The General (Retail) Sales Tax

Overview

1. Intent of the tax. The General Retail Sales tax is a tax on the disposition of income (consumption) rather than a tax on the sources of income (such as income, estate and gift taxation). General sales taxes are intended to apply broadly to an inclusive base of goods and services sold at retail[1], [2] Retailers engaged in business in Connecticut are required to collect and remit the tax to the state.[3] A consumption tax the tax has three key features: (i) its basis is the d*estination principle* of taxing goods and services consumed by Connecticut households and visitors in the state as well as goods shipped into Connecticut for consumption; (ii) the intent is to capture all Connecticut sales at retail regardless of the location of the seller; and (iii) exempting from the tax sales by Connecticut firms is appropriate when the good or service sold is delivered out-of-state. [4]

2. Tax Base. The tax base breadth (defined as taxable sales divided by state personal income) appears narrower than the average state, but this may arise in part as buyers make many purchases out of state or online. That said, under current arrangements the measure base breadth is headed for decline unless steps are taken to capture the changing composition of the new economy tax base For a given revenue yield this higher statutory rates in the future.

3. Multiple Tax Rates. Connecticut's sales tax structure is complicated in the sense that policy changes have been relatively frequent and a large number of tax rates are imposed. For example, most states have one or two sales tax rates while Connecticut has seven. Multiple tax rates require decisions both on whether the transaction is taxable and at what rate.

4. Revenue and short vs. long run volatility. The sales tax generated $3.98 billion in 2014, which accounts for a quarter (25%) of state tax revenues. The average US state sales tax generated closer to a third of total state revenues (31.2%).[5] Connecticut's standard 6.35 percent sales tax rate is below the median state and local sales tax rate of about 6.9 percent Connecticut's short run revenue elasticity is 0.6, which means sales tax revenues grow much more slowly than the economy[6]. However, over the past ten years the sales tax has also exhibited periods of volatility, indicating a potentially unstable tax characteristic of narrowly- based sales taxes.

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[1] Selective sales taxes are levied on specific commodities such as alcohol, motor fuel, tobacco transient, and accommodations are often used simultaneously. The Panel did not consider this class of taxes in its study agenda.

[2] Forty five states and the District of Columbia levy a general sales tax. The non-sales tax states are Alaska, Delaware, Montana, New Hampshire and Oregon

[3] As explained by Fox (2015) there are cases where taxpayer compliance and administrative enforcement is problematic.

[4] All states that levy a general retail sales tax (RST) also levy some form of compensating use tax. The use tax applies at the same rate as the sales tax and is imposed on purchase of taxable items made outside the state for use with in the state or when items purchased for a tax exempt purpose are transferred to a taxable purpose. The use tax is complementary to the sales tax and does not apply of the sale already has been, or will be, subject to the sales tax.

[5] Part of which may be explained by the statutory rate differential/ hard to say as Connecticut has multiple rates.

[6] Elasticity is a measure of the sensitivity of the tax to changing economic conditions. The measure s calculated by dividing the percentage change in revenue by the percent change in an aggregate measure of economic activity such as income or GDP. (Cordes, 2005).

5. Horizontal Inequity. The current Connecticut sales tax is rife with horizontal equities, some intended (sales tax holiday, specific exemptions from the tax base, reduced rates for legislatively favored activities) and others unintended (difficulty in taxing transactions such as internet sales and the shared economy).

6. Vertical Inequity. Because of the convergence of twin realities that (i) the ratio of consumption/income decreases as household incomes increase and (ii) the tax is imposed on broad sets of goods and services, the sales tax is regressive. However, to efficiently and effectively eliminate this vertical inequity by legislating changes in the base of the tax is sure to fail since sellers cannot effectively target sales to the situation of individual purchasers and households. What can work, however, is for Connecticut to view vertical equity as a goal for the tax system rather than a goal for each tax, and then use taxes linked directly to households, such as the personal income tax, to achieve the vertical equity goals. Moreover, a policy of enacting exemptions from the sales tax base tends to exacerbate regressivity since such tax base erosions require higher tax rate on non-exempt items for a given amount of revenue. Even worse, higher tax rates can create perverse effects such as (i) encouraging more online purchases to evade the Connecticut sales tax (which likely makes the tax more regressive); (ii) encouraging additional purchases of non-taxed items; (iii) creating retailer complexity and therefore higher costs of compliance, and (iv) providing greater incentives for sellers and buyers to evade or avoid the sales tax.

7. Non-neutralities. Because the RST is intended as a tax on final retail consumption, there is one broad class of exemptions that make sense, and that is for business-to-business sales of intermediate inputs in the production and distribution process. Nonetheless, 35 percent of the State's sales taxes are currently collected on such transactions.[7] Taxation of intermediate purchases not only raises the cost of doing business in Connecticut but also changes relative prices that affect consumption decisions. There is also the problem of "tax pyramiding" whereby the same item is taxed more than once in the production and distribution process.

8. A tax at risk of becoming obsolete. As one of the "big three" of state and local taxation (the income and the property tax are the other two), a state cannot allow the sales tax to become fiscally obsolete. As a response to state revenue needs in the Great Depression and its immediate aftermath (1929-1938), 24 states adopted a general sales tax (Connecticut was a Post WWI adopter in 1947). For the economies of that time (even as late as 1969 when Vermont was the last state to enact) when the retail economy was largely "goods" rather than "services" based, it was a good 20th century way to generate revenue. But, as well documented for this panel and by others, the "old" economy in which tangible property was typically manufactured and physically delivered is giving way to the 21st century, which is that of the internet, software, technologies that do not require a presence where the retail consumer is located, and changing business models such as the sharing arrangements of TaskRabbit, Uber, Airbnb, and HomeAway, And, this is only a partial list of just what one sees going on today. It is hard to neatly predict what the 2020s and beyond will be like as technology and innovation arrive at fast pace. But what Connecticut can do in order to be in a position to adjust to these new economy changes is to stick with the

[7] Fox (October 27); Council on State Governments and Ernst and Young LLP, Total State & Local Business Taxes, 2015.

principle that if the final retail consumer in Connecticut, then the sale is in Connecticut. And it's taxable.

Connecticut Sales Tax Options Matrix

Revenue Neutrality. All base broadening (narrowing) is understood to be made with the hard budget constraint of revenue neutrality. There are two ways to accomplish this: (1) A sales tax base broadening (narrowing) that captures new revenue triggers a reduction (increase) in the general statutory rate of the standard 6.35 %. And/or (2) a revenue gain (loss) can be offset by a change in the rate and/or base of another type of revenue that is part of the Connecticut State/Local tax system.

	Policy Option	Description and Impact	Evaluative Criteria and Comments
Options Designed for the New Economy			
1	Remote Sales. Robust Assembly and Executive collaboration to legislate a more expansive definition of nexus (a taxable event).	Remote sales—both catalogue mail order and E-Commerce sales over the internet—have expanded rapidly over the past decade (Fox, p25. Fig 7). Although Connecticut is aggressive in taxing e-sales (estimated $300 m of collections s in 2015), it is still expected to lose about $100m this year due to non-compliance. At present, DRS, like other states are limited by US Supreme Court decision [Quill v. North Dakota (504 US 298 (1992], which says that a remote seller cannot be required to collect the tax on behalf of the state to which the sale of a good or service is destined. To be clear, however, Quill does not say that the tax is not due. Accordingly, states, Connecticut along with several other states have become aggressive in forcing voluntary collection, arguing that if a sale is destined (delivered) to the state, there is nexus. [8]	*A Panel Recommendation would be mandate (now as well as for all future DRS) that Connecticut remain aggressive and coordinate with other states in this effort*. Taxing remote sales the same as non-remote sales reveals a classic case of the merits of base broadening order to satisfy the Panel's criteria for a "good" state/local revenue system. (i) revenue productivity increases; (ii) taxing remote sales migrates the horizontal inequity that results from the taxability of "brick and mortar" sales locations, which are shown to shown to have lost revenues to the out of state remote sellers. There is also an (iii) efficiency (neutrality) argument for = taxing of online and other remote sales: remote sellers (e.g., Amazon) are more likely to acquiesce to enforcement efforts in large vs. small states. Inclusionary taxation would also allow firm with a clear physical presence in Connecticut to become more (iv) competitive *vis—a -vis-* out of state vendors who are not physically present but nonetheless sell into Connecticut.

[8] Connecticut (as well as other state sales tax law) imposes "Use Tax" at the same rate as the sale tax that is to be paid of the sales tax is not. But use tax enforcement and thus collection is very problematic. Not only are most consumers not aware of this obligation, but also, even those who are aware find the payment process cumbersome. The result is that the use tax is typically ignored and difficult for the tax administrator to enforce. The Supreme Court was also clear that this inequity and non-neutrality could be cleared up by the US Congress. But Congress has failed to act. (Fox, 2012; October 27, 2015)

	Policy Option	Description and Impact	Evaluative Criteria and Comments
2	Digital Downloads. Taxing (retail) consumption digitized products.	Digitized transactions can be considered using the same logic as remote sales. The intent is to tax all retail consumption and to tax highly substitute items similarly (e.g., download music should be taxed the same as a CD: digitized moves the same as DVD).	*A Panel Recommendation would be to mandate that Connecticut remain aggressive with supportive legislation to direct DRS to ensure that consistent taxation is occurring between the remote, digitized economies and the traditional economies.* Such base broadening would enhance the Connecticut revenue productivity, fairness (horizontal equity)and efficiency of the Connecticut sales tax
3.	The Emerging Shared Economy. Use Companies that organize the sharing economy for enforcement and & remittance of the sales tax; tax the sharing and the traditional economy similarly	This option is extension of the option above; however in this case the issue is not only remote sales, but also how to get at the sales transactions of the rapidly emerging in-state "Sharing Economy" . Taxing emerging entities such as Airbnb (which compete with the local BNB that chooses a business model outside of the Airbnb network) and UBER (require the company, not the driver, to collect the tax) is one step in the process. The overall goal is to ensure that the (i) traditional and (ii) now emerging sharing business models are being taxed similarly.	*A Panel Recommendation to mandate that (i) DRS be aggressive insuring that there is similar tax treatment of services provided through the emerging sharing economy as with the currently taxable traditional economy and that (2) DRS conduct a comprehensive study on the taxation of the sharing economy in a manner that is consistent with the Panel's normative criteria for evaluating the quality of the Connecticut revenue system.*
4	Services. Tax now exempt/ favored services sold at retail.	As well documented by the Panel's research on the Connect Economy and its Fiscal Architecture, a key part of the new economy is the long term trend towards a services and away from a goods economy. Exempt services that can broaden the sales tax base and that frequently purchased by Connecticut consumers include: (i) renovation and repair services; (ii) marina services and towing; (iii) travel agents; (iv) residential utilities including water, electricity, natural gas); (v) barber shops and beauty salons; (vi) doctors, nursing and other health care services (cosmetic medical services are already taxable); (vii) bowling and billiards, and (vii)road and towing services.	Adoption of this recommendation would not only "fit:" the services economy, but dramatically improve horizontal equity, as well as enhance revenue productivity, tax simplicity (no need to sort out sales of services vs. goods). The effects on vertical equity ("gressivity") and on buoyancy are mixed. Any additional regressivity could be addressed through adjustments to the personal income tax rate structure and/or variable vanishing, refundable sales tax credits against the personal income tax. Too, qualifying consumers could use a smart card for over the counter purchases. Regarding revenue buoyancy. items (i), (iv) and (vii) would add stability. The other items would add some elasticity to what has recently been shown to be relatively inelastic tax (e=0.6). One can

			think of adding these services to the tax base as a revenue certainty hedge.
	Policy Option	**Description and Impact**	**Evaluative Criteria and Comments**
5	<u>Business-to-Business. Sales</u> Reduce Taxation of business-to-business (B2B) sales	Many intermediate (not retail B2B) services are currently taxable, which is inconsistent with the intent to tax consumption, except in cases where the final good or service is not taxed (e.g., items purchased for resale by sales tax exempt non-profits). Taxing intermediate purchases raises the Connecticut cost of doing business, alters relative prices as final products have supply chains of different length, and encourages vertical integration or bringing certain production in- house. Examples of business-to-business sales may include consulting services, computer purchases, digital downloads, office maintenance services and use of employment agencies. To fully accomplish this today the state would need a revenue neutral sales tax rate greater than 8 percent. However, the rate could be kept lower by expanding the base to more consumer goods and services including those noted in this matrix. A policy of exempting business-to-business sales would be a bold move by Connecticut, setting it apart from other states. In the context of the traditional economy, the revenue impact was, indeed, a practical barrier. But with new (and some old) economy base broadening this is becoming a viable option.	*Recommendation/Option: a commitment to evaluate areas where intermediate purchases are being taxed with the explicit goal to exempt business-to-business sales (including remote sales))* <u>Revenue Productivity</u>: Without offsetting base broadening or drawing on other state taxes the revenue loss significant ($1.4 bn in 2014). The positive tradeoffs are that of <u>enhanced neutrality/efficiency and increased competitiveness</u>
Options for the Traditional Economy			
	Policy Option	**Description and Impact**	**Evaluative Criteria and Comments**
6.	<u>Food for home consumption</u>. Impose the tax on all retail purchases of food, including for home consumption. Purchases made with food stamps would remain exempt.	The sales tax is intended as a broad tax on consumption and should exempt as little consumption as possible to allow a lower revenue neutral tax rate and to limit the tax's impact on consumption choices. The exemption a poorly targeted/blunt instrument for mitigating regressivity Moreover, other more effective means-targeted strategies are available. Connecticut is one of 31 states to exempt food for home consumption, and it does so at a significant cost of forgone revenues and a higher general statutory rate. If the revenues gained from taxing all food neutrally were applied to rate reduction, the CT general sales tax rate would fall to about 5.8% (before any low income	Recommendation/Option: Impose the tax on all retail purchases of food including that for home consumption; combine this change with means targeted statutory rate adjustments and/or tax credits through the income tax. Keep food stamp purchases exempt. __ Enhances <u>revenue productivity</u> and <u>stability</u> Enhances <u>horizontal equity</u> Enhances <u>vertical equity</u> if accompanied by means tested adjustments Reduces retailer <u>cost of compliance</u> (sorting out what is and is not taxable

		tax credit or smart card adjustment is made).	A non-neutrality: taxing groceries will lead to create some cross-border purchasing with neighboring Massachusetts, New York and Rhode Island, all which exempt food for home consumption.
	Policy Option	**Description and Impact**	**Evaluative Criteria and Comments**
7	Tax Holidays. Eliminate the sales tax holidays	Connecticut is one of 18 states that allows a sales tax holiday and along with Massachusetts is the only state north of Maryland with a holiday Tax holidays are generally justified as a way to enhance vertical equity and stimulate the economy. In fact, tax holidays are unlikely to achieve either objectives as they (i) are poorly targeted to low income households; high income buyers, with greater capacity to time their purchases during the holiday the perceived regressivity of the may be exacerbated; (ii)are more likely to change the timing of purchases rather than the total amount of purchases; thus Connecticut economy is not stimulated, Moreover, some studies show that holidays are just as, or more, likely in to result in higher profits for vendors than lower prices for buyers	*Recommendation/Option. Eliminate the one week sales tax holiday in August for clothing and footwear costing less than $100.* Connecticut allows a one week sales tax holiday in August for clothing and footwear costing less than $100. (The exemption amount was reduced from $300 to $100 this year and the complete exemption of clothing and footwear costing less than $50 was eliminated). Revenue Loss: $5.2 m Vertical equity: Poor targeting Neutrality: competes with (or may eliminate) the alternative business decision to compete in back-to-school sales.
8	Government Sales at Retail Levy the sales tax on sales by government in cases where the public activities compete with the private sector.	Imposing the tax on government sales levels the playing field to the extent that they compete with the private sector. The tax would cause governments to face the same after tax input prices as the private sector, which can help ensure that efficient decisions are being made throughout the economy. Connecticut recently extended the sales tax to parking at state parks, which is consistent with imposing tax on services that are similar to those being provided by the for profit sector.	*Recommendation Levy the sales tax on sales by government in cases where the public activities compete with the private sector.* Enhances horizontal equity and eliminates a competitive non-neutrality when sales tax exempt government competes with private entities. This is especially true in the case of the private sector offering of a highly substitutable good or service, but it could also be the case of the untaxed government service leads to reduced private sector intervention (offering for sale a similar service) in the economy Taxing government sales—government as taxpayer and well as tax collector—nets out revenues; that is there will be little or no revenue direct revenue generation to the state. Thus the primary argument is for efficiency—getting the relative prices right.