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Idea

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Broaden the sales tax base

Each Southern state should abolish sales tax holidays and review sales tax exemptions to eliminate those that don't meet contemporary economic needs.

Background

Just about every time you buy something, a few pennies are tacked on to the price to help fund necessary government programs and services. These sales tax collections are a significant portion of tax systems throughout the South.

Tennessee and Florida, which do not have a broad-based individual income tax, rely the most heavily on sales taxes among the Southern states. In Tennessee, sales taxes contributed 61.1 percent of total taxes in 2005. In Florida in the same year, they contributed 56.2 percent of total taxes for the state budget. Other Southern states ranged from a low of 19.4 percent in Virginia to 47.6 percent in Mississippi.[1]

Across the region, sales tax rates range from 4 percent to 7 percent. When combined with local sales tax rates, the percentage jumps to a range of 5 percent to 11.5 percent, as highlighted in Figure 1. But sales tax rates are only one determinant of how much revenue a state can collect through sales taxes. The sales tax base—the array of goods and services that are taxed—is another important factor in the size of a state's sales tax collections. In recent decades, the sales tax base has eroded in many states because of actions by state legislatures, as well as changes in the economy, which will be discussed in Idea 2.

Figure 1: State and local sales tax rates, 2004

	State tax rate	Maximum state/ local tax rate
Alabama	4	11
Arkansas	6	11.5
Florida	6	7.5
Georgia	4	7
Kentucky	6	6
Louisiana	4	10.25
Mississippi	7	7.25
North Carolina	4.5	7.5
South Carolina	5	7
Tennessee	7	9.75
Virginia	4	5

Source: Federation of Tax Administrators[2]
Note: State and Local maximum rate includes general purpose taxes, not specified taxes such as lodging and meals.

Sales tax exemptions and holidays have been part of this erosion. In essence, they serve as special tax breaks to certain businesses, organizations and individuals. Each state can be more proactive in broadening its sales tax base by examining the use of sales tax holidays and exemptions to eliminate those that no longer serve the needs of the state.

Sales tax exemptions and holidays have been eroding the sales tax base, which means sales tax rates are higher than they should be.

Removing unnecessary sales *tax preference*s will create a fairer tax and open the door for meaningful tax reform. Removing exemptions and holidays will create another payoff because states can decide whether to lower their sales tax rates or use extra revenues to improve programs and services sought by taxpayers. The Center also believes removing exemptions and holidays may create a more competitive business environment.

Reducing sales tax exemptions

States across the South offer a variety of sales tax exemptions on everything from groceries and medicine to fuel for pig farmers in Georgia. Households, businesses and organizations receive special exemptions, credits and exclusions from the sales tax because a state legislature deems it appropriate. But each of these exemptions comes at a cost to the state. While many exemptions are minor, the total cost of a state's exemptions can add up to a sizeable revenue loss. In South Carolina, for example, a fiscal year 2006 to 2007 forecast of the maximum revenue loss from all sales tax exemptions was $1.34 billion.[3]

Certain sales tax exemptions serve a tax policy purpose, such as making the tax system fairer. For example, a sales tax exemption on groceries removes the necessity of food from the sales tax base. This assists low-income families with their food purchases and makes the sales tax less *regressive*. Florida, Georgia, Kentucky Louisiana, and North Carolina exempt food for consumption at home (i.e., groceries) from the state sales tax, while Tennessee and Virginia tax groceries at a lower rate than other items.[4] While this exemption helps lower the sales tax burden on low-income taxpayers, it comes at a high cost to states. In Louisiana, the exemption on groceries will cost an estimated $182 million in Fiscal Year 2006.[5] North Carolina lost $416.8 million in sales tax revenue in 2004 to the groceries exemption.[6] In addition, the sales tax exemption on groceries is poorly targeted as it goes to everyone who purchases food, not just those taxpayers in need. Research has found that only 25 percent of the benefits of this exemption go to the 40 percent of taxpayers with the lowest-incomes.[7]

Research has found that only 25 percent of the benefits of exempting groceries from sales tax go to the 40 percent of taxpayers with the lowest-income.

While some exemptions serve one valuable tax policy purpose, such as *fairness*, they often harm other tax policy goals, such as *adequacy* and administrative ease:

- **Higher rates.** With each exemption, states lose money and run the risk of having to raise the sales tax rate to cover the cost of government services.

- **More red tape.** In addition, each exemption can create an administrative burden since all retailers are not subject to the same rules.

Rather than continually exempting certain items, individuals or businesses from the sales tax, states should strive to have the broadest possible tax base that achieves its tax goals. A broader base serves to spread taxes over all taxpayers—not just those who purchase a taxable item over an exempt item -- and gives states the opportunity to lower the sales tax rate.

Case study: Tennessee

It is estimated that Tennessee loses more than $2.7 billion in state revenues from 50 major tax exemptions.[8] This significant tax loss is comprised of more than $2.2 billion in sales and use tax exemptions, more than $211 million in gross receipts tax exemptions, more than $97 million in corporate franchise and excise tax exemptions, and some $222 million in other miscellaneous tax exemptions.

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Examples of individual tax exemptions include:

• Gasoline, diesel and aviation fuel	$663.1 million
• Prescription drugs, insulin and syringes	$341.4 million
• Energy fuels sold for residential use	$254.8 million
• Energy and water sales to manufacturers	$231.8 million

- Industrial machinery and equipment $164.7 million
- Food sales $77.8 million
- Farm machinery and equipment $19.1 million
- Cable Television $18.2 million
- Membership dues of civic and business organizations $11.8 million
- Non material cost of manufactured homes $8.6 million
- Physical fitness activity fees $4.1 million

Abolishing sales tax holidays

One particular sales tax exemption that has few tax policy merits is the sales tax holiday, which eight Southern states implement (Figure 2). These annual sales tax holidays sound good. They offer tax exemptions on certain items, such as back-to-school clothes and supplies, and are limited to a specific time-period, generally three or four days. But a closer look shows they don't seem to be worth the trouble.

Figure 2: Southern states with sales tax holidays
Alabama
Florida
Georgia
Louisiana
North Carolina
South Carolina
Tennessee
Virginia

Georgia, for example, offers a combined sales tax holiday for energy efficient appliances and back-to-school items such as clothes, supplies and computers. Georgia legislators renew the exemption annually and decide on a three-day period towards the end of summer to hold the tax holiday. Consumers receive the tax exemption on clothes and shoes that are less than $100 per article, books and supplies less than $20 per item, and computers and computer accessories less than $1,500 per sales transaction. In addition to the back-to-school items, residents receive a holiday tax exemption on the purchase of energy efficient appliances, such as EPA-approved or Energy Star dishwashers, ceiling fans and refrigerators, which cost less than $1,500 per product.[9]

Some tax experts refer to the sales tax holiday as a gimmick.

Florida was the first Southern state to offer a sales tax holiday in 1998. Georgia, Louisiana, North Carolina, South Carolina and Tennessee implemented holidays soon thereafter. Recently, Alabama and Virginia passed legislation to start a sales tax holiday in 2006. The amount of revenue lost because of such tax holidays ranges, as shown in Figure 3. Florida has the greatest revenue loss with $31.2 million in 2005, while Virginia is estimated to have the smallest revenue loss of $2.6 million in FY 2007. Often, these tax holidays also reduce local sales tax revenues. Such is the case in Georgia where the annual tax holiday will cost local governments an estimated $8.5 million in 2006.[10] Sales tax holidays are not a significant revenue drain on states when measured as a percent of total general sales tax collections. When comparing recent estimates of the cost of such holidays to 2004 actual sales tax collections, the holiday represents less than half of one percent of general sales tax collections in every state (Figure 3).

While the sales tax holiday does not harm the *adequacy* of funds significantly, it also does not achieve any significant tax policy benefits either. In fact, some tax experts refer to the sales tax holiday as a gimmick.[11] David Brunori of George Washington University notes it is laudable legislators would want to give low- and moderate-income families assistance with sales taxes since it is the most *regressive* tax and takes a larger portion of income from poor residents than from wealthy residents. But he says the sales tax holiday is a gimmick because it does not achieve those goals of making the tax more just and fairer in any significant way. Among the problems:

- **Short-term relief.** First, what little relief the sales tax holiday does provide is for three or four days a year. For the other 361 days of the year, taxpayers are left with a *regressive* tax. Reforms such as a broader sales tax base and a lower rate would provide more meaningful improvements and would be available year-round.

- **May not be passed on to consumers.** Second, Brunori and other tax analysts warn that retailers do not necessarily have to pass sales tax holiday discounts on to consumers at all.[12] Retailers can forego their own discounts and sales prices and rely solely on the state tax discount, so that families end up paying about the same as they would without the sales tax holiday.

- **Poorly targeted.** Lastly, the sales tax holiday is poorly targeted if its goal is to assist families in need. Every individual making certain purchases receives the tax benefit in the sales tax holiday, no matter what their income.

States with sales tax holidays would be well-advised to:

- **Study the effects of the sales tax holiday.** How much are consumers saving? What is the distribution of this tax holiday among low, moderate, and high income residents? Are retailers passing along the discounts to consumers?

- **Review the alternative uses of the holiday sales tax losses.** Should Florida, for example, provide consumers with $30 million in shopping discounts or should it use $30 million to give more targeted tax assistance or to fund a needed state program?

- **Consider better ways to help working families and make the sales tax fairer.** Is a three-day sales tax holiday reversing the *regressivity* of the sales tax? Or is it better to make comprehensive reforms, such as a broader sales tax base and a lower rate, that last year-round and will help low- and moderate-income families more? Is a sales tax holiday that goes to people regardless of need prudent, or would a tax reform such as a refundable earned income tax credit (See Idea 4) be more effective in making the tax system fairer and more *progressive*?

Figure 3: Estimated cost of southern sales tax holidays, 2004 to 2007			
State	**Estimated cost of sales tax holidays (dates vary from 2004 to 2007)**	**Total general sales tax collections, 2004**	**Sales tax holidays as a percent of general sales tax collections**
Alabama	$3.4 million	$1,893 million	0.18 percent
Florida	$31.2 million	$17,129 million	0.18 percent
Georgia	$11.3 million	$4,921 million	0.23 percent
Louisiana	$10.1 million	$2,681 million	0.38 percent
North Carolina	$11.0 million	$4,352 million	0.25 percent
South Carolina	$5.2 million	$2,727 million	0.19 percent
Tennessee	$10.0 million	$5,845 million	0.17 percent
Virginia	$2.6 million	$2,977 million	0.09 percent

Source: State Tax Expenditure Reports and Fiscal Notes[13]; U.S. Census Bureau[14]; Author's calculations
Note: Estimates are for revenue losses to the state general fund. Local revenue losses are not included. For the year of each estimate see footnote 13. Florida cost is back-to-school sales tax holiday. Tennessee is a rough estimate. Louisiana had a sales tax holiday in December 2005, which will not necessarily be an annual event.

A better sales tax

Each year, Southern states chip away at their sales tax bases by providing more and more exemptions and implementing new sales tax holidays. While many of these individual exemptions do not cost significant amounts of money, they create imbalances in the sales tax system because they provide special treatment to some individuals and businesses.

Rather than providing a multitude of exemptions and special breaks, states should seek to modernize their sales tax system by creating as broad of a sales tax base and as low of a sales tax rate as possible. A broader base and lower rate will provide meaningful tax reform by improving the *fairness* and administrative ease of the sales tax without lowering state revenues.

There is a viable, but less palatable alternative. Instead of using new revenues from broadening the base to lower sales tax rates, lawmakers could steer new revenues from abolished holidays and exemptions into programs and services sought by taxpayers.

Talking points

- Sales taxes are *regressive* because poorer people spend a larger share of their income to pay them.

- Over the years, special interests have gotten millions of dollars of customized sales tax breaks which eroded the pot of goods and services from which governments taxed sales. In turn, governments have had to increase sales tax rates to balance the revenues lost to special interests.

- A better way to tax sales is to remove exemptions and holidays, which will broaden the base—and allow states to lower sales tax rates. In turn, the sales tax will become fairer for all. The Center also believes removing exemptions and holidays also may create a more competitive business environment.

Endnotes

[1] Federation of Tax Administrators. "2005 State Tax Collection by Source." *www.taxadmin.org/fta/rate/05taxdis.html.*
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[5] State of Louisiana Department of Revenue. "2004-2005 Tax Exemption Budget." *www.rev.state.la.us/forms/publications/te(05_04).pdf*.
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[9] Hinton, Russell W. "Fiscal Note: House Bill 1219 Substitute (LC 18 5275S)." February 15, 2006
[10] *Ibid.*
[11] Brunori, David. "The Politics of State Taxation: Sales Tax Holidays–Real Relief or Political Gimmicks?" State Tax Notes. December 6, 1999; "Tax Holidays Have Big Pros, Bigger Cons." *StateNet Capitol Journal*. Vol. XII, No. 34. August 30, 2004. *www.statenet.com/capitol_journal/08-30-2004*.
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[14] U.S. Census Bureau. "State Government Tax Collections: 2004." *www.census.gov*.