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Internet Transactions and the Sales Tax

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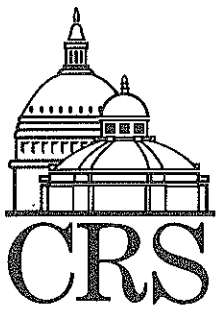
Steven Maguire
Analyst in Public Finance
Government and Finance Division



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Internet Transactions and the Sales Tax

Summary

The creation and subsequent activities of the Advisory Commission on Electronic Commerce focused attention on the issue of Internet taxation. The debate generally focuses upon the administration of the sales tax and the interaction with electronic commerce. Under present law, interstate vendors that do not have "substantial nexus" in the state of a purchaser's residence are not required to collect the sales and use tax on Internet transactions. In most cases, the state requires the purchaser to voluntarily remit a use tax to their home state. However, voluntary compliance with this requirement is quite low. Thus, states feel that the growing share of Internet transactions relative to traditional retail transactions will lead to a deterioration of their tax base and thus revenue. This report examines the sales and use tax in general, provides state-by-state sales tax revenue reliance estimates, and lists state and local sales tax rates. This report will be updated as new data become available.

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Internet Transactions and the Sales Tax

Introduction

This report is an introduction to the economics of electronic commerce and its potential impact on sales and use tax collections. Presently, 45 states (and the District of Columbia) require that retail outlets add a fixed percentage to the sales price of all taxable items (inclusive of federally imposed excise taxes). The sales tax is applied to transactions occurring in the store and is collected and remitted by the vendor. For remote transactions where the vendor and consumer are in different states, the consumer is responsible for remitting the use tax.[1] The use tax is levied on the *use* of a product or service.

In addition to the states, there are numerous localities and special taxing jurisdictions that maintain an estimated 6,400 different sales and use tax rates in the United States.[2] For transactions physically taking place at the store or retail outlet, collection of the sales tax is straightforward. The vendor simply applies the appropriate tax rate. However, with the expanding acceptance of the Internet as an alternative to traditional retail transactions, the collection of the sales and use tax has become an issue of significant importance to vendors, sub-national governments, and consumers.

There were several bills introduced in the 106th Congress that addressed the taxation of Internet based commerce. Generally, the legislation can be differentiated by following four components: 1) whether to extend the current three-year moratorium; 2) whether to continue to grandfather existing Internet access taxes; 3) whether to expand the moratorium to prohibit taxation of digitized goods and services, or possibly all electronic commerce; and 4) whether to have Congress take action to facilitate the collection of state sales and use taxes on interstate sales of goods and services arranged over the Internet. For a more in-depth review of internet related legislation introduced in the 106th Congress, see CRS Report RL30412, *Internet Taxation: Bills in the 106th Congress.*

This report has two related parts. The first describes the imposition of the sales and use tax from the tax administrator's point of view. The second provides an overview of the economic aspects of sales taxes and how Internet transactions, or

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[1]This is true only if the vendor does not have physical presence, or substantial nexus, in the consumer's state of residence.

[2]Goolsbee, Austan and Jonathan Zittrain, "Evaluating the Costs and Benefits of Internet Transactions," *National Tax Journal,* vol. 52, no. 3 (September, 1999) p. 413-428. In addition, research by *Vertex Inc.*, a private company that collects and sells jurisdiction tax data to vendors, found that over the last six years an average of 639 jurisdictions per year implemented tax rate changes a year.

'Internet taxes,' have changed the role of the sales tax in state and local government finance. The report concludes with some further observations.

The Imposition of the Sales and Use Tax

State and local governments that impose a general sales tax on transactions typically calculate the tax as a fixed percentage of a retail good's purchase price.[3] In theory, the sales and use tax is seen in part as a benefit tax levied on businesses and consumers for state and local expenditures such as fire protection, road maintenance, education, and police protection. Most states require monthly remittance of the sales tax and often offer discounts to businesses that pay early or have total sales exceeding a threshold amount.[4] The use tax is remitted by the consumer.

Exempt Transactions. However, not all transactions are taxed. In some States, business-to-business transactions are not subject to the retail sales tax with the understanding that the purchaser is using the good as an input to production. These business to business transactions are exempt primarily because including the transactions leads to 'pyramiding' of the sales tax. For example, if a coffee shop were to pay a retail sales tax on the purchase of wholesale coffee beans, and then impose a retail sales tax on coffee brewed for the final consumer, the total sales tax paid for the cup of coffee would exceed the statutory rate.

In addition to some business purchases, many individuals and organizations are exempt from the sales tax. Entities wishing to claim the sales tax exemption are often issued a certificate indicating their tax-free status and are required to present their certification at the point of transaction. Non-profit organizations, such as those whose mission is religious, charitable, educational, or to promote the public health, are often the beneficiaries of sales tax-exempt status.

Substantial Nexus. The United States Supreme Court has held that a state has no authority to require a vendor to withhold that state's sales and use taxes unless the vendor has a "substantial nexus" with the taxing state.[5] Generally, substantial nexus means physical presence. Out-of-state businesses without substantial nexus in the taxing state are not required to collect state and local sales use taxes on transactions involving customers in the home taxing state. The residence of the purchaser is not a sufficient nexus. However, the Court has also held that Congress, under its power to regulate interstate commerce, could grant authority to the states to require the vendor to collect use taxes.

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[3]Some states impose a gross receipts tax which is similar to a general sales tax. A gross receipts tax is levied on businesses receipts and not the consumer expenditure. However, businesses in these states collect the tax on each transaction.

[4]Currently, 17 of the 45 states with a sales tax do not offer a vendor discount.

[5]There are two decisions that clarified the taxation of out-of-state vendors. In *National Bellas Hess v. Illinois Department of Revenue* (1967) the court established the substantial nexus argument. In *Quill v. North Dakota* (1992) the court upheld the nexus argument and further specified the physical presence standard for substantial nexus.

Because interstate Internet transactions do not have the sales and use tax added to their price by out-of-state vendors, it is argued that Internet retailers and catalogue retailers have a competitive advantage over traditional 'bricks and mortar' vendors who are required to collect the tax. The equitable treatment of all vendors is the objective of many of the proposed changes to the administration of the sales and use tax.

If the vendor does not have substantial nexus the *consumer* is required to remit the use tax to their state government. All states with a sales tax also impose a use tax though compliance is very low. Thus, contrary to what some observers say, Internet purchases are not "tax free."[6]

The Economic History of the Sales and Use Tax

In 1932, Mississippi was the first state to impose a general state sales tax.[7] During the remainder of the 1930's, an era characterized by declining revenue from income and corporate taxes, 23 other states followed suit and implemented a general sales tax to compensate for the lost revenue.[8] At the time, the sales tax was relatively easy to administer and could raise a significant amount of revenue with a relatively low rate.[9] Given the relative success of the sales tax in raising revenue, all but five other states added the sales tax to their tax infrastructure by the late 1960. Use taxes are in practice analogous to the sales tax though the tax is on the *use* of the product purchased rather than the transaction. The last of the 45 states to enact a general sales tax (along with a use tax) was Vermont in 1969.

The revenue a sales and use tax generates depends upon the chosen rate and the base to which the rate applies. The more narrow the base the higher the rate must be to raise an equivalent amount of revenue. States often have similar consumption expenditures included in their tax base, but they are far from uniform. Tax rates also vary considerably from state to state depending in part on their reliance on other revenue sources. Following is a brief analysis of the sales tax and the challenges electronic commerce pose for the imposition and collection of the tax.

Efficiency. A commonly held view among economists is that a "good" tax (or more precisely, an efficient tax) is one that does not significantly distort behavior.

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[6]The much discussed moratorium on Internet taxation applies to any multiple or discriminatory taxes targeted explicitly at Internet retailers. The sales and use tax is not a new tax.

[7]The *use* tax, the companion to the sales tax, was added in 1938. In the early years of the sales tax, states began with general sales then added the use tax to capture revenue from sales made out-of-state. Eventually, states adopting a sales tax included the use tax in the initial legislation.

[8]Fox, William F., ed., *Sales Taxation: Critical Issues in Policy and Administration, Sales Tax Trends and Issues*, by Ebel, Robert and Christopher Zimmerman (Westport, CT: Praeger, 1992), pp. 3-26.

[9]The highest rate in 1934 was 3%, which was considered quite high. Today, in some jurisdictions in Louisiana and Oklahoma, the rate can be as high as 9.5%.

Broadly speaking, individuals should make the same relative choices before and after a tax is imposed. The greater the distortions in behavior, the greater the economic welfare loss.

Products purchased over the Internet that escape taxation (i.e., the consumer does not remit the required use taxes), are cheaper and thus generally preferred to the products offered at traditional retail outlets which are required to collect the tax. However, if the transaction costs associated with the Internet purchase, e.g. shipping and internet access fees, exceed the sum of the traditional transaction costs (time and transportation for example) and the applicable sales tax, the consumer will choose the traditional means of transaction. Note that the shipping costs added to Internet purchases are analogous to the transaction costs associated with traditional "main street" shopping, not to the sales taxes imposed.

Equity. The sales tax has often been criticized as a regressive tax, or a tax that disproportionately burdens the poor.[10] Assuming Internet shoppers are relatively better off and do not remit use taxes as prescribed by state law, they can avoid paying tax on a significant portion of their consumption expenditures.[11] Those without Internet access at home or work, on the other hand, are not afforded the same opportunity to "evade" the sales and use tax. In this way, electronic commerce may actually exacerbate the regressiveness of the sales tax, at least in the short run.

Tax Base. In theory, the base of a comprehensive consumption tax should include all income that is not saved.[12] The sales tax, which is often considered a consumption tax, is perhaps better identified as a transaction tax on tangible personal property. Most states only tax tangible goods purchased at the retail level. Services, such as legal and medical, are expenditures often omitted from the sales tax base.[13]

Ideally, the sales tax base should be broad enough to avoid drastic fluctuations in the revenue stream. State budgets must be balanced annually, thus a consistent revenue stream engendered by a broad base sales tax is important for fiscal stability. With the apparent shift in the United States from an economy based on transactions of tangible personal property to intangible products and services, the sales and use tax base will continue to narrow.[14] It is then likely that sales tax revenue will also begin to show greater volatility.[15] However, for services, the move from traditional means of transaction to transactions over the Internet does not portend a large loss

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[10]A regressive tax collects a smaller percentage of personal income as income increases.

[11]Goolsbee and Zittrain (1999) found that the average Internet user had on average two more years of education and $22,000 more in family income than non-Internet users.

[12]A common identity in the economics of income accounting is the following: C=Y-S. Or, consumption (C) equals income (Y) less saving (S).

[13]Only two states tax medical services, Hawaii and New Mexico.

[14]Bruce, Donald and William Fox, "E-Commerce in the Context of Declining State Sales Tax Bases," (February, 2000). Mimeo, University of Tennessee, Knoxville.

[15]States without groceries in the sales tax base, considered a relatively constant expenditure, are more vulnerable to cyclical shocks to the sales tax base.

in state and local sales tax revenue because services are often outside the sales tax base.[16]

It is difficult to determine the base erosion that results from growth in untaxed Internet transactions because reliable estimates of consumption expenditures at the state level are not available. The total potential loss can be estimated with greater precision; the loss in revenue can only be as great as the revenue currently collected from the sales and use tax. For comparative purposes, Table 1 presents a rough estimate of the sales tax base for the fifty states, their localities, and the District of Columbia relative to personal income.[17] The last column (f) of Table 1 is the tax rate on unadjusted personal income (in addition to any existing personal income taxes) that would be necessary to achieve the revenue produced by the current state sales and use tax.

Tax Rate. Sales tax rates low enough to avoid altering consumer behavior create fewer distortions than do high rates. However, state sales tax rates vary considerably as do the local rates piggy-backed onto the state levy. Mississippi and Rhode Island have the highest state sales tax rate of 7%. Oklahoma and Louisiana have the highest potential combined state and local rate of 9.5%. The higher rates in these states create an even larger wedge between those that must collect the sales tax and those that do not. Clearly, residents in the high sales tax jurisdictions gain more from Internet purchases (and tax evasion) than do those in low tax rate states.

Table 2 presents the sales tax rates for the 50 states, their localities, and the District of Columbia. Also reported in Table 2 is the reliance of the states on the general sales (and gross receipts) tax (as measured by CRS). The Bureau of Economic Analysis (BEA) also collects data on excise taxes and selective sales. We do not report these receipts because they are typically collected at the wholesale stage, not at the point of retail transaction. For example, the gasoline excise tax is typically paid by the carrier (tanker truck) at the point of collection (the end of the pipeline), not retail sale. Even though gross receipts taxes have more in common with traditional business taxes, the BEA combines them with general sales taxes. Six states, indicated by italics in Table 2, identify their retail sales tax as gross receipts or general income tax. The base of the gross receipts is sometimes broader than the retail sales tax. Depending on the vendor, revenue generated by Internet transactions with out-of-state purchasers may or may not fall under the gross receipts tax.

Sales Tax Reliance. Based upon our calculations, the states most reliant upon general sales and gross receipts taxes, with over 57% of total revenue derived from the tax, are Tennessee, Washington, and Florida.[18] This result is not surprising: these states do not have a personal income tax. In fact, the top six states in terms of reliance upon the general sales tax do not have a personal income tax.

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[16]According the Boston Consulting Group, sales of financial services were second to sales of computer goods in the first six months of 1998. Goolsbee and Zittrain (1999).

[17]Assuming all states had a uniform base, which they do not.

[18]U.S. General Accounting Office, *Sales Taxes: Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain*

In Table 1, States without a personal income tax are identified in italics. Alaska is dissimilar from all other states because of the absence of personal income taxes and sales and use taxes. States without a sales and use tax are represented in bold. Ordinal rankings in terms of reliance appear in the last column of Table 2.

A permanent ban on sales and use taxes on Internet sales would affect states proportionately to their reliance on the sales and use tax for revenue. States that rely heavily on the sales tax also have generally higher rates which exacerbate the difference between the after sales tax retail price and the Internet price. Alternatively, states with low rates (and in turn less reliance) would tend to have a smaller 'wedge' between the two modes of transaction. High rate-high reliance states would tend to recognize the greatest revenue loss given the expected change in consumer's behavior resulting from a ban on the taxation of Internet transactions. The economic welfare loss, defined as the degree to which individuals change their behavior in response to tax law, will also be significant.

If sales taxes were eliminated entirely to achieve equity between Internet transactions and traditional retail transactions, states may turn to an additional tax on personal income to help balance their budgets. Assuming this course of action is pursued, i.e total elimination of the sales tax, column (f) in Table 1 offers the minimum personal income tax rate necessary to yield equal revenue. The calculation also assumes that all personal income is included in the income tax base.

The Advisory Commission's Final Report

The Advisory Commission on Electronic Commerce submitted its final report to Congress in early April of 2000. The final report included three recommendations or findings: 1) to close the "digital divide", 2) to explore internet privacy issues, and 3) to support making permanent the moratorium on international tariffs at the earliest possible date. However, the commission did not arrive upon the necessary two-thirds vote for six additional "policy proposals." The six "policy proposals" included a five year extension of the moratorium on multiple and discriminatory taxes and clarification of nexus (physical presence rules).

Conclusion

Ultimately, eliminating the sales and use tax on a select type of transactions and not others will likely lead to distortions in consumer behavior. These distortions would be minimized by taxing all transactions, regardless of mode, at the same rate (perhaps even zero). Whether this can be achieved with the current sales and use tax structure is an open question.

Table 1. Potential Sales and Use Tax Base of the Fifty States

State (*italics* =no personal income tax) (*=no state sales tax)	GSGR[a] State Tax Revenue 1998 ($000's)	Clothing in Base (in 2000)	Groceries in Base (in 2000)	State Personal Income 1998 ($000's)	GSGR Tax as Percent of Personal Income 1998
(a)	(b)	(c)	(d)	(e)	(f)
Alabama	1,570,650	Y	Y	93,566,943	1.68%
Alaska*	0	n/a	n/a	15,823,391	0.00%
Arizona	3,050,111	Y	N	108,086,511	2.82%
Arkansas	1,513,673	Y	Y	51,762,820	2.92%
California	21,301,860	partial	N	900,899,903	2.36%
Colorado	1,530,832	Y	N	114,449,124	1.34%
Connecticut	3,031,699	partial	N	123,430,960	2.46%
Delaware*	0	n/a	n/a	22,257,563	0.00%
District of Columbia[b]	855,000	Y	N[d]	19,525,661	4.38%
Florida	12,923,644	holiday	N	386,654,430	3.34%
Georgia	3,993,493	Y	N	191,864,830	2.08%
Hawaii	1,425,352	Y	Y	31,268,323	4.56%
Idaho	652,843	partial	Y	25,901,148	2.52%
Illinois	5,596,046	Y	Y[e]	349,029,419	1.60%
Indiana	3,166,706	partial	N	143,362,349	2.21%
Iowa	1,528,824	Y	N	68,719,683	2.22%
Kansas	1,619,246	Y	Y	65,854,217	2.46%
Kentucky	1,981,290	Y	N	84,833,878	2.34%
Louisiana	1,981,231	Y	Y[f]	93,429,786	2.12%
Maine	830,758	Y	N[d]	28,619,679	2.90%
Maryland	2,161,233	Y	Y	154,163,998	1.40%
Massachusetts	2,962,535	partial	N	202,252,119	1.46%
Michigan	7,572,789	Y	N	255,038,802	2.97%
Minnesota	3,243,611	partial	N	130,736,634	2.48%
Mississippi	2,034,804	Y	Y	52,283,212	3.89%
Missouri	2,627,839	Y	Y[e]	132,955,487	1.98%
Montana*	0	n/a	n/a	17,826,735	0.00%
Nebraska	919,750	Y	N	41,211,643	2.23%
Nevada	1,771,955	Y	N	47,794,729	3.71%

State (*italics* =no personal income tax) (*=no state sales tax)	GSGR[a] State Tax Revenue 1998 ($000's)	Clothing in Base (in 2000)	Groceries in Base (in 2000)	State Personal Income 1998 ($000's)	GSGR Tax as Percent of Personal Income 1998
New Hampshire[c]*	0	n/a	n/a	34,625,867	0.00%
New Jersey	4,766,195	partial	N	275,531,478	1.73%
New Mexico	1,454,913	Y	Y	24,753,112	5.88%
New York	7,615,370	holiday	N	575,767,817	1.32%
North Carolina	3,272,774	Y	Y	182,035,666	1.80%
North Dakota	309,139	Y	N	13,854,813	2.23%
Ohio	5,531,207	Y	N	282,920,265	1.96%
Oklahoma	1,328,295	Y	Y	70,469,389	1.88%
Oregon*	0	n/a	n/a	81,309,693	0.00%
Pennsylvania	6,313,056	partial	N	322,705,796	1.96%
Rhode Island	525,672	partial	N	26,614,157	1.98%
South Carolina	2,162,858	Y	Y	82,039,415	2.64%
South Dakota	442,549	Y	Y	16,388,045	2.70%
Tennessee[c]	4,027,787	Y	Y	128,244,293	3.14%
Texas	12,474,161	holiday	N	494,543,763	2.52%
Utah	1,277,126	Y	Y	44,297,177	2.88%
Vermont	194,501	Y	N	14,309,450	1.36%
Virginia	2,225,021	Y	Y	186,685,782	1.19%
Washington	6,909,239	Y	N	159,673,674	4.33%
West Virginia	856,276	Y	Y	35,086,721	2.44%
Wisconsin	3,047,406	partial	N	131,546,684	2.32%
Wyoming	335,383	Y	Y[g]	11,169,256	3.00%

Sources: Columns (b) and (e): Bureau of Economic Analysis. Columns (c) and (d): State Tax Handbook 2000. Column (f): author's calculations.

Notes: [a] General sales and gross receipts tax (GSGR). [b] General sales and gross receipts data are from the annual report of the District of Columbia municipal government which is not directly comparable to the other states. [c] Only capital income is included in the personal income tax. [d] Snack food excluded from exemption. [e] Subject to a reduced rate. [f] Exemption is partially suspended. [g] Some snack foods are taxable.

Table 2. Reliance of State and Local Governments on the Sales and Use Tax

State (*italics*=gross receipts tax) (*=no local tax)	State Rate 2000	Total Potential State & Local Combined Rate 2000	Total State Tax revenue 1998 ($000's)	GSGR[a] State Tax Revenue 1998 ($000's)	GSGR Tax as Percent of Tax Revenue	Reliance Rank
(a)	(b)	(c)	(d)	(e)	(f)	(g)
Alabama	4	5 to 8	5,734,128	1,570,650	27.39%	37
Alaska	0	7[c]	1,186,235	0	0.00%	47
Arizona	5	5.5 to 6	6,949,270	3,050,111	43.89%	9
Arkansas	4.625	6.125 to 8.125	4,056,582	1,513,673	37.31%	13
California	6	7.25 to 8.25	67,713,433	21,301,860	31.46%	27
Colorado	3	4 to 6.75	5,898,349	1,530,832	25.95%	39
Connecticut*	6	6	9,393,604	3,031,699	32.27%	23
Delaware*	0	0	1,981,473	0	0.00%	48
District of Columbia[b]*	5.75	5.75	2,444,800	855,000	34.97%	16
Florida	6	6 to 7.5	22,513,115	12,923,644	57.41%	3
Georgia	4	5 to 7	11,589,495	3,993,493	34.46%	20
*Hawaii**	4	4	3,176,246	1,425,352	44.88%	8
Idaho	5	5 to 7	2,057,378	652,843	31.73%	26
Illinois	6.25	7 to 8.75	19,771,284	5,596,046	28.30%	34
Indiana*	5	5	9,747,426	3,166,706	32.49%	22
Iowa	5	6	4,802,531	1,528,824	31.83%	25
Kansas	4.9	5.9 to 7.4	4,647,921	1,619,246	34.84%	19
Kentucky*	6	6	7,115,149	1,981,290	27.85%	36
Louisiana	4	7 to 9.5	6,082,026	1,981,231	32.58%	21
Maine*	5*	5	2,369,820	830,758	35.06%	15
Maryland*	5	5	9,190,482	2,161,233	23.52%	42
Massachusetts*	5	5	14,488,496	2,962,535	20.45%	45
Michigan*	6	6	21,692,742	7,572,789	34.91%	18
Minnesota	6.5	6.5 to 7.5	11,503,928	3,243,611	28.20%	35
Mississippi*	7	7	4,343,435	2,034,804	46.85%	7
Missouri	4.225	4.725 to 7.475	8,222,326	2,627,839	31.96%	24
Montana*	0	0	1,331,895	0	0.00%	49
Nebraska	5	5 to 6.5	2,633,216	919,750	34.93%	17
Nevada	6.5	6.5 to 7	3,228,206	1,771,955	54.89%	4

State (*italics*=gross receipts tax) (*=no local tax)	State Rate 2000	Total Potential State & Local Combined Rate 2000	Total State Tax revenue 1998 ($000's)	GSGR[a] State Tax Revenue 1998 ($000's)	GSGR Tax as Percent of Tax Revenue	Reli-ance Rank
New Hampshire*	0	0	1,008,518	0	0.00%	50
New Jersey*	6	6	15,604,971	4,766,195	30.54%	30
New Mexico	5	5.125 to 6.9375	3,574,537	1,454,913	40.70%	10
New York	4	7 to 8	36,154,533	7,615,370	21.06%	44
North Carolina	4	6	13,869,426	3,272,774	23.60%	41
North Dakota	5	6 to 7	1,078,375	309,139	28.67%	32
Ohio	5	5.5 to 7	17,642,836	5,531,207	31.35%	28
Oklahoma	4.5	5 to 9.5	5,300,829	1,328,295	25.06%	40
Oregon*	0	0	4,999,091	0	0.00%	51
Pennsylvania	6	6 to 7	20,629,483	6,313,056	30.60%	29
Rhode Island*	7	7	1,783,913	525,672	29.47%	31
South Carolina	5	5 to 6	5,683,148	2,162,858	38.06%	12
South Dakota	4	5 to 8	833,662	442,549	53.08%	5
Tennessee	6	7 to 8.75	6,996,120	4,027,787	57.57%	2
Texas	6.25	6.75 to 8.25	24,629,000	12,474,161	50.65%	6
Utah	4.75	5.75 to 7.5	3,457,679	1,277,126	36.94%	14
Vermont*	5	5	957,656	194,501	20.31%	46
Virginia	3.5	4.5	10,542,966	2,225,021	21.10%	43
Washington	6.5	7 to 8.6	11,806,170	6,909,239	58.52%	1
West Virginia*	6	6	3,011,990	856,276	28.43%	33
Wisconsin	5	5 to 5.5	11,149,754	3,047,406	27.33%	38
Wyoming	4	4 to 6	855,716	335,383	39.19%	11

Sources: Columns (b) and (c): Federation of Tax Administrators. Columns (d) and (e): Bureau of Economic Analysis. Column (f) and (g): author's calculations.

Note: [a] General sales and gross receipts tax (GSGR). [b] General sales and gross receipts data are from the annual report of the District of Columbia municipal government which is not directly comparable to the other states. [c] In 1999, 97 of 162 municipalities in Alaska levied a sale taxes and 7% was the highest rate of those 97.