

WOULD TAX EVASION
AND TAX AVOIDANCE
UNDERMINE A
NATIONAL RETAIL
SALES TAX?

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Abstract - *A national retail sales tax has surfaced as a potential replacement for the current system of federal income taxation. A primary concern is that the revenue-neutral required tax rate may easily exceed 30 percent, leading to tax base erosion through widespread avoidance and evasion. This paper examines specific avenues for avoidance and evasion for both firms and individuals under a comprehensive national sales tax and discusses implications for the underground economy. The analysis shows that opportunities for avoidance and evasion will be sustained, not eliminated, by a change in tax structure. Unfortunately, lack of experience in administering a high-rate, indirect tax system precludes definitive statements regarding the likely extent of tax base erosion under a national sales tax.*

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INTRODUCTION

The current regime of personal and corporate income taxation evokes strong criticism. The income taxes give rise to substantial efficiency losses, administrative and compliance costs are viewed as excessive, and the IRS is perceived by many to be overly intrusive. The search for potential replacements to the federal system of income taxation has led many in the direction of some form of broad-based consumption tax, ranging from a value-added tax (VAT) (and its close cousins, the various flat taxes) to a national retail sales tax (NRST).

Until recently, there was little serious discussion of an NRST as a replacement for the personal and corporate income taxes. An important reason for the shift in sentiment in favor of an NRST is the growing perception of success of state/local governments in administering the current retail sales tax.¹ But in many respects this is an illusion. Yes, the current state/local retail sales tax is a productive revenue source that gives rise to modest compliance costs for most firms and inconsequential compliance

costs for final consumers. But the retail sales tax, as currently structured across the states, is not the neutral, broad-based consumption tax that appears in the textbook. An extensive array of final sales on services and other activities escape taxation. The retail sales tax also falls heavily on business input purchases, with studies suggesting that about 40 percent of all revenues are derived from taxes on intermediate sales (Ring, 1989). And while compliance with the retail sales tax is quite good (aside from the mail order sales problem and the growing electronic commerce problem), a primary reason is that current tax rates are modest, giving rise to only modest incentives for evasion and avoidance. Finally, administrative and compliance costs are low when compared to other taxes, but the retail sales tax has largely avoided dealing with difficult-to-tax sectors, including the array of services.² The comparative advantage of the states in administering a retail sales tax, and the business community's familiarity with complying with the same tax, simply does not extend to the broad-based NRST envisioned by some.

Several proposals have surfaced for an NRST. Former Indiana Senator Richard Lugar has discussed a federal sales tax with a 17 percent rate, but has produced few specifics. Advocacy groups, including Citizens for an Alternative Tax System and Americans for Fair Taxation (AFT), also have pushed for a federal sales tax. The AFT has examined some of the specific aspects of a broad-based NRST, although details have not been released as of this writing. The most detailed approach to date is the National Retail Sales Tax Act of 1996 (H.R. 3039), introduced in the House of Representatives on March 6, 1996, by Representatives Schaefer, Tauzin, Chrysler, Bono, Hefley, Linder, and Stump (hereafter, referred to as the S-T proposal).

The AFT and S-T proposals share many common features.³ Each would supplant the current structure of federal income taxation and estate/gift taxation. The base of each would seek to tax comprehensively virtually all final consumption (including the sales of nonprofit and government enterprises). Intermediate sales would enjoy suspension of tax under both systems. The AFT proposal would further require tax payments on dual-use input purchases (i.e., purchases easily divested for personal use), with rebates available after taxpayer filing of information reports. Equity concerns would be met through rebates available to all households, administered by the Social Security Administration through employers. The states would administer the NRST to exploit their current comparative advantage in sales tax administration.⁴

A major concern of these proposals is the required tax rate. The S-T proposal specifies a 15 percent rate, whereas the AFT proposal calls for a 23 percent rate. But many observers argue that the rate of a revenue-neutral NRST might easily exceed 30 percent (for example, Bartlett, 1995). Coupled with state/local sales tax rates, the combined tax rate on final sales to consumers might approach and even surpass 40 percent. An important question arises as to whether a sales tax rate of this magnitude is enforceable. Unfortunately, there is no modern experience to draw from on administering a broad-based, high-rate indirect tax.⁵

The potential for base erosion through tax evasion and tax avoidance provides the motivation for this paper. If base erosion under an NRST proves to be substantial, the fundamental revenue, efficiency, and equity goals of the tax system will be compromised. The

remainder of this paper explores specific avenues for tax avoidance and tax evasion under an NRST, focusing first on firms and then on individuals and households. A separate section explores implications for the underground economy.

AVOIDANCE AND EVASION ISSUES FOR FIRMS

A neutral sales tax that did not fall on input purchases would give rise to no avoidance incentives for firms.⁶ However, should the sales tax fall on purchased inputs, distortions will arise over input choices (including self-supply though vertical integration) and location choices. There is no evidence on how the sales tax impacts input choices and little specific knowledge of how state/local sales tax rate and base differentials influence firm location. However, since taxes generally tend to have modest effects on firm location decisions⁷ and most inputs presumably would be freed of tax under a broad-based NRST, and because international sites may entail higher costs, any location distortions would be quite small.

An NRST would provide an incentive for firms to register in order to be freed of the tax burden on purchased inputs. An important potential side benefit is improved compliance by having more firms (and their information reports) under the tax net. The breadth of the base of the NRST ultimately would dictate the number of taxpayers that would have to be registered and the difficulties that would be encountered by tax administration. Since there has been no detailed and comprehensive assessment of a national sales tax, inferences on this question must be drawn from recent analyses of a federal VAT.⁸ The GAO's (1993) study of a federal VAT assumed a relatively broad

base and provides a reasonable point of departure.⁹ The assumed tax base excludes rental housing, owner-occupied housing, and financial intermediation services, but includes education, health, and nonprofit and government service providers. The estimated number of registered taxpayers is 24.4 million. But many more taxpayers may require registration, depending on the specific way in which an NRST is structured. For example, comprehensively adding owner-occupied housing to the tax base would potentially triple GAO's estimate of the number of registered taxpayers.¹⁰ In general, one consequence of a broad-based sales tax is inclusion of large numbers of small taxpayers with limited revenue potential. While tax enforcement is difficult under any circumstances, such large numbers of small taxpayers further dilute scarce administrative resources.

Some retail firms, especially those with high value added (such as service providers), may choose not to register at all, in turn simply paying sales tax on their inputs.¹¹ These firms could then lay outside the tax net and sell their services at preferential rates. The primary administrative check on such illegitimate firm behavior is verification through use of third-party sources, such as telephone directories and professional registries, and street canvassing. A good point of departure for an NRST would be existing rosters of vendors under the state/local sales tax, although these listings would miss many firms due to the narrowness of the state sales tax base.

Due to potential tax advantages, some individuals may seek to register as firms to disguise their consumption as the purchase of business inputs. The AFT proposal provides a disincentive, since tax would be required on all intermedi-

ate purchases and vendors would have to file explicit rebate claims to be relieved of tax. (Note that this approach differs from a credit-invoice VAT in that the latter provides tax credits as opposed to rebates.) But under both the AFT and S-T proposals, traditional auditing activities will likely remain key to effective enforcement. Since the extent of the over-registration problem has not been documented under the current state/local sales tax, the consequences for an NRST are unclear.

Identification and notification of registered but nonfiling taxpayers can be automated through the administrative apparatus as is common with the state/local sales tax. Due and Mikesell (1994) note a 13 percent delinquency rate for the state sales tax, with problems confined largely to smaller firms. Primary reasons for delinquency are poor record keeping and scarce operating capital. An NRST would aggravate delinquencies, especially if firms were to pay tax on intermediate purchases and receive rebates at some future point as with the AFT proposal. The rebate system, which provides an additional control device, will require a one-time increase in firm operating capital. The resulting liquidity problem should not be severe, however, if refunds are provided expeditiously.¹² Delinquencies may also be increased under an NRST, simply because of the amount of revenue at stake. That is, some firms may be tempted to retain sales tax collections temporarily for business or personal use. However, this temptation is not so different from the incentive that arises in the context of withholding and remittance of personal income and payroll taxes for an employer and her staff. Sound enforcement and an interest penalty system that ensures that vendors do not benefit from the use of collected revenues can mitigate this problem.

Many might perceive the shift to an NRST as an opportunity to eliminate (or at least reduce) misreporting problems attributable to exempt and use taxable sales, problems that plague the state/local sales tax.¹³ Exempt and use taxable provisions in the state/local tax code currently give rise to extensive compliance complexities and opportunities for taxpayer abuse. But the use tax problem will be sustained. For example, a small retailer who personally consumes inventory would be required to remit use tax, as with the current state/local sales tax. Inputs acquired tax free from international suppliers would pose a particularly thorny problem of observation and verification for tax administration. The AFT proposal would likely require that tax be paid on these imports, with relief granted through tax rebates. Under the S-T tax, concerns over the acquisition of dual-use inputs generally would be met by the direct remittance of tax on purchases and subsequent access to tax credits.

Similarly, a broad-based NRST is unlikely to encompass all goods and services, and some sensitive activities, such as health and educational expenditures, may be exempt or taxed at preferential rates.¹⁴ Definitional problems would most certainly arise regarding legitimate expenditures. Moreover, any rate variations would increase tax complexity and lead to greater noncompliance.¹⁵ The taxation of specific categories of consumption, such as financial, insurance, and housing services, would also add complexities to the tax code.¹⁶ For financial and insurance services, problems arise due to the absence of explicitly paid market prices for many services and the investment nature of many expenditures. The problem is even more acute for housing services, which represented 26.1 percent of personal

consumption spending on services and 14.2 percent of total personal consumption spending in 1993.¹⁷ Taxation of rents would require registration of huge numbers of taxpayers who would have to distinguish between business and individual consumers, in much the same way that vendors must separate taxable from nontaxable sales under the state/local sales tax. Addressing these and other issues will add to the complexity of the tax, raising administrative and compliance costs. At the same time, voluntary compliance can be expected to decline and opportunities for abuse will expand.

Incentives to underreport gross sales and taxes withheld would increase with the rate of the NRST, and successful evaders would have a potentially enormous competitive advantage over legitimate vendors. Of course, firms and individuals may be able to evade existing income tax liabilities, providing a mechanism to offer products at better than competitive prices under the current tax regime. Yet the ultimate extent of any competitive advantage hinges on administrative features and relative incentives to evade across income and sales tax regimes. Administrative features determine the relative *ability* to evade income versus sales taxes. To the extent a sales tax is more easily evaded, which may or may not be the case, the compliance problem would grow under an NRST. Equally important are incentives, which may be appreciably different under a sales tax versus an income tax regime. Should a retailer choose to evade his income taxes, the total amount of tax that can be evaded is equal to taxable income times the tax rate. And if the rate of sales taxation is equal to the rate of income taxation, the return to a dollar of underreporting is the same for each tax. But taxable retail sales will, in general, exceed

income, in most instances by a wide margin. Accordingly, the amount of tax a nonfiling retailer can save increases substantially under a high-rate national sales tax because of the concentration of revenues at the retail level. This consideration suggests an even stronger competitive advantage and a more serious compliance problem for the sales tax cheat relative to the income tax cheat.

Misreported gross sales are not a serious problem under the existing sales tax, in part because enforcement relies on cross verification with federal and state income taxes. (Similarly, the European VATs operate side-by-side with income taxes.) The multiple tiers of information reporting, coupled with independent enforcement activities undertaken by federal, state, and local tax administrators, provide numerous opportunities to verify taxpayer reports. Enforcement of an NRST would be hampered if the tax supplanted the personal and corporate income taxes, although it is not clear how significant the problem would be.

A potentially serious problem would arise under the AFT proposal as firms fraudulently overstate refund claims for taxes paid on input purchases and goods/services purchased for resale. A primary concern is simply the volume of transactions that would be subject to taxation and rebate. In effect, the AFT approach to business tax relief yields a dual-use turnover tax that provides refunds on all intermediate purchases.¹⁸ The magnitude of turnover will be enormous for the economy as a whole, far in excess of the value of final sales. Accordingly, vast amounts of revenue would be at stake at the preretail level. Under a system of suspension, revenues are simply foregone and the worst case scenario is no tax revenue; under a

rebate (or VAT credit) system, tax administration could incur deficits in the extreme (if unlikely) case of uncontrollable abuse. One mitigating factor is that under the AFT proposal firms must make formal misstatements to the revenue authorities, as opposed to simply misstating their intentions to other firms through presentation of exemption certificates. This psychological consideration, which is often discussed as a unique strength of the credit-invoice VAT, is of unknown practical value.¹⁹

In general, misreporting problems probably would have less to do with large retailers (with systematic and centralized accounting systems) than with smaller retail and service firms. Likely problem areas would correspond to those sectors that give rise to problems for the state/local sales tax (and the VAT), including repair services (automobiles, appliances, and homes), trade contractors (electricians, plumbers, and carpenters), personal services, agricultural products and services (veterinarians, landscaping, and food products), and retailing generally. Three administrative controls will be necessary to ensure reasonably accurate sales tax reporting. First and foremost is a sound penalty system that provides certain and unequivocal sanctions for misreporting and fraud. Second, the reporting system for business input purchases must support auditing activities. Generally, all input transactions on the part of buyer and seller should be documented so that detailed paper (or usable electronic) trails are produced for all purchases.²⁰ This would yield an audit trail similar to that under the credit-invoice system of the VAT.²¹ Third, there must be a good system of audit selection for sales tax vendors that seeks to identify firms with atypical reporting patterns. Unfortunately, the states have had limited

success in developing objective and systematic audit selection systems for the state and local sales tax.²²

AVOIDANCE AND EVASION ISSUES FOR INDIVIDUALS

Under the current state/local sales tax, individuals have four legal options to reduce tax liabilities: change spending patterns toward favorably taxed items; make purchases and pay sales tax in low-tax jurisdictions; choose one's location of residency in a low-tax region; and self-provide otherwise sales-taxable goods and services. The first two options, encouraged under the existing state/local sales tax, would largely vanish under a uniform-rate NRST.²³ However, if one views tax exempt casual sales as "favorably taxed," an exception arises under S-T, since there would be a *de minimis* exemption of \$2,000 per person per sale, with a \$5,000 annual limit. This provision would be exploited by taxpayers, especially at high tax rates, using traditional mechanisms, such as garage and yard sales, and flea markets. But new services also may be developed to facilitate and promote consumer-to-consumer sales. For example, firms could aggressively market the use of electronic bulletin boards to link buyers and sellers, collecting fees for their services. While the fees would be sales taxable, the transactions between buyer and seller would be exempt up to *de minimis* levels. Monitoring by tax administrators would be extremely difficult. Moreover, effective enforcement would require maintenance of records for all consumers engaged in casual sales, causing registration rosters to balloon.

Similar administrative and avoidance problems would arise from international purchases. (See below for a discussion of the evasion aspects of this same

issue.) The S-T tax would provide a *de minimis* exemption of \$400 of goods per person per entry and an annual limit of \$2,000 per person. The incentive introduced by a high-rate NRST would induce abuse. For example, depending on specific statutory legislation, offshore marketers may be able to offer a shipping service for products shipped tax free from abroad directly to each member of a household.²⁴ As with casual sales, administrative enforcement would require maintenance of import records for all individuals acquiring goods/services from abroad.

It is unlikely that the switch to a national sales tax would have appreciable impacts on residency location patterns.²⁵ One reason is that under source-based income taxation one need only change the situs of receipt of income, whereas under a destination-based sales tax one must change the situs of residence to avoid the tax, which entails high costs.²⁶ An equally important consideration is the counterfactual. That is, to the extent that individuals confront roughly comparable burdens under the existing income tax versus an NRST, there is little motivation to change country of residence. This consideration suggests that any incentives to emigrate may be highest for the elderly. The reason is that the assets and savings of the elderly have already been taxed under the system of income taxation and the introduction of a national sales tax would substantially increase their lifetime tax burden. But even the elderly would have little motivation to emigrate since they would likely confront some form of indirect tax (admittedly at a lower rate) in the new country of residence.

The potential for self-provision of sales taxable items has received little more than speculation. Households may, for

example, choose to engage in home production activities, such as gardening and home maintenance, to avoid payment of sales taxes. As with potential migration responses, a key consideration is the counterfactual to an NRST. Clearly, the returns to home production—tax savings on home-produced goods and services that would otherwise be sales taxable—would rise under an NRST. But elimination of the income tax would at the same time raise the relative returns to market work. Moreover, an important offsetting influence to engage in home production would be the significantly higher tax rate on the household's purchased inputs. On net, it would appear that little change in aggregate home production would take place in response to movement from an income tax to an NRST.

International "border shopping" and tax evasion are serious threats to the viability of an NRST. In general, for border shopping to be classified as avoidance as opposed to evasion, taxpayers must either pay sales tax in the jurisdiction of purchase or directly remit use tax in the jurisdiction of consumption.²⁷ Since an NRST would be a destination tax, taxpayers will be required to pay use tax on imported goods and services beyond *de minimis* levels as noted above. But collecting such taxes is problematic. Under the S-T, reliance would be placed on the import duty administration, although enforcement would be difficult except for directly imported tangible products. Yet, even with tangible products, complete enforcement would prove impossible (and costly) unless every traveler and his possessions were carefully scrutinized. The S-T tax also would require returns to be filed by taxpayers if use tax is to be paid. Despite the existence of mechanisms to accommodate direct use tax payments by consumers (primarily

through income tax reports), state experience with administration of the use tax and voluntary taxpayer filings has been dismal at best.²⁸ Admittedly, many final consumers are unaware of their current use tax obligations. This situation would not likely change appreciably following implementation of an NRST. As a result, the international border shopping problem will likely translate into a tax evasion problem as consumers simply choose not to remit their required use tax liability.

As Due (1986) notes, the use tax problem (for businesses and individuals) is the most important reporting problem for the state/local sales tax. At the same time, overall evasion on *in-state* sales is estimated at less than five percent of revenues (Due, 1974). Estimates for 1994 indicate an *interstate* tax gap on mail order sales alone of \$3.3 billion, or 2.4 percent of state sales and use tax collections (ACIR, 1994). Since the latter estimates apply only to tangible personal property (as opposed to services and electronic commerce, for example), they understate the revenue losses to state and local governments, potentially by a wide margin. Moreover, the existing tax gaps pertain to a much lower rate of sales taxation than would be the case under an NRST.

The importation of services, especially the direct delivery of electronic and information services, will represent a specific challenge to tax administration. The problem is complicated by limited state experience (or experience in the context of other indirect taxes) in administering a sales tax on intangibles in general and telecommunications and information services in particular.²⁹ As a result, a broad-based NRST would enter uncharted waters with no good practical experience to draw upon. Since legal, accounting, financial, information,

education, and other services could conceivably be produced abroad, a serious use tax problem may emerge. At the same time, there are two constraints that may naturally rein in transactions involving such activities. First, certain services that require close contact between buyer and seller, like health, repair, and many personal services, simply would not lend themselves to abuse via international and electronic commerce. Second, buyers of services are broadly interested in quality, and foreign suppliers may not be in a position to assure quality and back up their sales. For example, buyers of educational services may be interested in obtaining a degree or certificate of advancement through a recognized and fully accredited institution. Similarly, buyers of insurance and financial services will want to know that they are dealing with a viable and legitimate enterprise that will back up its sale. In general, consumers will want to have recourse should they be displeased with their purchase, but this may not be possible with foreign suppliers.

The bottom line is that it would be extremely difficult to track and tax the purchase of both intangible services and tangible products obtained from international marketers. Long-term growth in direct marketing and more recent growth in electronic commerce, coupled with the tax advantages arising from successful sales tax evasion, will contribute to erosion of the base of a national sales tax. It is simply not realistic to expect consumers to file returns for many of their purchases, as would be required under the S-T tax, and collection from many foreign sellers would be precluded by the absence of nexus. The tax collection problem will be aggravated by the tax administrator's inability to observe inherently unobservable transactions involving electronic

commerce; observing transactions involving tangible products will come only at high cost. Collection efforts might be redirected to third parties, including common carriers, telecommunication service providers, or credit card companies. However, such a step would be unprecedented. Imposing collection burdens on third parties raises compliance costs substantially to parties largely incidental to the transaction itself, and may expose the same firms to the risks of the audit lottery.³⁰

A new compliance concern would also surface under an NRST as some low-income consumers seek to take advantage of mechanisms intended to alleviate the regressivity of the tax.³¹ The S-T proposal would provide a family consumption refund and the AFT proposal would provide a wage-conditioned rebate, each to be available to all families and each to be administered through the existing apparatus of the Social Security system. The rebate programs are similar since they are based on the sales tax rate applied to reported wage income up to the poverty level of income. Employers would administer the rebate by withholding less Social Security tax for each worker, increasing take-home pay. The Department of Treasury would then reimburse the Social Security Administration, so that there would be no reduction in trust fund balances. Since the rebate is available to all households and there is no cutoff for relief (i.e., those with income greater than the poverty level of income enjoy the full value of the rebate), there is no incentive to underreport wage income.³²

For those with income below the poverty level, there is an incentive to report income since the individual gains by the amount of the sales tax rate for every dollar of wage income reported.

Unfortunately, this same incentive may be exploited by some low-income individuals who game the relief system to their own advantage through fictitious work arrangements. For example, consider two households with income below the poverty level.³³ If the households agree to exchange day care duties for an equal wage, the families would have access to refundable tax credits. A similar scheme could apply to illegal-source as opposed to legal-source income. The only binding constraint on such activities is the poverty ceiling for low-income relief and the tax administrator's ability to observe wage income.

IMPLICATIONS FOR THE UNDERGROUND ECONOMY

While the discussion above has focused on specific avenues for evasion and avoidance, a more general question is how the switch from a system of income to sales taxation might alter taxes generated from the underground economy. Unfortunately for proponents of an NRST, the answer is not much.

Consider first the case of the evasion of legal-source income on the part of an individual entrepreneur or a small retailer. In the case of an income tax, the evader may pay little or no income tax and maintain a pricing advantage over competitors. Now assume the income tax is replaced by a retail sales tax, so that all of the evader's consumption is subject to sales tax. On first appearance, it seems as if the evader is now within the tax net since the income that previously escaped tax is now taxed on the uses side. However, the rise in post-tax prices that would accompany the new NRST would allow the evader to raise the price for his services by the amount of the tax and potentially retain the receipts for personal use. So while

tax is paid on the vendor's personal consumption, the vendor may now retain sales tax receipts in the same way income taxes were not paid under the income tax counterfactual. The result is no increase in net revenues collected from the evader.³⁴ In fact, since final sales will exceed income, a similar tax rate potentially would mean *less* revenue for the successful evader of sales taxes.

Consider next the evasion of illegal-source income.³⁵ Under an income tax, the recipient of illegal-source income would likely report no income and hence pay no income tax. Similarly, after the switch to an NRST, no sales tax revenue would be generated unless the entrepreneur engaged in illegal behavior collected and remitted tax on his sales, an unlikely scenario. It might be argued that the entrepreneur's tax bill rises by the amount of the sales tax imposed on personal consumption. But there remains no increase in net collections, insofar as the production and sale of these purchases flowed through the formal (as opposed to the underground) economy. The reason is that the value added that underlies the value of the final product would have been taxed on the sources side of the household budget under the alternative income tax system. So, instead of no income tax being generated on illegal-source income, the sales tax would collect no revenue on illegal sales.

One consequence of these considerations is that the only real gain from a national retail sales tax is the perception that members of the underground economy are paying tax. This may have important value if these perceptions enhance the voluntary compliance of other taxpayers.

A second and somewhat more subtle consequence is that the switch to a

sales tax regime will likely change the way in which many of the same firms and individuals seek to game the tax system to their own advantage. Based on state experience with the sales tax, small firms and service providers tend to have rather dismal compliance patterns.³⁶ For example, a recent study of the sales tax gap in Iowa (State of Iowa, 1995) found the largest gaps associated with firms with average annual taxable sales of less than \$250 thousand. A similar pattern emerges for the income tax, as illustrated by 1992 estimates showing that 47.2 percent of the legal-source income tax gap was attributable to nonfarm sole proprietorships.³⁷ The experience abroad with single and multistage sales taxes provides further evidence that smaller firms have poorer compliance patterns (Tait, 1988; Bird, 1967). Hence, a switch from an income tax to a national sales tax regime will likely switch the mechanism the same parties exploit in reducing their tax liabilities. Under the personal and corporate income taxes, individuals and firms may not record sales and may overstate deductions and credits to reduce taxable income. Under an NRST, individual entrepreneurs may choose not to charge tax on sales, underreport sales, and overstate refund claims or abuse the system of suspension. Similar activities may be undertaken by corporate entities to relieve themselves of tax liability.

Conclusions

The degree of compliance with any tax hinges on the rate and base structure, which introduces incentives and opportunities for abuse; attitudes, which determine whether taxpayers exploit opportunities for abuse; and tax administration, which provides oversight, enforcement, and control. A high-rate NRST would benefit from relatively

positive taxpayer attitudes toward compliance that prevail in the United States. At the same time, incentives and opportunities for both tax avoidance and tax evasion will be sustained, although the specific avenues for reducing one's tax liability may change. Moreover, administrative enforcement will be hampered by the high costs associated with observing taxable transactions (especially in the context of services), not unlike the current system of income taxation.

There are certain features of the proposals for an NRST that may retard abuse, including the S-T tax's requirement of tax (and subsequent provision of tax credits) on dual-use inputs and the AFT's use of rebatable input taxes and formal filings with the tax administration. But there will be ample avoidance opportunities, including *de minimis* provisions for international purchases and casual sales, and potentially serious evasion problems associated with the concentration of revenue at the retail stage and input credit fraud.

On balance, the lack of experience in administering a high-rate, broad-based indirect tax means that it is impossible to say whether evasion and avoidance would be more or less pronounced under an NRST than under an income tax (or VAT) regime. Will the tax base whither? Probably not. Will there be radical improvement in compliance patterns? Probably not. Unfortunately, the available evidence does not allow a more unequivocal statement.

ENDNOTES

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¹ See Mikesell in this issue for a discussion of the current system of state/local sales taxation.

² For the state sales tax, Due and Mikesell (1994) showed administrative costs as a percent of revenue varying between 0.4–1.0 percent. Due and Mikesell (1983) provided a more comprehensive listing of states, with administrative costs averaging about 0.7 percent of collections. This is similar to estimates for the European VAT of about 0.7 percent (Sandford, Godwin, and Hardwick, 1989) and for the U.S. personal income tax of 0.6 percent (using the estimate of IRS spending on the income tax of \$5 billion, taken from Slemrod, 1996). Compliance costs show considerably more variation. For the U.S. sales tax, compliance cost estimates fall between 2.0–3.8 percent of revenues (research summarized by Cnossen, 1994). Sandford, Godwin, and Hardwick estimated compliance costs of the U.K. VAT at 3.7 percent of collections. In Slemrod, it is argued that compliance costs are likely in the range of \$70 billion for the personal and corporate income taxes, or about nine percent of combined income tax revenues in 1995. Hall (1996) provides strikingly higher estimates for the U.S. income taxes, totaling 20.1 percent of collections. Hall estimates that the Armev–Shelby flat tax plan would cost 1.2 percent of collections to comply with, versus 4.6 percent for the USA tax plan and 1.0 percent for the S-T NRST.

³ Burton and Mastromaro (1996) provided a favorable review of the S-T proposal. Bartlett (1996) and Mikesell (1996) provide critiques.

⁴ The S-T proposal would compensate taxpayers filing monthly reports through a credit equal to the greater of \$100 or 0.5 percent of revenue collected. This extension of “vendor's compensation” to compliant firms is similar to practice under the state/local sales tax. Due and Mikesell (1983), now somewhat dated, reported that nearly half of the states provide vendor's compensation, usually a flat percentage of gross collections (from 1.0–3.6 percent). Sliding scales are also common, with more support for smaller firms, consistent with their relatively higher compliance costs. The S-T plan would go further than traditional state practice by providing a tax credit equal to 50 percent of the purchase price of any new equipment required to comply with the tax. States administering the S-T tax on behalf of the federal government would be allowed to keep 1.0 percent of collections.

⁵ Combined state/local sales tax rates remain, with few exceptions, below ten percent. A simple average of the VAT's standard rate in the OECD was 17.1 percent in 1995 (OECD, 1995). Due (1986) noted that many countries switched from variants of the retail sales tax to VATs because of the belief that compliance would be less of a problem. Some of these countries had relatively high indirect tax rates, including Sweden (10 percent), Norway (13.6 percent), Iceland (20

- percent), and Zimbabwe (over 20 percent). Yet there is no specific evidence of a growing compliance problem in the face of rising tax rates. Moreover, Stranger (1973), Egret (1973), and deMoor (1973) note no reduction in evasion in Norway, France, and the Netherlands, respectively, following the switch to a VAT. There are instances of specific excise tax rates well in excess of 30 percent, including the state excise taxes on cigarettes and motor vehicle fuels. ACIR (1985) estimated the cigarette tax gap at 5.4 percent of collections in 1983, with 70 percent of the loss due to sales on Indian reservations. The Council of Governor's Policy Advisors (1996) estimated that the elimination of fuel tax evasion would yield a 6.5 percent revenue gain for the average state. These gap estimates are much lower than the corresponding estimates of 20 percent for the personal income tax (Slemrod, 1992) and 22.7 percent for the corporate income tax (Rice, 1992), and compare favorably to gap estimates for the VAT (OECD, 1988; Oldman and Woods, 1983). A primary explanation for the relatively low gap estimates for the excise taxes on cigarettes and fuel is the unique apparatus of enforcement, including extensive monitoring and controls at pre-retail stages. But even these enforcement mechanisms can break down in the face of high tax rates. For example, in the 12-month period following Michigan's cigarette tax hike from 25 to 75 cents a pack, cigarette sales in Michigan plummeted 31 percent (Lee, 1996).
- ⁶ As used here, avoidance refers to any legal mechanism to reduce tax liabilities. If all input purchases and goods acquired for resale were tax exempt, firms would have no tax burden to avoid.
- ⁷ Bartik (1991) provided a comprehensive review of the business location literature.
- ⁸ Dronenburg (1995) examined a federally administered consumption tax and concluded that only 7.3 million taxpayers would need to be registered. But this estimate applies to a sales tax that parallels the existing state structure, rather than a broad-based consumption tax as envisioned by an S-T or AFT.
- ⁹ Roughly the same number of firms would be required to register under both a comprehensive VAT and a comprehensive NRST. Under a VAT, registered firms at both the preretail and retail levels would pay tax and have access to relief on input purchases. Under a retail sales tax, revenues would be collected on final sales of any type from registered taxpayers, while all entities engaged in firm-to-firm sales would need to be registered to receive relief of tax on intermediate sales.
- ¹⁰ There were 44.9 million owner-occupied homes in the United States in 1993 (*Statistical Abstract of the United States 1993*, 1993).
- ¹¹ Due and Mikesell (1994) reported that over-registration is a more serious problem than under-registration with state and local sales tax.
- ¹² The S-T tax would allow tax credits on dual-use input purchases to be applied to tax collections on final sales in the same month in which taxes on inputs were paid; if refunds are warranted, they are to be provided within 60 days. Dual-use inputs are defined as goods/services for which 25 percent or more of sales are to consumers.
- ¹³ The use tax is imposed on the consumption of goods for which sales tax has not been applied in the jurisdiction of purchase. An example is the tax-free purchase of an automobile in one state, and the subsequent registration of the vehicle and payment of use tax in the resident jurisdiction.
- ¹⁴ The AFT proposal would exempt expenditures on tuition and job-related coursework.
- ¹⁵ Agha and Haughton (1996) found that multiple VAT rates are associated with a higher degree of noncompliance.
- ¹⁶ Such complexities can give rise to compromises in structural design. One compromise, common with the VAT, is to zero rate final sales from tax and at the same time deny suspension on input purchases. This second-best approach allows the labor component of value added to escape tax.
- ¹⁷ *The Monthly Labor Review* (June, 1996) provides a breakdown of consumption spending for 1993 and projections for 2005.
- ¹⁸ Similarly, a VAT is a turnover tax that provides tax credits on intermediate sales. The volume of tax credits under a VAT would far surpass the value of final retail sales, as with the AFT rebate system.
- ¹⁹ Shoup (1973) states "It is psychologically more difficult for most taxpayers to file a false return than file a false statement with a vendor." It is this aspect of the VAT that the AFT rebate system seeks to mimic. But this and other self-enforcement features of the VAT credit-invoice system are likely overstated. For example, it is often argued that there is an incentive for firms to ensure that tax is shown on purchase invoices so that traders have access to credits. But the incentive for taxpayers is to ensure tax is *shown*, not necessarily that tax has been *paid*. VAT invoice fraud is not well documented, but it does exist (Egret, 1973; Tait, 1988). In a similar vein, it is argued that cheating at preretail stages will mean more revenue at subsequent stages of production due to the absence of invoiced tax payments. But this argument once again ignores the possibility of invoice fraud across stages of production. Finally, there is no VAT credit system at the final retail stage, and there is evidence of underreported final sales (Egret; Cnossen, 1981). The real strength of VAT's credit-invoice system is the rich paper trail that potentially allows for improved verification

opportunities. This strength is not, however, an inherent feature of a VAT, since comparable information reports could be required under rebate and suspension systems.

- ²⁰ New modes of payment and the increased use of electronic modes of payment have created some problems for taxpayer information reporting under the state sales tax. A good example is the corporate purchase card, essentially a credit or debit card that allows firms to streamline purchasing procedures. But data support systems must ensure that adequate information reports are generated for all transactions. See Lippman and Smith (1996).
- ²¹ The existence of comprehensive paper trails does not ensure improved tax administration and tax compliance. The reason is that it is costly for tax administrators to verify and assimilate taxpayer information reports. Experience with the VAT in this context is not encouraging. Han (1990) discussed Korea's ill-fated efforts to make comprehensive use of VAT invoice data in the early 1980s.
- ²² See Due and Mikesell (1994) and Murray (1995).
- ²³ If state/local rate and base differentials are sustained after implementation of an NRST, they will continue to distort consumption behavior. Moreover, the returns to successful evasion will be increased. Should preferential rates or exemptions be extended to consumers under an NRST, further distortions in consumer spending behavior can be expected. Indirect evidence on consumption distortions is provided by rapid growth in mail order sales, which outpaced growth in the gross national product during the 1970s and 1980s (ACIR, 1994). More direct evidence was offered by Mikesell (1970), who reviewed the early evidence on the impact of sales tax rate differentials and found substantial taxpayer responses. Mikesell's independent analysis produced an elasticity with respect to the sales tax rate of between 1.7 and 11.0. Walsh and Jones (1988) found that grocery store sales in West Virginia responded sharply to the phase out of the sales tax on food.
- ²⁴ Statutory language also would have to be carefully crafted and customs enforcement would be needed to avoid the "drop shipment" problem encountered by the states. With drop shipments, a good is sold to an out-of-jurisdiction reseller who receives a resale exemption. But the reseller does not take direct possession, instead shipping the product directly from the manufacturer to the final consumer. (See Madsen and King, forthcoming, for the state aspects of this problem). A similar scheme might be developed by off-shore resellers who buy goods directly from manufacturers, receive an export exemption, and then have the product shipped by common carrier directly to the consumer. If the off-shore marketer does not have nexus, tax remittance by the final consumer or the manufacturer would be required.
- ²⁵ The only comprehensive treatment of subnational taxes and expenditures on household location patterns is Fox, Herzog, and Schlottmann (1989). They find no significant sales tax effects on domestic household migration patterns.
- ²⁶ While the sales tax is a destination tax, in practice, destination commonly means the point of sale. The complementary use tax is intended to ensure that items (generally only tangible commodities) purchased tax free in one jurisdiction are taxed in the jurisdiction of consumption. Generally, there is no apportionment of sales and use taxes across the jurisdictions in which consumption takes place.
- ²⁷ The states have had difficulties in collecting excise taxes on cigarette sales on Indian lands due to legal ambiguities and limitations on state taxing authority. See ACIR (1985) and, more generally, Zelio (1995). This raises the specter of Indian reservations becoming a tax haven under an NRST. But this would not be the case (absent explicit statutory intent) since congressional acts can supersede treaties granting sovereign rights to Indians on their lands. See the Cherokee Indian Case of 1870 presented in Prucha (1990).
- ²⁸ Due and Mikesell (1994) and Caldwell (1996) discussed state-by-state practice in collecting use tax.
- ²⁹ Murray (1997) discusses practical problems in applying the state sales tax to telecommunication services and electronic commerce.
- ³⁰ In general, third-party shippers (including common carriers and telecommunication service providers) do not know final retail price nor the nature of goods/services being shipped. Some states have sought to impose collection and remittance burdens on third-party telecommunication service providers due to the difficulty of collecting tax from buyers and the impossibility of collecting tax from sellers due to the absence of nexus. For an industry perspective on the problem, see Information Highway State and Local Tax Study Group (1995).
- ³¹ Gold (1992) noted that the primary concern of the states that administer equity-based rebate programs is nonparticipation rather than noncompliance. The federal earned income tax credit also has less than complete coverage, but there are serious compliance problems as well. See GAO (1994) and Holtzblatt (1991).
- ³² An "avoidance" issue would surface for low-income individuals since wage income would be preferred to nonwage income. Multiple job holders might present a separate problem if individuals sought multiple rebates.
- ³³ See Yin and Forman (1993) for a similar example in the context of the federal earned income tax credit.

- ³⁴ If the evader is entirely out of the tax net under an NRST, there will be no opportunity for the individual to enjoy tax relief on legitimate input purchases. Hence, it again appears that the sales tax may increase the tax burden on the evader. But the income tax counterfactual must be carefully considered. Had the individual purchased inputs from legitimate vendors under the income tax regime, such purchases would have embodied the income tax burden that underlies the value added on such goods and services. The switch to a sales tax regime means the loss of these income tax revenues in exchange for the new revenues of the evader who has no exemption certificate or no access to credits for taxes paid on inputs. The net effect is no change in aggregate collections.
- ³⁵ See Armev (1995) for a discussion of this specific issue and a general critique of a national sales tax.
- ³⁶ The problem for tax administrators is aggravated by the large numbers of small firms and their limited contribution to total sales. Census data for 1992 reveal that one-third of retail trade establishments accounted for only three percent of sales; 77.8 percent of service firms accounted for 23.5 percent of sales; and 58.6 percent of construction firms accounted for 23.2 percent of sales. Almost 58 percent of retail trade establishments were either partnerships or sole proprietorships; the comparable figure for service establishments is 84.5 percent.
- ³⁷ Department of Labor (1992). This summary estimate is based on an IRS analysis that relies on the Taxpayer Compliance Measurement Program.

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