



ON THE MONEY

States turn to sales tax to compensate for revenue shortfalls

By Lorene Yue
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March 21, 2004

It's no secret that the economic slowdown is hurting the revenues of state governments. What's gone almost unnoticed is how states are trying to make up the shortfall.

"The combined average state and local sales tax rate rose 26 percent last year," said Diana DiBello, of Vertex Inc., a Pennsylvania tax software company. "That is almost as much as in the previous nine years."

The average sales tax rate in the United States was 8.534 percent last year. As unfunded and underfunded federal mandates continue to pile up, bumping up sales tax rates appears to be the most painless way to generate more state revenue.

"Most states find it easy to raise the sales tax rate by 0.25 percent," said Diane Yetter of the Sales Tax Institute, a division of Chicago-based Yetter Consulting Services Inc. "When you raise the sales tax by 0.25 percent, we pay in pennies. But if you raise the income tax, everybody sees that in their paycheck and it's a chunk."

On March 1, Arkansas' state sales tax jumped to 6 percent from 5.125 percent. Last year, Idaho, Ohio and Vermont raised state sales tax rates by 1 percent. New York raised its rate by 0.25 percent. A total of 412 municipalities raised their rates by varying amounts.

Here's what you should know about the sales tax:

-- It's a key moneymaker. "It's the primary source of revenue for most states," said Chad Davis, director of government relations for the National Retail Federation. "About the lowest percentage of state revenue it contributes is 20 percent, and for some states it is more than half."

Florida and Washington each reaped roughly 60 percent of 2002 state revenue from sales taxes, according to the Federation of Tax Administrators. Neither state levies an individual income tax, typically the second-largest revenue generator.

The average state rate in 2003 was 5.326 percent, up less than 0.1 percent from 2002.

-- A few states don't have one. Delaware, Alaska, Montana, New Hampshire and Oregon don't impose a sales tax. But that doesn't mean municipalities in those states don't love the tax. For example, Wrangell, Alaska, has the highest city sales tax rate in the country at 7 percent.

Colorado has the second-lowest state sales tax at 2.9 percent, while Mississippi, Rhode Island and Tennessee have the highest at 7 percent.

Arab, Ala., has the distinction of having the highest official combined sales tax at 11 percent, but officials in the town of 7,500 said no one actually is charged that rate. Arab residents pay 8 percent in sales taxes -- 4 percent levied by Alabama and 4 percent in city sales tax. If any businesses are established on the 20 acres of farmland in Cullman County that the city annexed years ago, they would have to collect an additional 3 percent county sales tax, putting the total at 11 percent.

-- Confusion at the checkout. Some states exempt staple foods and basic clothing from sales tax, but there's no consistency in the exemptions overall.

Retailers have been pushing for adoption of a streamlined sales tax -- official rules that will enable businesses to uniformly categorize products and thus determine what type of sales tax to impose. "We ask that a belt be either clothing or an accessory -- the classification can change its tax rate," the Retail Federation's Davis said. "The states need to look at each item and know which category it goes in."

"That's a big controversy," said Yetter of the Sales Tax Institute. "What is food? In some places, marshmallows are food while mini-marshmallows are candy."

-- No salvation by Internet. Online retailers are required to collect sales taxes in states where they have a physical presence. However, some companies collect regardless of their locations.

If you did not pay sales tax on an Internet or catalog purchase, then you are supposed to pay a use tax through your state income tax return. But there is little or no enforcement, and many buyers just let it slide.

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