

## How Can Washington’s Sales Tax Be Made Fairer?

Sales and excise taxes are one of the most important revenue sources for Washington, comprising 60 percent of Washington tax revenues in fiscal year 2005—and are also one of the most unfair taxes levied by the state. In the past decade, 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 available to Washington lawmakers: broad-based exemptions and targeted sales tax credits.

### The Problem: Washington 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.

Washington 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 tend to be purchased disproportionately by low-income 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 sales tax relief. Exemptions eliminate all sales taxes on particular items. 29 states (including Washington) 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, although Washington does not.

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 value of the credit does not depend on 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 income tax liability but substantial sales taxes. The box at right shows the design of the Kansas food sales tax credit. Eight states allow refundable tax 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 are eligible.	
Income Level	Refund
\$0 to \$14,300	\$75 per person
\$14,301 to \$28,600	\$37 per person
\$28,601 or more	no refund

### Disadvantages of Exemptions

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

*Exemptions and credits are both sensible options for making sales taxes less unfair—but neither is sufficient to eliminate the basic unfairness of Washington sales taxes.*

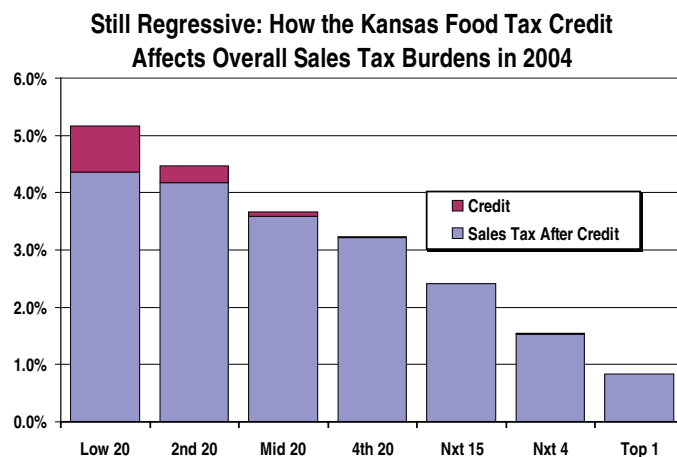
- Exemptions are often very costly. For example, exempting groceries can reduce the revenue yield of each penny of sales tax by up to twenty percent. This puts pressure on lawmakers to increase the sales tax rate on all the remaining taxable items.
- Exemptions are poorly targeted. The poorest 40 percent of taxpayers typically receive only about 25 percent of the benefit from exempting groceries. The rest goes to wealthier taxpayers for whom sales taxes on food are not especially burdensome.
- 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 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.
- 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 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.

### Are Credits a Better Alternative for Washington Policymakers?

Sales tax credits can help Washington 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 is the added burden on taxpayers. All of the states that currently allow sales tax credits require taxpayers to file an application form, usually in conjunction with income tax forms. Eligible taxpayers who do not know about the credit, or who do not have to file income taxes, 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 for Washington Tax Fairness

Exemptions and credits are both progressive options for low-income tax relief—but neither is sufficient to offset the basic regressivity of Washington sales taxes. As the chart above shows, the Kansas sales tax remains quite regressive even after accounting for the state's sales tax credit. 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