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Taking a Holiday from Common Sense: Proposed National Sales Tax Holiday Offers Questionable Benefits to Consumers

In a December 23 letter to President-elect Barack Obama, the National Retail Federation (NRF) suggested that Obama's pending stimulus plan should include a provision for a series of nation-wide "sales tax holidays" during which consumers would pay no state sales taxes on their purchases. The NRF proposal would suspend all state sales taxes for three ten-day periods during 2009. But the actual benefits to consumers from a tax holiday would be more uncertain—and less immediate—than the stimulative impact of direct federal spending.

How Would a National Sales Tax Holiday Be Implemented?

The NRF's letter to Obama suggests three temporary "holiday" periods of ten days each, in March, July and October of 2009, during which state governments would not collect sales tax on transactions that would normally be taxable under state tax laws (with the exception of tobacco and alcohol). This means that every item sold, from a hamburger to a new car, would be exempt if purchased during any part of this thirty-day period in 2009. (During the other eleven months of the year, of course, these items would all be taxable.)

The NRF suggests that state governments would voluntarily not collect sales tax revenue during these three ten-day periods, and would be entirely reimbursed for their revenue loss by the federal government. The five states that do not levy state sales taxes would each receive grants approximating the amounts given to a sales-tax state with similar populations.

Who Benefits from Sales Tax Holidays? Lessons from the States

The idea of a temporary sales tax holiday is not a new one: more than fifteen states have enacted a temporary holiday from their state sales tax in recent years. These holidays average 2 or 3 days in length, and usually apply to specific items such as back-to-school supplies. These holidays are consistently popular among elected officials because they are among the most visible tax cuts available (what other tax cut gets free advertising from retailers?) and because they cost less than permanent tax cuts.

It's no mystery why lawmakers like sales tax holidays—but it's far less clear whether these holidays end up primarily benefitting consumers or retailers. On its face, a "holiday" from a 5 percent sales tax should reduce consumer prices by 5 percent. But retailers can take advantage of a tax holiday by increasing their prices (or failing to reduce them by the full 5 percent) during the tax holiday. And there is some evidence that Florida retailers did exactly that during a sales tax holiday there: one study found that up to 20 percent of the potential benefits from that state's sales tax holiday were reclaimed by retailers in the form of higher prices.

There are also questions about how families at different income levels would be affected by a tax holiday. Sales taxes hit low-income families hardest, so a <u>permanent</u> sales tax cut will offer the biggest benefit to less well-off families. But temporary tax cuts offer the biggest benefit to those consumers who can afford to delay their purchases to coincide with the tax holiday. Since low-income taxpayers frequently spend most of their income just getting by, these families don't have the luxury of shifting the timing of their spending in this way. By contrast, wealthier taxpayers are more likely to be able to delay their purchases.

Of course, to the extent that a tax holiday simply shifts the timing of consumption rather than increasing it, the stimulative impact of such a plan would be sharply reduced. Given the choice between paying sales tax on a new car in January and buying the car tax-free in March, many sensible consumers will wait until March. But it's hard to see how encouraging consumers to delay their purchases two months can be seen as an economic stimulus.

If consumers delay their purchases, that will also increase the likelihood that the sales tax holiday turns out to be a net revenue loss for the states, since federal reimbursements to the states would have to be based on sales tax forecasts rather than actual retail sales. "Dozens of states already face huge budget shortfalls this year," noted CTJ State Tax Policy Director Matt Gardner. "State lawmakers' first goal right now is likely to avoid painful spending cuts, not to blow a new hole in their sales tax base."

There are also questions of timeliness. Everyone agrees that any stimulus legislation should be enacted quickly. But it would be difficult to promptly implement the tax holiday, as it would require not only Congressional approval but also immediate legislative action in each of the 45 states that levy state sales taxes.

Lastly, the NRF proposal presents troublesome design questions:

- Should stimulus dollars be sent to the very richest Americans? A sales tax holiday would make no distinction between low-income families in danger of losing their homes and well-off families whose consumption has been unaffected by the economic downturn.
- Why should the federal government pay for a holiday for state sales taxes, but not for local taxes? Doing so gives a much bigger break to a wealthy state like Connecticut, with a 6 percent state tax and no local tax, and penalizes poorer states like Louisiana, which has a state tax of 4 percent and local taxes averaging more than 4.7 percent.
- Who would pay for the worker training and computer programming costs that retailers would incur in preparation for the tax holiday?
- Does it make sense to give the biggest tax breaks to consumers living in the states that have the highest state tax rates and the broadest tax bases? Consumers living in states that have made their sales taxes less unfair by exempting groceries and utilities will get less under the NRF plan.

Achieving Federal Stimulus: Better Alternatives

The NRF's rationale for its tax holiday idea is a good one: they hope that it will "help stimulate consumer spending." But a better way to achieve this goal is short-term government action that will immediately boost spending. Increasing food stamps or extending unemployment insurance benefits are targeted forms of financial assistance that will likely have this effect.

As many economists have suggested, tax cuts are simply a less direct stimulative tool than direct spending. "Federal aid to state governments can be stimulative if it goes towards 'shovel ready' projects or allows the states to avoid cutting essential services," noted Gardner. "But a federally-funded state sales tax holiday would be an administrative nightmare for Congress and the states, and offers benefits to consumers that are neither immediate nor clear."

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