The American Retail Sales Tax: Depression’s Child in the New Economy of the 21st Century

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Prepared for “Public Finance and the New Economy”
Georgia State University
April 27, 2018

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The American Retail Sales Tax: Depression’s Child in the New Economy of the 21st Century

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The retail sales tax represents the American approach to a general tax on household consumption expenditure, an alternative to the value-added tax levied through much of the rest of the world. If the two taxes were to be levied in their textbook formats, they would apply to exactly the same tax base and burden exactly the same households in exactly the same amounts. However, as what apparently is always the case, what the theory of taxation prescribes and what the lawmakers produce turn out to be significantly different and that is particularly true for the retail sales tax. As will be discussed in this paper, the practice of retail sales taxation causes the tax to fall short of its considerable promise as an efficient, robust, and equitable means for distributing the cost of government across the private economy, with some promise that the tax will develop more problems in the economic environment of early years of the 21st century. Maybe other tax alternatives would be better. However, the retail sales tax yields a significant share of state (and local) tax revenue and that share would be difficult to replace in a manner that is equitably, fiscally, economically, and politically feasible. That suggests a clear need to attending to the problems for retail sales tax operation. Indeed, some administrative features of the typical retail sales tax may make it more compliance-robust than the value-added tax in that environment.¹

The retail sales tax is important because household consumption has strong status as an ability-to-pay standard for dividing the cost of government and as a tax without some incentive issues raised by income taxation. While many analysts focus on the Haig-Simons income standard for defining ability to bear the cost of government, there is a strong logic for the use of personal consumption as the standard, that is, for using actual consumption as opposed to the potential consumption concept embedded in Haig-Simons. As Nicholas Kaldor explained the logic of the consumption standard some years ago, “…each individual performs this operation [identifying tax capacity] for himself when, in light of all his present circumstances and future prospects, he decides on the scale of his personal living expenses. Thus a tax based on actual spending rates each individual’s spending capacity according to the yardstick which he applies to himself.”² Personal assessment of current affluence, future prospects, and underlying economic status as measured by personal consumption spending would appear, in a market economy, to be an excellent indicator of economic capacity to bear the cost of government services. Whatever the individual feels he or she can afford to purchase from the private sector is a good measure of what the individual can afford to contribute to the provision of public services. Using the same standard for both private and public services seems unassailable in logic for a market economy. Therefore, it is important to create a retail sales tax structure that capitalizes on the special self-declaration advantage of this standard for taxation in the new and changing economic, demographic, and social environment. The tax is a device for dividing the cost of government according to household consumption expenditure; it is not a luxury consumption tax, a tax on

¹ Recent studies do indicate that retail sales tax compliance rates seem to be higher than is the case for value-added taxes. See John L. Mikesell, Comparing Operations of Retail Sales and Value-Added Taxes,” Tax Notes, October 8, 2012, p. 188.
business operations, or a tax on business profits and trying to make it such defeats the fundamental logic of the tax.

The problem is that the retail sales tax faces major challenges in the early days of the 21st century. Some of these challenges can be corrected by legislative action because they emerge from errors of omission or commission by the states. Others are the product of exogenous forces, some of which help sales tax operations while other make sales tax operations more difficult. Before considering these challenges, it is useful to understand the role that this tax has had in the American fiscal system and have some idea about its future prospects.

The Fiscal Role and Fiscal Prospects for the RST

The American retail sales tax emerged from a desperation experiment in Mississippi in the midst of the Great Depression. Revenue from the property tax, the largest single source of state tax revenue at the time, collapsed, falling by 11.4 percent from 1927 to 1932 and by another 16.8 percent from 1932 to 1934. States were not collecting enough revenue to meet their service obligations or to provide expected assistance to local governments. Mississippi (followed by West Virginia) showed that retail sales taxes could produce immediate cash collections, even in low income jurisdictions. That revenue provided the means necessary for continued payment for state services and state aid to local governments. Other states paid attention to that experience. In 1933, eleven other states adopted the tax (two let them expire almost immediately). By 1938, twenty-two states (plus Hawaii, not yet a state) were collecting the tax; six others had also imposed the tax for a short time, but had let them expire. Table 1 provides a complete history of state retail sales tax adoptions in the United States.

State revenue data provide evidence of how substantial and quickly general sales taxes had an impact on state revenue systems. Figure 1 documents the early history of general sales tax reliance by tracking the shares of national state tax revenue from property, general sales, and individual income taxes from 1902 to 1950. Individual income taxes were in place in five states (Massachusetts, Delaware, Arkansas, Georgia, and Idaho) before the first retail sales taxes, but their revenue contribution was modest in the national perspective and apparently for each state. However, revenue from the individual income tax grew and eclipsed collections from state property taxes early in the 1940s but its share was considerably less than

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3 There has been some confusion about which state enacted the first retail sales tax and when. Because statutory names do not always translate easily into fiscal concepts, taxes are considered to be retail sales taxes on the basis of their nature (i.e., general coverage of retail transactions, a mechanism to exclude many business inputs from the tax, and a means for accommodating addition of tax to prices paid by customers without having that addition to price to itself be subject to the tax), not on the basis of their legal name. Here are the results from such a reading. Mississippi converted its multi-rate gross receipts tax into a tax with most features of a modern retail sales tax in 1932 and West Virginia enacted a free-standing retail sales tax in 1933. Earlier taxes enacted in Mississippi, Kentucky, Georgia, and West Virginia lack important features of retail sales taxes, particularly absence of mechanisms to remove pre-retail transactions from the base, inclusion of any revenue from adding tax to the purchase price in the taxable base, and annual exemptions from tax subtracted in annual calculation of tax owed. These earlier taxes are operationally true gross receipts or turnover taxes, not retail sales taxes.

4 Some sources list Indiana as adopting a retail sales tax in 1933. That is incorrect. The tax adopted then was a gross income tax, an extremely broad tax that encompassed both gross receipts and income and lacked all features necessary to be considered a retail sales tax. Indiana did not adopt a retail sales tax until 1963. The vestiges of that earlier tax continued to complicate Census tax data for many years.

5 The general sales tax data used for this figure include revenue from both retail sales taxes and gross receipts taxes. Because of how Census reports data and how states devise their tax laws, the data used for the figure overstate retail sales tax revenue for some states and understate it for others. There is no feasible way to standardize the data to a consistent retail sales tax – as is done for sales tax data in later discussions – so the data for this figure are illustrative only. The patterns are accurate, even though the specifics will not always be.
that from the general sales taxes through the period examined here. General sales tax revenue exceeded collections from the property taxes shortly after the adoption of the earliest sales taxes. The early history thus shows the critical role that general sales tax had in the finances of state governments during the Great Depression, the World War II period, and through the middle of the twentieth century. That importance continues to the present, as more recent data show.

Data Sourcing.

The data for Figure 1 are for all general sales taxes, retail sales taxes as well as gross receipts (turnover) taxes, and follows the classification for data collected by the U. S. Bureau of Census. These data are not appropriate for analysis of the modern retail sales tax without adjustment, as will be explained. Data for retail sales tax analysis begins with the annual general sales tax collection reports from the Governments Division of the U. S. Bureau of Census, a tabulation of data provided by the individual states on the taxes levied by each state. [http://www.census.gov/govs/statetax/]. These data by themselves do not provide a basis for comparisons of retail sales taxes across states (i) because of certain Governments Division reporting conventions (e.g., collections of some retail sales taxes that do not apply throughout the state and whose revenue is designated for use only within the area that the tax applies are sometimes included with state tax collections), (ii) because of some statutory peculiarities in states (e.g., some states exempt motor vehicle sales from the general sales tax but tax them in a virtually equivalent motor vehicle excise tax collected by the Department of Motor Vehicles), and (iii) because some data included in the Census general sales and gross receipts tax category are for taxes that are not retail sales taxes (e.g., the Washington business and occupation tax). The data used here for comparison and analysis of the state retail sales taxes is the product of that standardization procedure. In some instances, the adjustments are relatively large. In fiscal year 2016, adjusted retail sales tax data ranged from 73.2 percent to 127.6 percent of Census reported data. To fail to adjust to a standard retail sales tax concept would give a misleading of tax structure and performance across states.

Data for these adjustments come from a broad variety of sources. These include unpublished data graciously provided by Census, department of revenue annual reports, state comprehensive annual financial reports, state budget documents, and direct inquiries to state officials. Data from these sources do not always match perfectly with Census general sales and gross receipts data but collections data with the adjustments, even with their imperfections, provide a better basis for comparing tax revenue and base breadth across all the states than would the raw Census data. These adjustments do make a difference. For example, for fiscal 2015, while Census report and adjusted collections are the same for many states, adjusted data for states ranges from 73 to 127 percent of Census reported data. To fail to make these adjustments to standardize interstate comparisons would give a misleading view of retail sales tax performance. The

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6 Motor fuel taxes yielded more revenue than did general sales taxes until the mid-1940s, but these collections were usually earmarked for roads and highways and not available for general government purposes.

7 Taxes are considered to be retail sales taxes on the basis of their nature (i.e., general coverage of retail transactions, a mechanism to exclude many business inputs from the tax, and a means for accommodating addition of tax to prices paid by customers without having that addition to price to itself be subject to the tax), not on the basis of their legal name. For instance, the Hawaii general excise tax and the New Mexico gross receipts taxes are included as retail sales taxes because of features consistent with a retail sales tax while the Delaware gross receipts tax lacks those features and is not. The structure, not the legal name, determines whether a tax is included among the retail sales taxes.

8 The details of and the logic for these standardization adjustments are explained in John L. Mikesell, “State Retail Sales Taxes: Revenue Performance for Fiscal 2015,” *State Tax Notes*, 71 (February 20, 2017). The adjustment factors are not the same for all years. For instance, the Indiana gross income and West Virginia business and occupation tax need to be subtracted from the Census reports for some years (both taxes have been repealed). The Governments Division has not treated the gross receipts taxes the same in all years, so adjustments for individual states are not always the same.
standardized data are not generated for years before 1970 because of problems in obtaining data needed to make the adjustments and because the number of states levying a retail sales tax prior to 1970 differs from that in later years.

Retail Sales Tax Revenue in the Modern Era.

The national total retail sales tax collections exceeded the collections from every other state tax from 1947 through 2001. Retail sales tax revenue was then surpassed by collections from state individual income taxes. That probably is not surprising, in light of the fact that the individual income base would be expected to be larger than a household consumption tax base, that the income elasticity of the income tax base is somewhat higher than the elasticity for the sales tax base, and that states without individual income taxes adopted them steadily through that period. By fiscal 2016, total state individual income tax collections exceeded $345 billion, compared to over $288 billion for state retail sales taxes. However, those national totals conceal the continuing dominance of the retail sales taxes in a number of states and it is important to focus on the finances of those states because that is where sales tax policy is made and where the impact of revenue from the tax matters for government finances. Responses to challenges to state finances in the 21st century are going to come from the individual states, not from some over-arching national reaction.

Figure 2 provides insight into the importance of the retail sales tax in the finances of the individual states by presenting the mean sales tax reliance (retail sales tax revenue divided by total tax revenue) for the forty-five states levying a retail sales tax over the 1970 to 2016 period. It also provides the mean individual income tax reliance for the same states. Sales tax reliance among these states, while fluctuating across some years, is actually slightly higher in 2016 (0.342) than it was in 1970 (0.320). Reliance peaked in 2002 (0.364), then declined until 2008 (0.337), increased in 2009 (0.344), declined until 2013 (0.331), and then increased to its 2016 level. Mean retail sales tax reliance over the 1970 through 2016 period has consistently and reliably been in a band between 0.32 and 0.36. That is markedly different from the path of mean individual income tax reliance. Although the path of income tax reliance is interrupted by recessions in the early 1980s, mid-1980s, 1991, 2001, and 2007-2009, the secular path has distinctly been upward, from 1970 (0.172) to 2016 (0.322). However, the individual income tax has not replaced the retail sales tax in its place of importance in state government finances. Concern about the health of state government finances cannot ignore the state of the retail sales taxes because states who levy these taxes do rely on them, on average, more than they do on the next most important tax. Any challenges to the viability of the retail sales tax base translate into challenges for the finances of state governments.

Structural Residuals.

Before considering the challenges and opportunities in the 21st century for the retail sales tax, it is important to understand that the present sales tax continues some residuals from its depression-era roots. First, the tax base tends to apply broadly to purchases of tangible personal property but only selectively, if at all, to purchases of services. In the 1930s, the service component of household consumption was far less than it is today and the omission seemed not to have significant consequences. Furthermore, states were unsure about their ability to administer that portion of the tax. There was no audit trail back to inventory purchases for administrators to track, making verification seem questionable and many service sellers were small and, often, informal in nature. It seemed not worth the effort to try applying the tax to services. 

Alaska, Delaware, Montana, New Hampshire, and Oregon are the states not levying a retail sales tax. Although efforts to levy the tax have been made in Montana and Oregon, none are likely to do so in the foreseeable future.

Interestingly, the gross receipts (turnover) taxes that were being adopted at roughly the same time did include receipts from services in the tax base.
Second, the retail focus was on finished products. The taxes tended to exempt inventory purchases but did not broadly exempt other business inputs. The idea that the tax was not on purchase of finished products, but was intended to be a tax on household purchase of finished products presented a barrier to the broad exemption of business purchases that characterizes the ideal retail sales tax as consumption expenditure tax.

Third, the taxes were added at time of purchase, rather than being embedded in the shelf price of products in the way that European value added taxes usually are. Legislators understood that cooperation of retailers was critical for operation of the tax and retailers wanted to avoid being seen as responsible for the increase in price necessary to cover the tax. Hence, adding tax at time of purchase was one of the costs associated with overcoming objection of retailers to the tax.¹¹ That improved tax transparency but probably inhibited legislative action when new revenue was needed and added an incentive to obtaining revenue in more hidden ways (like taxing intermediate goods).

Each of these structural features continues today and influences how the tax operates in the 21st century. Given the significance of the tax in state government finances, a critical concern for governments in the 21st century is to maintain that revenue because of its importance in the health of state government finances. There are challenges and advantages in the new operating environment.

Challenges to the Retail Sales Tax from Legal Structure

Tax revenue in any economic environment, traditional or new, depends on the size of the tax base because there are social, economic, and political limits on the ability to adjust statutory rates to generate a desired yield. Challenges to the retail sales tax base are an important policy concern because of the importance of that tax in state government finances, as has been demonstrated earlier. The problem is that the retail sales tax base has a pattern of disappearance as a share of the economy and this endangers its utility as a contributor to those revenue systems.

Figure 3 reports the history of mean retail sales tax breadth across the states from 1970 to 2016. The record is one of almost constant decline, from 49.0 percent in 1970 to 37.3 percent in 2016. That is a major decline in revenue potential. Although there have been some disruptions to that general pattern as states change their tax structures and as economic change impacts state fiscal systems, the pattern is remarkable in its overall consistency. The typical state retail sales tax base has narrowed as a share of the economy of the state over the years and this has meant that, in order for states to maintain the place of their sales tax in their revenue systems, they have been required to gradually increase the statutory tax rate they apply to that base. Figure 4 illustrates the relationship in rather dramatic fashion: while mean reliance has remained roughly the same over the period, mean tax breadth has declined and the mean statutory rate has increased. That is a generally mechanical relationship but it is important because little good can be said about a narrow base/high statutory rate revenue program. It is helpful to consider what might be within state power to preserve base breadth (some influences may be exogenous and more difficult to deal with) because that revenue potential will be crucial in the economy of the 21st century.

A sales tax base may be statutorily narrowed either by an exclusion (when a transaction or contribution to otherwise taxed gross receipts is omitted from the tax law) or by an exemption (when a transaction that would be included in the tax base is removed from taxation by a provision in the tax law). An example of

¹¹ Being added at purchase may have less impact on consumer decisions than having the tax embedded, as research by Chetty et al finds, but it almost certainly has greater impact on lawmakers who have little interest in visible tax increases. (Raj Chetty & Adam Looney & Kory Kroft, 2009. "Salience and Taxation: Theory and Evidence," *American Economic Review*, 99(4), pages 1145-1177, September.)
an exclusion appears in the California law: tax applies to gross receipts “defined as the total amount for which tangible personal property is sold, leased, or rented, valued in money.” If the transaction does not involve tangible personal property, i.e., services, real property, or intangible personal property (or anything else clever lawyers can insert within the missing group), the receipts from the transaction are not taxed. West Virginia law illustrates exemption language: the tax applies to “purchases of tangible personal property and services except for those identified as exempt for reason.” The exemption may be for type of purchase (an exemption of food purchased for at-home consumption in many states), by type of purchaser (state universities in many states), or by type of seller (cookies sold by Girl Scouts). In terms of impact on base breadth, it probably makes no difference whether the preference is delivered by exemption or exclusion, although exclusions are probably more likely to emerge when the tax law is initially being adopted and exemptions are added over time.  

Exclusions.

The exclusion that is most inconsistent with the general concept of a tax on household consumption is the exclusion of service purchases. Economically there is no difference between a household purchase of a service and purchase of a good – each satisfies a consumer demand and each is part of household consumption expenditure. Unfortunately, many states got off to a bad start when they initially adopted their sales taxes and excluded all or almost all household service purchases from the tax base and it has proven to be difficult to correct that initial error.

Extending the retail sales tax to include at least some services is a perennial topic whenever states are seeking additional revenue or considering reforms in their tax systems. Often the discussion about the change goes much further than does any actual change in the system. However, there have been some expansions in coverage of services. State sales taxes may be divided into three groups: those taxes that are limited to purchases of tangible personal property, those taxes that tax purchases of tangible personal property plus a list of services selected for taxation, and those taxes that generally tax purchases of tangible personal property and services. The division of states into these groups has changed somewhat over the past forty-eight years.

In 1971, twenty-six states excluded purchases of services from the base, seventeen applied the tax to service purchases on a selective basis, and two included services in the tax base on a basis roughly equivalent to that for coverage of purchases of tangible personal property. In 2018, only three excluded services, thirty-eight taxed service purchases on a selective basis, and four states taxed services generally. As the data show, the selective approach to extending the base to services is far more prevalent than elimination of the exclusion. For instance, in 2018 Kentucky selectively included the following list of services: labor and services for certain repair, installation, and maintenance of personal property; pollution control facilities, landscaping services, janitorial services, pet care veterinarian services (small animals), pet grooming and boarding services, fitness and recreational sports centers, industrial laundry services (uniforms), golf courses and country clubs, limousine services, dry cleaning and laundry services (except coin operated), linen supply, diet and weight reducing centers (non-medical), overnight trailer campgrounds, other personal

12 A number of states produce tax expenditure budgets that include their sales tax. Most are based on the reference law definition of a normal structure for delimiting a tax expenditure and a few are based on a conceptual baseline. Those using the latter approach are somewhat more likely to identify exclusions in the tax expenditure budget estimates. [John L. Mikesell, “State Tax Policy and State Sales Taxes: What Tax Expenditure Budgets Tell Us About Sales Taxes,” American Review of Public Administration 42 (2, 2012): 131 – 151.]

care services, bowling centers, and extended warranties – and that was only after an over-ride of the Governor’s veto.

Figure 5 illustrates the potential power of reducing the services exclusion for combating the reduction in breadth of the tax base. There are three sales tax bases calculated from Bureau of Economic Analysis reported in the figure for the 1970 to 2016 period. One reflects the typical retail sales tax base at present, one reflects the current tax base with currently-untaxed household services added, and one reflects that expanded base but without health care and education services.\textsuperscript{14} All three are adjusted relative to their levels in 1970 for easier comparison. The impact of adding services to the tax base on constraining the disappearance of the tax base is readily apparent. While the current typical sales tax base is around 20 percent narrower in 2016 compared with 1970, the base with all services added is actually about 11 percent broader, and the base without health care and education services is only 8 percent below its 1970 level. It is clear that adding services to the base, in addition to broadening the coverage at the time of the addition, will dramatically reduce the base narrowing (and probable rate increasing) associated with the typical base. Because it is not likely that the economic environment of the 21\textsuperscript{st} century will show consumer behavior radically different from that of the recent past, so an important step for preserving state revenue systems would be to significantly expand the coverage of the sales tax to purchases of services. The important new economy challenges will be whether to expand generally or selectively and whether to exclude certain services, like health care and education, for non-economic reasons.\textsuperscript{15}

Exemptions.

The second challenge to retail sales tax productivity comes from exemptions from taxation. Over the years, legislation has nibbled away coverage in the tax base. Attention here will be devoted to larger household consumption exemption categories, although there are many other isolated exemptions in some states. Table 2 details how treatment of these categories of consumption expenditure has changed in the state sales taxes from `1970 to 2018 for food for at-home consumption, clothing, prescription medicines, gasoline, cigarettes, and presence of a tax holiday. Only cigarettes have become more likely to be taxed by the states, and cigarette consumption is a small and dying expenditure category (from 1.24 percent of personal income in 1970 to 0.67 percent in 2016). Full taxation of these consumption categories has become more rare, either through full exemption or by provision of a reduced tax rate. Interest groups are perpetually finding new ideas for exempt categories and legislators are only too happy to respond to those pressures as the concentrated value to the narrow interest politically overwhelms the general cost to the sales tax, the impact of which is diffuse throughout the economy.

The problems with exemption are well-known – absence of targeting, high revenue loss, additional cost of compliance and administration, distortion of consumer behavior, etc. – and it is particularly distressing in light of the fact that the credit/rebate system provides an alternative approach that eliminates virtually all

\textsuperscript{14} Consumption classification for national income accounts does not exactly match categories used in retail sales tax law, so the data here should be considered reasonable approximations only. The typical current tax base equals durable goods, plus non-durable goods less off-premises food and beverage, food produced and consumed on the farm, pharmaceuticals, and net expenditures abroad by U. S. residents, plus water and sewerage, electricity and gas, purchased meals and beverages, accommodations, and telecommunications. Note that some of these categories count as services in BEA accounts, although they are treated as tangible personal property purchases in most sales tax laws. The second base adds all services not already taxed, except life insurance is subtracted because of its investment elements. The third base is the second base less health care and education services.

\textsuperscript{15} A legislative challenge is to keep services predominantly purchased as business inputs exempt to prevent tax pyramiding. This objective can be difficult to achieve because appearing to tax businesses instead of households has political charm, not to mention the attractiveness of hiding a chunk of the tax burden from the tax.
these difficulties with exemption. Currently five states (Maine, Kansas, Oklahoma, Idaho, and Hawaii) operate some form of sales tax credit that returns to families some or all of sales tax paid on purchases, giving greatest relative relief to lowest income families and lesser (or no) relief to more affluent families. That is one state fewer than the number of state offering the program in 1971 (Colorado, Indiana, Nebraska, Massachusetts, Hawaii, and Vermont), but only Hawaii offered the program in both years. The credit/rebate system promises efficiency, equity, and less revenue loss. Its apparent unpopularity is somewhat surprising, particularly in light of the spread of the earned income tax credit program, a program with some similar characteristics.

A change of particular note, probably more significant as a symptom of the problem than as a direct revenue loser, is the sales tax holiday, a short period in which sales tax is not collected on certain otherwise taxable purchases. These tax holidays were unheard of in the United States until the New York state holiday in 1997, but they now infest the sales tax structure of almost half the states, as Table 2 shows. Targets for holidays include back-to-school supplies, clothing, computers, hurricane preparedness supplies, Energy Star appliances, and guns and some states have multiple holidays scheduled for the year. In 2017 Texas held holidays for emergency preparedness supplies, Energy Star appliances, water conserving products, and back-to-school clothing and supplies, possibly a record. The holidays do cause revenue loss and Georgia and Massachusetts have recently dropped their holidays because of that problem. However, Wisconsin added a holiday for 2018. Nothing but political incentives support the holidays as evidence shows that the holidays simply shift the timing of purchases.16

Rising Statutory Rates.

There is a final challenge that flows from the problem of exclusions, exemptions, and consumer preferences for services that combine to narrow the tax base. If states wish to maintain desired reliance on the retail sales tax, they will need to increase their statutory sales tax rates. The problem is that there has been a general consensus, heavily based on pre-value-added tax experience in Scandinavian countries with high-rate retail sales taxes, that retail sales tax rates much above 10 percent are likely to produce compliance issues so difficult that the tax becomes almost impossible to administer. American retail sales tax rates are drifting ever-closer to that danger level, particularly when local governments add their own rates to that levied by the state. Table 3 shows how state statutory rates have drifted upward since 1970. Rates of 6 and 7 percent are no longer rare and a narrowing base will require more rate increases if the position of the sales tax is to be preserved in state revenue systems. Rates are moving toward the danger zone in which significant non-compliance begins to become more attractive and, unless states can manage the narrowing base problem, that prosaic problem will become a significant challenge for state tax administrators in the first part of the 21st century.17

A challenge that states face in the new economy that is entirely within their control is preservation (and expansion) of the statutory sales tax base. Avoiding more exemptions of household consumption purchases and elimination of some currently in place would be beneficial to state fiscal sustainability. Concern with


17 A quieter revenue loser is the vendor discount, a share of total sales tax collections that vendors get to keep as compensation for remittance of the tax. Such discounts are provided by twenty-eight states, only sixteen of which have a maximum amount that may be retained. Paying taxes is a normal part of doing a business, so this compensation is particularly doubtful and several states have quite sensibly constrained the payments in recent years.
what can be controlled by state lawmakers should be primary as they face changes from the new economy that are largely outside their control.

**Challenges to Retail Sales Taxes That Are Exogenous to the Tax Authorities**

Not all challenges to state retail sales taxes are directly in the control of tax authorities. A technology-based economy creates a new operating environment for retail sales taxes. Changes began in recent decades and certainly will continue into the 21st century. Because long-term forecasts are wrong and changes emerge in surprising ways, it is worthless to make distant guesses about what will develop to make sales taxation easier or more complex. However, it is possible to identify some innovations and technology that have either improved or harmed the prospects for tax collection and to make modest extensions of those changes. The concern from more difficult collection is that evasion will increase and, accordingly, revenue will not be received for provision of public services and that compliant taxpayers will be put at competitive disadvantage. As is the case in many areas, most change has both positive and negative impacts.

**Internet and the Remote Vendor.**

The technological bane of the last two decades has been commerce via the internet, in particular commerce from remote vendors (vendors from outside the taxing state). States have been unable, or at least believed themselves to be unable, to require vendors with no physical presence in the state to register and collect use tax on common-carrier deliveries into the state, meaning that states could only enforce the tax directly from purchasers, an approach certainly less efficient and effect than collecting the tax indirectly through the vendor. That constraint was the product of the Supreme Court rulings in *National Bellas Hess v. [Illinois] Department of Revenue* (386 U.S. 753 (1967) and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), two cases that established the right of states to tax such activity but limited state ability to require vendors to collect the tax to those with physical presence in the state. To do otherwise would place an undue burden on interstate commerce, but Congress had the responsibility to determine when burden might be undue and could provide other remedies. The decisions were on catalog sales, an operation considerably different from sales transacted through the internet and that has been the hassle when states saw the considerable growth in commerce initiated via the internet by no-physical-presence vendors. States were concerned about protecting their retailers from vendors able to sell without collecting sales tax and about protecting their tax base from loss to such transactions. The amount of revenue lost through remote vendor sales is unknown and there is considerable range in estimates. The Government Accountability Office recently estimated 2016 loss at 2 to 4 percent of potential tax. A more-widely accepted study by Donald Bruce,

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18 The dramatic relative and absolute increase in the service sector is part of the movement from a manufacturing/goods driven economy. A response to that transition is within the scope of legislative change and was discussed in the prior section.
19 A technology that changed sales tax administration dramatically and for the good was the development of bar coding with electronic cash registers in the late 1970s. Proper collection of tax no longer depended on categorization by the clerk and audit could focus on coding and inventory. There is no reason to expect that the person running a cash register is expert in sales tax law and regulations and the bar-coding system renders that expectation irrelevant.
20 The principal remote vendor villain has changed over the years. For some time, L. L. Bean was the target of state complaints (and the company that spoke out regularly in defense of its non-registration position). It was then replaced by Amazon as that company developed a larger role in the economy. Amazon now collects tax for all forty-five sales tax states (but not local taxes) on products it sells directly but does not collect for vendors using their platform. It is interesting to speculate what company will become the prime target if the states do not prevail in the *Wayfair* case. It could be L. L. Bean again, because that company has not changed its position.
William F. Fox, and LeAnn Luna estimates the loss at around 5.2 percent in 2012.\textsuperscript{22} And an updating on the Bruce, Fox, and Luna estimates to 2015 that also adds loss from traditional mail-order shopping places the loss at 9.0 percent.\textsuperscript{23} In sum, the loss, while unknown, ranges from big to really big and states are not unreasonable in seeking an avenue to protect their retailers and their sales tax base. Expansion of the new economy makes the quest to close the tax gap ever more important.\textsuperscript{24}

States are pursuing two alternative approaches to establishing their ability to collect tax on remote, no-physical-presence vendor sales. The approach given much attention is the challenge to the current legal precedent in the Supreme Court. South Dakota in 2016 passed a law requiring vendors lacking physical presence in the state to remit tax as if they were in the state if either (1) gross revenue of sales into South Dakota exceeded $100,000 in the year or (2) the vendor had 200 or more transactions into the state. That brought an immediate challenge, as was its intent. In the case \textit{South Dakota v. Wayfair} (U. S. Supreme Court Docket Number 17-494, 2018), the state asserts that physical presence has little merit in light of massive changes in the economy since the earlier rulings, that technology makes the requirement of collecting tax on behalf of jurisdictions to which purchases are delivered no longer an excess burden, and that significant economic presence in a state’s market is a more reasonable standard for the registration / collection requirement. Opposing \textit{amicus} briefs stress the continuing value and clarity of the physical presence standard, the costs associated to remote vendors of complying with a changed standard, and constitutional questions about extraterritoriality, among other concerns. The case is argued April 17, 2018 and the conclusion will be announced sometime in the summer. It would be hazardous to guess what will happen.

States have a powerful option if the physical presence standard is not overturned in the \textit{Wayfair} case. In \textit{Direct Marketing Association v. Brohl}, the Supreme Court accepted as constitutional a Colorado law that required out-of-state retailers (excluding those making less than $100,000 in gross sales into the state) not collecting Colorado tax to (1) notify their Colorado customers of their use tax filing and payment obligations; (2) annually furnish Colorado customers with information on their prior-year purchases; and (3) annually file with the Colorado Department of Revenue a detailed statement of each customer’s purchases. The Court reasoned that the prior issue of undue burden was one of requiring collection of tax and the Colorado law only required reporting of transactions, hence not creating the burden issue.\textsuperscript{25} The idea is that vendors with substantial economic presence in a state may be required to report those operations without facing the undue burden that was seen as a problem previously. Under the Colorado scheme, any retailer not choosing to voluntarily collect and remit tax would have to report transactions in the state and the Colorado Department of Revenue could use that data to pursue collections from purchasers directly, presumably focusing its attention on those with the greatest liability. There is also the prospect that vendors might find it easier and less expensive to simply register, collect, and remit tax that to do the reporting to customers and the Department of Revenue required if they do not collect the tax. In full operation, the Colorado system closes the door on loss of tax revenue and unfair competition with in-state vendors.

\textsuperscript{22} Donald Bruce, William F. Fox, and LeAnn Luna, “State and Local Government Sales Tax Revenue Losses from Electronic Commerce,” University of Tennessee, April 13, 2009.


\textsuperscript{24} The glib approach is to observe that the uncollected sales tax on purchases from remote sellers equals compensating use tax owed by purchasers and states only need to do their job by collecting from those purchasers. Although states do make some effort to collect these use taxes, for instance by including a reporting line for use tax on state income tax forms and by policing transactions without paid tax on audits, the direct approach to collecting a transaction tax is generally impossible.

\textsuperscript{25} Not as outlandish as it might seem: the Colorado system did not require that vendors know local sales tax rates or other complications in the state. They simply had to record the transactions. The state could sort out the rest.
vendors will register rather than going through the reporting process, some customers will remit use tax when they receive the notification from the vendor of the amount of relevant purchases, and the state can use its enforcement system to pursue customers who have not paid the appropriate tax through the first two avenues (certainly using a de minimus standard in that effort). The approach neatly combines collection from vendors, collection from purchasers, and third-party information in an effective manner. Even without an end to the physical presence standard, states have a tool to deal with the remote vendor problem and the only surprise is that only Louisiana, Pennsylvania, Vermont, and Washington have chosen to follow the Colorado route to expanding tax coverage. Some states, e.g., Indiana, North Dakota, Massachusetts, Maine, Mississippi, among others, have enacted laws requiring firms with sales above particular limits to register and collect, obviously ignoring the physical presence standard entirely, but their success will ultimately depend on Wayfair. The Colorado-inspired tool does not.

It is always possible that Congress might act to provide a mechanism that would allow for collection of tax from remote vendors. Such proposals – Remote Transactions Parity Act, Marketplace Fairness Act, Business Activity Tax Simplification Act, Digital Goods and Services Tax Fairness Act, Online Sales Simplification Act, and others -- have been bubbling for more than two decades and have gone nowhere.26 Unfortunately, the proposals generally resort to some exotic scheme for collection and do not take the direct route of requiring vendors with substantial economic presence to register and collect tax. It is not likely that Congressional action will occur before the Wayfair decision is announced, but Congress does always have the option of changing the rules of interstate taxation. Some argue that changing the registration standard is properly a legislative matter and, accordingly, should be done only by Congress. Others argue that re-interpretation of a judicial ruling is certainly a judicial matter. However, concern that the physical presence standard is not appropriate with the new economy has been present for well over a decade and Congress has not acted, so action in the near future is doubtful.

The bottom line is that, states now have significant capacity to deal with the remote vendor problem, if they choose to use that power. States are even now aggressive: 31 have laws of one sort or another demanding collection from firms without physical presence. The Colorado reporting approach puts more responsibility on a department of revenue for collection of revenue than would an approach emerging from a reversal of Quill. However, if physical presence continues to be the standard, states are far from being without tools appropriate to collecting from no-physical-presence transactions. The remote vendor problem emerging from the new ways in which business gets transaction is closer to being resolved than it ever has been before and is not longer a great danger to viability of the retail sales tax.27

The sharing economy.

The sharing economy is an economic structure in which there is peer-to-peer transactions of goods or services facilitated by some on-line platform (Airbnb or VRBO for short-term lodging or Uber and Lyft for taxi service). The transactions could be done without the on-line platform (accommodating tourists in an extra room was not uncommon in the 1950s and 1960s, for instance), but having the platform regularizes, organizes, and expands the market, while giving the vendor greater flexibility in regards to operation of the business. The platform makes it possible for a small business to advertise globally and to avoid concerns about payment, leaving the business operator free for other endeavors. A business that might require a

26 On the other hand, the No Regulation Without Representation Act would codify the physical presence standard and preclude all efforts to expand tax on sales by remote vendors.

27 There is another internet business issue that impacts states which include transient lodging in their sales tax base. On-line travel operators maintain a sales tax advantage in hotel sales because they apply the tax rate to the room rate they pay (a wholesale price), rather than to the room rate paid by the customer (the retail price). That gives such operators a price advantage over competitors who must apply the tax to the retail price, as well as reduces revenue collected by the tax.
large amount of administrative effort by the operator can now operate without putting those responsibilities on the operator.

An expansion of small, often informal businesses always has presented a challenge for sales tax administration. In many respects, the tax issues here are those that sales tax administrators have struggled with in the past in regard to informal economic activity, casual sales, flea markets, and the like. It is not clear that the problems have been fully dealt with in the past, nor is it clear that what is referred to as the sharing economy will be successfully dealt with in the future, at least so long as the administrative model is the one used for collection of tax from fixed location, formal business enterprises. It is not clear that vendors will register as tax collectors, that taxes will be remitted appropriately, nor that pursuit of unpaid tax from particular vendors will merit the administrative cost involved. However, Airbnb does provide a model for feasible collection of the sales tax on transient lodging for is 660,000 hosts. Airbnb has agreements with a number of states (and localities in some of the states) to collect and remit taxes on behalf of their hosts. Lodging guests are charged the relevant tax at the time of booking and remits the tax to the jurisdiction according to the relevant due dates for payment. States currently with such agreements for retail sales tax, according to Airbnb, include Arizona, Arkansas, Colorado, Idaho, Kansas, Kentucky, Louisiana, Maine, Michigan, Mississippi, North Carolina, North Dakota, Oklahoma, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Utah, Washington, Wisconsin, and Wyoming. (That does not include all states levying their sales tax on transient lodging.) The collection agreements also apply to state and local lodging excises that may be levied in addition to or instead of the retail sales tax. Using the platform as tax collector presents a practical approach to dealing with both compliance and administration of the tax.

Applying the retail sales tax to the other notable sharing enterprise – ride sharing or transportation network companies – is more complicated. First, states frequently do not include taxi services among the list of taxable services. That means that applying tax to ride sharing operations would involve either treating this set of service providers differently from the treatment received by their competitors or balancing out treatment by taxing both ride share service and regular taxi service. Either option creates a special interest block that makes legislation particularly difficult. Unless the legislation is buried in a larger base revision program, in which the static from winners and losers tends to cancel out, the expansion empirically has only minimal chance of approval. The first phase for dealing with the ride sharing sector of the new economy would be to include the service involved in the sales tax base. Only a handful of states have taken that step.

Second, ride share operators are small businesses, there are many of them, and many likely have little experience with sales tax compliance. Uber and Lyft are private companies and they do not provide data on how many driver-partners – vendors, in sales tax terminology – are in their systems. However, some indication is available for Uber. According to a report done for the company by Jonathan Hall and Alan Krueger, at the end of 2014, the company had 162,000 driver-partners (individuals who had at least four trips in the last month) and 40,000 new driver-partners had joined in December of that year. That means that, in addition to the numbers of driver-partners being large, that there has to be considerable churn in the numbers who are active at any time. There are not as many Lyft drivers as there are Uber drivers and a number of drivers are in both platforms. But the total businesses in this portion of the shared economy is a considerable number. Sales tax compliance systems require that all drivers in either system for some portion of the year would be registered and that, according to their periodic sales volume, would be subject to a regular reporting schedule. The most efficient approach would be for the sales network platform that arranges the match between driver and customer and collects from the customer be responsible, in other

words, adds sales tax to the fare and remits collections according to the prescribed schedule. Just as there is inconsistency across states in whether transportation services (like shared rides) is taxed, there appears that platforms and revenue departments have not reached an agreement about how the sales tax will function. No single compliance profile applies in all states and the range of arrangements is considerable. In some states (Rhode Island is one), the applicable sales tax is added to the customer’s bill and the platform handles remittance to the state. In other states (Ohio is one), Uber disputes its responsibility for collecting the tax. It argues that it merely provides an App that connects drivers and riders and certainly does not provide transportation services, so it has no responsibility for the tax. The Ohio case is with the state Board of Tax Appeals. In another state (New York), the applicable sales tax appears to be deducted from the fare to be received by the driver, rather than being added to the pre-tax taxi fare. In other places (Hawaii), the tax appears to be entirely up to the driver. Most reports from drivers come from Uber operations, but there appears to be variation across states in how Lyft deals with the tax. What is clear is that sales tax treatment of this portion of the shared economy has not been resolved and, should more states move toward inclusion of taxi services in the tax base to keep up with trends in the new economy, the problems will increase. Leaving the sales tax responsibility up to the driver promises great problems of compliance and administration because many drivers would have small tax liabilities, many operators are not familiar with sales tax obligations, and there is much churn in the active driver population from month to month. It would be a repeat of problems in drawing the line between untaxed casual sales and taxable business operations. The Airbnb approach would seem to afford the best solution to the dilemma: have the platform (Uber or Lyft) collect the relevant sales tax when it charges the customer and remit all tax collections to the relevant jurisdiction as they become due. However, there clearly is resistance to this approach, possibly because neither firm wants to be at competitive disadvantage.

Zappers and Phantomware.

Sales suppression technology (phantomware and zappers) makes sales disappear from the records of the vendor. Zappers are essentially a high-tech approach to skimming cash from receipts that conceals tracks involved in the transaction. The technology has its origin in Europe, probably because the high value-added tax rates make evasion more attractive to businesses. However, zappers have been discovered in the United States as well, even though our sales tax rates are considerably lower than the European value-added tax rates, making the skim less profitable. The zapper program when installed on an electronic cash register causes the transaction, as it is rung up, to disappear from the establishment’s records and allows the owner to alter records to make it appear that sales volume has been less than it actually was as associate records, e.g., inventory and so on, are adjusted accordingly to make all traces of the transaction to disappear. The vendor reports lower sales volume and keeps the sales tax collected on the zapped transactions. This is a major problem because tax authorities have regarded the records from electronic system to be accurate. Traditionally the zapper was applicable to cash transactions only, because of fewer means of tracking transactions outside of the establishment, but recently evaders have started systems that work with credit and debit card transactions by routing records through international firms.

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30 Not all new economy transitions make for sales tax problems. Prospects for a “cash less” society have interesting implications. The growth in the use of debit and credit cards likely makes sales tax enforcement somewhat easier. Payments in cash are easier to make disappear than are the electronic records associated with use of cards. That would make verification of records easier – a second flow of data to check – and complicate successful skimming. It will be interesting to see whether “cash only” restaurants in some large cities change their policies, i.e., will access to the “cash less” customers overwhelm the prospects for sales tax skimming?
No certain defense is available to prevent the operation of zappers and every state sales tax system is vulnerable. A search for zapper systems has become a necessary step in all audit and enforcement actions and audit may entail making sample purchases to determine whether they were correctly included in vendor records. It is illegal to possess a zapper in a number of states, including Arizona, Arkansas, California, Connecticut, Florida, Georgia, Illinois, Indiana, Kentucky, Louisiana, Maine, Michigan, North Carolina, Oklahoma, Tennessee, Texas, Utah, Vermont, Washington, West Virginia, and Wyoming.

Summing Up

The retail sales tax emerged during the Great Depression as a means for state fiscal survival. It became a stalwart of state government revenue systems through the second half of the twentieth century. Despite significant increases in state reliance on individual income taxes, the retail sales tax remains the most important tax source for several states and a major contributor in all the forty-five states levying such taxes. It serves as an important device for limiting over-reliance on the individual income tax. The tax would be difficult to replace with revenue from other options available to the states.

Sales tax collections are challenged by some elements of economic change. Development of the shared economy makes administration more complicated because of the expansion of near-informal vendors on the market. Commerce emerging through the internet complicates enforcement. New mechanisms for skimming make enforcement take steps that have not seemed necessary in the past. But expansion of the cashless economy potentially makes enforcement somewhat easier and some relief from the remote vendor problem may be at hand. Cooperation from market platforms may simplify collection from shared economy vendors. The new economy is not all gloom and doom for the sales tax.

It may be argued that the forces of the new economy are outside the control of legislators and administrators and there is considerable truth to that view. However, it is undoubtedly the case that a considerable share of the challenge to state retail sales taxes lies fully within the control of state lawmakers. States continue the Great Depression era focus of the sales tax on the purchase of tangible personal property and covering purchases of services, a dramatically growing share of consumer expenditures, selectively at best. That means that the sales tax base covers a declining share of economic activity as years go by. States are able to maintain reliance on the sales tax only by increasing the statutory tax rate on that diminishing base. A high rate – narrow base policy is not good policy. But that is what state lawmakers have tacitly adopted. While there are certainly concerns from the changes brought by the new economy, the first round of protection of the retail sales tax in the twenty-first century would be to make the traditional portion of the tax base more consistent with the realities of that new economy.

Both endogenous and exogenous challenges impact the equity, efficiency, and productivity of the retail sales tax. There are difficult issues in devising a robust tax, but none seems insurmountable with sales tax system restructuring to deal with the challenges. Rather, the problems are heavily political because solutions may impact members of organized interest groups, but some states have had modest success at fruitful restructuring. The sales tax future much depends on the design of strategies to enact identified solutions to structural, behavioral, and administrative threats. None are impossible.
<table>
<thead>
<tr>
<th>Year Tax Became Effective</th>
<th>State</th>
<th>Year of Expiration</th>
<th>Year of Reinstatement</th>
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<tbody>
<tr>
<td><strong>Prewar</strong></td>
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<tr>
<td>1932</td>
<td>Mississippi</td>
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<tr>
<td>1933</td>
<td>Arizona, California, Illinois, Michigan, North Carolina, Oklahoma, South Dakota, Utah, West Virginia</td>
<td>New York</td>
<td>1934</td>
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<td>1934</td>
<td>Iowa, Missouri, New Mexico</td>
<td>Kentucky</td>
<td>1936</td>
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<td>1937</td>
<td>Alabama, Kansas</td>
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<td>1938</td>
<td>Louisiana (repealed 1940)</td>
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<tr>
<td>1942</td>
<td>Louisiana</td>
<td></td>
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<tr>
<td><strong>Postwar</strong></td>
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<td></td>
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<tr>
<td>1947</td>
<td>Connecticut, Maryland, Rhode Island, Tennessee</td>
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<tr>
<td>1949</td>
<td>Florida (and District of Columbia)</td>
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<tr>
<td>1951</td>
<td>Georgia, Maine, South Carolina</td>
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<td>1953</td>
<td>Pennsylvania</td>
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<td>1955</td>
<td>Nevada</td>
<td>1955</td>
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<td>1960</td>
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<td>1967</td>
<td>Minnesota, Nebraska</td>
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<tr>
<td>1969</td>
<td>Vermont</td>
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Figure 1. National Shares of State Tax Revenue from Property, General Sales, and Individual Income, 1902 - 1950
Figure 2, Mean State Retail Sales and Individual Income Tax Reliance Among the 45 Sales Tax States, 1970 - 2016
Figure 3. Mean State Sales Tax Breadth (Base Relative to Personal Income), 1970 - 2016
Figure 4. Retail Sales Tax Reliance, Breadth, and Effective Rate, State Aggregate Relative to 1970, 1970 - 2015

- **Reliance**
- **Breadth**
- **Rate**
Figure 5. Sales Tax Base Relative to Personal Income: Current Typical Base, Current Base, Current Base Plus Untaxed Household Service, and Base Plus Services Except Services Except Health Care and Education (Relative to 1970)
Table 2. Household Consumption Exemptions in Individual States, 1970 and 2018 (E = category is exempt; RR = category is taxed at reduced rate; T = category is taxed at standard rate)

<table>
<thead>
<tr>
<th>Item</th>
<th>Status in 1970</th>
<th>Status in 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Food for at-home consumption</strong></td>
<td>E: 16; RR: 1; T: 28</td>
<td>E: 32; RR: 6; T: 7</td>
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<tr>
<td><strong>Clothing</strong></td>
<td>E: 4; E-children: 1; T: 40</td>
<td>E: 7; T: 38</td>
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<td><strong>Prescription medicines</strong></td>
<td>E: 26; RR: 2; T: 17</td>
<td>E: 44; RR: 1</td>
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<tr>
<td><strong>Gasoline</strong></td>
<td>E: 38; T: 7</td>
<td>E: 36; RR: 6; T: 3</td>
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<tr>
<td><strong>Cigarettes</strong></td>
<td>E: 15; RR: 6; T: 24</td>
<td>E: 2; RR: 3; T: 40</td>
</tr>
<tr>
<td><strong>Sales tax holiday</strong></td>
<td>No states</td>
<td>One holiday: 10 states; two holidays: 5 states; 3 holidays: 1 state; 4 holidays: 1; zero holidays: 28</td>
</tr>
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Table 3. Statutory State Sales Tax Rate Distribution Across States, 1970 – 2018 (January 1)

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<tr>
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<td>17</td>
<td>4</td>
<td>2</td>
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<tr>
<td>4% and fractions</td>
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<td>15</td>
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<td>11</td>
<td>11</td>
</tr>
<tr>
<td>5% and fractions</td>
<td>5</td>
<td>6</td>
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<td>14</td>
<td>9</td>
<td>8</td>
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<td>6% and fractions</td>
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<tr>
<td>8% and fractions</td>
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