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# Reform and Simplification of Indiana State Taxes: The Retail Sales Tax

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The Indiana state sales tax yielded over $6.8 billion in fiscal 2013, roughly 40 percent of total Indiana state tax revenue, over a third more than yielded by the second most productive tax (the individual income tax), and more revenue than from any source outside of federal aid. Figure 1 shows the trend toward greater retail sales tax reliance over the years since 1970, when only around 20 percent of tax revenue came from the tax. Whether by design or by policy accident, Indiana has substantially shifted toward heavier use of the sales tax in support of state services, making it the foundation for the state revenue system.

The tax applies to retail transactions involving tangible personal property, public utility services, renters of accommodations for less than 30 days, and renters of other properties at a rate of 7 percent, one of the highest statutory tax rates in the United States. The previously noted high reliance is possible only with this high rate because of the narrowness of the sales tax base. Competitive problems that might otherwise emerge with this high rate are mitigated somewhat because, in contrast to the adjacent states of Ohio and Illinois (and many other states), Indiana localities may not levy their own sales taxes, so the state rate is the only rate applied to taxable transactions. This absence of local rates makes the sales tax much less complicated for consumers, vendors, and tax administrators.

Given the importance of the tax for support of government services in Indiana, it is imperative that the tax be structured in a way that does least damage to the economy and citizens of the state. Although Indiana lawmakers have avoided many of the more egregious structural elements found in a number of other state sales taxes, the Indiana structure is not now fully appropriate to the conditions of the twenty-first century. Reasonable reforms can make the tax both simpler to operate and a more robust revenue source. Although many tax experts would agree with Richard Bird that the retail sales tax "is now an aberration in the world perspective,"[1] it is an American and Hoosier institution with a firm place in the revenue profile. As such, it is important to structure the tax so that it avoids the worst of the problems that cause it to merit that low international regard.

## An Ideal Retail Sales Tax

The ideal retail sales tax distributes the cost of government according to the amount of consumption spending by the household and, in practice, provides the closest approximation to a general consumption tax in the American system. As a general tax on consumption, it would avoid the

[1] Richard M. Bird, "Rethinking Subnational Taxes: A New Look at Tax Assignment," IMF Working Paper WP/99/165, Fiscal Affairs Department, International Monetary Fund, December 1999: 16.

disincentive to saving that is characteristic of income taxes. Further, it would provide the fundamental fairness advantage of basing payment for government services according to self-evaluated ability to purchase services from the private sector. As Kaldor put it some years ago, "…each individual performs this operation [identifying their capacity] for himself when, in light of all his present circumstances and future prospects, he decides on the scale of his personal living expenses. Thus a tax based on actual spending rates each individual's spending capacity according to the yardstick which he applies to himself."[2] Household consumption expenditure presents a useful measure of capacity to bear the cost of government services.

While the consumption tax logic provides powerful support for the retail sales tax, it is wrong to think that the taxes in practice are general consumption taxes. Sullivan observes that the problem with retail sales taxes is "how far they stray from true consumption taxation,"[3] in particular by taxing transactions that are not consumption (they are purchases made by businesses) and by excluding from tax transactions that are consumption (they are final purchases by households). Generalizations are complicated by the fact that, although states do copy from their neighbors somewhat, each state adopts its own sales tax without any national template that might serve as a guide for uniformity and without any comparable federal tax that they might copy, in the manner that state income taxes tend to start from the federal structure, even though they have absolutely no requirement to do so. Each state levies a retail sales tax on its own, structured by the particular preferences and interests of its lawmakers, the interest groups that influence them, and the population. Unfortunately, the Indiana retail sales tax as it is now structured suffers from its differences from being a uniform tax on household consumption and moving the tax closer to that standard would present a useful approach to improving and simplifying the tax.

## The Narrowing Indiana Sales Tax

The Indiana retail sales tax base has become smaller as a share of the state economy over time. This narrowing is clearly apparent in Figure 2, a graph of the Indiana implicit sales tax base as a share of Indiana personal income over the 1970 to 2013 period. The decline in that share has been persistent over the years, falling from 0.544 in 1970 to 0.381 in 2013. Some abrupt shifts are easily explained by legislative actions, as with the exemption of food for at home consumption in 1973 (almost a 15 percent decline in the ratio from 1972 to 1973), but most of the decline has been gradual and persistent. In terms of revenue potential, the loss has been dramatic: if the 2013 share were the same as the 1970 share, revenue from the current 7 percent tax rate would be 43 percent higher – or the revenue necessary to finance the state budget could be raised at a much lower tax rate. But the share is much lower and, in order to support the increased sales tax reliance noted earlier, the statutory sales tax rate has had to increase dramatically, as shown in Figure 3. The Indiana sales tax rate has gone from one of the lowest in the United States (2 percent) to one of the highest. As the base narrows, the rate must increase to maintain the revenue needed to support the sales tax share of the state budget.

The relatively diminished sales tax base is not caused by reduced household spending. Figure 4 shows that U. S. household consumption as a share of personal income has steadily increased over the 1970 to 2013 period, from 0.749 in 1970 to 0.814 in 2013. The spending rate is higher, not lower. However, household spending on goods has declined over that period, from 0.369 percent

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[2] Nicholas Kaldor, *An Expenditure Tax* (London: George Allen & Unwin, 1955): 47.
[3] Martin A. Sullivan, "Can States Swap Sales Taxes for Income Taxes?" *Tax Notes* (February 18, 2013): 789.

of personal income in 1970 to 0.275 in 2013. Household spending behavior has shifted away from purchases of goods to purchases of services and, taken to the Indiana economy, means that the sales tax base can be expected to narrow even when no legislated policy changes are made. The retail sales tax base is gradually disappearing because households are substantially increasing the share of their incomes being spent on services and services are largely excluded from the Indiana sales tax base. That endangers the role that Indiana tax policy appears to have defined for the retail sales tax.

**Reforms to Simplify the Retail Sales Tax**

The design of an ideal retail sales tax is simple: if a household makes a purchase for personal consumption, the tax should be levied and if a business makes a purchase, the tax should not apply. By taxing each such individual transaction through the year, the accumulated tax base will be household consumption spending during the year. Reforms aimed at making the retail sales tax more closely conform to the principles of general consumption taxation will mean some exempt or excluded transactions would become taxed and other taxed transactions would become exempt. They may be conveniently divided into those involving household purchases and those involving business purchases.

Every exclusion and exemption requires drawing a line in collection of the tax, both in terms of compliance and administration, and wherever a line is drawn, there is economic advantage to being on one side or the other of that line. Drawing these lines makes for contention and complexity, so for purposes of tax simplification, the fewer the lines the better. Exemptions and exclusions should be in the tax only for the strongest policy reasons. These provisions are the source of complexity and their elimination provides the path to responsible sales tax simplification.

<u>Taxing Household Purchases</u> The logic of the general sales tax makes exemption of any purchase of goods or services by a household suspect. The exemption complicates compliance and administration as vendors must maintain separate collection and accounts to insure that the tax is collected and remitted on taxable purchases and administrators must verify that distinctions are properly followed. Exemptions create distinctions between households on the basis of their tastes and preferences and exemptions create pressure to increase the statutory rate. As statutory rates become higher, more is at stake on an individual purchase and mis-categorization of taxable purchases as exempt becomes more attractive.

Indiana has fewer suspect household purchase exemptions than do some states, but some that the law provides should be reconsidered. The most troubling is the general exclusion of purchases of services by households. This exclusion removes a considerable and growing component of household consumption from the tax base, thus contributing to the need for high statutory rates to generate necessary revenue, produces invoicing that artificially distinguishes between "parts and labor" in some transactions, and creates distinctions between similar taxed and untaxed transactions. Figure 5 gives a few illustrations of the strange distinctions created by the exclusion of services from the tax. Taxation of services purchased by households would provide a level playing field between alternatives as well as improve the productivity of the tax and make it more consistent with the consumption standard. Businesses would no longer need separate accounting and reporting for sales of tangible personal property and services – and most businesses selling services to households that would become taxable are already registered because they are selling goods.

Another household purchase exemption, adopted from good intentions, is the exemption of food purchased for at-home consumption. The idea behind the exemption is the tendency for higher income households to spend a smaller share of their annual income on such purchases in comparison with the share spent by lower income households. That pattern causes the exemption to provide greater relative relief to lower income than to higher income households, thereby reducing regressivity of the sales tax. But the revenue loss is substantial – roughly 15 to 20 percent of the potential tax base – and much of the total tax relief is given to households that are seldom understood to be deserving of welfare. If one recognizes that purchases made by federal Supplemental Nutrition Assistance Program (SNAP) payments are exempt as a requirement of participation in the program, the additional relief provided by food exemption goes only to those households with incomes above standards for that program. In general, around 43 percent of that tax relief goes to households with incomes above $75,000 – households not usually seen as requiring state financial assistance. The exemption also creates the potential for extra complications: examples include the distinction between pumpkins for eating and pumpkins for decoration in Iowa, the determination of Twix as a candy or as food in Illinois, and taxability of Papa Murphy's Take 'N' Bake pizza in several states. A simpler and more targeted approach to providing regressivity relief is the tax credit/rebate system pioneered with the initial adoption of the Indiana sales tax in the 1960s. In that program, food was taxable but households received an individual income tax credit equal to the estimated sales tax on food paid by low income households. Thus, low income households faced no net sales tax liability on food purchases and higher income households received relief that was a declining share of their income. The program significantly reduced sales tax regressivity while directing relief only on the most deserving and reducing the need for vendors selling both food and other goods from maintaining separate accounts. With SNAP payments now delivered via debit card, technology makes it possible to limit food tax relief only to those households most deserving while preserving the tax on an important portion of household consumption.

A third issue arises in regard to the complex approach that Indiana employs for sales taxation of gasoline, special fuel, and aviation fuel. The tax applies to the purchase price excluding state and federal excise tax applied to the fuel. Those excises are, effectively, proxy charges for the use of highways that they finance and there is no logical reason for giving the purchase of highway services particular relief under the retail sales tax. Furthermore, various taxes do get embedded in the price of many other goods taxed under the sales tax and no special provision is given those purchases. Balanced treatment of economic activity suggests that these motor fuel purchases should be taxed on the same basis as other transactions. That would make the operation of the sales tax simpler and more transparent, as well as provide for some expansion of the tax base.

In sum, if a transaction is a household consumption expenditure, that purchase should be taxed at the uniform retail sales tax rate. If the household would qualify for some form of economic assistance, there are direct approaches to providing that assistance that do not make compliance and administration of the retail sales tax more complicated, that involve less revenue cost than purchase exemption, and that do not add distortions to the economic marketplace. Those approaches should be favored over general purchase category exemptions or exclusions. Exemption of prescription drug purchases and medical and dental services may be reasonable and would add little complexity to operation of the tax, but any other household consumption expenditure exemptions are suspect.

<u>Exempting Business Purchases</u>

The retail sales tax should tax the last exchange in the supply chain from producer through distributors and retailers to households. No matter how finished the purchased item is, no matter how the purchase appears to be a retail purchase, purchases of business inputs do not belong in the ideal retail sales tax base. If a business purchases an input, that purchase should not be taxed. To tax such purchases would conceal a portion of the true sales tax burden from the citizenry, would discourage business expansion and development by increasing business costs, would make competition with other jurisdictions for industrial development more difficult, would violate the idea that tax burdens should be determined by levels of household consumption, and would be at variance with the idea that tax burdens should be aligned with either government benefits received or capacity to bear the cost of government. Business purchases do not belong in the tax base.[4]

Indiana provides more complete exclusion of business purchases from the sales tax than does the typical state and than does its surrounding states. Furthermore, its law does not add such complications as limiting exemption only to new and expanded industry or to expenditure only in geographically designated areas, so it has some simplicity advantages over a number of state sales taxes already. But the exemption is far from complete. As Table 1 shows, the share of the Indiana retail sales tax base made up of business purchases is below the national average for all years from 2004 through 2004 and is below the share for all surrounding states but Michigan for those years as well. However, around one-third of the Indiana retail sales tax base is made up of purchases by businesses, so the state still misses the ideal structure by a considerable margin. That represents a concealed and distorting impediment to the Indiana economy and broadening the exemption is an important priority for nurturing a dynamic economy.

One danger in making the reasonable reform of expanding the tax base to encompass service purchases is that services purchased as business inputs will get included in that expansion. If they are, all the problems associated with including business purchases of tangible property will be encountered. Of course, businesses that sell services should be able to purchase their inputs without paying sales tax on them, in exactly the same manner as business purchases of goods should be exempt.

The standard for purchase exemption should be whether the purchase is made by a business as an input to the operations of that business, not whether the item (or service) is finished, whether it is used in direct production, or becomes a part of a product to be sold. For most business purchases, the test would not be difficult to implement: households do not purchase many cash registers or forklifts, so sales like these require little testing for exempt status. It is more difficult for mixed use products – those that might be used in business operations or for household consumption – with pickup trucks as an example. Vendors would need to make the proper classification on these sales, just as they must now with decisions about whether the business purchase is going for an exempt or taxable use in the business, but the classification would be much easier with a broad exemption.

That general standard of business purchase exemption would put Indiana businesses ahead of other states and on a competitive par with businesses in Europe and other parts of the world that operate in a value-added tax environment. It would be consistent with the philosophy of the tax, would make compliance and administration of the tax less complex, and would significantly improve the economic climate of the state.

Other Features of the Tax

Indiana is one of twenty-eight states currently providing a collection discount as a percentage of tax collected as a reimbursement for tax compliance and inducement for timely payment. In 2011, the total discount was $18.6 million, around 0.33 percent of sales tax due. The cost of compliance with other taxes is regarded as a normal cost of operating a business and reimbursement is not seen as appropriate for these taxes, so singling out sales tax collectors for preferential treatment has limited

[4] Governments and non-profit organizations should be treated in the same manner as businesses because such entities are an alternative approach to provision of goods and services to the public. Their input purchases should be exempt and their sales should be taxed. Of course, services provided at no charge would not be taxed, but services that are sold would be.

justification. Considerable financial penalties associated with late payment and late filing can induce timely payment without loss of tax revenue that the collection discount brings. Elimination of the discount would reduce one line on the tax return without sacrifice of logic of the tax and its operations.

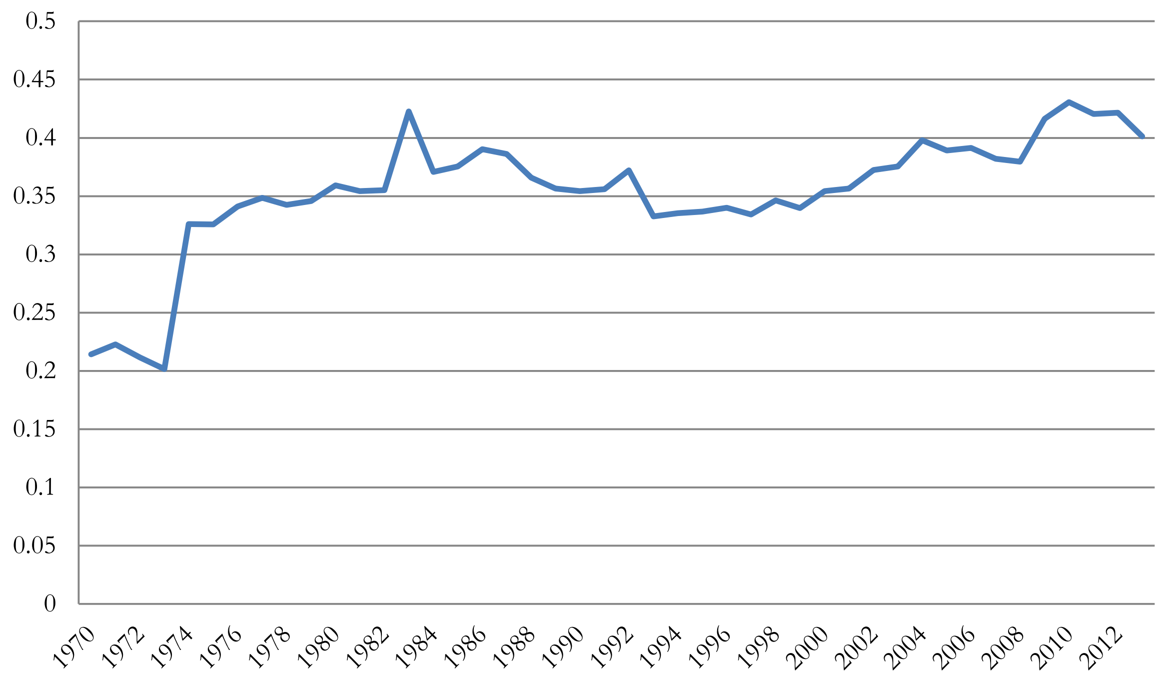
The state has wisely avoided sales tax holidays, a popular gimmick that adds complexity for no good policy purpose. Exempting selected transactions from the sales tax for a few days – purchases of certain clothing and school supplies shortly before the start of the school year or purchases of energy-efficient appliances, for instance – creates a loss of tax revenue, adds to compliance and administrative cost because sales must be tracked to a particular dates, and does little more than shift the timing of purchases. Even if it does add to total sales volume, most of the economic impact accrues outside the jurisdiction conducting the holiday because few jurisdictions host the factories that make consumer products covered in the holiday. The holiday may even not generate savings for consumers as vendors use the holiday to replace price promotions they would otherwise offer. Indiana should continue to avoid this gimmick.

**Conclusion**

Indiana relies on its retail sales tax more heavily than on any other tax. To maintain services to state residents, it is important that the tax remain a robust revenue producer while creating as few disruptions as possible. The current tax is not well-designed for the economy of the twenty-first century because it fails to be a uniform tax on consumption expenditure. Its base is unduly narrow because it excludes most household purchases of services and excludes some household purchases of goods. It is unduly broad because a considerable fraction of the base consists of business input purchases. No good comes from a narrow-base, high rate strategy of taxation, particularly when that base is mis-defined, and Indiana needs sales tax reform to move closer to the uniform consumption tax ideal. It is unduly complicated because of exemptions contrary to the consumption tax ideal.

The heart of tax simplification is to reduce the number of lines between taxable and exempt that must be drawn. A retail sales tax designed after the ideal provides the height of simplification because it has but one distinction: is the purchase made by a business or is it a consumption purchase by a household? Fortunately, a tax designed on that simplified principle is also a tax that is designed exactly according to the basic principles of general consumption taxation. Reform and simplification are perfectly matched.

**Figure 1. Indiana Retail Sales Tax as Share of State Tax Revenue, 1970 - 2013**



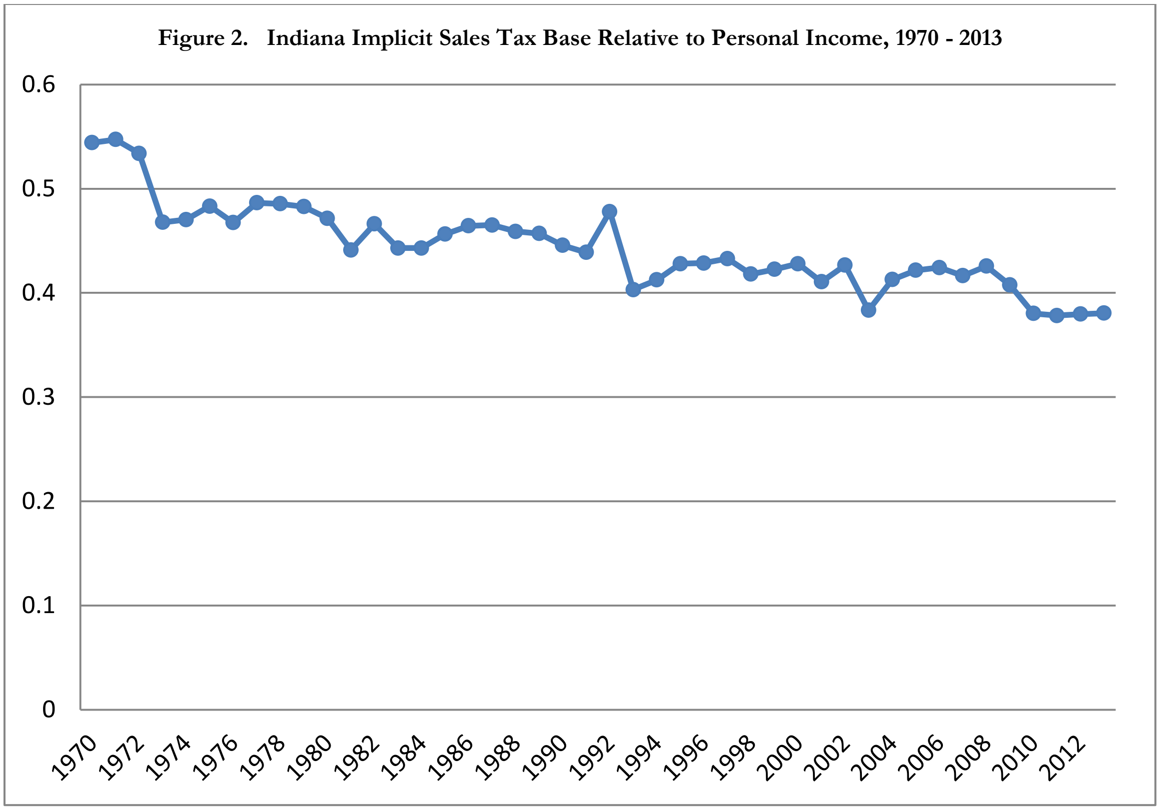


Figure 2. Indiana Implicit Sales Tax Base Relative to Personal Income, 1970 - 2013
0.6
0.5
0.4
0.3
0.2
0.1
0
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988
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2004
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2008
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2012

**Figure 3. Indiana Retail Sales Tax Rate from 1970 to 2013**

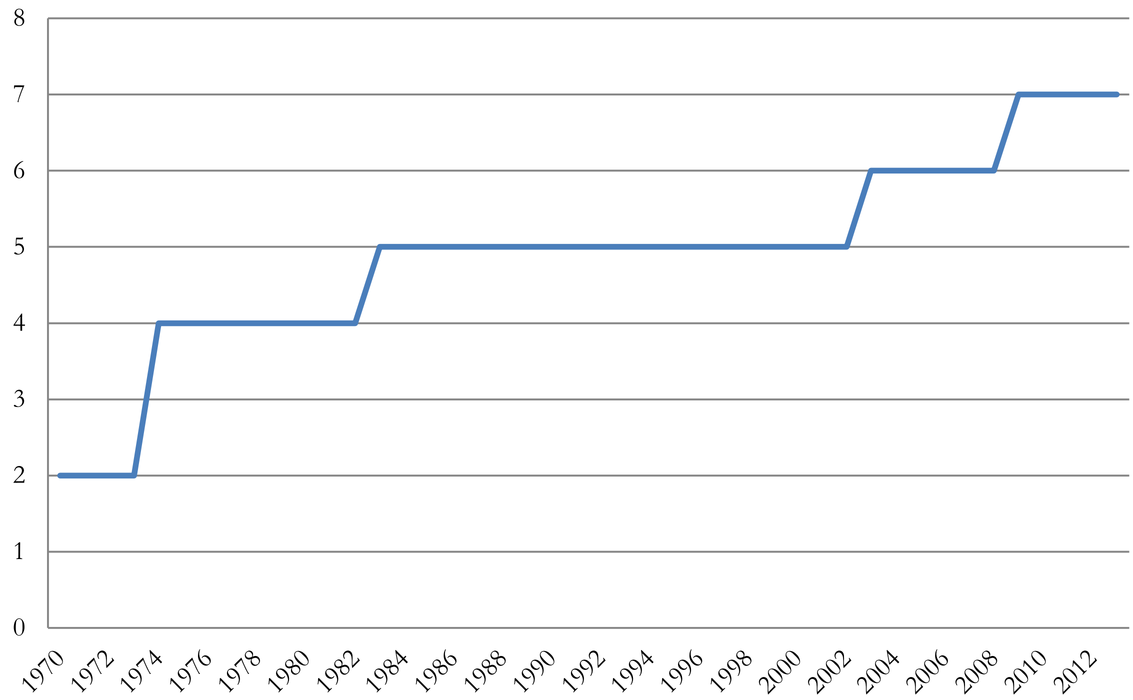

**Figure 4. U.S. Personal Consumption And Consumption of Goods Share of Personal Income**

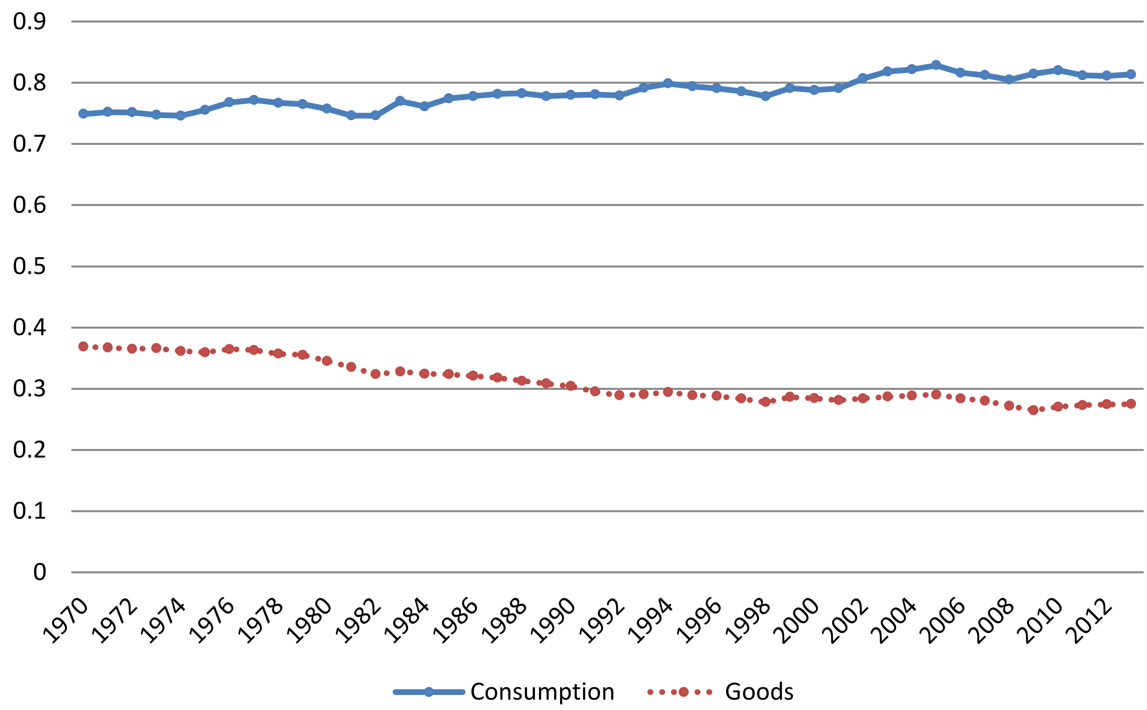

**Figure 5. Taxability Distinctions Created by Exclusion of Services from the Sales Tax Base**

| EVENT | UNTAXED | TAXED |
|---|---|---|
| Improving Personal Appearance | Caps on front teeth | New wardrobe from Jos. A. Bank |
| Improve Lifestyle | Hire architect to design new family room | Buy a BMW |
| Income Tax Preparation | Hire H&R Block to do return | Buy J.K. Lasser's tax preparation guide from local bookstore (not electronic) |
| Improve the House | Hire carpet cleaners | Buy carpet cleaning machine |
| Improving Golf Game | Get a lesson from course pro | Buy new golf clubs |
| Family Business | Hire a telephone answering service | Buy an answering machine |
| Get Better Looking | Get hair dyed at beauty shop | Buy Clairol for hair dying at home |
| Protecting the Car | Optional extended warranty | Non-optional dealer warranty |
| Romance | Junior buys membership in dating service | Junior buys flowers for his date |
| Preparing to retire | Hire an investment planner | Buy a book on investment strategies |
| Death | Hire a lawyer to draft Grandma's will | Buy a casket for Grandma |

Table 1. Business Share of Retail Sales Tax Base

| | National Average | Indiana | Illinois | Michigan | Ohio | Kentucky |
|---|---|---|---|---|---|---|
| 2004 | 0.416 | 0.315 | 0.416 | 0.317 | 0.400 | 0.444 |
| 2005 | 0.411 | 0.320 | 0.419 | 0.297 | 0.415 | 0.461 |
| 2006 | 0.415 | 0.319 | 0.419 | 0.322 | 0.435 | 0.471 |
| 2007 | 0.423 | 0.313 | 0.426 | 0.326 | 0.425 | 0.461 |
| 2008 | 0.405 | 0.314 | 0.419 | 0.316 | 0.399 | 0.452 |
| 2009 | 0.410 | 0.322 | 0.417 | 0.356 | 0.421 | 0.455 |
| 2010 | 0.422 | 0.320 | 0.492 | 0.324 | 0.437 | 0.465 |
| 2011 | 0.419 | 0.319 | 0.499 | 0.327 | 0.432 | 0.449 |
| 2012 | 0.448 | 0.335 | 0.462 | 0.327 | 0.453 | 0.483 |

Source: Computed from U. S. Bureau of Census, Governments Division, *State and Local Government Finances* and Ernst & Young, *Total State and Local Business Taxes (various years)*