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SALES TAX EXEMPTIONS VS. REFUNDABLE TAX CREDITS

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At the present time, forty-five states levy some form of sales tax on consumer goods. The main reason for the popularity of the tax is that it is a comparatively painless method of raising revenue. However, the variety of philosophies adopted in making such levies is as great as the jurisdictional authorities legislating such taxes.

The most commonly heard objection to the sales tax as a vehicle for raising revenue is the regressivity of the tax. Another objection is that it hits hardest on low income taxpayers (this is not necessarily the same as being regressive). Several methods have been devised to overcome these objections and some methods achieve this goal. In fact, with certain modifications such a levy can become progressive or at least proportional.

This paper will focus on comparing two of these modifications which have been gaining in popularity as a means of reducing regressivity.

Possibly, before getting into that comparison, a standard should be set for determining what is meant by a "regressive" tax. A sales tax is considered to be *regressive* if the effective tax rate (i.e., the ratio of taxes paid to income) decreases as income increases. If the effective tax rate remains the same for all income brackets, it is *proportional*, and if the rate increases as income increases, the tax is *progressive*. In other words, if the tax takes a greater percentage from small incomes than from large incomes of taxpayers, it is *regressive*.

One of the basic theoretical concepts in U . S. taxation is the requirement that taxes be equitable. Equity in taxation requires that persons with the same ability to pay should pay equal amounts of taxes and those with greater ability should pay more taxes than those who are less able to pay. Therefore, if we take the foregoing to be true and assume that a regressive tax is undesirable, the next step in accomplishing the "fairest" tax system would be to consider alternatives that would eliminate regressivity. Which brings us back to the main topic for discussion–consideration of two of these alternatives: Exemptions from taxation and sales tax credits.

An attempt will be made to explain the purpose of these alternatives, their respective degree of popularity, and the various forms in which they are presently in use, and to consider any empirical data which may be available to ascertain whether the purpose of their enactment is being accomplished.

SALES TAX EXEMPTIONS

Generally speaking, three broad areas of exemption exist under statutes imposing sales taxes in the U. S. These are:

1. Exemptions arising out of the immunities of governmental agencies or out of the exercise of governmental functions
2. Exemptions arising under the Commerce Clause of the Federal Constitution
3. Specific exemptions created out of governmental taxing policies or social and economic considerations

The "exemptions" which will be considered here are only those in the third category, which exempt certain classes of consumption products, specifically food, clothing, utilities, and medicines.

Currently, sixteen states exempt food, six have at least a partial clothing exemption and twenty-eight exempt at least some utilities. Generally, the stated purpose of each of these exemptions was to lessen the regressive effects of the sales tax. There seems to be little doubt that the food exemption does reduce the regressivity of the tax. A statistical study by Economist J. M. Schaefer based upon New Jersey expenditures before and after the enactment of that state's sales tax supports this conclusion. (The economist's explanation for this is the "relatively low income elasticity for food purchases along with the importance of food expenditures relative to total taxable spending".)

However, the study reached the opposite conclusion as to the clothing exemption, i.e., the clothing exemption failed to reduce regressivity—the income elasticity of clothing exceeded that of other taxable commodities. The study was extended by Professor David G. Davies and the same conclusion was reached based upon relative consumption expenditures nationwide.

The studies concluded that the utilities exemption achieved the goal of reducing regressivity but to a lesser extent than the food exemption.

The exemption for medicine and drugs seems to have a purpose other than reducing regressivity. This exemption benefits two unfortunate groups. It

reduces the burden on the poor and also partially relieves the burden on those who are unfortunate enough to incur heavy expenditures for medicine. Therefore, in those states that have already adopted a system of credits, some have retained the exemption for prescription drugs and medicines.

Despite the fact that some of the exemptions do reduce regressivity, the opponents of such a system list several objections:

1. The use of exemptions removes a large amount of revenue which must be replaced by increasing the rates of tax on the remaining taxable goods sold to consumers and business enterprises. A large share of the additional burden will be borne by lower income groups to the extent the taxes are shifted forward.

2. Exemptions discriminate against individuals having relatively high preferences for taxed items and low preferences for exempt commodities. This objection is continued with the observation that there may be a reallocation of resources resulting from the tax—from taxed to nontaxed goods—with the resulting loss in satisfaction to the consumer but with no additional revenue to the government.

3. Administration is complicated because the vendor must distinguish between taxable and exempt goods. This in turn makes auditing of records for compliance more difficult.

4. Each exemption leads to demands for additional exemptions.

SALES TAX CREDIT

Now let us consider a sales tax system where some or all of the consumption exemptions are replaced by a credit intended to refund sales taxes paid. Presently, seven states plus the District of Columbia have adopted some form of per capita credit in order to alleviate the regressive effect of the sales tax. (It should be noted that other states have credit provisions, however, that were enacted without any consideration of relief from sales tax). Indiana, Colorado, Nebraska, and Idaho grant a flat sum credit ranging from $7 to $10 regardless of income. Massachusetts allows $4 per taxpayer, $4 for his spouse and $8 for each dependent; the District of Columbia, Vermont and Hawaii have adopted systems where the amount of the credit varies inversely with the taxpayer's income.

Generally, the amount of the credit is set to reflect the sales tax paid on estimated minimum necessary purchases. Some of the features generally found are:

1. Some period of residency in the state is required to qualify.
2. The credit is available for refund (as opposed to being useable only as an offset to income tax).
3. The period in which the credit may be claimed is limited.
4. In states allowing flat rate credits, the total credit is determined by multiplying the per capita amount by the number of federal exemptions claimed (exclusive of the exemptions for age and blindness).
5. Spouses filing separate returns are limited to the amount of credit which would be available if joint returns were filed.
6. An individual who qualifies as the dependent of another taxpayer may not claim the credit.

The advantages of the credit system over exemptions most often cited are:

1. The credit is easier to administer for the vendor and for the state in auditing to prevent evasion.
2. More flexibility is available through the credit since it can be adjusted up or down. Also, non-residents can be excluded, if desirable.
3. The credit does not cause discrimination as between differing consumer products with its consequent reallocation of resources.
4. The credit allows discrimination against high income taxpayers, if desirable.

Perhaps an examination of some of the problems encountered by the states already having the credit system could aid other states which may be considering implementation of the system. For example, the Hawaii and Vermont sales tax laws contain a provision whereby the income limitation for qualification for the credit is determined using "modified gross income." This causes complications resulting from the fact that taxpayers must provide not only information as to their taxable income but also as to their tax-exempt income, thus requiring an additional complicated schedule in the return. Massachusetts had similar problems resulting from complex information requirements for the determination of eligibility.

Another criticism aimed at the use of credits stems from the fact that the benefit does not reach persons not filing income tax returns. The type of individual falling into this category is likely to belong to the low income group that the credit is designed to benefit.

From the strictly revenue-raising point of view, it appears that the credit

system would be more advantageous. First, since the vendor collects and remits the sales tax on all sales immediately to the state, the amount collected would be increased. However, the state would not refund the credit until the returns are filed. This is known in accounting circles as a timing difference with the result being a one-time increase in revenue which would never be reversed until the credit provision is repealed. Second, non-residents would pay the tax on all purchases but may be excluded from claiming the credit. Third, refunds due individuals not filing returns would remain with the state.

CONCLUSION

In attempting to alleviate the regressive effect of sales taxes, consideration should be given to the various consumption exemptions and to the use of a refundable per capita credit. Whereas the food and utilities exemptions accomplish to some extent the desired goal, clothing exemptions tend to increase the regressive effect of the tax.

The use of refundable tax credits can make the sales tax more progressive. However, if an excessive number of conditions are placed upon qualification for the credit by the legislature, the administration of the system may become more complex for the state. •

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