CHAPTER SIX

NEW YORK SALES AND EXCISE TAXES

Sales and excise taxes, or consumption taxes, are the main reason for the overall unfairness of New York taxes. General sales taxes and specialized excise taxes on items such as alcohol and tobacco hit low- and middle-income taxpayers especially hard. Moreover, each of these taxes face structural limitations that threaten to further reduce the yield and fairness of these taxes over time. This chapter looks at options for increasing the adequacy and fairness of New York sales and excise taxes.

New York Consumption Taxes: How High?

New York sales and excise taxes are lower than the national average. In fiscal year 2002, New York sales and excise taxes amounted to 3.3 percent of personal income—36th highest in the nation and more than ten percent below the national average. By this measure, New York sales and excise taxes have fallen from 3.9 percent in 1977 to 3.3 percent in 2002. As a result, the state's ranking fell from sixteenth to 36th highest during this period.

However, this result is mostly due to the state's historically low reliance on excise taxes. New York sales taxes were only slightly below the national average in fiscal 2002, while excise taxes in New York were 25 percent lower than the U.S. average.

The Most Regressive Tax

Consumption taxes are inherently regressive because low-income families spend more of their income on purchases of items subject to sales and excise taxes than do wealthier taxpayers. Typically, low-income families spend three-quarters of their income on items subject to sales tax, middle income families spend about half their income on items subject to sales tax, and the wealthiest taxpayers spend less than a sixth of their income on such items. The distributional impact of New York consumption taxes reflects this pattern:

- Sales and excise taxes consume 9.5 percent of the income of the poorest New York taxpayers.
- Middle-income New Yorkers pay 5.7 percent of their income in sales and excise taxes;
- The wealthiest one percent of taxpayers pay 1.2 percent of their income in sales and excise taxes.

Put another way, the New York consumption tax structure is equivalent to an income tax with an 9.5 percent rate for the poor, a 5.7 percent rate for the middle class, and a 1.2 percent rate for the wealthiest New Yorkers. Obviously, no one would intentionally design an income tax that looks like this—yet by relying heavily on consumption taxes, this is the choice New York policy makers have made. The main reason this pattern is tolerated in consumption taxes is that their regressive nature is concealed by an innocuous-looking single rate and that the amount families pay is hidden in many small purchases throughout the year. Property taxes and income taxes are much more noticeable because taxpayers usually receive an annual bill for payment of these taxes.

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Bang for the Buck?

Another disadvantage of sales taxes is that they are usually not deductible for families who itemize their federal or state income taxes. (For 2004 and 2005 only, federal itemizers can choose to write off sales taxes in lieu of writing off income taxes, but few New Yorkers will find this advantageous.) In contrast, taxpayers who itemize deductions on their federal and state income taxes are allowed to deduct payments for local property taxes. The general non-deductibility of sales taxes means that these taxes offer a poor "bang for the buck" from the perspective of individual taxpayers, who must shoulder the entire cost of the state and local sales taxes they pay.

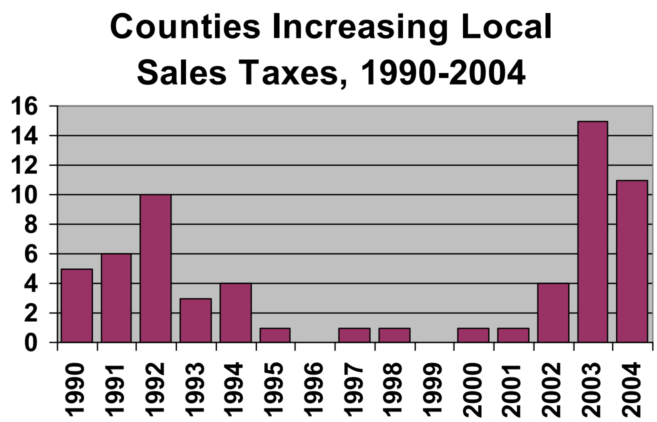
A Low-Rate Tax?

The New York general sales tax was introduced in 1965 at a rate of 2 percent. The rate increased to 3 percent in 1969 and 4 percent in 1971. Most recently, the state sales tax rate was temporarily increased from 4 to 4.25 percent. [19] Taken on its own, the state sales tax rate is the lowest in the region.

However, New York allows local governments to levy additional sales taxes at much higher rates than

[19]This temporary tax increase is in effect for two years, from June 1, 2003 to May 31, 2005.

most other states. All local governments are allowed to impose up to 4 percent, and a few have been authorized to impose up to 4.25 percent. This means that the maximum sales tax rate in any New York jurisdiction outside of New York City is 8.25 percent. The New York City general sales tax rate is even higher, at 8.625 percent.



In the past two years, more than twenty counties have increased their sales tax. While these tax hikes are less visible than the state tax increases state lawmakers have sought to avoid, they nonetheless make the state's tax system more regressive.

A Narrow Tax Base

New York's sales tax base applies to both tangible personal property (goods such as furniture and books) and certain intangible services. However, state law has carved out a variety of exemptions for goods and services that make the New York sales tax base narrow compared to most other states. The most important reason for this is that New York exempts sales of groceries, and other "necessities" such as prescription and nonprescription drugs and residential utilities, from the state 4.25 percent rate.

The state also allows a wide variety of other sales tax exemptions. These fall into two broad categories: exemptions of goods and exemptions for services.

Sales tax exemptions for goods reduce New York taxes by more than $8.3 billion annually—almost as much as the state collects in sales taxes each year. In other words, the state sales tax is now almost more loophole than law.

Certain exemptions benefit individual consumers. Residential utilities are exempt, as are sales of prescription drugs. Sales of clothing were exempted by 1998 legislation, although that exemption was suspended in 2003.

Most exemptions were explicitly written into the tax code by legislators. However, another important class of sales tax exemptions can't be found on the books at all. While the New York sales tax applies to sales of goods unless exempted, sales of services are exempt unless explicitly taxed. This is due to an accident of history: in the early twentieth century (when most state sales tax statutes were written), economic activity in the United States was focused primarily on the production and consumption of tangible goods, and services were much less important. However, since 1950, the importance of services has increased almost continuously.

In the past two years, more than twenty counties have increased their sales tax rates.

The challenge facing New York—and all other states with outmoded sales tax laws—is to modernize the sales tax base by including at least some sales of personal, professional or business services. However, many states have failed to achieve this. A 1996 study by the Federation of Tax Administrators (FTA) found that of 164 potentially taxable services, less than half were taxed by most states.[20] The FTA study found that New York has done better than many states in adapting its sales tax base, but that the state still taxes just 74 of these 164 services. Notable omissions from the New York base include:

- personal services—laundry, dry cleaning, shoe repair, veterinary services and residential utilities;
- business services—machinery and equipment used in the production process;
- professional services—legal and accounting.

New York lawmakers have broadened the base somewhat. In 1990, for example, the state legislature expanded the tax base to include specific services such as parking, auto leases, janitorial services and detective services. Yet, as the FTA survey shows, many services remain exempt.

Approaches to Sales Tax Reform

New York relies more heavily on sales taxes than most states, with a relatively high overall rate and

[20]Federation of Tax Administrators, *Sales Taxation of Services: 1996 Update*, Research Report No.147 (Washington, DC: Federation of Tax Administrators), April 1997.

a broad tax base. Yet the state also allows a wide variety of exemptions, many of which may be unwarranted. As New York seeks to raise more revenue for education, which exemptions should be eliminated, and which should be preserved?

Economists generally argue that base-broadening is the best means of ensuring the long-term vitality of a tax. Narrow-based taxes tend to fluctuate more because changes in particular economic sectors can affect the overall yield of the tax, while broader-based taxes are less sensitive to these changes.

To be sure, exemptions can help make sales taxes less regressive, especially when the items exempted are "essentials" such as utilities and prescription drugs. But exemptions are a costly and poorly targeted approach to sales tax relief. For example, exempting groceries from the 4.25 percent state sales tax costs more than $1.4 billion annually—and the benefits of exempting food go to even the wealthiest taxpayers. A less expensive way to provide targeted tax relief would be a tax credit for low-income taxpayers. Five states currently allow such a credit. The box below shows the details of one such program, the Kansas food sales tax refund. Kansas lawmakers have targeted this rebate to taxpayers over 55 and taxpayers with children under 18. This approach offers several advantages over exemptions: low-income credits can be targeted to New York residents only, and can be designed to apply to whichever income groups are deemed worthy. Chapter Nine of this report shows the impact of enacting such a credit in New York.

The Kansas Food Sales Tax Refund

Income Level	Refund
$0 to $13,150	$72 per exemption
$13,151 to $26,300	$36 per exemption
$26,301 or more	no refund

Sales tax exemptions are sometimes simply good economics. There exists broad unanimity among economists that sales tax bases should include services —yet these same economists stress that any base-broadening reform should distinguish between services consumed by individuals and services consumed by businesses. If the goal of a properly designed sales tax is to tax all (and only) retail sales for final consumption, then taxing services consumed by businesses as an intermediate step in the production process is undesirable.

The potential revenue yield of taxing business consumption is tempting—but taxing these services would distort the economic behavior of businesses. A company that finds itself taxed four times in the process of producing a single good (three times on the purchase of intermediate goods and once on the sale of the final product) will face an incentive to escape taxation by "vertically integrating"—that is, producing intermediate goods itself.

By contrast, a clear-cut case can be made for extending the sales tax base to include personal retail services consumed by individuals.

Sales Tax Holidays for Clothing

In 1997, New York lawmakers exempted sales of clothing under $110 from the state sales tax, and allowed an optional local exemption. However, the legislature recently suspended this exemption for one year, allowing in its place a four-week "sales tax holiday." This is a problematic way of achieving low-income tax relief, for several reasons:

- A four-week sales tax holiday for selected items still forces taxpayers to pay sales tax on these items in the other forty-eight weeks of the year. In the long run, sales tax holidays leave a regressive tax system basically unchanged.
- Sales tax exemptions create administrative difficulties for state governments, and for the retailers who must collect the tax. For example, exempting clothing requires a sheaf of regulations to define what is clothing and what is not. A temporary exemption requires retailers and tax administrators to wade through red tape for an exemption that lasts only a few weeks.
- Sales tax holidays are poorly targeted, providing tax breaks to even the wealthiest taxpayers. The benefits of sales tax holidays are not limited to state residents, but also extend to consumers visiting from other states.
- Many low-income taxpayers spend all of their income just getting by—which means that they have less disposable income than wealthier taxpayers. These poor taxpayers may not be able to shift the timing of their consumption to coincide with temporary sales tax holidays. By contrast, wealthier taxpayers are more likely to be able to time their purchases to coincide with the holiday.

Sales tax holidays do have advantages, of course. The biggest beneficiaries from a sales tax cut are low- and middle-income families. And the heavily-publicized manner in which sales tax holidays are administered means that taxpayers will be very aware of the tax cut they receive—and will know that state lawmakers are responsible for it.

But in the long run, sales tax holidays are simply too insignificant (and too temporary) to change the regressive nature of a state's tax system—and may lull lawmakers into believing that they have resolved the unfairness of sales taxes. Policymakers seeking to achieve greater tax equity at a minimal cost would do better to shift the overall tax burden to wealthier taxpayers by scaling back sales taxes permanently, or by providing a permanent low-income tax credit.

Should Internet transactions be taxed?

Another important pitfall facing state and local sales taxes is the importance of Internet-based retail transactions. A growing share of retail purchases are being made on the Internet, and are not being taxed. According to a recent study, the New York state and local revenue loss from "e-commerce" was about $1.1 billion in 2003 and will reach $2.4 billion by 2008.[21]

The most appealing solution to the question of the appropriate tax treatment of e-commerce is that it should be treated in exactly the same manner as other retail transactions. That is, retail transactions that are taxable when sold as a "bricks and mortar" transaction should also be taxable when sold via electronic transactions. This is an intuitive notion of tax fairness that most people would agree on.

At present, New York lawmakers have taken all available steps to achieve an equitable approach to taxing Internet transactions. Legislation passed in 2003 makes the state a member of the Streamlined Sales Tax Implementing States.

However, neither this legislation nor any other potential action by the current legislature can reach Internet sales by firms without a physical presence in New York. In 1998, the U.S. Congress created a moratorium prohibiting states from taxing Internet sales by companies that do not have a physical presence in the consumer's home state, effectively limiting states' ability to tax most Internet sales. The moratorium expired in November 2003, but is currently being debated in Congress. Until the issue is decided at the federal level, New York will not be able to take additional steps to tax Internet-based transactions.

[21]Donald Bruce and William Fox, "State and Local Sales Tax Revenue Losses from E-Commerce: Estimates as of July 2004." Center for Business and Economic Research, (Knoxville: Univ. of Tennessee) July 2004.

Selective Sales and Excise Taxes

New York relies on a variety of selective sales taxes and excise taxes that apply to sales of particular retail items. In some cases, these taxes are levied instead of the general sales tax: in others, these excise taxes are levied in addition to the sales tax.

New York levies several alcohol taxes, including a beer tax of 11 cents per gallon and a per-gallon tax on sales of wine and other alcoholic beverages.

New York also taxes sales of cigarettes and other tobacco products, including a state cigarette tax of $1.50 per pack and an additional local New York City tax of $1.50 per pack.

The state levies a variety of taxes on gasoline. When the gas tax was introduced in 1929, it was levied at 2 cents per gallon. Now, an 8-cent per gallon excise tax is only one of three taxes that affect consumers of gasoline: the state and local sales tax rate of up to 8.75 percent also applies, and a "petroleum business tax" of 14 cents per gallon applies as well.

There have been several important changes to New York excise taxes since the early 1990s.

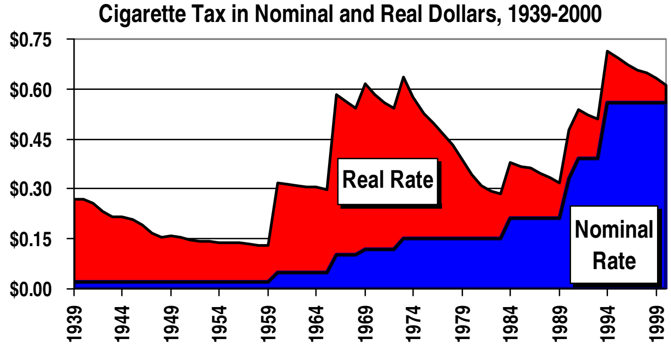
- The state cigarette tax has been increased five times since 1990, rising from 21 cents to $1.50 per pack.
- New York City increased its local cigarette tax dramatically in July of 2002, from 8 cents per pack to $1.50 per pack. The total tax on a pack of cigarettes in New York City is now $3.00.
- The petroleum business tax has increased steadily throughout the past decade.
- The beer excise tax has been gradually lowered from 21 cents to 11 cents per gallon.

Excise taxes are, in general, even more regressive than sales taxes. ITEP's January 2003 *Who Pays* study found that excise taxes consumed 2.7 percent of the incomes of the poorest New Yorkers, 1.1 percent of the incomes of middle-income taxpayers, and 0.1 percent of income for the wealthiest New Yorkers.

Excise Taxes and Inflation

In recent years, New York lawmakers have increased cigarette taxes at both the state and local levels. Retail sales taxes are levied on an *ad valorem* basis—that is, they are calculated as a percentage of the sales price. This means that when inflation increases the price of goods subject to the tax, sales tax revenues will automatically increase. Unlike sales taxes, the excise taxes described in this section are imposed on a per-unit basis rather than as a percentage of the sales price: for example, the New York state cigarette tax is a flat $1.50 cents per pack, no matter how much the pack of cigarettes costs. Excise tax revenue grows (or contracts) only when the volume of the commodity sold grows or contracts, and does not respond to changes in price. In an inflationary environment, this means that states must continually raise the rates of excise taxes in order to keep revenues up with inflation. The chart on this page shows the history of New York lawmakers' unsuccessful attempts to avoid these inflationary losses in cigarette tax revenue. The cigarette tax was enacted in 1939 at 2 cents per pack —or 39 cents per pack in today's dollars. But the real value of the tax gradually declined until it was increased to 5 cents in 1960—after which it again began to lose its value. The state's recently enacted 39 cent-per-pack cigarette tax increase is already having a similar effect: the short-term value of the hike is gradually being offset by an inflationary decline.

How Inflation Affects Excise Taxes: New York's Cigarette Tax in Nominal and Real Dollars, 1939-2000



Conclusion

The major source of unfairness in the New York state tax structure is the state's growing reliance on regressive sales and excise taxes as a revenue source. This makes the tax system more regressive, and decreases the long-term adequacy of state revenues by increasing reliance on slow-growth sales and excise taxes. In addition, the state's use of "sin" taxes designed more to discourage consumption than to raise revenues exerts a drag on state revenues.

As the state grapples with ways of achieving adequacy in school funding, it should also keep in mind that taking the "business as usual" approach—funding schools with regressive sales tax hikes—would exacerbate the structural imbalance in the New York tax system.