

Options for Progressive Sales Tax Relief

Sales taxes are one of the most important revenue sources for state and local governments—and are also one of the most unfair taxes. In recent years, policymakers nationwide have struggled to find ways of making sales taxes more equitable while preserving this important source of funding for public services. This policy brief discusses the advantages and disadvantages of two approaches to progressive sales tax relief: broad-based exemptions and targeted sales tax credits.

The Problem: Sales Taxes Are Unfair

State and local sales taxes are *regressive*, requiring low-income and middle-income taxpayers to pay more of their income in tax than wealthier taxpayers. These taxes are regressive because low-income families spend more of their income on items subject to sales tax than do wealthier taxpayers.

Lawmakers seeking to provide relief for low-income taxpayers have two choices:

- They can provide general sales tax *exemptions* for items such as groceries and utilities that constitute a larger share of income for poorer taxpayers.
- They can provide targeted low-income tax *credits* instead of exemptions.

Exemptions and Credits: How They Work

Exemptions are the most popular approach to progressive sales tax relief. Exemptions eliminate all sales taxes on particular retail items. For example, thirty one states exempt groceries from their state sales tax, and almost all states exempt prescription drugs. Many states also exempt sales of residential utilities such as electricity or natural gas.

Targeted tax credits are an innovative alternative to exemptions. These credits generally give a flat dollar amount for each family member, and are available only to taxpayers with income below a certain threshold. These credits are usually administered on the state income tax forms, but are refundable—meaning that the full credit is given even if it exceeds the amount of income tax a claimant owes. Refundability is important because it allows low-income credits to be used by taxpayers who have little or no income tax liability but a substantial sales tax burden. The box at right shows the design of the Kansas food sales tax credit. Eight states allow credits that are designed to provide sales tax relief.

The Kansas Food Sales Tax Refund

Only taxpayers over 55, taxpayers with children under 18, and disabled taxpayers

Income Level	Refund
\$0 to \$15,150	\$80 per person
\$14,851 to \$30,300	\$39 per person
\$30,300 or more	no refund

Disadvantages of Exemptions

The main disadvantage of sales tax exemptions is that they make the sales tax base (that is, the total dollar amount spent on taxable items) much narrower, and reduce the yield of the tax for each percentage point of the sales tax rate. Economists generally argue that the sales tax base should be as broad as possible, for several reasons:

- Exemptions are poorly targeted. *The poorest 40 percent of taxpayers typically receive only about 25 percent of the benefit from exempting groceries.* The rest goes to wealthier taxpayers who can more easily afford to pay the sales tax on groceries.

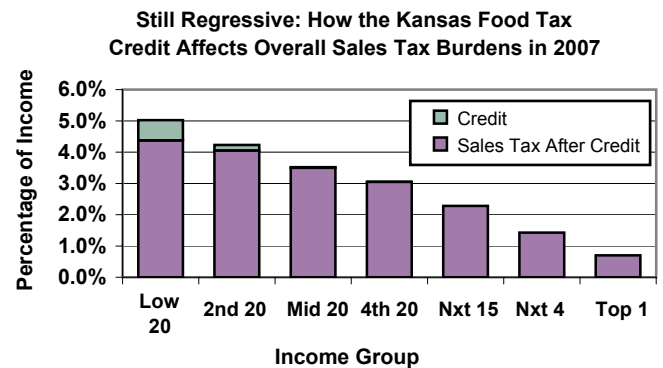
Exemptions and credits are both progressive options—but neither is sufficient to eliminate the basic unfairness of sales taxes.

- While exemptions can make the sales tax less regressive, they also create a new source of unfairness: differential 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 non-food items.
- 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.
- Exemptions are often very costly. For example, exempting groceries can in some cases reduce the revenue yield of the sales tax by nearly twenty percent. This puts pressure on lawmakers to increase the sales tax rate on all the remaining taxable items.
- In states that allow local sales taxes, lawmakers must decide whether sales tax exemptions should apply to local taxes as well. Doing so can be costly to local governments, but failing to do so creates more complication for retailers and tax administrators.
- Exemptions are an administrative challenge to policy makers because any exemption requires a way of distinguishing between taxable and exempt products. For example, in some states a food item may be taxable based only on whether or not the seller provides eating utensils. Exemptions require tax administrators to make countless decisions of this sort, and retailers must be familiar with all of these rules.

Are Credits a Better Alternative?

Sales tax credits can help policy makers to avoid each of the problems described above. The precise targeting of credits means that they can be much less expensive than exemptions. Credits do not affect the sales tax base, so the long-term growth of sales tax revenue is more stable. And credits are easier for tax administrators to manage.

However, sales tax credits do have disadvantages. The main drawback of credits as an alternative to exemptions is the added administrative burden on taxpayers. All of the states that currently allow sales tax credits require taxpayers to file an application form, usually in conjunction with state income tax forms. Eligible taxpayers who do not know about the credit, or who do not have to file an income tax form, may not claim the credit. This means that an effective outreach program is a critical part of any effort to provide sales tax credits of this sort. By contrast, exemptions are given automatically at the cash register—so consumers don't need to apply or even to know about them.



Sales Tax Relief: Only Part of the Solution

Exemptions and credits are both progressive options for low-income tax relief—but neither is sufficient to offset the basic regressivity of sales taxes. As the chart on this page shows, the Kansas sales tax remains regressive even after accounting for the state's sales tax credit, with low-income Kansas taxpayers paying more than four times as much as the wealthiest taxpayers as a share of income. Sales tax exemptions and credits can each be part of a broader strategy for tax fairness that includes a progressive, graduated personal income tax, but sales tax breaks are likely to be insufficient on their own to eliminate the unfairness of state and local taxes.

To find out more about this issue, contact ITEP at (202) 299-1066