Issue Brief

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Addressing the Regressivity of Sales Taxes:
Hard to Overcome and Made Worse by Income Tax Cuts

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One important issue in the discussion over whether to adopt a sales tax in Oregon is who would bear the burden of the tax. A sales tax is inherently regressive; the tax is not based on taxpayers' ability to pay. Some proponents acknowledge that sales taxes place a heavier tax burden on low-income households than on middle- or upper-income households, but maintain that exempting necessities, such as food, or including low-income credits through the income tax, are sufficient to address the problem.[1]

Analysis of a leading sales tax proposal shows that it is difficult to offset the regressive impacts of a sales tax.[2] Exempting food sales and other necessities makes a sales tax less regressive, but only to a small degree. Most of the state and local tax systems that place the highest tax burden on low-income households have sales taxes that exempt sales of food and other necessities, such as prescription drugs.

Proponents of a sales tax are correct that low-income credits are crucial to offsetting the regressivity of a sales tax, but the credits must be refundable, targeted, and sufficiently large. The low-income credit in the leading proposal under discussion in Salem would be insufficient to offset the increased tax burden on low-income households.

Adopting an across the board (non-targeted) income tax reduction along with a sales tax would exacerbate the regressivity of Oregon's tax system.[3] It gives a huge tax cut to affluent households that already bear a smaller tax burden than low-income households.

States with the most regressive tax structures rely heavily on sales and excise taxes.

Oregon's state and local tax distribution is regressive due to heavy use of excise and property taxes, taking 9.4 percent from the lowest-income fifth of households and just 8.9 percent from the richest one percent of households, (Table 1). The regressivity of Oregon's tax system is even more extreme when the deduction for state and local income and property taxes (but not sales or excise taxes) from federal taxable income is taken into consideration.[4] This paper compares Oregon with other states using the initial incidence, before the impact of the federal income tax deduction.

Many other states have considerably more regressive tax systems than Oregon's. The ten most regressive state tax systems take a much larger share of the income of low-income households than high- or middle-income ones. In Washington, for example, the lowest-income fifth of households pay 17.6 percent of their income in state and local taxes, while the richest one percent pay only 3.3 percent.[5]

Many other states have considerably more regressive tax systems than Oregon's.

Table 1.	Oregon compared to the ten most regressive state tax systems				
	Taxes as a share of income for non-elderly				
	Poorest 20%	**Middle 60%**	**Richest 1%**	**Ratio of Poorest 20% to Richest 1%**	**Ratio of Middle 60% to Richest 1%**
Oregon	9.4%	8.8%	8.9%	106%	99%
Washington	17.6%	11.2%	3.3%	537%	343%
Florida	14.4%	9.8%	3.0%	476%	325%
South Dakota	10.0%	8.4%	2.3%	440%	369%
Nevada	8.3%	6.5%	2.0%	420%	331%
Tennessee	11.7%	8.9%	3.4%	347%	264%
Texas	11.4%	8.4%	3.5%	331%	244%
Pennsylvania	11.4%	9.0%	4.8%	238%	187%
Illinois	13.1%	10.5%	5.8%	224%	180%
Alabama	10.6%	9.6%	4.9%	216%	195%
Michigan	13.3%	11.2%	6.7%	199%	168%

Source: Institute on Taxation and Economic Policy. Not including value of federal offset.

The most regressive state and local tax systems rely heavily on sales and excise taxes, have little or no income taxes, or have flat-rate income taxes. Seven of the ten most regressive states, defined by the gap between the effective tax rates on the lowest-income 20 percent and the richest one percent of households, rely heavily on a sales tax.[6] All of the ten most regressive states have sales taxes.

Sales taxes are regressive even when food and other "necessities" are exempt.

Sales taxes are inherently regressive because low-income families generally spend everything they earn, and often more, while high-income families save larger portions of their income.[7] The sales tax thus applies to virtually all of the income of low-income households, but relatively little of the income of affluent households. Most states with sales taxes exempt some "necessities," but this only slightly alters the regressivity of a sales tax.

States with sales taxes that exempt food and other necessities still have steeply regressive tax systems.

Table 2.	General sales tax burden and food exempt in most regressive states			
	Lowest 20%	Middle 20%	Richest 1%	Food Exempt?
Washington	4.7%	3.3%	0.8%	Yes
Florida	4.2%	3.3%	0.6%	Yes
Texas	4.1%	3.1%	0.7%	Yes
Illinois*	3.5%	2.6%	0.6%	Yes
Michigan	3.0%	2.1%	0.6%	Yes
Pennsylvania	2.4%	1.9%	0.4%	Yes
Nevada	3.4%	2.6%	0.6%	Yes
Tennessee	6.1%	4.9%	1.0%	No
South Dakota	4.1%	3.0%	0.6%	No
Alabama	3.9%	3.1%	0.6%	No

Source: Institute on Taxation and Economic Policy.
*Illinois taxes food at a reduced rate of 1 percent compared to 6.25 percent on other goods.

States with sales taxes that exempt food and other necessities still have steeply regressive tax systems. Seven of the ten most regressive states exempt food sales from their sales taxes (Table 2). Washington's sales tax, for example, takes 4.7 percent of the income of low-income households and only 0.8 percent of the income of the richest one percent of households, despite the fact that Washington does not tax sales of food. Most of the states with highly regressive tax systems also exempt prescription or non-prescription drugs, or both, from the sales tax.[8]

HB 3500 shows regressivity "fixes" don't always work.

To be effective in countering the regressivity of a sales tax, credits to offset the increased burden from a sales tax must be fully available to low-income taxpayers, regardless of their income tax liability. In other words, if the credits exceed the income tax liability of the households they must be "refundable." In 2001, the Oregon Legislative Assembly recognized the importance of refundability to low-income families when it made the Working Family Child Care Credit refundable. The state earned income tax credit (EIC), which is currently set at 5 percent of the federal EIC, is not refundable. Because it is available only to the extent that a family owes income taxes, some low-income families do not receive the full value of the credit.[9]

The leading sales tax proposal, House Bill 3500, attempts to address its regressivity by increasing the Oregon EIC to 25 percent of the federal EIC, and making it refundable. House Bill 3500 also lowers the income tax rates to 0, 2, and 4 percent from 5, 7, and 9 percent, among other provisions.[10] The components of the sales tax in House Bill 3500 are still under discussion, but will likely include goods and some services, with exemptions for food and several other necessities and goods, similar to the sales tax in Washington state.[11]

Analysis of the EIC and rate reduction provisions in House Bill 3500 shows that even though the EIC is refundable and significant in size, and the rate reductions are extreme, they are not large enough or adequately targeted to low-income taxpayers to offset the regressivity of the sales tax.[12] If the five percent, broad-based, sales tax in House Bill 3500 had been fully implemented in 2003, it would have raised taxes on low-income households by $468 (Table 3).

The income tax rate cuts and the refundable EIC offset only half of the added tax burden on low-income households from the sales tax. The refundable EIC, which is targeted to low-income families with children, would lower taxes on low-income households by $61, on average. The decreased income tax rates would lower the taxes paid by low-income households by $171. The House Bill 3500 sales tax, even when combined with these reductions, would raise the taxes paid by Oregon's low-income households by $227, or 2.4 percent of income.[13]

Middle-income households would pay $1,229 in sales taxes, and face a net tax increase of $130, or 0.4 percent of their income, after including the impacts of the income tax rate cuts and expanded EIC.[14]

Cutting income taxes can make matters worse.

The regressive, broad-based sales tax, even after exempting food and other necessities would *raise* taxes by 4.9 percent of income for the lowest-income fifth of households and by just 0.9 percent of the income of the richest one percent (Table 3).[15]

The refundable EIC is targeted, in that it does decrease the tax burden on certain low-income households, primarily working families with children, without benefiting the affluent. Families without children get little relief from the EIC, and it is only the most destitute working households without children who can obtain that minimal relief.[16] The EIC provides virtually no relief to seniors. As a result, low-income households as a group would see their taxes reduced by just six-tenths of one percent (0.6 percent) if the state EIC is made refundable and increased five-fold to 25 percent of the federal credit.

Extreme income tax rate reductions and a significant, refundable earned income tax credit are neither large enough nor adequately targeted to offset the regressivity of a sales tax.

Table 3. Combined impact of sales tax with income tax cuts

All Oregon Taxpayers, 2003			
2003 Income Group	Lowest 20%	Middle 20%	Richest 1%
Income Range	Less Than $16,000	$27,000 to $43,000	$265,000 or More
Average Income	$9,600	$34,000	$709,800
Refundable Earned Income Credit			
Tax Change as a % of Income	–0.6%	-0.2%	--
$ Average Tax Change	-$61	-$55	--
Income Tax Rate Cuts			
Tax Change as a % of Income	–1.8%	-3.1%	–3.9%
$ Average Tax Change	-$171	-$1,040	-$27,552
5% Broad-based Sales Tax with Necessities Exempt			
Tax Change as a % of Income	4.9%	3.6%	0.9%
$ Average Tax Change	$468	$1,229	$6,577
Net Impact of These Changes			
Tax Change as a % of Income	2.4%	0.4%	-3.0%
$ Average Tax Change	$227	$130	-$20,957

Source: Institute on Taxation and Economic Policy, June 2003

On the other hand, the across-the-board reduction in income tax rates in House Bill 3500 makes the disparity in tax burden between low-income and affluent households significantly worse. The change proposed in House Bill 3500 gives much greater tax cuts to those with upper incomes, and the relief to low-income households is not enough to offset the added burden of the sales tax. Reducing the income tax rates to 0, 2, and 4 percent provides a tax cut worth 3.9 percent of income to the highest-income one percent of households (nearly $28,000 on average), but just 1.8 percent of income to the lowest-income households ($171 on average) and 3.1 percent to middle-income households ($1,040 on average). The net effect of these sales and income tax provisions of House Bill 3500 is a significant tax reduction for high-income households, and tax increases on middle- and low-income households.

Summary.

Sales taxes are an option for raising additional revenue for vital state services. Sales taxes are, however, inherently regressive, taking a larger share of the income of low-income households. Exempting food and other necessities and adopting an expanded and refundable EIC are insufficient to offset the added tax burden on low-income households. Adding to the mix an extreme, across-the-board decrease in income tax rates would exacerbate the overall regressivity of Oregon's tax system and would fail to offset the sales tax's added burden on low-income households. To prevent tax burdens from rising sharply on low-income households under a sales tax scheme, tax credits must be targeted to all low-income households and made refundable and larger than what has been proposed to date. If tax cuts for upper-income households are coupled with new sales taxes, then the distribution of the tax burden will shift further onto low-income households.

Endnotes:

[1] See, Williams, Max, "Where do you stand? Sales tax time is now," *The Oregonian*, June 8, 2003.

[2] House Bill 3500, introduced by the House Revenue Committee, has become the focal point of sales tax discussions in the House, where revenue-raising measures must begin. One of the ranking members of the Committee, Representative Max Williams (R-Tigard) is the measure's leading proponent. Williams considers the bill as introduced "a template" and has been meeting with legislators and others to refine the details of the concept.

[3] The regressivity of Oregon's current tax structure is explained in Thompson, Jeff, *On Whose Backs?: Tax Distribution, Income Inequality, and Plans for Raising Revenue*, Oregon Center for Public Policy, July 1, 2003, available on the internet at http://www.ocpp.org/2003/es030701.htm.

[4] *Ibid*, page 2.

[5] State and local tax distribution data from the Institute on Taxation and Economic Policy (ITEP), *Who Pays?: A Distributional Analysis of the Tax Systems in All 50 States – 2nd Edition*, January, 2003. This report also provides the tax burdens after the federal income tax deduction for income and property taxes.

[6] "Heavy reliance" indicates that a state receives a relatively large share of its total tax collections from the sales tax. ITEP considers a state to rely "heavily" on a sales tax when the sales tax generates more than 25 percent of the state's total tax and non-tax revenue.

[7] Consumer expenditure data show that low-income households spend considerably more than they earn, on average.

[8] According the Federation of Tax Administrators, sales of prescription drugs are exempt in Alabama, Michigan, Nevada, South Dakota, Tennessee, and Washington. Sales of both prescription and non-prescription drugs are exempt in Florida, Pennsylvania, and Texas. Illinois applies a reduced rate to sales of prescription and non-prescription drugs. Available at: www.taxadmin.org/fta/rate/sales.html.

[9] See Lewis, John, *Making Ends Meet: Improving Oregon's Earned Income Credit,* Oregon Center for Public Policy, February 25, 2003 for a discussion of the importance of refundability in low-income tax credits. Available at http://www.ocpp.org/2003/es030225.htm.

[10] House Bill 3500 also includes provisions designed to give tax relief to affluent households. House Bill 3500 would exempt capital gains income and repeal Oregon's inheritance tax.

[11] The services included in the House Bill 3500 sales tax, as modeled here, would include cable TV, laundry/dry cleaning, film processing, repair of tangible property, gardening/lawn care, Moving/storage, pet/vet services, water softening services, safe deposit box rental, car parking and towing, admissions (entertainment and sports), and club memberships. Services excluded from House Bill 3500, as modeled here, include education/day care/elder care services, health care services, real property maintenance and repair, legal services, and accounting services.

[12] Some sales tax proponents argue that one of the benefits of the sales tax is that it collects taxes from people in an underground economy who evade income taxes. Those who evade income taxes would not benefit from the refundable credits.

[13] While the components add up to a $232 increase in taxes, the components interact and result in the $227 change in tax burden for low-income taxpayers.

[14] The complete version of House Bill 3500, which includes exempting capital gains income and repealing Oregon's inheritance tax would have nearly the same impact of middle-income households, since they have little or no capital gains income or inherited wealth.

[15] The sales tax burden on low-income households is nearly five percent, even after exempting food, because they tend to spend more than their income. See note 7.

[16] See Lewis.

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