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IS A SALES TAX HOLIDAY THE BEST WAY TO PROVIDE TAX RELIEF FOR CALIFORNIANS?

This summer, Governor Davis would like to take Californians on a holiday, a sales tax holiday. In his 2001-02 Budget, the Governor proposed a three-day period in late August during which purchases of certain clothing and computer hardware items will be exempt from the sales tax.¹ The goals of the sales tax holiday are to provide tax relief to California families and to stimulate the economy during the back-to-school shopping season.² The exemption would apply to the state portion of the sales tax and to local sales taxes, unless the governing body of the local jurisdiction votes against participation. AB 1199 (Cardenas) would enact the Governor's proposal, and would provide a one-time sales tax exemption during the period August 24-26, 2001, for the sale of clothing or footwear items that are priced under \$200 and computer hardware items priced under \$1,000.

The Board of Equalization (BOE) estimates that the revenue loss attributable to the holiday would be \$45.9 million including \$28.4 million from the state General Fund, \$3.0 million each for the Local Revenue Fund and the Public Safety Fund, \$7.5 million in local Bradley-Burns tax revenue, and \$4.0 million in local transit funds.

Similar sales tax holidays have become very popular recently with eight states – New York, Florida, Texas, Connecticut, South Carolina, Pennsylvania, Iowa, Maryland – and the District of Columbia enacting exemptions on the purchases of clothing and/or computers for periods ranging from two to ten days.

Is a Sales Tax Holiday an Effective Means to Provide Tax Relief?

Based on the BOE estimate of forgone revenue, each Californian would save approximately \$1.36 from the sales tax holiday. While all consumers who purchase exempt items during the sales tax holiday will realize some savings, certain consumers may receive greater benefits.

For example, consumers age 65 and older would receive a relatively small share of the benefits of a sales tax exemption for clothing and computer purchases, as this age group is responsible for a small share of these purchases. In 1999, consumers 65 and over, who made up 20.3 percent of consumer households, made 12.5 percent of apparel purchases and 12.9 percent of miscellaneous household equipment purchases including computer hardware.³ Likewise, the distribution of benefits across income levels would be uneven.

¹ The sales tax rate includes 4.75 percent state rate for the General Fund, 50 percent state rate for the Local Revenue Fund, 50 percent state rate for the Local Public Safety Fund, up to 1.25 percent local Bradley-Burns rate for local discretionary funds, and .125 to 1.25 percent local transaction and use rate.

² Department of Finance, *Governor's Budget Summary, 2001-02*, p. 48.

³ Bureau of Labor Statistics, 1999 Consumer Expenditure Survey, Table 57 downloaded from <http://stat.bls.gov/cex/1999/aggregate/age.pdf>.

Households in the west spent an average of \$1,538 on clothing and footwear in 1998 and 1999.⁴ Based on average expenditure levels, a household that made 20 percent of their annual apparel purchases during the sales tax holiday would save approximately \$25. The tax savings would be lower for low income households with incomes between \$10,000 and \$15,000, approximately \$14, and higher for high income taxpayers, approximately \$43 for with an annual income of \$70,000 or higher.⁵ High income households would have a greater ability to spend more during the three-day tax holiday as they generally have more disposable income, so their tax savings could be even greater.

However, sales taxes are regressive taxes, meaning that poor people pay a greater share of their income on these taxes than do those with higher incomes. One reason the sales tax places a higher burden on the poor is because purchases of taxable goods represent a greater share of low income taxpayers' income, while those with higher incomes spend more on non-taxable services. In 1998, the poorest fifth of California households paid 4.3 percent of their income in sales taxes. In contrast, the highest one percent of households paid .08 percent their income in sales taxes.⁶

While a sales tax reduction should provide greater benefits as a percent of income to low income taxpayers, low income households may benefit less for three reasons:

- Low income consumers would be less likely to be able to afford the price of computers than higher income earners, even with the sales tax savings.
- Apparel purchases represent a small share of total expenditures for both low and high income consumers.
- Low income households may not have sufficient savings to make a large volume of purchases during the sales tax holiday.

Impact on Retailers

Will retailers benefit from the sales tax holiday? If the tax holiday results in an increase in new sales, not merely a shift in the timing of sales that would have occurred without the tax holiday, then retailers would realize a net benefit from the holiday.

While it is difficult to predict what might happen in California, it is possible to look at the experience of other states. In 1997, New York held a seven-day sales tax holiday on clothing priced under \$500. The NY Department of Taxation and Finance (DTF) estimated that sales during the holiday period were 73.1 percent higher than they would have been without the exemption, but were only slightly higher (2.9 percent) for the same quarter in the prior year.⁷ The year-to-year quarterly growth was no higher than the DTF expected given the economic growth for the period. The low year-to-year quarterly growth in sales indicates that most of the increased sales during the tax holiday represented a shift in the timing of purchases rather than additional purchases.

⁴ Bureau of Labor Statistics, 1999 Consumer Expenditure Survey, Table 34, downloaded from <http://stat.bls.gov/cex/1999/CrossTabs/regbyinc/xregnw.pdf>.

⁵ Based on data from the 1999 Consumer Expenditure Survey, Table 34, assumes that low income taxpayers spend \$163.20 on clothing and footwear during the holiday and that high income taxpayers spend \$517.80.

⁶ Institute on Taxation and Economic Policy.

⁷ New York State Department of Taxation and Finance, *The Temporary Clothing Exemption: 1997* (March 27, 1998), downloaded from http://www.tax.state.ny.us/statistics/policy-special/clothing/clothing_analysis.htm.

Impact on Local Government

Local jurisdictions will have the option of not participating in the sales tax holiday. However, if they do participate, the state would not reimburse local governments for any revenue losses incurred during the holiday. Local jurisdictions may find it difficult to opt out of the sales tax holiday due to pressure from retailers, who fear losing sales to competitors in participating jurisdictions. Research suggests that a one percent difference in the sales tax rate between two jurisdictions results in 7 percent higher per capita sales in the jurisdiction with the lower rate.⁸ In the first year of New York's sales tax holiday, only six of the state's 56 counties elected not to participate in the holiday, and none of these were bordered by states with lower sales tax rates for exempted items.⁹

Conclusion

The Governor's goals for the proposed sales tax holiday are to provide a tax break for Californians and stimulate economic activity. While the holiday would provide some tax savings for California taxpayers, the benefits would be limited and would favor those with higher incomes. The impact of the holiday on retailers is not clear given that their compliance costs could be high and that sales increases would most likely be from shifts in the timing of purchases rather than additional purchases.

⁸ Mikesell, John L., *The 'Supply-Side Message' of the New York Clothing Tax Holiday*, "State Tax Notes No. 835 (March 17, 1997).

⁹ *Ibid.*