

Sales Tax Base Erosion in Kansas

Principal Findings

- Although the sales tax is generally perceived by many to be a broad-based tax on final consumption, in most states it is neither broad-based nor limited to final consumption.
 - Economic changes and policy decisions have coalesced to accelerate changes in the sales tax base in recent years.
 - The principal causes of erosion of the sales tax base include:
 - Legislated statutory exemptions,
 - Attempts to tax services,
 - Cross-border shopping, and
 - Technological change.
- One important reason for the erosion of the Kansas sales and use tax base is the passage of a large number of statutory exclusions and exemptions to the tax.
 - Since 1937 there have been 71 original exemptions and exclusions from the sales and use tax, 53 expansions in exemptions or exclusions, 20 restrictions in exemptions and exclusions, and 62 other changes in the sales and use tax statutes, for a total of 206 legislative enactment or changes in the Kansas sales and use tax statutes.
 - In 1938 the total value of exclusions and exemptions from the sales and use tax base was \$121.4 million of sales.
 - By 2005 this had mushroomed to \$68,633.8 million of sales.
 - The value of the exclusions and exemptions is actually nearly twice the size of the actual sales and use tax base in 2005 of \$35,706.0 million.
 - In 1938 the total value of exclusions and exemptions was \$2.4 million.
 - By 2005 this had mushroomed to \$3,637.6 million.
 - The value of the exclusions and exemptions is actually nearly twice the size of the actual sales and use tax collections in 2005 of \$1,892.4 million.
 - The largest increases in exemptions and exclusions in the sales and use tax base occurred during the early 1970s and the early 1990s.
- The most significant exclusion is for component parts and items consumed in the production process.
 - In 2005 this item alone accounted for \$43,787.0 million of sales that were not taxed.
 - The exclusion of component parts and items consumed in production alone amount to a sales and use tax loss of \$2,320.7 million.
 - The second largest exclusion is for government and nonprofit purchases.
 - This exclusion resulted in the loss of approximately \$299.9 million in state sales and use tax revenue in 2005.
- The statutory exemption of specifically enumerated services resulted in the loss of approximately \$258.0 million in state sales and use tax receipts in 2005.
 - One study estimated that extending the sales tax to all readily-taxable services would increase state sales tax revenues by approximately \$500 million or 29 percent.
 - Overall if all services broadly construed were included state sales tax revenue could be increased by as much as \$1,944.6 million.
 - This value is actually higher than 2005 sales and use tax receipts which were \$1,892.4 million.
- Almost as significant the exclusion of agricultural and land use related transactions resulted in the loss of approximately \$251.7 million in sales and use tax revenue in 2005.
 - Another significant exemption is the exemption of items otherwise subject to specific excise taxes.
 - In 2005 the total value of this exemption was \$202.6 million in sales and use taxes.
 - Finally the exemption of the transactions of benevolent organizations resulted in the loss of approximately \$181.7 million in sales and use taxes in 2005.

Policy Choices

- In addition to actual sales and use tax receipts of \$1,892.4 million in FY 2005, the State of Kansas could anticipate as much as:
 - \$3,637.6 million in additional revenue from the elimination of the identified exclusions and exemptions,
 - \$1,994.6 million in additional revenue from the comprehensive taxation of services, broadly defined, and
 - \$286.2 million in additional revenue from the taxation of remote sales.
 - All total, theoretical sales and use taxes for fiscal year 2005 could be as high as \$7,760.8 million, approximately 4.1 times present sales and use tax collections.
- The future of the sales tax is tied to addressing four problems (Fox, 1998):
 - Avoiding proliferation of sales taxes on business inputs,
 - Keeping household purchases of tangible personal property inside the tax base,
 - Bringing household purchases of services into the tax base, and
 - Getting Congress to help states enforce use taxes.
- Problems with legislative statutory exemptions
 - The cumulative fiscal impact of the exemptions is huge.
 - Tax exemptions that may benefit only a few shift the burden, either by taking money away from the vital services or by forcing others to pay higher taxes to compensate for revenue losses.
 - Exemptions are adopted piecemeal, often in response to specific industry requests, without being weighed against each other or against needs for public programs.
 - Once adopted, exemptions are rarely evaluated or repealed, even though economic pressures and needs change dramatically over time.
 - Public revenues are growing more slowly than the demand for public services, since the tax system is based on the economy of the 1930s, rather than on the economy of the twenty-first century.
- The Hodge Committee (1970: 10) recommended that the retail sales tax should remain focused on consumption rather than on production. This is consistent with contributing to the long-run economic development of the state by putting Kansas in a better position competitively in seeking to attract new industry.
 - The committee recommended that component part rule be retained and refined
 - The committee suggested that it would be more desirable to exempt “consumables” as a class than to continue the policy of selective exemption through listing specific items.
 - However, the committee concluded that a general exemption for machinery and equipment used in production was not warranted.
- Arguments for inclusion of services in the sales tax base
 - The sales tax should be as broadly applicable to consumer expenditures as possible and therefore the tax should be imposed on services as well as tangible property because both satisfy personal needs and wants.
 - Taxation of services makes the sales tax less regressive because expenditures for services tend to increase as personal income rises.
 - Revenue from the sales tax is more responsive to rising levels of personal income and economic activity if services are taxable, because under such conditions expenditures for services increase relatively more than purchases of basic commodities.
 - Administration of the sales tax is simplified if the tax is applicable to services rendered in conjunction with sales of tangible personal property, i.e., it is not necessary to separate the amount charged for services from the amount charged for such property.

- The Hodge Committee (1970: 16) recommended that the sales tax should not be extended to include personal and professional services.
 - The committee concluded that if additional services were to be taxed, the most practical approach would be to start with services associated with the sale of tangible property and performed generally by firms already registered under the sales tax act.
 - One of the difficulties of taxing services is determining the situs of intangible services, their allocation, and the application of the *use* tax to such services.
 - Without the use tax, purchases from out-of-state sources would be encouraged to the disadvantage of local suppliers.
 - Thus, it would be difficult to apply the use tax to purchases of services.
- The Hodge Committee (1970: 12) recommended that the educational exemption should be retained because to remove it would merely mean an increase in property taxes. Further, the committee suggested that expenditures constituting a legitimate part of the school program should be exempt and that the same rules should apply to public and private non-profit schools at all levels of education.
- The Hodge Committee (1970: 12) recommended that that the exemption of purchases by hospitals operated by religious or other non-profit organizations should be continued. It was concluded that a general exemption of purchases by non-profit hospitals would be consistent with the granting of an exemption for purchases of prescription drugs and prescribed medical devices.
- The Hodge Committee (1970: 11) recommended that the exemption of purchases by religious, charitable, and benevolent organizations should be repealed.