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Sales Tax Overview

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This document is intended to provide an overview and discussion of concepts and issues associated with a sales tax to the Revenue and Transportation Interim Committee. It provides no policy recommendations. It is intended only as a review of factors to be considered when designing sales tax legislation.

Presented first is a basic definition of a sales tax which is followed by an overview of the Department of Revenue's sales tax model. This model has been developed to simulate the effect of proposed legislation. Brief discussions of some issues that are important when considering a sales tax are included after the overview.

Objective of a Sales Tax

In addition to property and income taxes, most states rely on a tax of final consumption to generate revenue. In theory, the purpose of a sales tax is to tax the consumption of final goods and services without taxing intermediate goods that are used as business inputs. In practice, this is hard to achieve.

In recent sessions, various legislators have proposed a sales tax as an option to fund public education while providing relief for property and income taxpayers.

Overview of Sales Tax Model

The Department of Revenue has developed a sales tax revenue estimation model using data from the Economic Census of Business, the Consumer Expenditure Survey and population projections from the Census Bureau. This model is capable of exempting individual industrial sectors, like education services or wholesale trade, individual goods and services within industries, and exempting certain groups of consumers like businesses or governments.

The model can project revenue for different types of sales tax legislation. For example, it can estimate revenue if all construction inputs are exempt from the tax. It can also handle any tax rate that is in proposed legislation.

Since the sales tax model relies on data from national sources, and in some cases the data is out of date, assumptions have to be made. The primary assumption is that consumption patterns in Montana are similar to consumption patterns for the rest of the country. A second major assumption is that the population estimates are accurate. In addition, since the Economic Census of Business is conducted every five years, the last

published cycle is from 2002. It is possible that consumption patterns have changed substantially in the last five years. Because of these data limitations, the reported numbers are always only estimates of revenue generated by sales tax legislation.

Volatility of a Sales Tax

The volatility of a sales tax depends on the tax base. If a wider variety of transactions are taxed, then the revenue from a sales tax will be more stable. In addition to being more stable, a sales tax with a large tax base will generate more revenue. A broader base also generates revenue with a lower tax rate improving the efficiency of the tax. The constitutional maximum for a sales tax in Montana is 4 percent (Article XIII, Section 16, Montana Constitution). Modeling done by the Department has shown a broad tax base could raise significant amounts of revenue even with a tax rate below the constitutional limit.

Most states exempt unprepared food on equity grounds, assuming that consumption of food is not a voluntary expense. For states that do not include groceries in their tax base, taxing unprepared food would increase revenue by 20 to 25 percent. Some states that tax groceries have implemented an income tax rebate for low income taxpayers to make the sales tax less regressive.

In addition to food, making services taxable broadens the tax base. The taxation of services varies widely by state. Some states tax only a few services to avoid taxing business inputs, while others tax most services because they make up the final stage of consumption. In 1979, services represented 47.4 percent of final consumption; in 2002 they made up 58.8 percent.

Durable goods and certain business purchases make up most of the rest of the tax base. However, consumers can delay these purchases until economic conditions are more favorable. This leads to a tendency for sales taxes with a narrow tax base to be more volatile and fluctuate with the business cycle.

In addition, there has been an increased use of the internet to purchase durable goods. The United States Supreme Court ruled that collecting a sales tax from out-of-state vendors is an excessive burden on the retailer, so states are unable to collect revenue from mail order and internet retailers (*Quill Corporation v. North Dakota*). If people change their consumption patterns and purchase on-line to avoid paying the sales tax, then revenue will be more volatile.

Also, sales tax revenue depends on individuals' consumption, which is determined by many exogenous factors. The Montana model is based on past consumption at the national level, which includes the underlying economic factors; but it is unable to predict how a change in some external factor will affect revenue. Only the revenue from a given change in consumption spending can be estimated. Even with a broad tax base, revenue will fluctuate depending on economic conditions.

For example, with rising housing prices and increased home equity, consumers were more willing to spend money on items that would be included in the tax base. As the housing market has weakened in some areas of the US, consumers are no longer confident in their home equity positions, leading to consumption spending declines. Changing conditions such as those in the housing market that influence consumer consumption are very difficult to predict and limit the ability of a sales tax model to forecast revenues.

Expenditure and Population Growth Rates

In order to project future consumption, expenditure growth rates were calculated using information from the Consumer Expenditure Survey published by the Bureau of Labor Statistics. This is a sample of consumers nationwide, but it is assumed that consumers in Montana have the same consumption patterns. The model also assumes that the annual growth rates for each product will be the same as the annual growth rate from 2001 – 2006. For the average consumer, the annual growth rate for overall expenditures was 4.14 percent while average wages and salaries grew by 4.65 percent. Examples of other growth rates are: alcoholic beverages 7.33 percent, food away from home 3.81 percent, food at home 2.06 percent, healthcare 4.86 percent, and televisions, radio and sound equipment 6.54 percent. These growth rates reflect what the average consumer spends on these items, not the total value of taxable transactions. In order to estimate the total increase in sales, these growth rates need to be combined with population growth estimates.

According to the Census Bureau’s estimates, the population of Montana grew at an annual rate of 0.8 percent from 2003-2007. This, combined with the expenditure growth rates, provides the estimates for the growth in total sales for the different industries (Table 1).

Table 1: Annual Growth of Total Sales
Population and Expenditure Growth Rates Combined

Sector	Estimated Annual Growth Rate, 2002-2008
Sector 42, Wholesale Trade	4.70%
Sector 44-45, Retail Trade	4.28%
Sector 51, Information	4.85%
Sector 52, Finance & Insurance	4.93%
Sector 54, Professional, Scientific, & Technical Services	4.93%
Sector 56, Admin & Support & Waste Management & Remediation	4.93%
Sector 52, Health Care & Social Assistance	4.15%
Sector 72, Accommodations & Foodservices	4.98%
Sector 81, Other Services (except public administration)	3.74%

The following three estimates show the difference in revenue with different tax bases. They are based on legislation proposed in the 2003, 2005, and 2007 legislative sessions. All three bills exempted unprepared food (groceries) and prescription medicines. They also shared a common tax rate, 4 percent and exempted business and government expenditures. The differences between the three estimates are in the mix

of goods and services taxed. HB749 had the largest base. It taxed consumer goods and personal and business services except for a few specifically exempted items. HB760 exempted most business services, but included personal services. SB554 had the narrowest base because it only taxed consumer goods, implicitly exempting most services. The three bills are included to demonstrate the potential revenue generation of a sales tax of 4 percent with different tax bases.

Compliance

All states with a sales tax require businesses with a physical presence in the state to collect the tax on the state's behalf. Reducing the cost of collecting and remitting the tax may lead to increased compliance.

Each of the three example bills included a vendor allowance to compensate businesses for collecting and remitting the sales tax. In all three bills, the allowance was a percentage of the tax collected, with a cap ranging between \$50 and \$350 a month. One criterion of all three vendor allowances is that the remittance of sales taxes is made on time.

Another important way to reduce the cost of implementing a sales tax is to keep the tax as simple as possible. Simplification is enhanced by applying one tax rate to all goods and services, and to clearly define what is taxable and what is not. In some cases, goods are sold along with a service. When this is the case, it can be confusing how much of the total bill should be included in the tax base. If the tax is too complicated, with a single business having many different exemptions or different tax rates, this increases the cost to the retailer of complying with the sales tax. If the cost is too high, then compliance may fall.

As mentioned earlier, out-of-state internet and mail order vendors do not collect the sales tax. All states with a sales tax compliment the sales tax with a use tax that places the responsibility on individuals to remit to the state taxes for goods that were purchased when no sales tax was collected. This means that for internet and mail order purchases, the individual taxpayer is thus responsible for paying a use tax. In reality, payment of use taxes is impossible to enforce. The more internet and mail order purchases, the less compliance there will be.

The streamlined sales tax project (SST) is an attempt to reduce the cost of complying with state and local sales taxes. There are predefined categories of goods and services, and large, multi-state retailers are allowed to certify their accounting software to collect sales taxes. Following the guidelines of the SST means that retailers have consistent definitions for what is taxable and what is exempt in local taxing districts. While the goal of the SST is to collect sales tax from out-of-state retailers, actually reaching this goal is not in the immediate future.

Nonresidents Share of a Sales Tax

The share of sales tax that non-residents pay is determined by what goods and services are included in the tax base. If many services that are not typically consumed by non-residents are in the tax base, then the proportion of the tax that out-of-state residents pay is smaller. In all of the scenarios for a sales tax, the goods and services that are disproportionately purchased by non-residents are included. In the three previous examples of sales tax legislation, the dollar amount that non-residents pay is the same.

For 2005, the Institute of Tourism and Recreation Research (ITRR) at the University of Montana estimated that nonresidents spent \$2.76 billion in Montana. This is broken down by category in table 2.

Table 2: Nonresident Expenditures	
Exempt Expenditures	
Groceries, Snacks	\$232,900,000
Gasoline, Oil	\$773,300,000
Misc. Services	\$39,700,000
Total Exempt Expenditures	\$1,045,900,000
Taxable Expenditures	
Transportation Fares	\$55,200,000
Outfitter, Guide	\$118,700,000
Auto Rental & Repairs	\$129,400,000
Hotel, B&B, etc.	\$257,800,000
Retail Sales	\$433,700,000
Restaurant, Bar	\$586,400,000
Campground, RV Park	\$44,900,000
Licenses, Entrance Fees	\$56,300,000
Total Taxable Expenditures	\$1,627,200,000

The tax that non-residents pay is calculated by multiplying the total taxable expenditures by the 4 percent sales tax rate. At the 2005 levels, this would total \$65.1 million in tax revenue. For the three bills, the result is a range from 10.2 percent of total taxes paid with the largest tax base to 15.3 percent with the smallest. Since all three example sales taxes specifically exempt groceries and fuel, non-residents do not have to pay any tax on them. Miscellaneous services were not included as taxable expenditures because it is not clear how they would enter into the tax base. Since Billings is a regional trade center, there may be quite a bit of exempt expenditures included in this category.

Neighboring States

Table 3 shows the sales tax rates and the tax base for neighboring states. It gives an indication of how these nearby states tax food, prescription drugs and services.

Table 3: Sales Tax Exemptions

State	Tax Rate	Food	Prescription Drugs	Services (168 Possible)
Idaho	6		Exempt	30
North Dakota	5	Exempt	Exempt	27
Oregon	No Sales Tax	-	-	-
South Dakota	4		Exempt	146
Utah	4.75	Lower Rate = 2.75	Exempt	57
Washington	6.5	Exempt	Exempt	157
Wyoming	4		Exempt	62
	Average Tax Rate	No Tax on Food	No Tax on Prescription Drugs	Average Number of Services Taxed
Nation*	5.40	30/46	45/46	55.21

* Includes District of Columbia, five states (AK, DE, MT, NH, OR) do not have a state sales tax.

One concern raised in previous debates is that a sales tax would cause firms to lose sales to other states that have a lower sales tax rate than Montana. Because the maximum rate can only be 4 percent which is less than or equal to the rates of bordering states, implementing a sales tax should not cause Montanans to shop in those states because of a lower tax rate.

Instead, residents of those states may not come to Montana to make purchases, causing a decrease in the sales of Montana businesses. According to Due and Mikesell, this is most likely to occur in the Billings area because of its proximity to Wyoming (Due and Mikesell, 1995). Since there are not population centers near the borders of Idaho, North Dakota or South Dakota, it is not likely that residents from these states are making purchases in Montana to avoid paying a sales tax.