

RESEARCH UPDATE

Institute for Economic Advancement

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What does cutting the grocery sales tax really mean?

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With a growing state budget surplus, many Arkansans are talking about eliminating the six-cent tax on groceries. In fact, there are a few proposals already being discussed for the upcoming 2007 legislative session. Therefore, this update reports the estimated loss in tax revenues from immediately and completely eliminating the grocery sales tax.

Considering that general sales tax is an important source of revenue for the state of Arkansas, it is important to examine the dynamic impact of such a change in tax policy. As such, we employ the REMI model that uses baseline values to develop a control forecast.¹ The proposed grocery sales tax policy change is then incorporated into the model to generate an alternative forecast. The difference in the alternative forecast and the control forecast is the economic and fiscal impact of the tax policy change on the state of Arkansas.

While there are many different scenarios and/or proposals to eliminate the grocery sales tax, this update explores the effect of completely cutting the grocery sales tax in 2007 and its effect over a 10-year horizon. This also illustrates the seriousness of such a tax cut and the importance of understanding the secondary effects when formulating fiscal policy changes.

Many consumers feel that the state simply cuts the tax proceeds without any other changes; however,

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the grocery sales tax has been a source of revenues of which accounts for a number of different spending programs funded by the government (e.g., estimated grocery sales tax revenues of \$224 million in 2005 went into the “budget pool” that was allocated to government programs). Since the state of Arkansas works on a balanced budget, the elimination of such a tax would result in the elimination of one or more government programs (in order to keep a balanced budget).

Lately, and due to the budget surplus, many individuals and legislators have proposed some sort of tax relief with the surplus. This is where the elimination of the grocery tax has come into play (and gained a lot of support). If the state does not cut government programs and finances the tax cut solely on the surplus, then the surplus will be completely eliminated in 3 to 4 years. At that time, state policymakers must raise other taxes to finance existing programs or must cut government spending.

Here are some numbers to consider. In order to solely finance the cut in the grocery sales tax over the next ten years, the state budget surplus today would need to exceed \$2 billion.²

¹ Regional Economic Model, Inc. (REMI) Policy Insight 8.0 User Guide, 2006.

² Assuming a 4–5% discount rate.

Alternatively, a complete cut in the grocery sales tax in 2007 would reduce the tax revenues collected by about \$240 million. This tax cut would give consumers an increase in purchasing power. Some of this increase in purchasing power will result in increase tax revenues collected by the state. Therefore, government spending would not necessarily need to be cut by the full amount of the (forgone) grocery sales tax.

In order to keep a balanced budget, the \$240 million grocery tax cut in 2007 will need to be offset by a cut in government spending of \$226 million (1.7% cut in spending). However, there are other costs associated with the grocery sales tax cut and subsequent cut in government spending:

- Total employment will decline in public administration-related jobs (some of which will be offset by private nonfarm employment gains)
- Total loss of \$671 million over the 10-year period in Gross State Product (mainly) due to the cut in government spending

Some industries may benefit in terms of increased employment or demand associated with increased consumer spending (from increased disposable income due to the grocery sales tax cut):

- Occupations in food preparation and production will experience an increase in employment
- Food manufacturing, wholesale and retail trade, accommodations and food services will experience an increase in demand
- Arts, entertainment, and recreation demand will increase

While other proposals have been discussed to phase out the grocery sale tax over several years, many of the same issues will come up. One cannot just eliminate the tax and everything else remains the same. Either raise (other) taxes, cut government spending, or some combination of both is needed to keep the budget balanced. The budget surplus is not enough to cover the cost of cutting the grocery sales tax completely; therefore, policymakers are faced with the same decision at some point in the (near) future.



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