Memorandum

To: Sen. Kaufmann, Revenue and Transportation Interim Committee

From: Aaron McNay, Tax Policy and Research AM

Date: May 24, 2016

Subject: Low Income Sales Tax Exemptions

When examining the relative strengths and weaknesses of various tax types, one of the common concerns raised when examining sales taxes are their disproportionate impact to low income households. For example, the State of Minnesota estimates that households in the first two income deciles paid an average effective sales tax rate of 7.3 percent in 2012. At the same time, households in the top two income deciles paid only 1.6 percent of their incomes in state sales taxes for the year. This memorandum examines the various policies states have implemented to reduce the regressive impact sales taxes have on their residents.

Goods and Services Exemptions

The most common method states use to reduce the impact a sales tax has on low-income households is to exempt goods and services that low-income households spend a disproportionate share of their income on from taxation. For example, low income households spend a relatively large share of their income on food that is prepared at home, as well as medical drugs. As a result, most states exclude the sale of non-prepared food, such as groceries, and prescription drugs from their sales tax. By excluding these items, the average effective tax rate paid by low-income households decrease.

There are several disadvantages to goods and services exemptions, however. First, exemptions tend to be poorly targeted to low-income households, as the sales tax exclusion is applied to the purchase of the exempted goods by high and low-income households. The poor targeting makes the amount of revenue lost because of the exemption relatively large when compared to the benefits provided to low-income households. Second, the exemption of some goods is likely to increase the volatility of sales tax revenue, due to the narrower tax base. The increased volatility of revenue would make it more difficult to forecast revenue and keep the state's budget balanced.

Income Tax Credits

In addition to exemptions, states with income taxes have begun offering tax credits to low-income households to compensate for the burden placed on them by a sales tax. The form that the income tax credit takes can vary significantly. One option is for states to provide a refundable credit that is only available to households with incomes below a specific threshold. The credit can be a set amount, or adjusted based on the number of individuals who reside in the taxpayer household each year. Another option that some states have implemented is the creation, or expansion, of a state Earned Income Tax Credit (EITC). Overall, while the creation of income tax credits for low-income households, or other possible income tax changes, would not reduce the regressive nature of the sales taxes, they would reduce the overall tax burden of low-income households and reduce the overall tax structure's regressiveness.

The advantage of tax credits over exemptions is that it allows the tax reduction to be targeted specifically to low-income households. In addition, the use of tax credits would also limit the tax benefit to in-state residents, while an exemption would apply to out-of-state residents as well. Both of these advantages reduce the overall revenue cost of the tax change, while reducing the sales tax revenue volatility by keeping a broad tax base.

However, there are some disadvantages to using income tax credits. First, an income dependent credit increases the implicit marginal tax rate faced by low-income households associated with any benefit reduction that occurs as incomes increase. Second, low-income households would have to claim the credit when preparing their income taxes to receive the credit. Some estimates suggest that 20 to 30 percent of low-income households who qualify for similar credits, such as the EITC, fail to claim the credit. Exemptions would not have this problem, as they would be deducted automatically at the time of sale.

Other Programs

The two programs described above are the primary methods that other states have attempted to reduce the tax burden sales taxes place on low-income households. During the last Revenue and Transportation Interim Committee meeting, you requested information on other methods that other states have used to reduce the sales tax burden of low-income households. Two state programs have been implemented to reduce the burden of sales taxes and could be used for low-income households. The two programs are South Dakota's Sales Tax on Food Refund Program and Oklahoma's Disabled Veterans Sales Tax Exemption Card program.

To help offset the regressivity of the state's sales tax, the State of South Dakota provided households with incomes at, or below, 150 percent of the poverty level with a quarterly stipend to spend on food for the quarter. What differentiates this program with the tax credits in the previous section is that this program was administered through the state's Electronic Benefit Transfer System, it was provided quarterly and the stipend could only be used for purchasing food. Instead of having each household report the amount they spent on food, the benefit amount was set equal to the USDA's estimate of a household would spend on a low-cost nutritious diet. Households that were enrolled in the Supplemental Nutrition Assistance Program (SNAP) were enrolled in this program automatically, while other households would need to apply quarterly. The program was discontinued in 2012.

This program had advantages similar to those of the income tax credits. First, the administrative costs were relatively low, as the program worked through systems already in place. Second, the program was targeted specifically to low-income state residents. This reduced the cost of the program relative to good specific exemptions. Relative to an income tax credit, this program also has the advantage of providing the sales tax rebate on a quarterly basis, which would help households who meet the qualifications, but may have to wait a significant amount of time before the next annual income tax filing period.

This program also has many of the disadvantages of the state tax credits. First, the phase-out of benefits at 150% of the poverty level creates an implicit marginal tax rate at the phase-out income limit. Second, the qualified households would need to apply for the program, and continue sending income updates every quarter. This has the potential to reduce participation rates.

In addition to South Dakota's program, the State of Oklahoma currently provides 100 percent disabled veterans a sales tax exemption card. Under the program, qualified individuals receive a sales tax exemption card, which they use when making purchases subject to the sales tax. Under the program, each qualified individual are exempted from the first $25,000 in sales taxes each year. While this program is currently only available to disabled veterans, similar programs could be created for other groups, such as low-income households.

Oklahoma is the only state that I know if that currently has a program of providing a sales tax exemption card in place and operating. South Dakota's legislature proposed a similar program for the purchasing of food for households below 200 percent of the poverty line in 2003. However, the proposed bill was not passed into law.

Using a sales tax exemption card does have some advantages over other programs. First, like the income tax credit, the card would be targeted to low-income households who reside in the state. This would reduce the revenue impact of the program relative to a good specific tax exemption. Second, the use of the card by individuals would allow the sales tax reduction to be customized to each taxpayer household, unlike the limited customization available for an income tax credit.

One large issue would arise from a sales tax exemption card system, however. Income tax credit programs and South Dakota's Sales Tax on Food Refund Program both estimated benefits based on an ex-post income basis. For example, the amount of credits each qualified household received for both credits were based on the household's income from the previous year or quarter. However, a sales tax exemption card could not provide an exemption to sales made while a household's income is known. The issuance of a card would have to be based on a household's income from the previous year. As a result, households that had incomes that qualified them for the program in one year would not be able to have their purchases excluded from the sales tax until the next year, at which time their income may have increased. Oklahoma's disabled veteran program avoids this issue, as a person's disability level is unlikely to change significantly from one year to the next.

This program also has some of the disadvantages of the other programs. First, the phase-out of benefits at a specific income level creates an implicit marginal tax rate at the phase-out income limit. Second, the qualified households would need to apply for the program, and would likely need to continue sending income updates for each successive year. This is likely to have a negative impact on participation rates.