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A FEDERALLY FINANCED SALES TAX HOLIDAY WOULD BE DIFFICULT TO IMPLEMENT AND WOULD HAVE LIMITED STIMULUS EFFECT

by Nicholas Johnson and Iris Lav

The National Retail Federation and others have suggested that the federal stimulus package should include a "national sales tax holiday." This would be a period of time, perhaps ten days, in which states would reduce or eliminate their sales taxes. The federal government would compensate states for the lost revenue. The appeal of such a plan appears to be rooted in the sensible notion that the stimulus package should encourage spending by giving tax breaks to consumers. But upon closer examination, a national sales tax holiday is found to have a number of significant problems that would prevent it from being implemented in a timely manner and would sharply limit its effectiveness.

- A federally designed sales tax holiday would take a number of months to enact, organize, and implement at the state level; it is highly unlikely that many states — if any at all — could have such a program in place for the holiday buying season. Each state legislature would need to meet to enact the plan for its state, but most are not in session until January or February. Special sessions are possible, but generally require some time to put together and carry substantial cost. (For example, it costs $2 million to hold a special session in Texas).

- Once state legislatures meet and enact the appropriate changes in state sales taxes, state revenue departments would need to write regulations or implementation guidance to adapt the parameters of the holiday to their own sales tax systems, each of which is unique, and would need to educate hundreds of thousands of retailers as well as the general public about the holiday. Retailers would have to be given time to reprogram their machines and train their employees. As explained below, it is not reasonable to expect that all of these steps — from federal enactment to full implementation at the state level — could be accomplished in many places before the spring of 2002.

- Because it could not be implemented quickly, a holiday would have limited value as a stimulus. Many economists expect the economy to begin recovering by early 2002. If a sales tax holiday is not available until later in 2002, as seems likely, the impact on consumers could come too late.

- Moreover, *if consumers delay making major purchases in order to take advantage of the holiday, it could actually worsen the recession*. If Congress enacts the sales tax holiday and consumers expect their state to implement the holiday in February or March of 2002, they could hold off making large-ticket expenditures until that time.

- The proposal would do nothing to help states close their widening budget deficits, since the federal reimbursements would — at best — compensate states only for revenue foregone due to the holiday. Depending on the specifics of the proposal, some or all states could come out behind. If federal reimbursements are based on historical sales tax collections, for example, states would not get reimbursed for taxes on additional sales that are shifted into the sales-tax holiday period from the preceding and following weeks. In addition, there are issues relative to the timing of the reimbursement states would receive. To avoid adding to states' fiscal difficulties by forcing them to borrow money at a time when many are already facing deficits, the federal reimbursement would need to be distributed *at the same time* that the holiday was occurring, despite the impossibility of knowing how much the revenue losses will be.

- The federal reimbursement for such a holiday would not be distributed in an even and fair manner among the states. Five states (Alaska, Delaware, Montana, New Hampshire, and Oregon) levy no sales tax at all, and so their residents would not benefit. The other 45 vary widely in both the sales tax rate and the base of goods and services on which it is levied, so the benefits would vary widely among residents of these states as well.

- Better alternatives for using the stimulus package to boost consumer spending exist. The most obvious ways are a rebate to low-income workers who are more likely to spend the rebate than high-income individuals, and expansions of unemployment income benefits, which would replace a portion of lost wages and are very likely to be spent.

- Providing additional federal funds to states at this time also is important. As states throughout the county face widening budget gaps, their balanced budget laws will force them to increase taxes or cut state spending, either of which would dampen state economies and the national economy. In the last recession, three-quarters of the states raised sales or excise taxes. Assistance to states to ward off these actions could be provided through an enhanced Medicaid match or another mechanism to provide fiscal relief to states. The proposal for a sales tax holiday, by contrast, would at best hold states harmless and at worst deepen states' fiscal problems.

A Federally Mandated Sales Tax Holiday Would Be Difficult and Costly for States to Administer

To have value as a stimulus, the holiday would need to be put in place quickly. A substantial delay in getting the stimulus into the hands of consumers would make it far less effective. In fact, a sales tax holiday that does not take effect for several months after federal enactment could actually have a counter-stimulative effect if consumers delay major purchases to take advantage of it.

It would take most states some months to put a holiday in place. To begin with, changing state tax law requires legislative action. But most legislatures do not meet year-round. The typical legislature is not scheduled to return to session until January, 2002, and some do not meet until later in the year. Six states — Arkansas, Montana, Nevada, North Dakota, Oregon and Texas — are not scheduled to meet at all until 2003. Although governors could call legislatures into special session earlier, most states use special sessions very sparingly because of their cost and the burdens they impose on their part-time legislators.

Even after legislation is passed, states would need to write regulations explaining which items are exempt and also addressing such issues as layaways, installment purchases, returns, exchanges, and so on. The treatment of local sales taxes, common in many states, would also need to be determined, as would the treatment of business-to-business purchases which are a large share of taxable purchases in most states. Since every state has a different sales tax system, these regulations would be different in every state. State revenue departments, many of which have quite small staffs, would be tasked with writing these regulations just as the state income-tax filing season is beginning.

Once the regulations are written, retailers — including mom-and-pop stores as well as major multistate chains — would need to reprogram cash registers and train staff to ensure that the exemption is administered properly. And, of course, consumers would need to be educated on the holiday.

Note that for the great majority of states, a sales tax holiday would be a novel administrative exercise. Only about a dozen states have ever enacted state sales tax holidays. Moreover, those state sales tax holidays to date have been quite narrow in their scope, applying only to clothing, footwear, school supplies, or computers. This narrowness has allowed administrators to focus on the subset of retailers most affected by the holiday. The much broader nationwide holiday that is now being proposed would require a level of outreach and education beyond what any state has undertaken to date.

Taking into account all that must occur to put a sales tax holiday in place, it is reasonable to suspect that if federal legislation authorizing a national sales tax holiday were enacted by early December, most states could not implement the holiday until the spring.

Costs to States

The cumbersome process of implementing the holiday would require significant expenditure of funds for states, a particular problem now since most states are enacting spending cuts. (In some states, these include cuts in spending on revenue administration.) The cost of a special legislative session by itself can be substantial, because legislators — who in many states serve on a part-time basis — must be reimbursed for travel and expenses, state employees must be paid overtime, and so on. In Texas, where the legislature is not scheduled for a regular meeting until January 2003, the governor has estimated that each special session costs approximately $2 million.

Other costs to states would include overtime for revenue department staff, the cost of mailings, and perhaps costs associated with the fact that some retailers might mistakenly apply the holiday to goods that are not covered by it or extend it beyond the appropriate window. In addition, retailers themselves would face added costs. Although for many large retailers the cost of reprogramming cash registers and training staff may be negligible, some smaller retailers could find themselves substantially inconvenienced. (According to the Florida Department of Revenue, one “frequently asked question” from retailers about that state’s sales tax holiday is “Who’s going to pay for reprogramming my computers/scanners/cash registers so they will not charge tax?" The answer, the department says, is that retailers must pay for it themselves.)

The Federal reimbursement provided to states would inevitably be an approximation of the actual revenue losses, because the actual revenue loss would be impossible to determine. Some states might be over-reimbursed; more likely, many states would be under-reimbursed. Some proposals, for instance, would compensate states on the basis of sales tax collections in a comparable period of the previous year. These states would be reimbursed only for the revenue they would lose if no consumers shifted purchases into the holiday period. States' experiences, however, are that substantial shifts of purchases into the sales tax holiday period and out of adjacent, taxable periods are likely to occur. If states are not compensated for the shifted sales on which they otherwise would have collected tax, the program will create a net revenue loss for states.

> **Alice M. Rivlin on a National Sales Tax Holiday**
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> In a September 28 letter to the New York Times, former Federal Reserve Board vice-chair (and former director of CBO and OMB) Alice M. Rivlin pointed out the flaws in a national sales tax holiday. She wrote:
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> "... [S]timulating consumption, especially by low- and moderate-income people, would help our shocked economy get back on the track, but the stimulus needs to be quick, fair and uncomplicated. State sales taxes vary widely, and five states do not tax sales at all. A percentage point reduction might stimulate consumption in states with broad coverage, but would be less effective in states with narrow coverage and ineffective in states without a sales tax. Changing state tax laws would also require state legislatures to meet in 50 states. A rebate tied to workers' payroll taxes would be a quicker and fairer way of stimulating consumption."

Moreover, to avoid worsening states' immediate fiscal problems, the reimbursement would need to be distributed at the same time that the holiday was occurring, meaning that the revenue loss would need to be predicted in advance — an exercise that is particularly likely to be inaccurate. If states have to wait number of months for reimbursement, they would likely have to borrow funds and incur costs of interest payments. Those costs would further contribute to the deterioration of state fiscal conditions.

Federal Reimbursement Would Be Difficult to Distribute in a Fair and Even Manner

Five states — Alaska, Delaware, Montana, New Hampshire, and Oregon — have no state sales taxes. In the other 45 states, the rates and bases of sales taxes vary widely. For instance, some states tax food, clothing, utilities, and gasoline under their sales taxes; others do not. Annual per-capita sales tax collections range from as little as $350 in Vermont and Virginia to over $1,000 in other states like Hawaii, Washington, and Connecticut. (See table on next page.) Consumers in the latter states, therefore, would get about three times as much tax relief from the bill as consumers in the former states.

There Is No Evidence from State Sales Tax Holidays That They Stimulate the Economy

States that have implemented sales tax holidays have reported increases in sales during the holiday period. There is reason to suspect, however, that these increases in sales have not translated into overall improvements in state economies. Much of the reported increases can be attributed to consumers shifting the timing of their purchases from the weeks before or after the holiday "window" to within it. The New York State Department of Taxation and Finance reported that the state's seven-day 1997 sales tax holiday on clothing did not increase quarterly clothing sales beyond what would have been expected even without the holiday; in other words, New York shoppers bought no more clothing in the winter of 1997 due to the holiday than they would have bought anyway. A second kind of shifting that may occur when a single state has a holiday is that retailers make more sales to residents from other states. In the context of a national sales tax holiday, neither of those shifts would be helpful as a stimulus.

Not all of the benefits from a sales tax holiday would flow directly to consumers. Only about 60 percent of state sales tax revenue comes from consumer purchases; the remaining 40 percent comes from business-to-business purchases. In addition, there is some evidence that retailers raise their prices or offer fewer discounts during a sales tax holiday. A study of the 2001 Florida sales tax holiday by a team of University of West Florida economists found that retailers' price hikes captured about one-fifth of the potential savings that otherwise would have gone to consumers.

State Sales Tax Revenue Per Capita, FY 2000

	Sales Tax Revenue per Capita		Sales Tax Revenue per Capita
Washington	$1,313	Idaho	$577
Hawaii	1,268	Pennsylvania	575
Connecticut	1,004	Georgia	566
Nevada	972	Massachusetts	562
Florida	939	Ohio	552
New Mexico	826	Kentucky	537
Mississippi	820	Illinois	515
Tennessee	782	North Dakota	514
Michigan	771	West Virginia	507
Minnesota	757	Missouri	498
Wyoming	747	Maryland	472
Arizona	708	Louisiana	461
California	693	New York	451
Texas	672	Colorado	430
Maine	665	Oklahoma	418
New Jersey	655	North Carolina	418
Wisconsin	654	Alabama	383
Kansas	649	Vermont	354
South Dakota	646	Virginia	349
Arkansas	638	Alaska	0
Utah	637	Delaware	0
South Carolina	613	Montana	0
Nebraska	601	New Hampshire	0
Rhode Island	592	Oregon	0
Iowa	589		
Indiana	589	United States	621

Note: Figures do not include local sales taxes.
Source: U.S. Census Bureau.

Better Options for Aiding Consumers and States

As the evidence from states shows, a federal sales tax holiday would largely reimburse states for sales tax revenue on sales that would have occurred anyway. This suggests that a holiday would be a highly inefficient form of stimulus because it would not increase consumption.

The federal government has a number of options other than a national sales tax holiday to target tax relief to consumers and to encourage spending. For instance, a tax rebate to low-income workers who did not benefit from last summer's rebate would put money in the pockets of families that are most likely to spend it. Similarly, an expansion of unemployment insurance benefits to cover more of the unemployed and make benefits more adequate could increase the proportion of lost wages that are replaced by unemployment insurance. Because it replaces lost wages, unemployment insurance benefits are highly likely to be spent.

In addition, to the extent that the federal government wishes to influence the taxes levied on consumption, it can target general fiscal relief to states in the form of increased Medicaid payments or other aid. In the last recession of the early 1990s, about three-fourths of the states raised consumption taxes to balance their budgets. To the extent that federal aid can help states balance their budgets and thus avoid raising taxes, one result is likely to be lower consumption taxes and commensurate benefits to consumers.