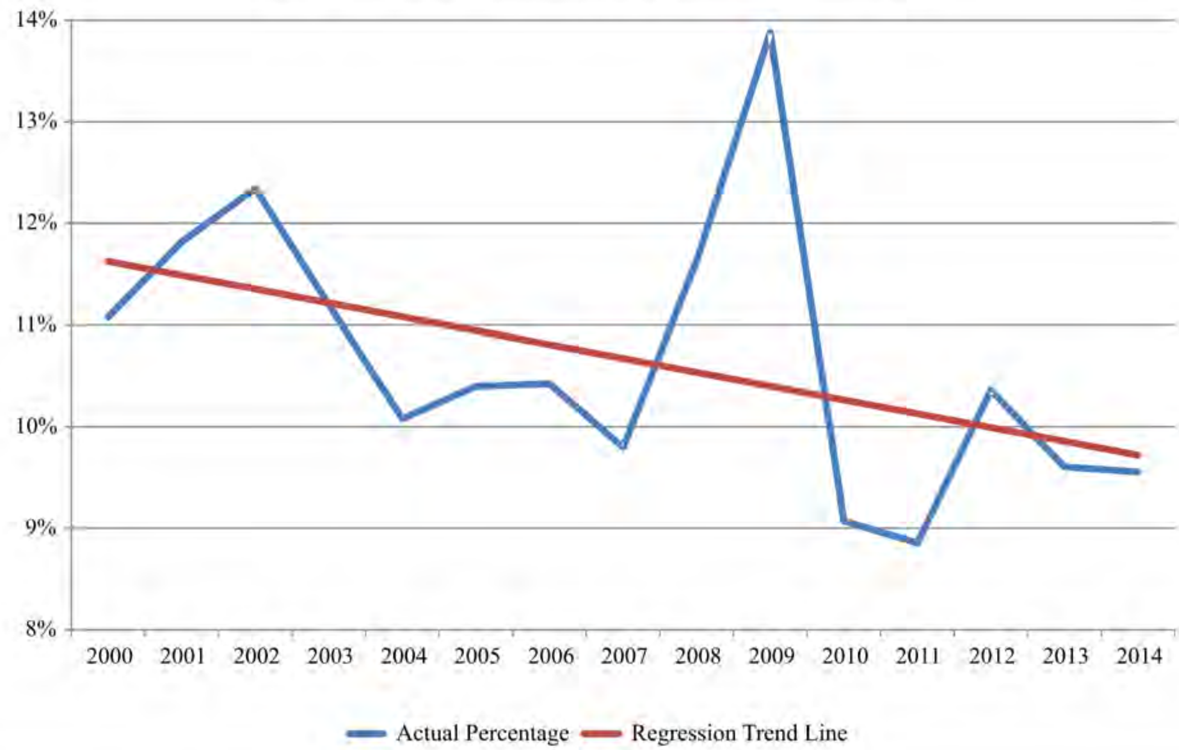
In this edition of State Fiscal Affairs, the authors discuss the downward trend in sales tax collection. They note ways that the trend could be halted, particularly through the expansion of the base to include sales of services, and discuss impediments to that solution.

State and local governments in the United States have levied sales taxes for many years and relied on them for a substantial share of revenue. Yet, as with all sources of revenue, that reliance provides advantages and disadvantages. On one hand, sales tax is visible, offers a relatively stable revenue source, and is administered at a relatively low cost once the tax structure is in place. On the other hand, economic analysis shows that the sales tax — even with exemption of food for home consumption — tends to be regressive; it is collected at the point of sale although it is intended to be a destination-based tax (leading to use taxes); there are nexus issues restricting collection of sales and use taxes; and, perhaps most importantly, the tax typically excludes purchases of services.

How alarmed should government officials and taxpayers be regarding the sales tax's diminishing importance, given its characteristics? Shown in Figure 1 below, general sales taxes declined from more than 11 percent of total state and local government revenue in 2000 to about 9.5 percent in 2014. That decline amounts to nearly half a billion dollars. Even if selective sales or excise taxes are included, the share of revenue decreased from 16 percent to about 14 percent. As a comparison, federal grants accounted for about 17 percent of state and local government revenue in 2014, property taxes about 13 percent, and income taxes about 10 percent. Total state and local government sales tax collections amounted to 3.3 percent of personal consumption spending in 2000, but only 3 percent in 2015. So, a smaller fraction of recent consumer spending is generating sales tax revenue compared with the start of the 21st century.

There are several possible explanations for these trends. One could be that subnational governments reduced nominal sales tax rates; however, the opposite is true. The median state sales tax rate was 5 percent in 2000 and rose to 6 percent in 2017. And that does not include local government sales taxes that have been increased or adopted during that period. If state and local governments had not increased the tax rates, the magnitude of sales tax revenue compared with consumer spending would have fallen even more.

Figure 1.
General Sales Tax Revenue as a Percentage of State and Local Government Revenue, 2000-2014



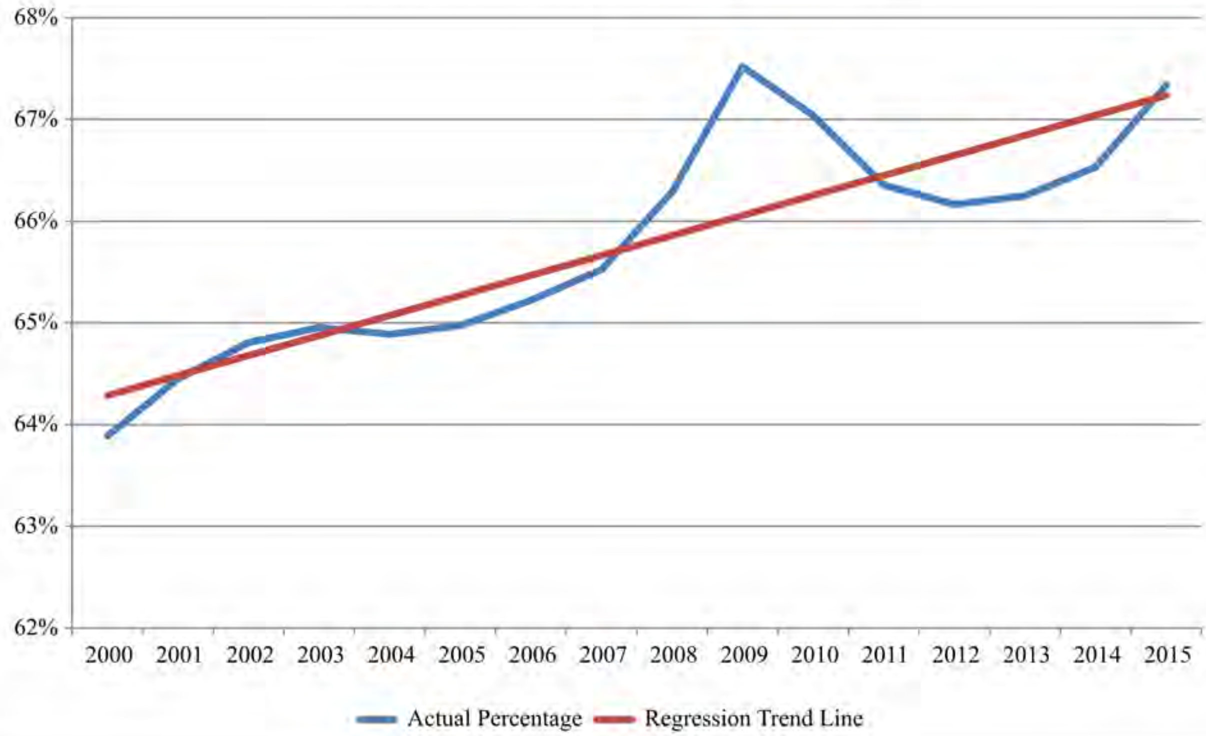
A second possible explanation is that state and local governments have changed laws to reduce the sales tax base; that is, remove goods or services from taxation. Numerous changes to the composition of state sales tax bases are common in most years, as documented by the annual "Fiscal Survey of the States" report by the National Association of State Budget Officers.[1] There are typically both additions to and deletions from the tax base, and there is no evidence that the legal scope of the tax base has been diminished overall.

A third possible cause of the sales tax revenue loss is consumer substitution of online purchases for what was once purchased at bricks-and-mortar retail establishments. In many cases, such as when there is no legal nexus of the seller in the buyer's state, the buyer's state cannot force the online seller to collect the use tax on internet transactions. However, several important developments have reduced the revenue implications of online sales. First, numerous states have become more aggressive in defining nexus and collecting use tax. Second, Amazon.com Inc. — by far the largest online seller and as of 2016, the eighth largest U.S. retailer overall — agreed as of April 1 to collect sales (use) taxes for all states that impose the tax.

The fourth and most likely explanation is the well-known and well-documented change in consumer behavior toward increased purchasing of services. In 2000 purchases of goods accounted for about 36 percent of total consumer spending. Purchases of most goods have traditionally been part of the sales tax base (the most common exception being purchases of groceries). By 2015 less than one-third of consumer spending was for goods, with the remainder being for services, which typically are

[1]"Fiscal Survey of the States," National Association of State Budget Officers.

Figure 2.
Consumer Spending on Services as a Percentage of Total Consumer Expenditures, 2000-2014



not in the sales tax base.[2] The reality is that consumers are spending more on transactions that are typically not taxable, as shown in Figure 2.

Our home states, Michigan and California, follow those national sales tax trends. In Michigan the state general sales tax provided 10.9 percent of total state and local government revenue in 2000, but only 8.8 percent in 2015. During that period, the state sales tax rate has remained at 6 percent, and local governments in Michigan are not permitted to levy sales taxes. Even if select sales taxes, such as tobacco, alcohol, and gasoline, are included, the share of revenue provided by sales taxes fell from 14 percent to 13 percent.

The sales tax case for California is more complicated both because the state government has changed the tax rate and because local government sales taxes are common and substantial. Even so, the state and local government general sales taxes provided just over 11 percent of total state and local government revenue in 2000, but less than 9 percent in 2015. Even when including selective sales taxes, such as tobacco, alcohol, and gasoline, the share of revenue provided by sales taxes fell from just under 15 percent to 12 percent.

If states maintain the status quo, the sales tax will continue to decline in importance as a revenue source. One option to maintain sales tax revenue is to increase tax rates so that the tax continues to generate similar revenue. That is what subnational governments have done in the past. But a negative effect of that approach is that governments would be taxing a smaller and smaller share of personal consumption at higher and higher rates. Politically, it requires state

[2] The Great Recession generated an anomaly in the trends shown in figures 1 and 2. Sales tax revenue became relatively more important with sharp declines in income taxes, as income declined relatively more than consumption during the recession. Also, consumer-purchasing patterns changed, with consumers putting off purchases of durable goods so that spending on services became a greater share of total spending.

legislatures or voters to continually raise tax rates, which is unlikely.

A commonly suggested policy change to maintain sales tax revenue is for governments to modernize the tax. Modernization involves adding purchases of services to the tax base and finding mechanisms to include online transactions. Substantial progress has been made on the second component, but practically none has been made on the first.

States — even those as politically liberal as California — have had great difficulty expanding sales tax bases to include purchases of services for a variety of reasons. It is partly because of the opposition of service providers, who lobby and campaign (including using campaign contributions) against being taxed. That services and goods are similar or economic substitutes, such as buying a car versus hiring a taxi, is often misunderstood by both lawmakers and voters. Opposition to including some services, such as housing, legal, and medical care, arises because they are often considered necessities and thus impose undue burdens on lower-income families. Finally, there is opposition to tax increases in general. To maintain revenue neutrality, sales tax base expansion might be paired with a rate decrease, but there is no guarantee that the lower rates will stay in place, which is a concern for those who oppose tax increases generally. With a larger base, tax rates might be increased by a small amount in the future to generate a net increase in revenue.

Technological developments illustrate how this problem could mushroom. Ride-sharing services (Lyft, Uber) and vehicle-sharing services (Zipcar) are already common. With the coming development and implementation of autonomous driving vehicles, it has been suggested that many individuals may no longer purchase their own cars, which sit idle a good part of the time. Instead, individuals might purchase ride services as required from companies that maintain fleets of vehicles. This is likely to require fewer vehicle purchases overall. States generate sales tax revenue when cars are purchased, but not when individuals purchase Lyft or Zipcar service. Technology seems likely to exacerbate the consumption trend from goods to services, making state action to modernize sales taxes even more crucial.

What Can or Should States Do?

If it is necessary for state and local governments to maintain, or even increase, revenue, several approaches are possible.

Governments might modernize sales taxation by including at least some services that match consumer behavior and consumption. In addition to generating revenue, there are other potential advantages. In some cases, such as entertainment admissions, inclusion of services would make the sales tax less regressive. Research suggests that taxing services broadly may make the sales tax slightly less regressive overall. Making the sales tax base more broadly match consumption is likely to reduce the volatility of collections. And taxing consumption regardless of how it is done may improve taxpayers' perception of the fairness of the tax system. Why should purchases of learning tools, such as books and software, be taxed, while education services for the same learning is untaxed?

If those modernization attempts fail, as they have in most cases in the United States so far, another option is for state and local governments to turn toward other revenue sources. For example, governments might consider increased taxation of "bads," rather than goods. Options include taxing a variety of negative externalities, such things as greenhouse gas emissions that affect climate change; other forms of pollution; congestion; and personal behavior with negative effects on others. And, of course, state and local governments might extend other traditional taxes, including property and the various types of income tax. However, those could be as much of an uphill battle as including services in sales tax bases.

Perhaps a two-pronged approach that tries to accomplish both sales tax modernization and the addition of other revenue options is best. It seems certain that if sales tax bases are not modernized, sales taxes are likely to continue to be a less significant revenue source. If governments turn to the revenue alternatives, sales taxation would be less necessary. Either way, the future of the traditional sales tax is uncertain at best.

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