

CHAPTER THREE

SALES AND EXCISE TAXES

Sales and excise taxes, or consumption taxes, are an important revenue source, comprising close to half of all state tax revenues in 2004. But these taxes are regressive, falling far more heavily on low- and middle income taxpayers than on the wealthy. Consumption taxes also face structural problems that threaten their future viability. This chapter looks at how these taxes work, and outlines options for making consumption taxes less unfair and more sustainable.

How Sales Taxes Work

Sales taxes apply to items we purchase every day, including goods (such as furniture and automobiles) and services (such as haircuts and car repairs). To compute the sales tax on a taxable item, the cost of the item is multiplied by the tax rate. For example, in Michigan, where the sales tax rate is six percent, the sales tax on a \$10 book is sixty cents. The cost of the book to the consumer, after tax, is \$10.60. The sales tax base is the total amount paid for all the goods and services subject to the tax. The sales tax is an example of an **ad valorem** tax—that is, a tax based on the price of the item sold.

In theory, the sales tax applies to all **retail transactions**—that is, sales to the final consumer. But every state allows some special exemptions. Almost all states exempt some items that can be thought of as “essentials”—rent and health care expenses are almost never taxed, for example. More than half of the states exempt groceries. Some states also exempt residential utilities such as electricity and natural gas, and a few states exempt sales of clothing. And in most states, the tax base does not include personal services such as haircuts.

States often have more than one sales tax rate. Some states apply lower tax rates to items such as groceries or utilities, as a means of providing low-income tax relief. Other states apply a higher tax rate to goods and services consumed primarily by tourists, such as hotels or rental cars. This is done to ensure that non-resident visitors pay their fair share of the sales tax.

Many states also have **local sales taxes**. These usually (but not always) apply to the same items as the state sales tax. Thus, calculating the total state and local sales tax is generally simply a matter of adding the state rate to the local rate and multiplying it by the cost of taxable items.

Every state with a sales tax also has a **use tax**, which applies to items that are bought outside a state for use within a state. The use tax is designed to prevent state residents from avoiding the sales tax by purchasing goods in other states. However, the use tax is rarely enforced.

Most states have more than one type of sales tax. They have a **general sales tax** (which is what most people mean when they talk about their state’s “sales tax”), and **selective sales taxes** on particular goods or services. A typical selective sales tax—which may have a different rate than the general sales tax—is a tax on the purchase of alcohol, tobacco or gasoline, or a tax on utilities, such as electricity and telephone service. Selective sales taxes, also known as **excise taxes**, are discussed later in this chapter.

Sales Taxes Are Regressive

Sales taxes are inherently regressive because the lower a family’s income, the more of its income the family must spend on things subject to the tax. Typically, low-income families spend three-quarters of their income on things subject to sales tax, middle-income families spend about half of their income on items subject to sales tax, and the richest families spend only about a sixth of their income on sales-taxable items. Thus, about three-quarters of the income of a low-income family, half of a middle-income family’s income and just one-sixth of the income of a rich

family is typically subject to sales tax. Put another way, a 6 percent sales tax is the equivalent of an income tax with a 4.5 percent rate for the poor (that's three-quarters of the 6 percent sales tax rate), a 3 percent rate on the middle-class (half of 6 percent) and a one-percent income tax rate for the rich (one-sixth of 6 percent). Obviously, no one could get away with proposing an income tax that looked like that. The only reason this pattern is tolerated in consumption taxes is that their regressive nature is hidden in a harmless looking single rate, and the amount families pay is hidden in many small purchases throughout the year.

The sales tax violates the basic tax fairness principle of taxing according to one's ability to pay: the highest burdens are shouldered by those low-income taxpayers with the least ability to pay them. Sales taxes also violate this principle in their insensitivity to fluctuations in taxpayer income: families will always need to spend money on sales taxable items such as food, clothing and utilities no matter how little they earn in a given year. A middle-income taxpayer who loses his job will still have to spend much of his income just to get by—and will still pay a substantial amount of sales tax even though his ability to pay these taxes has fallen dramatically.

The “Equal Tax on Equal Purchases” Fallacy

Despite the regressivity of the sales tax, some people claim that sales taxes are fair. After all, it is said, no one can completely avoid paying sales taxes since they apply to things that everyone—rich and poor alike—needs to buy. The sales tax hits everyone “equally,” goes this argument; the tax is the same on, say, a tube of toothpaste, no matter who buys it.

But this so-called “equality” is precisely why sales taxes *fail* the test of fairness. The cost of toothpaste, and therefore the sales tax on it, is the same for a rich person as for a poor person. But the rich person has many times more income. So the amount that the rich person pays in tax on that tube of toothpaste is a much smaller share of his or her income than the same tax on a middle- or low-income family.

Of course, a rich family does consume more and thus pays more sales tax in dollars than does a less well-off family. But in terms of what those dollars mean to rich families—as a portion of their income and how it affects their standard of living—the sales tax is much less of a burden on the rich than it is on middle- and low-income families.

Sales Taxes on Business—Who Pays?

Most state sales taxes are designed to exempt purchases made by businesses, on the theory that the sales tax is supposed to be a tax on final personal consumption. But the distinction between business and individual purchases is often difficult to make, and as a result every state applies its sales tax to some business purchases. These **business-input** sales taxes add to the cost of producing goods and services, and therefore they are mostly passed forward to consumers in the form of higher retail prices. In other words, taxing business inputs through the sales tax is generally akin to taxing the consumer more than once on the same retail sale. As a result, expanding the sales tax base to include business services will usually hurt low-income taxpayers.

Some of the sales tax paid by businesses is **exported** to out-of-state consumers. For example, Mississippi taxes industrial electrical use at a 1.5 percent rate. A Mississippi-based manufacturer that sells primarily to consumers in other states will likely be able to pass through most of the tax it pays on electricity to consumers in Texas, California, Massachusetts, and elsewhere. In this case, only a little of the tax hits Mississippi's middle- and low-income families.

A Volatile, Slow-Growth Tax

Sales taxes are a mainstay of state budgets nationwide. But during times of economic uncertainty, sales tax collections can be volatile. They can fall both when there is an economic

downturn and when people are afraid a downturn is coming. If a family thinks it may face hard times soon, it may delay some spending in anticipation of the worst. Purchases of big-ticket items like new cars are particularly likely to be postponed. As a result, sales tax revenues can fall during periods of economic uncertainty—even before a recession has set in.

Even in good economic times, the sales tax usually is not a fast-growing tax. The main reason for this is that sales taxes only reflect the income you spend. (By contrast, income taxes depend on the total amount of income you earn.) Sales taxes also grow more slowly than the economy for reasons that have to do with the antiquated tax base in many states: the fastest-growing area of personal consumption is services, which are currently not taxed by most states. The slow growth of sales taxes frequently forces lawmakers to increase the sales tax rate just to keep tax revenues growing with inflation.

No Federal Deductibility

Heavy reliance on sales taxes carries one big disadvantage for states: sales taxes are generally not deductible by itemizers in computing their federal taxable income. (2004 federal tax legislation allows residents of states without income taxes to temporarily deduct their sales taxes, but this tax break is only available in 2004 and 2005—and taxpayers must choose between deducting sales taxes and deducting income taxes, so this tax break will generally only benefit itemizers living in non-income tax states.) Because these taxes generally can't be written off on federal tax forms, every dollar of sales tax that is paid initially by state residents ultimately comes out of their pockets—and every dollar of a sales tax cut that goes to state residents remains in their pockets. In this sense, income and property taxes offer a much greater “bang for the buck” than sales and excise taxes—an important point as lawmakers decide which taxes to increase or cut.

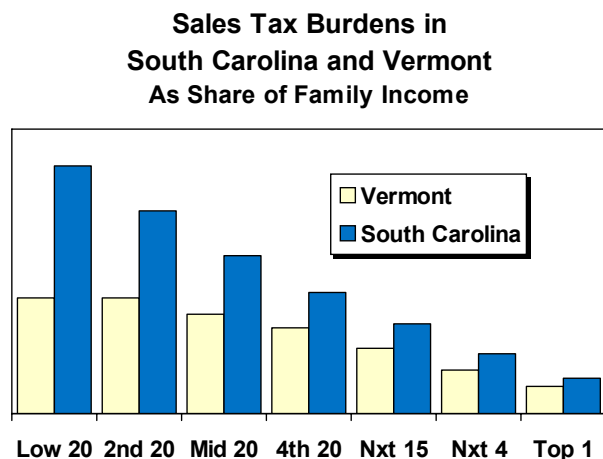
Sales Tax Reform: Issues and Options

As lawmakers struggle to bring the sales tax into the twenty-first century, they face difficult decisions ranging from the age-old question of how broad the sales tax base should be, to newly evolving concerns such as the wisdom of taxing services and of taxing Internet-based transactions. This section surveys problems facing the future of the sales tax.

Broadening the Sales Tax Base

Every state's sales tax allows targeted exemptions. These exemptions are usually intended to make the sales tax less unfair. Sales taxes can be made less regressive by taxing more of the things the wealthy consume the most and fewer of the things on which middle- and low-income families spend their money. Of course, every state and local general sales tax is regressive. But the degree of unfairness ranges substantially—from moderately regressive in states like Vermont to extremely regressive in states like South Carolina. The most important factor affecting regressivity is whether groceries are taxed. Taxing food is extremely regressive because such a high portion of the income of poorer families goes to mere sustenance.

But there are reasons to be concerned about the long-term impact of proliferating sales tax exemptions. Economists generally argue that the sales tax base should be as broad as possible, for several reasons:



- Exemptions are very costly. Exempting groceries can reduce the revenue yield of each penny of sales tax by up to twenty percent. This puts pressure on lawmakers to increase tax rates.
- Exemptions are poorly targeted. The poorest 40 percent of taxpayers typically receive about 25 percent of the benefit from exempting food. The rest goes to wealthier taxpayers.
- Exemptions tend to make sales tax collections fluctuate more, because changes in particular economic sectors can affect tax collections. The broader the tax base, the less sensitive tax revenues will be to sudden swings in retail purchases of particular items.
- In states that allow local sales taxes, lawmakers must decide whether exemptions should apply to local taxes as well. Doing so can be costly to local governments, but not doing so creates more complication for retailers and tax administrators.
- While exemptions can make the sales tax less regressive, they also create a new source of unfairness: different treatment of taxpayers at a given income level. By exempting food while taxing other retail sales, lawmakers are discriminating against taxpayers who spend more of their money on things other than food.
- Exemptions are an administrative challenge to policy makers because any exemption requires a way of distinguishing between taxable and exempt products. For example, New York taxes marshmallows as snack food, but exempts mini-marshmallows as groceries. Exemptions require tax administrators to make countless decisions of this sort, and retailers must be familiar with all of these rules.

Sales Tax Credits

Lawmakers seeking to make the sales tax less unfair without breaking the bank do have an alternative to broad-based exemptions: targeted **sales tax credits**. These credits generally give a flat dollar amount for each member of a family, and are available only to taxpayers with income below a certain threshold. These credits are usually refundable, meaning that the value of the credit does not depend on the amount of taxes a claimant pays. This approach offers several advantages over sales tax exemptions: credits can be targeted to state residents only, and they can be designed to apply to whichever income groups are deemed worthy of tax relief. The box at right shows the details of one such program, the Kansas food sales tax refund. Low-income Kansas taxpayers over 55 years old, and non-elderly Kansans with children, can claim up to \$72 for each family member. In 2004, Kansans with incomes up to \$26,900 were eligible for the credit.

The Kansas Food Sales Tax Refund

Only taxpayers over 55, taxpayers with children under 18, and disabled taxpayers are eligible.

Income Level	Refund
\$0 to \$13,450	\$72 per person
\$13,451 to \$26,900	\$36 per person
\$26,901 or more	no refund

The precise targeting of credits means that they are much less expensive—and much better targeted—than exemptions. Credits do not affect the sales tax base, so the long-term growth of sales tax revenues is more stable. And credits are easier for tax administrators to manage.

However, sales tax credits have one important disadvantage: they must be applied for. All of the states that allow sales tax credits require taxpayers to fill out a form every year. Taxpayers who do not know about the credit—or who do not have to file income tax forms—may not claim the credit even if they are eligible. This means that an effective outreach program must be a central part of any effort to provide sales tax credits. By contrast, exemptions are given automatically at the cash register—so consumers don't need to apply or even to know about them.

It is also important to recognize that sales tax credits will never be able to eliminate the regressivity of sales taxes. The Kansas sales tax remains quite regressive, even after the food sales tax refund. It would take a very large tax credit to eliminate the extra sales tax burden on low-income taxpayers. And while a state may be able to relieve the sales tax burden on low-income families through a credit, there is no practical way to make sales taxes on middle-income families

equal to the light sales taxes borne by the wealthy. Since low- and middle-income families bear most of the burden of the sales tax, a sales tax and rebate system that ended up taxing the middle class at the same low rate as the rich wouldn't be worth the trouble of collecting (and rebating).

To be sure, rebates or credits can be valuable to poor families. But no one should think that they can entirely solve the problem of sales tax regressivity.

Business Sales Tax “Loopholes?”

The sales tax is well enough understood that special interest loopholes in the tax law tend to get noticed, especially compared to some of the more complex tax breaks that are sometimes hidden in the income tax. That doesn't mean, however, that special interests don't work hard to get preferential sales tax treatment. Indeed, when states consider expanding their sales tax bases, lobbyists for such potential targets as lawyers, accountants, dry cleaners, advertising agencies, country clubs and others will fight tooth and nail for their exemptions.

On the other hand, one type of supposed “business loophole” in the sales tax—the tax exemption given for many purchases by businesses—is not simply the result of effective lobbying, but also is often based on sound economic principles. For example, nobody thinks that retailers should pay sales tax when they buy goods at wholesale. If they did, the goods would be taxed twice—once at the wholesale transaction and once at the retail sale—with the ultimate consumer bearing the burden of this double-taxation.

But the same principle applies when, for example, furniture-making companies buy wood to make into tables and chairs. If they must pay sales tax on the wood, then the wood will, in effect, be taxed twice—once when it is bought by the manufacturer, and again when it is bought by the consumer as part of the furniture. When sales taxes from earlier stages of the production process pile up on the final consumer, economists call it **pyramiding** or **cascading**.

Cascading sales taxes can create serious economic problems. For example, suppose one furniture manufacturer chops down trees, does all the wood machining, shaping and assembly itself, and runs its own retail stores. But another furniture manufacturer buys semi-finished wood from a lumber company, which in turn bought it from a timber company. And suppose that the second manufacturer sells its furniture at wholesale to unrelated retail stores. Only the final retail furniture sales of the first, integrated manufacturer will be taxed, since until then, the furniture and its components never change ownership. But under a “cascading” sales tax system, the products of the second manufacturer would be taxed four times: first when the wood is purchased by the lumber company, second when purchased by the furniture manufacturer, third when bought by retailers, and finally when sold to consumers at retail. Such a strange tax system would give the products of the integrated company a huge competitive advantage over those of the second manufacturer—even though the multi-company approach to furniture making and sale might be just as economically efficient.

An oddity created by taxing business inputs is that the effective sales tax rate on income (that is, sales taxes as a percentage of income) may actually end up higher than the nominal sales tax rate. In other words, a state can have a 5 percent sales tax rate but there may be families that have 6 percent of their income going to sales taxes. This is caused by two related phenomena. First, families pay a higher price for a product because the tax on the purchases by businesses increases the cost of making, wholesaling and retailing the product. Second, the retail sales tax applies to this added increment in the price, compounding the problem.

Taxing business inputs can also undermine the methods used to make the sales tax less unfair. For example, if grocery stores pay sales tax on the smocks they buy for their clerks or the fees they pay their lawyers, and these taxes are passed on to their customers in the form of higher retail food prices, the benefit of exempting food from the sales tax is partially undermined. These examples illustrate that supposed “business loopholes” in the sales tax must be analyzed to see if they are sensible rules or undeserved tax breaks.

Sales Tax Holidays—Boon or Boondoggle?

In recent years, lawmakers in more than a dozen states have sought to relieve the burden of sales taxes by enacting “sales tax holidays.” These are temporary sales tax exemptions for clothing, computers, school supplies, and other “back to school” expenses. Most sales tax holidays last only a few days.

Virtually any sales tax cut will provide larger benefits, as a share of income, to low-income taxpayers than to the wealthy. But sales tax holidays are a problematic way of achieving low-income tax relief, for several reasons:

- A one-week sales tax holiday for selected items still forces taxpayers to pay sales tax on these items in the other fifty-one weeks of the year, leaving a regressive tax system basically unchanged.
- Any sales tax exemption creates administrative difficulties for state governments, and for the retailers who must collect the tax. But a temporary exemption requires retailers and tax administrators to wade through a sheaf of red tape for an exemption that lasts only a few days.
- Sales tax holidays are poorly targeted, providing tax breaks to both wealthy taxpayers and nonresidents.
- Many low-income taxpayers don’t have the luxury of timing their purchases to coincide with week-long sales tax holidays. By contrast, wealthier taxpayers are likely to be able to time their purchases appropriately.
- Retailers know that consumers will shift their spending toward sales tax holidays to take advantage of the temporary tax exemption. Savvy retailers can take advantage of this shift by hiking prices during the holiday.
- Perhaps most important for cash-strapped lawmakers, sales tax holidays are costly. Revenue lost through sales tax holidays will ultimately have to be made up somewhere else.

Sales tax holidays do have advantages, of course. The biggest beneficiaries from a sales tax cut are the low- and middle-income families for whom these taxes are most burdensome. And the heavily-publicized manner in which sales tax holidays are typically administered means that taxpayers will be very aware of the tax cut they receive—and will know that state lawmakers are responsible for it.

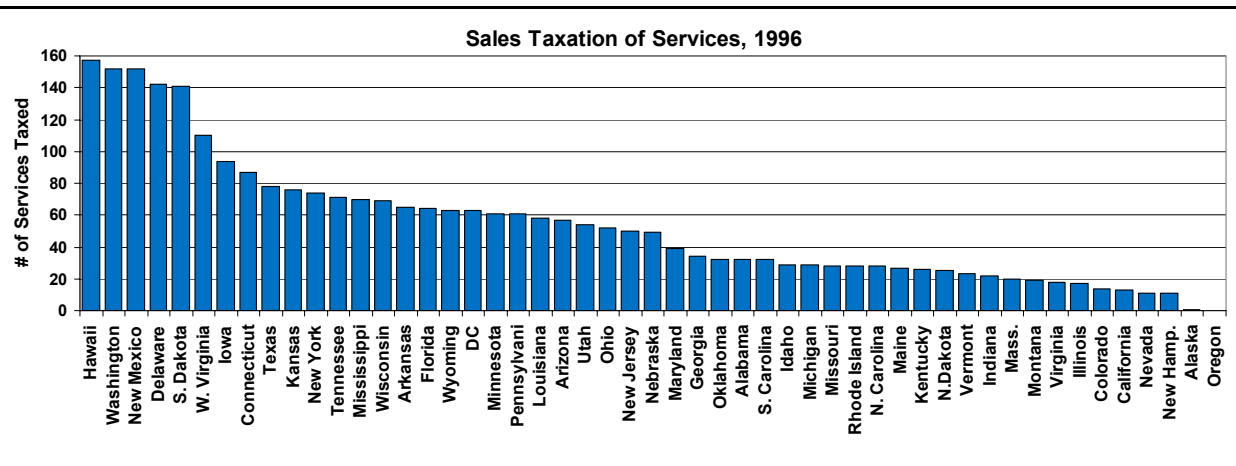
But in the long run, sales tax holidays are simply too insignificant to change the regressive nature of a state’s tax system—and may lull lawmakers into believing that they have resolved the unfairness of sales taxes.

Should Sales Tax Apply to Services?

Most state sales taxes were enacted early in the twentieth century, at a time when most of the things people purchased were tangible goods like cars, furniture and books. But in the past fifty years, American consumer purchases have changed dramatically, shifting toward consumption of services like haircuts and car repairs. But few states have extended their sales tax to include services in their tax base. Only Hawaii, South Dakota, and New Mexico have a comprehensive service tax, and, according to the Federation of Tax Administrators, a majority of states still apply their sales tax to less than one-third of the 164 service categories that are potentially taxable. Though it can be politically difficult to accomplish, there are sound tax policy reasons for seeking to expand the sales tax base to include some—but not all—services.

The basic rule of thumb for which services should be taxed is very similar to the way states seek to tax goods: services consumed by individuals should be taxed, while services consumed by businesses in the process of producing goods and services of their own should be exempt. Taxing business services may seem tempting to lawmakers because of the potentially high revenue yield—but doing so will actually make sales taxes more unfair in the long run, since business sales taxes are (usually) passed through to consumers in the form of higher prices. Because these passed-through taxes are built into the prices of the goods we buy every day, the consumer doesn’t see these hidden taxes—and the amount of this hidden tax that is included in any particular retail purchase will vary depending on the number of taxed stages in the production process for a given retail item. But consumers will, in general, feel the pain from efforts to impose sales taxes on business services.

Taxing personal services can make the sales tax more fair in two ways. First, taxing services helps ensure that the amount of sales tax anyone owes will depend primarily on how much they



spend—not what they spend it on. There is nothing inherently better (or worse) for society in spending money on services as opposed to goods. Taxing goods but not services discriminates in favor of consumers who prefer services, and discriminates against those who prefer goods.

Expanding the sales tax base also makes the tax less regressive, because higher-income households spend more of their money on services while lower-income families primarily purchase goods. Of course, the sales tax will still be regressive overall no matter how broad the tax base is made. But taxing services can be an important step toward reducing sales tax regressivity.

Taxing services will also increase the amount of sales tax revenue collected at any given tax rate—which makes it less likely that lawmakers will be forced to raise the sales tax rate to balance budgets. And broadening the tax base makes sales tax revenues more stable in the long run, because declines in one area of taxable consumption will be offset by gains in another.

Should Internet transactions be taxed?

A growing share of retail purchases are now being made on the Internet—and are not being taxed by states. According to a recent study, the total state and local revenue loss from “e-commerce” was \$15.5 billion in 2003.⁴ The study projected that this revenue loss will reach \$21.5 billion by 2008. Left unchecked, this revenue loss will sap the vitality of state sales taxes.

From a tax fairness perspective, Internet-based transactions should be treated in the same manner as other retail transactions. That is, retail transactions that are taxable when sold by Main Street retailers should also be taxable when sold over the Internet, for several reasons:

- Exempting e-commerce transactions is unfair to Main Street retailers. Retailers who choose to sell their wares primarily in a “bricks and mortar” setting rather than making sales over the Internet are unfairly disadvantaged by a policy that exempts e-commerce.
- Exempting e-commerce transactions is also unfair to consumers. Consumers who are unable to access the Internet are unfairly disadvantaged by having to pay sales taxes on their purchases. Exempting Internet retail sales probably increases the regressivity of sales taxes as better-off taxpayers are able to avoid these taxes through Internet purchases.

However, states are currently powerless to remedy this source of unfairness. A series of U.S. Supreme Court decisions, most recently *Quill v. North Dakota* (1992), have found that states cannot require retailers to collect sales taxes on items purchased from remote sellers (that is, sellers based in other states). As a rationale for this decision, the Court cited the complexity of state and local sales tax systems. The Court argued that with so many states, counties, and municipalities

⁴Donald Bruce and William Fox, “State and Local Sales Tax Revenue Losses from E-Commerce: Estimates as of July 2004” Center for Business and Economic Research, (Knoxville: Univ. of Tennessee) July 2004.

levying different taxes at different rates with different tax bases, forcing retailers to figure out the appropriate tax to collect on sales to each jurisdiction would impose an unacceptable administrative burden on these sellers.

However, the Court also indicated that this problem could be resolved, noting that there are good reasons to try to collect taxes on remote sales: even businesses that engage only in mail-order or Internet sales in a state still benefit from the public services that make these transactions possible—and should help to pay the cost of providing these services. The Court also noted that Congress could pass legislation allowing states to require sales tax collection on remote sales, and hinted that Congress would be more likely to pass such legislation if state lawmakers took immediate steps to simplify the current maze of tax bases and tax rates.

In recent years, states have responded to the Supreme Court's suggestion by cooperating to simplify their sales tax rules. The Streamlined Sales Tax Project (SSTP) was formed in April of 2000 by representatives of most states to develop a plan to simplify sales tax structures. In 2002, these representatives agreed on model legislation, called the Streamlined Sales and Use Tax Agreement (SSUTA), designed to be enacted by each state legislature. This legislation will become legally binding (in states enacting it) when 10 states representing 20 percent of the U.S. population enact it. However, even after this happens, the states will still be powerless to require the collection of sales taxes on remote sales until Congress acts to enable them. Although bills have recently been introduced in Congress that would allow states to collect sales tax on remote sales, these bills have so far failed to advance.

How Excise Taxes Work

Excise taxes are sales taxes that apply to particular products. Compared to sales, income and property taxes, excise taxes do not raise very much revenue. This is primarily because excise taxes lack a broad base, focusing instead on a narrow base of a few products—typically tobacco, fuel, and alcohol. Unlike general sales taxes, excise taxes usually are applied on a per-unit basis instead of as a percentage of the price. For instance, cigarette excise taxes are calculated in cents per pack. And most gasoline excise taxes are imposed in cents per gallon.

Because excise taxes are generally not itemized on consumer receipts, they tend to be invisible to the taxpayer. In the case of gasoline taxes, some states have one tax when fuel enters the state and another that is applied at the pump. New York, for example, has what appears to be one of the lowest state gasoline tax rates at only 8 cents per gallon. But after adding in the Petroleum Testing Fee, the Petroleum Business Tax, the Supplemental Business Tax and the Oil Spill Cleanup and Removal Tax, however, the New York tax that shows up in the pump price is around 32 cents per gallon. Consumers don't see these taxes in the price—but they're still there.

Excise Taxes Are Regressive

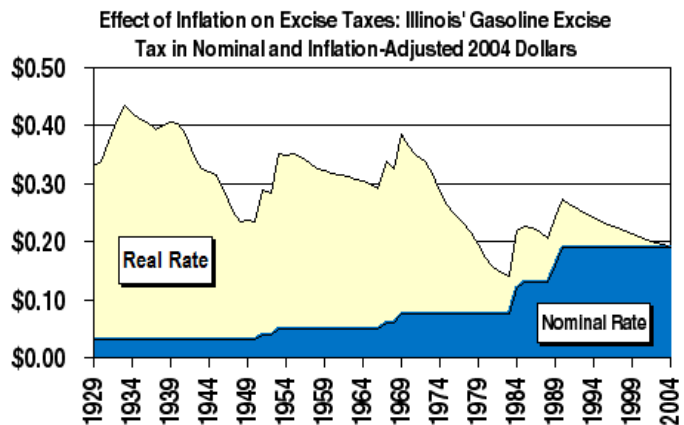
Like sales taxes, excise taxes apply to purchases that take more of the income of middle- and low-income families than of the rich. But excise taxes are usually even more regressive than general sales taxes.

With a sales tax, the tax is at least related to the price of the thing purchased. So the sales tax paid on a wealthy person's Mercedes is more—in dollars—than the tax on a middle-income family's Chevrolet. But because excise taxes are usually calculated on a per-unit basis, it doesn't matter that rich people often buy more expensive things. The tax is the same on premium wine and beer as on less expensive brands. Moreover, there are natural limits on what can be spent on most items subject to excise taxes. Rich people typically don't drive more in a year than do middle-income families, so their gasoline tax bills are almost the same in absolute dollars. As a result, the share of income spent by the wealthy on excise taxes is particularly low.

A Slow-growth Tax

Excise tax revenues tend to grow very slowly, which makes them an inadequate source of revenue over the long run. The per-unit base of excise taxes means that these taxes inherently grow more slowly than the economy.

Excise tax revenue grows only when the volume of the commodity sold grows, and does not respond to changes in prices. In an inflationary environment, this means that states must continually raise the rates of excise taxes just to keep revenues up with inflation. The chart at right shows the legal rate and the inflation-adjusted rate of Illinois' gasoline excise tax over time.



No Federal Deductibility

Excise taxes are not deductible in computing federal taxable income. As a result, every dollar paid by residents of a state in excise taxes is a dollar out of their pockets. There is no offsetting reduction in federal income taxes for those who itemize deductions.

“Sin” Taxes

A sin tax is a tax (almost always an excise tax) levied on a good or service that is deemed to be in some way detrimental to society—typically products such as alcohol, cigarettes, and gasoline. Proponents of sin taxes argue that these taxes are good because they discourage a particular behavior—smoking, for example, or driving gas-guzzling cars—by raising the price of the product. If the tax is imposed *for the express purpose* of affecting behavior rather than raising revenue, the tax may be successful. However, many policy makers cloak their desire for a revenue generator with these arguments, and as a revenue generator, a sin tax is inherently flawed.

Most revenue sources are expected to grow with inflation and an increasing population; most sin taxes, however, are a naturally *decreasing* source of funding. As the tax increases, consumption—and revenues—will decrease. Many states are using these revenues to support programs, such as education or health programs, that have a naturally increasing need for funding. The result is that, while sin taxes may bring in enough revenue to support the designated program for a few years, in the long run a deficit will inevitably appear unless the taxes are raised yet again.

Excise Tax Issues

Excise taxes are inherently regressive. In some cases, however, a slight improvement can be made by making an excise tax apply to the value of the goods taxed instead of basing it on the number of units purchased. For instance, having a 4 percent tax on the value of liquor is somewhat less regressive than a 60 cents per-bottle tax. With the 4 percent tax, the amount due would be 40 cents on a \$10 bottle of liquor and \$1.20 on a \$30 bottle. Thus, those who can afford more expensive brands will pay more, in dollar terms. Of course, as a share of income the tax will still be very regressive—but less so than if the tax is a flat amount per bottle.

Some states have tried to improve upon the gasoline excise tax by enacting a variable tax rate, indexing the rate for inflation. Wisconsin, for example, adjusts its gas tax rate every April based on the U.S. Consumer Price Index. Six other states also tax gasoline on a variable basis.