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Sales Tax Exemption — The Erosion of the Tax Base  
*John Due*

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Sales Tax Exemptions -- The Erosion of the Tax Base

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## Abstract

The basic philosophy of a sales tax is that it should be a general levy on consumption expenditures. The early state sales taxes provided general coverage of commodity purchases, but they included many nonconsumption transactions, and they excluded services. There has been a limited trend over the years to add some services. But the major trend has been toward erosion of the base. Part of the trend, and particularly the exemption of industrial and farm machinery and equipment, can be defended on the grounds that these changes bring the taxes more in line with the basic philosophy of the sales tax. But the major form of erosion has been the steady increase in the exemption of consumption purchases, particularly food (once rare, now found in a majority of states), medicines, household fuel, other items, and sales to various nonprofit organizations. Most of these exemptions have been pushed by groups seeking to lessen regressivity of the tax--but most do so in a fashion objectionable in many respects, compared to alternatives. Virtually all exemptions complicate the operation of the taxes. Legislatures have not been at all careful in establishing the exact form of exemptions in such a fashion as to minimize operational difficulties. There are two major lessons from experience: one exemption breeds another, and exemptions, once provided, are very difficult to remove. Despite the erosion, most of the taxes do remain relatively broad in scope.



## SALES TAX EXEMPTIONS--THE EROSION OF THE TAX BASE\*

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As a practical, political matter, there appears to be an almost inevitable tendency for the coverage of any major tax to be eroded over the years. There are exceptions, as when deduction of motor fuel tax for Federal income tax was eliminated, and some states moved to add services to their sales taxes. But the general trend is the reverse, and sales taxes are no exception.

### The Philosophy of Sales Taxes

Taxes can of course be levied solely for the purpose of raising revenue. But in practice, typically there is an underlying philosophy relating to the choice of a tax to allocate the costs of government. A sales tax is traditionally regarded as a consumption-related tax, that is, a tax designed to distribute the costs of government in relation to total consumer spending--as distinguished from excises, designed to impose the burden in relation to expenditures on particular commodities, such as cigarettes. If a sales tax is to be a truly general consumption tax, it should apply to all expenditures for personal consumption purposes, but not to any transactions involving purchase for use in business activity. Exclusion of any personal consumption purchases favors those persons with disproportionate expenditures on these goods, leads to economic distortions by shifting purchases and production from taxed to untaxed goods, reduces revenue at given rates, and, as is well known, complicates compliance and administration. Inclusion of purchases for production purposes is contrary to the philosophy of the tax, results in a haphazard and uncertain distribution of tax burden, affects choice of production

\*I am indebted to Professor John Mikesell of Indiana University for cooperation in obtaining the information on which this paper is based; he is coauthoring a new edition of my State and Local Sales Taxation, which will be published by Johns Hopkins University Press later in 1982. I am also indebted to Mrs. Sharon Erenburg, Research Assistant at the University of Illinois, for her econometric analysis of influences on sales tax yields.

processes, and from a state's standpoint, may adversely affect economic development.

The early sales taxes were very broad in coverage of tangible personal property; Illinois, for example, had no exemptions, and most states had very few. But these taxes deviated from the basic philosophy in two ways: services were not taxed, and, in most states, exclusion of producers goods--purchases for business use--was limited to sales for resale. Thus a substantial range of business purchases was subject to tax. Partly this was a result of incomplete acceptance of the basic philosophy, partly of fear of administrative complications from exemption.

#### The Nonerosion Trend--The Taxation of Services

The one trend away from erosion has been the adding of at least some services to the coverage of the tax, but the extent of the added coverage varies widely. The type most widely added was hotel and motel service, until currently all states either apply their sales tax or a separate state or local tax. Some utility services were included in the base, producing a very complex picture. Rental of tangible personal property has been added by many states. Two of the early sales-tax-using states, Hawaii and New Mexico, provided general coverage of services rendered to consumers and still do; only South Dakota has come close to their coverage, while Washington, West Virginia, and Iowa provide fairly broad coverage. But once broad categories of services were brought within the tax, there has been some tendency to exempt certain specific types.

#### The Erosion of the Coverage

The commodity base of the sales tax has been very slowly eroded away--by a combination of forces that may be compared to pocket gophers working away

at a hill of potatoes. In 1981 alone, there were about forty exemptions added by the sales tax states, many minor, but all involving base erosion, with negligible changes in the opposite direction. A few examples will give some indication of the type of erosion. Alabama, for example, exempted sales to the Federation of Women's Clubs, the Chattahoochee Valley Hospital Society, and Goodwill Industries, in addition to prescription medicines. Arizona exempted required texts at state universities; Colorado, poultry; Florida, admissions to the National Football League championship game; Louisiana, antique airplanes; New York, certain racehorses; North Dakota, steam for processing agricultural products; Pennsylvania, supplies purchased by tourist promotion agencies; Texas, sesquicentennial medals; Virginia, sales to youth organizations which sponsor camping assemblies with attendance in excess of 20,000; Wisconsin, sales to a metropolitan sewerage commission.

There are two kinds of eroders, both of which reduce revenue at given rates and add to complications in the operation of the tax. But one type admittedly brings the coverage of the tax more in line with the basic philosophy of a sales tax; the other, however, is contrary to the philosophy. The first type is the exemption--or more appropriately exclusion--from tax of various producers goods--purchases made for business use. The second is the exemption of various consumption expenditures, either by type of commodity or type of purchaser.

#### Producers Goods

There has been a slow, steady trend toward broadening the exemption of major categories of producers goods. Such exemption was established early in a few states, such as Michigan and Ohio. But most states confined the exclusion to sales for resale, including parts and ingredient materials,

until recent years. Even yet, the exemption is confined to a few major categories, with many producers goods still covered. The major exempted commodities include:

Industrial Machinery and Equipment. In 1960, 22 of 36 sales tax states taxed this category fully and only 6 fully exempted it. By 1971, 22 of 45 states fully taxed and 13 exempted completely. In 1982, only 13 states--all west of the Mississippi--tax fully, and 21 fully exempt. Of the other states, 5 tax at a lower rate, in two instances the lower rate being a step in phasing in complete exemption, and in 6, exemption is provided for new and expanding industry only. There has also been a trend toward exemption of industrial consumables, but the present picture is so complex that a brief summary is not possible. In recent years there has been substantial exemption of pollution control equipment.

Farm Machinery and Equipment. The path toward exemption has been similar to that for industry. In 1963, 28 of 36 sales tax states taxed these items at the regular rate, and 2 at a lower rate; in 1970, 22 taxed fully, of 45; in 1982, 13. Currently, 7 states apply lower rates, and 25 exempt completely. The coverage of the exemption varies, however; nine states extend the exemption to include many minor farm items, including in most, hand tools. The exemption tends to be contagious; the exemption in Idaho clearly influenced the decision in Utah to exempt; those in Missouri, Indiana, and Wisconsin influenced the Illinois action to begin phasing in the exemption.

Who are the eroders in this sector? The chief attack on taxing industrial equipment comes from the various manufacturers--individual firms and associations--that will directly benefit from removal of the tax on their machinery and equipment purchases. The manufacturers are most concerned and can present the strongest case if competitors in neighboring states are exempt

on these purchases. It is no accident that the exemption is concentrated in the northeast sector of the country--and has spread slowly westward; Illinois, one of the last holdouts, has been phasing in the exemption, temporarily ceasing to do so because of revenue needs. Because California, the principal industrial state in the West, has never provided the exemption, most other western states have not done so either. The cause of the manufacturers has often been aided by state development agencies, seeking to improve the industrial climate of the state. Relatively objective bystanders have been reluctant to oppose the exemption--given their general philosophy about the appropriate scope of a sales tax.

Farm groups fight equally hard for the comparable exemption in agriculture, and they are strongly aided by the retailers of this equipment, particularly if the neighboring states do not tax these items, as the farmers can easily buy across the state line, and frequently escape use tax.

This trend is desirable in principle; it is, however, a handicap to maximum efficiency in administration. If the exemption is confined to major types of machinery and equipment, it is manageable, though many interpretative questions arise, and audit is slow and complex. Many of the problems center around the delineation between production on the one hand and distributional activities on the other. An alternative, of course, is to allow the exemption of all purchases for business use as distinguished from personal use, long permitted in West Virginia--but nowhere else. This is not unworkable, but it encounters all of the problems of distinguishing between business and personal expenses under income taxes and paves the way for serious nuisance compliance and audit problems, particular with regard to sales to farmers not subject to audit and to small businesses of various types.

The Trend toward Exemption of Consumption Goods

There has been a slow, but very definite and continuous trend toward the exemption of major classes of consumption goods--those purchased for personal use. It is difficult to provide a detailed documentation of the trend--but it has converted the sales taxes of most states into much more selective levies than those established in the 1930s. Not only have the new taxes introduced been much less broad in coverage, but the older taxes have been slowly reduced in scope. This should not be exaggerated; the typical sales tax remains relatively broad, but the change is significant.

The eroders are almost solely the groups seeking to reduce the regressivity of the sales tax and the burden on the lowest income groups. Labor unions, organizations of the elderly, community groups, legislators seeking votes for reelection, are among the leaders. There is much less concerted and unified opposition to the exemption; in many states the stand against it has been taken by the governor, but in other states the governor has been a leader in the drive for exemption. Retailers have opposed the change--but their political influence is often not great. The exemption has been easiest to attain in periods when the states tended toward budget surplusses; there is much less danger currently, given the serious financial condition of most states.

Food. As of 1945, only three of the 26 states using sales taxes exempted food (California, North Carolina, and Ohio). By 1963, eight of the 36 states did so (North Carolina had repealed the exemption, the only state to do so). The other exempting states were all ones newly imposing the tax. By January of 1971, 15 of the 45 sales tax states exempted food; currently, 26 states are exempting food, and two are taxing at a lower rate preparatory to phasing out the tax. In most of the remaining states, food exemption is a political issue of some consequence.



The objections to food exemption are so well known that little elaboration is required. The exemption has drastic effects on the tax base; a recent estimate, based on a study of experience in recent years, is that a state will lose from 16% to 17% of its revenue from food exemption. There is no need or justification for exempting food expenditures of the typical family. Persons preferring to concentrate luxury spending on food are favored. One of the major objections is, of course, the effect on compliance and administration. There are major interpretative questions, particularly if candy and soft drinks are kept taxable, and on the distinction between food and meals, which has plagued all food-exempting states. Misapplication of tax at the cash register is inevitable, even if not deliberate, and substantial audit time is allocated to check. It is true that one trend is lessening the danger of misapplication of the tax--the introduction in supermarkets of the computer linked scanner checkout system. The scanner reads the product code, the computer provides the price and the tax, and the computer system records and totals the tax separately. So long as the computer is programmed correctly for tax purposes on all items, there is no danger of misapplication of tax. But this system is limited, thus far, to a few supermarket chains. The danger of misapplication is always greatest with the smaller stores and the rapidly growing "convenience" outlets. The exemption of meals under a certain figure is always a source of nuisance, particularly when several persons eat together.

Drugs, Medicines and Related Items. This exemption also came slowly. As of 1945 only two states provided it; by 1963 the figure had risen to 11 out of 36, and by 1971 to 26 out of 45. In 1982 only three states, New Mexico, Hawaii, and Georgia, continue to tax fully. Of the 43 exempting states, eight exempt all drugs and medicines, while the others confine the exemption

to prescription drugs. There has been a tendency to add prosthetic and other devices. This exemption has perhaps the strongest justification of all, because the burden of medicine costs varies so widely among families. So long as the exemption is confined to prescription items, little administrative trouble is created. To extend beyond to all nonprescription drugs contributes little or nothing to equity and greatly complicates the application of the tax--since many drug items are not clearly delineated from cosmetics (e.g., sun tan lotion). In any event, the base is eroded.

Household Fuel. Stimulated by sharp increases in heating costs, there has been significant tendency to exempt household fuels, now by 31 states, but with a wide range of exact coverage of the exemption. These can be the source of the usual definitional and administrative problems, and they erode the base of the tax still farther.

Other Commodities. While the states have not added large numbers of miscellaneous exemptions, the same pressure groups that have pushed for food exemption have sought other exemptions as well. Clothing is at least in part exempt in 5 states--a change that makes the tax more regressive. Other exemptions, in a few states, include soap and other household supplies, bibles, and coffins.

An interesting feature of these exemptions is that once they are granted, they are virtually never withdrawn. North Carolina's elimination of the food exemption in 1961 is the only significant exception to this rule.

Articles Subject to Excises. The most unjustifiable of all exemptions, and the one in which some progress has been made to lessen its scope is the exemption of goods subject to state excises. The exemption was based on the premise that a commodity subject to a special levy should be exempted from a general tax to avoid "double taxation." This exemption makes no sense, since

administratively it is far easier, in most cases, to apply the general sales tax to these commodities. If the combined burden is regarded as excessive, the excise can be lowered. Gasoline was exempt in all but four states in 1963; it is now exempt in all but 11. Cigarettes were exempt in 11 of 33 in 1963; they are now exempt in 11 of 45. There is at least some improvement in both of these. Three states (of 36) exempted all liquor in 1963; currently only 2 do so out of 45. Subjecting these goods to the sales tax is particularly important because of the lag in excise tax specific rates behind the rate of inflation. This change is an easy source of additional sales tax revenue in states now desperately short of funds.

#### Sales to Various Organizations

By contrast, the exemption of sales to various religious, charitable, and educational institutes has grown. Summarization is difficult because of the wide variations in detail. Thirteen states of 36 provided general exemption of these sales in 1963; 25 do so in 1982, out of 45. Six states provided no exemption in 1963; eight states did not do so in 1982. The others provide varying degrees of partial exemption. The pressure for the exemption comes of course from the organizations benefitting from the exemption. There is constant tendency, year by year, to add more groups to exempt coverage, as suggested by the examples of 1981 legislative action noted above.

#### Can Erosion Be Stopped?

Many states are losing from a quarter to a third of the revenue they could obtain from a broad based sales tax. Thus a 4% rate on a broad base would yield as much revenue as a present 6% rate. In addition the states have created major compliance and audit problems. Is there any way of reducing or at least curtailing further erosion?

Without question the most serious source of erosion is the pressure of groups seeking to reduce the tax burden on the lower income groups. No matter how much sympathy one may have for the interests of the lowest income groups, provision of exemptions from a sales tax is a meat axe technique to attain this goal. The primary alternative is a credit against income tax, with a cash refund for those having no or inadequate income tax liability. This system is provided, in various forms, in 7 states, although limited to the disabled or elderly in two of these. Indiana has a limited credit system. This system sacrifices far less revenue to accomplish the desired objective and creates far fewer administrative and compliance problems than food and other exemptions. But it lacks the political appeal of food exemption--voters see the latter as providing more direct, obvious benefit. To many persons there is something inherently objectionable about taxing food--even the most exotic and expensive items. Thus for purely political reasons over the last decade, three states that operated the system abandoned it. But it remains a greatly superior alternative to exemptions.

From a longer range standpoint, the approach that should ward off this type of raid on the sales tax is a Federal general negative income tax system, replacing a myriad of present forms of aids to the poor, with amounts adjusted to compensate for sales tax. This approach is supported by many conservatives as well as liberals--but is not likely to get far under the present Federal administration.

As a more immediate approach, about all that revenue departments can do is try to induce legislative bodies to avoid multiplying exemptions and to establish them in such a way as to minimize adverse operational effects: to confine medicine exemptions to prescription items; to leave candy and soft drinks exempt if food is exempt; include cigarettes, gasoline and alcoholic

beverage within the base of the sales tax, for example. Revenue departments can seek to eliminate, by regulation or minor changes in the laws, provisions that are completely unworkable. But accomplishing even these limited objective is not easy. Legislative committees in some states listen seriously to officials of the revenue departments; in others they pay little or no attention and even less to so called experts testifying before them. Improvements are seriously restricted by three considerations. First, a basic rule is that once an exemption is granted, withdrawal or curtailment of it is extremely difficult--like trying to move an airport already built because persons complain of the noise. Secondly, any changes that would increase revenue currently encounter the almost irrational popular opposition to higher tax burden, however minor. Strong justifications can be advanced for curtailing growth in government expenditures and taxes--but unfortunately the pressure against such growth is currently so strong as to preclude urgently needed reforms in state taxes. And, finally, a type of domino principle is at work with exemptions. They are geographically contagious, especially among neighboring states, as well as within a state. One exemption almost universally leads to pressure for others. The surprising feature is that the sales tax coverages have stood up as well as they have against the gophers nibbling at the roots and the gypsy moths eating the leaves. But gophers can eat away at potatoes for a long period before anyone realizes the ultimate consequence--until the potato hills are dug and there are no potatoes--only vines.













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