Should States Tax Food?

Examining the Policy Issues and Options

Center on Budget and Policy Priorities

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Nicholas Johnson
Iris J. Lav

CENTER ON BUDGET
AND POLICY PRIORITIES

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Authors

Nicholas Johnson is a policy analyst with the Center on Budget and Policy Priorities' State Fiscal Project. He has authored several reports on state budget and tax issues.

Iris J. Lav is Deputy Director of the Center on Budget and Policy Priorities. She has directed numerous research and advocacy projects, and has written extensively on federal and state budget and tax issues.

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Center on Budget and Policy Priorities
820 First Street, N.E., Suite 510
Washington, DC 20002
(202) 408-1080

E-mail:center@center.cbpp.org
HandsNet: HN0026
Web: www.cbpp.org

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Executive Summary

Of the 45 states that levy general sales taxes, 20 apply their sales taxes to food purchased for home consumption.

States that tax food often cite revenue needs or simplicity of administration as their reasons. Sales taxation of food, however, also has disadvantages that weigh against considerations of revenue or simplicity. Those disadvantages — which include placing a disproportionate burden on lower-income households and lowering the rate of growth of sales tax revenues relative to consumption growth — have led the majority of states to raise revenues and simplify sales tax administration in ways other than taxing food.

Recently, healthy fiscal conditions have led many states to enact tax cuts. These tax cuts have focused largely on reducing income taxes in ways that provide more benefits to higher-income taxpayers than to less affluent state residents. For states that tax sales of food, relieving the tax on food for home consumption can provide substantial benefits to lower-income households. Some states have taken this course.

In January 1996 Georgia became the first state in more than a decade to enact an exemption for food. Georgia's legislation reduced the tax on groceries effective October 1996 and eliminates it fully as of October 1998. In 1996 North Carolina enacted a food tax reduction of one percentage point — effective January 1997 — as a possible first step toward exempting grocery food altogether; a second one-cent reduction goes into effect July 1998. Louisiana reduced its state sales tax on food from four percent to three percent as of July 1997. And Missouri reduced its state sales tax on food from 4.225 percent to 1.225 percent in October 1997. A number of other states are giving serious consideration to similar measures — partially or wholly exempting food from the sales tax or establishing credits to offset the food tax — in 1998.

Drawbacks to the Sales Tax on Food

Taxing food poses two particular problems for states. First, a tax on food falls more heavily on low- and moderate-income families than on better-off families.

- For a family of four that spends the lowest amount considered necessary for a nutritious diet and lives in a typical state that taxes food, sales taxes on food cost some $350 a year. That amount is more than a week's income for a family at the poverty line.

- As a share of income, food taxes are typically four to five times as high for poorer families as for upper-income families. Although other state taxes are levied heavily on the less-advantaged, few are so regressive — that is, absorb such a greater proportion of income for the poor than for the well-off.

- The burdens that state and local taxes place on lower-income families take on added importance at a time when government policies heavily emphasize moving families from welfare to work. Some 1.5 million families in which a parent works full-time remain poor. A reduction in the sales tax on food can make it easier for those families to support themselves on the earnings from a low-wage job.

A second problem is that the inclusion of food in a state's sales tax base contributes to a long-term decline in sales tax revenue as a share of the state's economy.

- The purchase of food for home consumption is a shrinking sector of the economy. In 1960 the average U.S. family spent 17 cents of each consumption dollar on food for home consumption; by 1995 the average family spent only eight cents of each dollar on food eaten at home.

- Revenues from taxing food would have declined in tandem with declining consumption had not sales tax rates been increased. In states with sales taxes, the average state sales tax rate rose from 3.5 percent in 1970 to 5.2 percent in 1996, an increase of nearly 50 percent, while sales tax revenue rose from 1.8 percent to 2.2 percent of personal income, an increase of about one-quarter.

- The declining share of consumption dollars spent on food could be offset in part if states also imposed their sales taxes on the *growing* sectors of consumption and economic activity, especially on purchases of services. Most states, however, exempt most services from their sales tax base. These exemptions often result in a decline in total sales tax revenue as a share of the economy over the long run.

- When major components of revenue decline over time relative to a state's economy, states find it difficult to maintain public services without raising tax rates. The National Governors' Association and the National Conference of

State Legislatures, among others, have identified lagging long-term revenue growth as a major problem confronting state governments.

Food in State Sales Taxes

Forty-five states and the District of Columbia levy general sales taxes. A majority of those states have in some way eliminated, reduced, or offset the tax as applied to food for home consumption. The relief strategies include full or partial exemptions from the sales tax for food purchased for home consumption and credits or rebates to offset the food tax. Of the states with sales taxes:

- Twenty-five states and the District of Columbia exempt most food purchased for consumption at home from the state sales tax.
- Five states tax groceries at lower rates than other goods; they are Georgia, Illinois, Louisiana, Missouri, and North Carolina.
- Six states — Hawaii, Idaho, Kansas, Oklahoma, South Dakota, and Wyoming — tax groceries fully but offer credits or rebates to offset some of the taxes paid on food by some portions of the population. (A seventh state, Georgia, provides both a partial exemption and a credit.) These credits or rebates usually are set at a flat amount per family member. As structured, these credits give eligible households only partial relief from sales taxes paid on food purchases.
- Nine states continue to apply their sales tax fully to food purchased for home consumption without providing any type of relief for low- and moderate-income families. They are Alabama, Arkansas, Mississippi, New Mexico, South Carolina, Tennessee, Utah, Virginia, and West Virginia.

Local governments, which in many states levy their own sales taxes, usually follow state policy on the food exemption. The major exceptions are local governments in Colorado and Arizona. While Colorado and Arizona are among the 25 states that exempt food at the state level, many cities and counties in those states tax grocery food purchases.

Policy Responses

Of the 45 states with general sales taxes, 36 have implemented policies to alleviate one or both of the problems associated with imposing the sales tax on food. Those 36 states have split, however, on the best way to alleviate burdens on low-income households while maintaining sales tax revenue growth.

- One strategy is to exempt food from the sales tax. Twenty-five states exempt grocery food from the sales tax. Five others tax food, but at a reduced rate.

- The other strategy is to offer credits or rebates to offset the sales tax on food. Six states tax food fully but offer credits or rebates. A seventh state — Georgia — both partially exempts food and offers a credit.

Food Exempted from the Sales Tax

The most common response among states to the problems inherent in the tax on food has been to exempt groceries — food purchased for home consumption[1] — from sales taxation.

- Exempting food from the sales tax provides tax relief to all consumers. Low- and moderate-income families, however, spend a larger proportion of their incomes on food than higher-income families and receive proportionately greater tax relief. The benefits from an exemption go directly to families at the checkout line.

  Although purchases made with food stamps are already exempted from sales tax by federal law, families that participate in the food stamp program still benefit substantially from a general food exemption because most families that receive food stamps must also use cash for a significant portion of their grocery purchases. Food stamps are not intended to cover the full cost of a family's basic diet.

- Exempting food helps a state to counteract the gradual decline in sales tax revenues as a share of the state's economy. Except for those very few states that also broadly tax services, states that tax food find that their sales tax revenue grows at a much slower rate than state personal income, requiring either tax rate increases or cuts in public services to compensate for the diminished revenue. States that exempt food, on the other hand, generally find that their sales tax revenue grows more rapidly, in many cases enabling them to maintain public services with less frequent tax increases. Of the 17

[1] The definition of food purchased for home consumption can differ by state.

states that fully taxed food throughout the 1984-to- 1996 period, all but three increased their general sales tax rates. Of the 25 states plus the District of Columbia that maintained sales tax exemptions for food during that time, just half (13 states) raised rates. And while the average rate increase in the 17 states that fully taxed food was 0.8 percentage points, the average increase for the states with food exemptions was less than 0.5 percentage points.

There also are some drawbacks associated with sales tax exemptions for food. The experiences of states with such exemptions during the last three decades, however, suggest that thoughtful design and planning can mitigate those problems.

- A state that exempts food from the sales tax initially gives up a significant amount of revenue — from 5 percent to 30 percent of its total sales tax revenue depending on the breadth of its sales tax base. A state that fully taxes food might find it difficult to forgo that much revenue without making deep cuts in government services. In recent years most states that have implemented sales tax exemptions for food have phased in the exemption over a number of years to allow time for adjustments and, to make up for the reduced revenues, either have gradually shifted reliance to other revenue sources or have increased the general sales tax rate.

- A state's decisions about how to accommodate the loss of revenue from eliminating or reducing the tax on food will, of course, determine how the costs and benefits of exempting food from the sales tax will be distributed across income groups. If a state makes up the lost revenue through a substantial increase in the sales tax rate, it could increase, rather than alleviate, the burden on some low-income households. Similarly, if the forgone revenue is not replaced and the resulting budget reductions fall disproportionately on programs and services for lower-income households, these households could be harmed rather than benefited. On the other hand, if the revenue loss from reducing or eliminating food tax is replaced from more progressive revenue sources such as the income tax, lower-income households are likely to realize the intended tax relief.

- If state policymakers have determined that some type of tax cut is desirable and affordable without spending cuts, eliminating the sales tax on food often will be of greater benefit to low- to moderate- income residents than a general cut in a more progressive tax such as an income tax. (Depending on the circumstances, the tax relief provided to some low-income populations by other forms of *targeted* low-income tax relief, such as a state Earned Income Tax Credit modeled on the federal EITC or a "circuit-breaker" property tax credit, might be as great or greater.[2])

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[2] A description of the relative advantages of various types of low-income tax relief is available in Center on Budget and Policy Priorities, *State Income Tax Burdens on Low-Income Families in 1997: Assessing*

(continued...)

- Exempting food from the sales tax creates several technical issues that, if not handled properly, can complicate administration of the tax and erode some of the benefits. For instance, creating a definition of "food" purchased for home consumption for purposes of the exemption can complicate the tax code and increase costs both for state administrators and for stores. To overcome this problem, recently enacted state exemptions in Georgia, North Carolina, and Missouri have adopted the definition of "food" used by the federal food stamp program. This definition — which identifies the items that may be purchased with food stamps — is familiar to most food retailers because they must incorporate it into their checkout procedures to comply with the federal food stamp law.

- States that exempt food at the *state* level must decide whether *local* governments will be required to exempt food. Though exemptions are costly to local governments, failing to require local exemption of food can diminish the benefits of a state exemption to low- and moderate-income families and can result in administrative complications. One option is for states to offset local revenue losses with increased state aid or increased authority to raise revenue from other sources.

Credits or Rebates to Offset the Sales Tax on Food

Like an exemption, a credit or rebate to offset the sales tax on food has both strengths and weaknesses. The primary strength of a credit is that it can benefit low- and moderate-income people in ways similar to an exemption but at a much lower revenue cost. It typically accomplishes this dual goal by limiting receipt of the credit to households that meet certain income or other guidelines.

Despite the potential advantages of targeting through a credit or rebate, states have had considerable difficulty implementing and maintaining adequate credit or rebate programs.

- None of the credit/rebate programs operating today fully offset the sales tax on food paid by most impoverished families. States tend to set the amount of the refund well below what a typical poor family is likely to pay in food tax, and they usually restrict eligibility to exclude many families below the poverty line.

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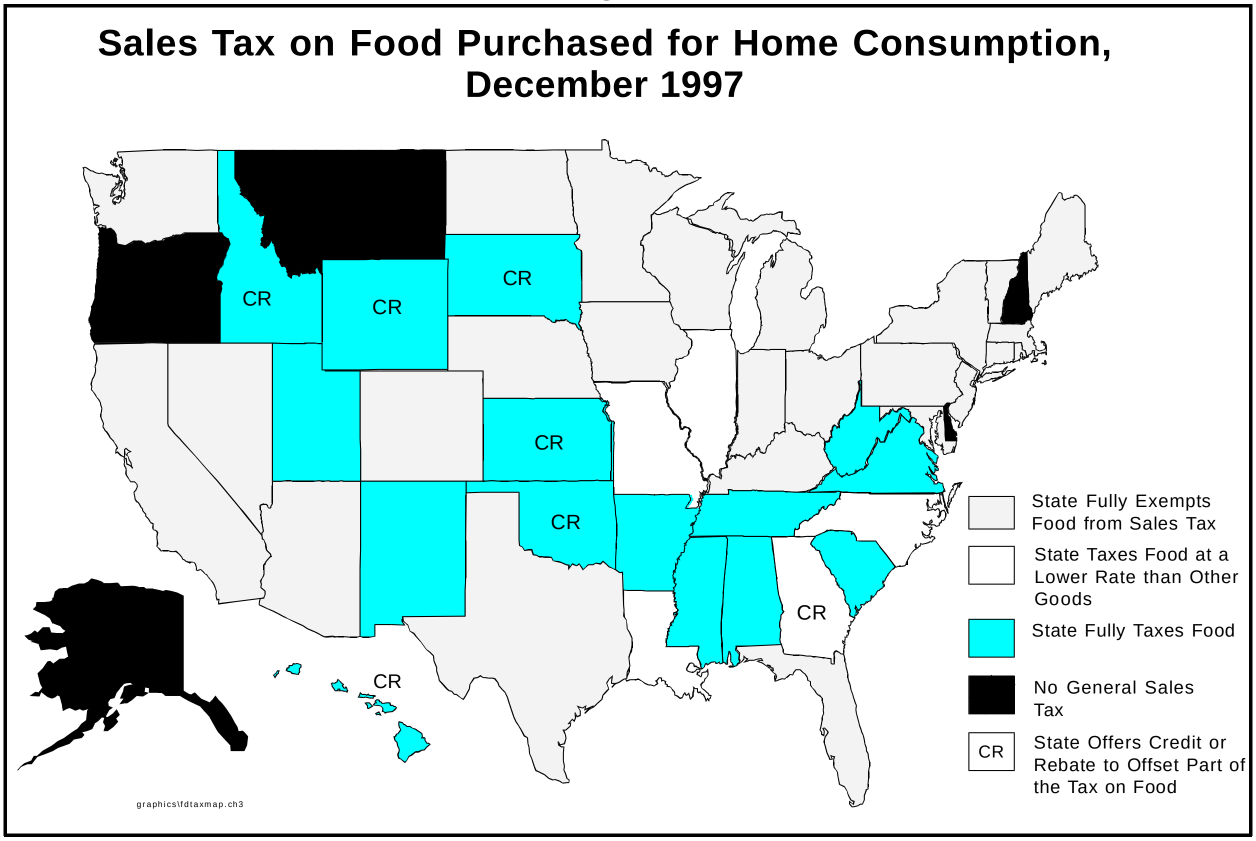
[2] (...continued)
the Burden and Opportunities for Relief (Washington, D.C., April 1998).

Figure 1



- Many eligible families fail to receive credits because states fail to promote the programs to reach the targeted populations. In Kansas, for instance, only about one-third of eligible families in recent years have received the rebates to which they are entitled.

- Credit or rebate programs tend to erode over time, as successive legislatures fail to adjust them for inflation. In addition, state fiscal crises have led legislatures to "raid" these programs for extra revenues — reducing or eliminating such credits — just at the time when relief for low-income households was most needed.

The weaknesses of existing credit and rebate programs do not necessarily mean these programs can never work — only that they must be designed with care.

- A state could design a credit that would fully offset the state and local sales taxes that a typical family at the poverty line might be expected to pay on food purchases. Such a credit would be available to all poor and near-poor families, with phase-out of the credit not beginning until income rises above the poverty line.

- Procedures for claiming the credit could be kept relatively simple. A state could undertake intensive outreach efforts to inform low-income households of their eligibility for the credit and could make a particular effort to ensure that filing information and procedures were accessible to all eligible residents.

- Income limits for eligibility and the size of the credit could be adjusted for inflation automatically.

There is substantial room for states to improve the way in which food for home consumption is handled under their sales taxes. States that exempt food may be able to simplify the administration of their exemption by defining "exempt food" in conformity with the federal definition of food purchasable with food stamps; this would give merchants a single set of rules to administer. States that provide credits or rebates against the food tax could take several steps. Such states could upgrade those credits so that they cover all low-income households and fully offset state and local sales taxes on a typical market basket for a family at the poverty line. In addition, such states could undertake outreach efforts to inform families of the availability of the credit and could take measures to ensure that the credit or rebate does not erode over time as a result of inflation. Finally, states that neither exempt food nor offer an offsetting rebate or credit could adopt one of those strategies and replace the forgone revenue from a more progressive revenue source.

I. Taxes on Food Affect Revenue Growth and Tax Equity

Sales taxes — whether or not they include food — typically contribute to two fundamental problems with state and local tax systems. One problem is that without periodic tax rate increases, tax revenue in most states tends to decline as a share of the state's economy. Over extended periods of time, this decline forces legislators to choose between cutting public services and raising taxes.

A second fundamental problem is that state tax systems place a disproportionate burden on the poor. According to one leading analysis, U.S. families at the bottom end of the income scale pay, on average, 12.5 percent of their incomes in state and local taxes, while families at the top pay an average of only 7.9 percent of their incomes.[1] Although the distribution of taxes relative to income varies from state to state, very few states tax their wealthy residents as heavily as their poor residents.

Sales taxes are not the only cause of state and local revenue problems. Lagging revenue growth is due partly to other factors, ranging from the structure of state business taxes to reliance on lottery revenues. Heavy taxation of the poor results in part from high property taxes and insufficient use of progressive income taxes. Nevertheless, state and local sales taxes, particularly sales taxes on food, contribute greatly to the structural problems of state revenue systems.

In most states the sales tax is a major source of revenue.

- In the 45 states plus the District of Columbia that levy general sales taxes, receipts from sales taxes in fiscal year 1994 provided an average of 24 percent of state and local government tax revenue. The share of state and local tax revenue provided by sales taxes ranged from less than 15 percent in

[1] These figures apply to families headed by non-elderly married couples. The analysis is discussed further on page 8.

Maryland, Massachusetts, New Jersey, and Vermont to more than 40 percent in Washington, Tennessee, and New Mexico.

- Most sales taxes are levied at the state level, but local governments in 33 states — including Alaska, which has no statewide sales tax — also assess sales taxes.

Lagging Growth of the Sales Tax Base

Because sales tax revenues are so important to state budgets, legislatures since the 1970s have raised sales tax rates to prevent revenue from declining in tandem with declining consumption.[2] In states with sales taxes, the average state sales tax rate increased from 3.5 percent in 1970 to 5.2 percent in 1996. But this increase of nearly 50 percent in sales tax rates yielded only a modest increase in state sales tax revenue, from 1.8 percent of personal income in 1970 to 2.2 percent of personal income in 1996, an increase of about one-fourth.[3]

Why did these repeated increases in sales tax rates not result in a commensurate increase in sales tax revenue relative to economic activity? It is because the amount of tax

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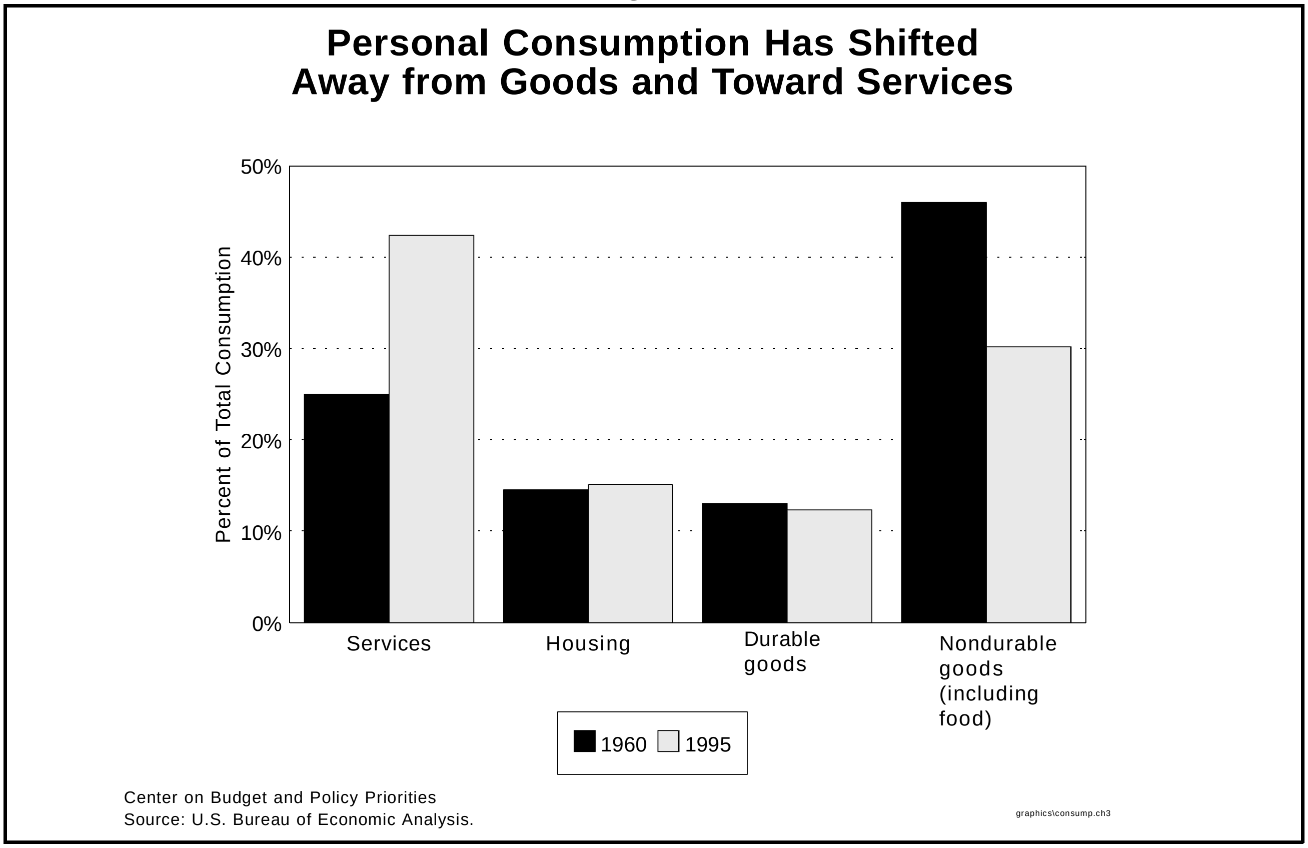
[2] The term "sales tax" in this paper refers to general sales taxes as defined by the U.S. Bureau of the Census in its *Government Finances* series. This definition includes most retail sales and use taxes and taxes on gross income, but it excludes nominal business license taxes as well as taxes that are levied specifically on such items as alcohol, tobacco, insurance products, motor fuels, amusements, and utilities. In several states, the sales tax is known in statute, if not in common parlance, by another name. In Alabama, Arkansas, and New Mexico it is a "gross receipts tax", in Hawaii it is a "general excise tax", and in Arizona it is a "transaction privilege tax." Washington state levies two taxes that the Census Bureau considers sales taxes — a "retail sales tax" and a smaller "business and occupation tax." The retail sales tax exempts food purchases; the business and occupation tax does not. For this analysis, Washington is counted as a state that fully exempts food from the sales tax.

[3] These calculations are based on U.S. Census Bureau data on state tax collections, on U.S. Department of Commerce data on state personal income, and on historic data on state sales tax rates collected by John F. Due and John L. Mikesell in *Sales Taxation: State and Local Structure and Administration*, 2nd ed. (Washington, D.C.: Urban Institute Press, 1994), p. 45, updated to include more recent state sales tax rate changes.

Figure 2



revenue is determined not only by the tax rate but also by the "tax base" — the goods and services subject to taxation. Most states apply their sales taxes not to the full range of goods and services produced by the economy, but only to tangible goods. Most sales of services are untaxed.[4]

Data from the Federation of Tax Administrators show that the median state applies its sales tax to fewer than one-third of 164 potentially taxable categories of services. The disparate treatment of goods and services in many states results in unequal treatment in circumstances where a good and a service are close substitutes for one another. For example, one family may pay a sales tax on its purchase of a lawn mower while its neighbors pay no sales tax on the lawn-care service they hire. A person may pay a sales tax when purchasing exercise equipment but pay no sales tax on the cost of attending an aerobics class. Beyond the inequality, this disparate treatment of goods and services also blunts the effectiveness of the sales tax as a revenue source.

As the United States shifts to a service-oriented economy, the typical state's sales tax base is gradually shrinking as a portion of total consumption. As Figure 2 shows, spending on services has displaced spending on various types of goods. The percentage of consumer

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[4] Three states — Hawaii, New Mexico, and South Dakota — do tax most services through their general sales taxes.

dollars spent on services rose from 25 percent in 1960 to 42 percent in 1995. Spending on non-durable goods such as clothing and food fell from 46 percent to 30 percent of total consumption, and spending on durable goods such as cars and furniture declined from 13 percent to 12 percent of total consumption.

Because sales tax bases typically are tied to the declining consumption of tangible goods rather than to the increasing consumption of services, the yield of each percentage point of the sales tax rate has been falling.[5] As a result, without periodic increases in tax rates, sales tax revenues in most states cannot keep pace with the growth in the economy. As the National Conference of State Legislatures and the National Governors' Association note in their 1993 report *Financing State Government in the 1990s*, "The absence of services from the tax base erodes the vitality of the sales tax and confronts state officials with the prospect of increasing tax rates to maintain current levels of revenue."[6] Although states have made incremental improvements in taxing services, political obstacles make it likely that many states will continue to exempt most services for some time.

Taxation of Food Exacerbates Lagging Revenue Growth

A sales tax that excludes services is further vulnerable to erosion when it includes food.[7] Figure 3 shows that during the last few decades, spending on food as a percentage of total consumption fell even more rapidly than spending on other tangible total consumption spending in 1960 to eight percent in 1995, a decline of more than half goods. The decline in purchases of food for home consumption — from 17 percent of — was far more precipitous than the decline of about one-fourth in spending on other non-durable goods and the decline of about one-tenth in spending on durable goods.

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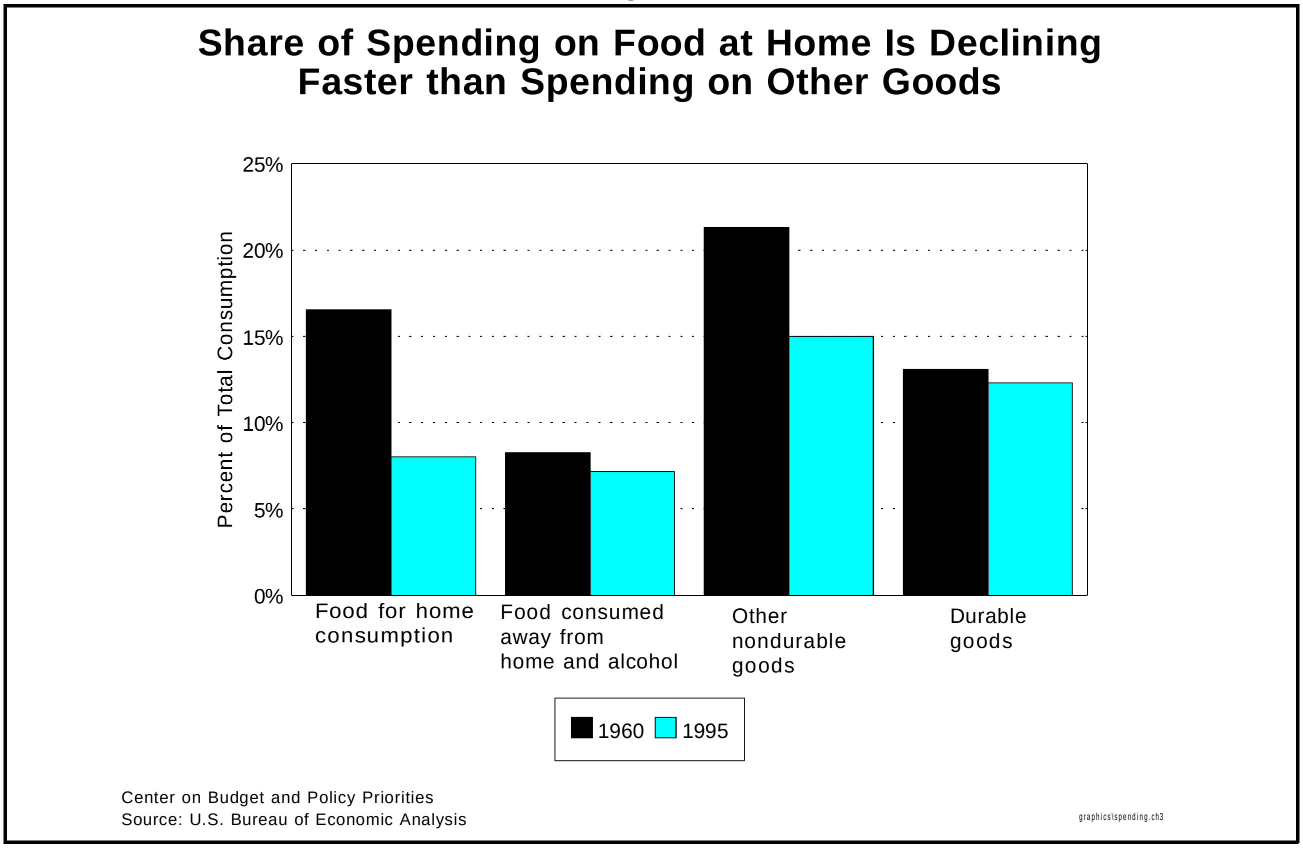
[5] In addition to the shift in consumption patterns from goods to services, a small part of the reduction in yield may be explained by new exemptions created by state legislatures. A few states, for instance, enacted exemptions for food after 1974. But most of the present food exemptions were already in place in 1974. Moreover, several states have broadened their sales tax bases to include a number of specific services since the 1970s.

[6] National Conference of State Legislatures and National Governors' Association, *Financing State Government in the 1990s* (Washington, D.C., 1993), p. 34.

[7] In general "food" in this paper is defined as food purchased for home consumption. Nearly all states tax the purchase of restaurant meals, either through the general sales tax or through separate meals taxes. Most states also tax alcohol. The problems associated with the tax on food do not necessarily apply to taxes on meals or alcohol, so those taxes are not considered in this paper.

Figure 3



Thus, in the absence of increases in a state's sales tax rate, the revenue raised from the portion of a state sales tax levied on food would have declined commensurately, by about one-half as a share of economic activity.

Looking more specifically at the effect of consumption patterns on sales tax revenue, researchers Richard F. Dye and Therese J. McGuire of the University of Illinois used national data to consider how revenue growth would have been affected during a 20-year period if states had taxed various types of consumption under their state sales taxes. Dye and McGuire measured the growth of a "core" sales tax base, which includes the tangible goods taxed by most states but not food for off-premises consumption. They found that, on average, revenues from a sales tax levied on tangible goods without food would have grown by 2.16 percent a year above the rate of inflation. Dye and McGuire then considered how changes to the basic sales tax base would have affected the rate of revenue growth. They estimated that adding services and utilities to the sales tax base of tangible goods would have increased the annual growth rate of the base by 23 percent, bringing the revenue growth up to 2.66 percent after adjustment for inflation. But adding food rather than services would have reduced the growth of the base by 11 percent, reducing growth to an inflation-adjusted 1.93 percent.[8]

[8] Richard F. Dye and Therese J. McGuire, "Expanding the Sales Tax Base: Implications for Growth and Stability," in William F. Fox, ed., *Sales Taxation: Critical Issues in Policy and Administration:*

(continued...)

Understanding revenue growth is much more than an academic exercise: The erosion of sales tax revenue poses a threat to the ability of state governments to pay for public services. As a state's economy and population grow, so does the cost of providing public services. As *Financing State Government in the 1990s* notes: "If structural problems prevent state tax revenues from growing in proportion to economic and population growth, the state would either have to cut spending repeatedly or raise tax rates to sustain spending in proportion to such growth."[9]

The Sales Tax on Food Places a Disproportionate Burden on Lower-Income Households

Despite the decline over time in the proportion of household income spent on food, food remains a large component of the budgets of the poor. Thus, sales taxes levied on food can impose a surprisingly large burden on poor families.

To purchase a nutritious diet at the grocery store, a family of four in 1997 in the continental United States must spend at least $4,950 per year, according to the U.S. Department of Agriculture. If a state's combined state and local sales tax rates total seven percent — a typical rate in states that tax food — the annual tax bill on that family's grocery purchases would be about $347. For a family at the poverty line, the tax paid on food is equivalent to about a week's wages.[10] Were it not for the tax, the family could buy an additional 3.5 weeks' worth of groceries.

High taxes on poor people are common in state tax systems, particularly in states that rely heavily on sales taxes and other consumption taxes. Consumption taxes are regressive; in other words, they place disproportionately heavy tax burdens on low- and middle-income families. This regressiveness is characteristic of sales taxes and other consumption taxes because as a household's income increases, a smaller

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[8] (...continued)
(Westport, Conn.: Praeger, 1992).

[9] National Conference of State Legislatures and National Governors' Association, p. 7.

[10] This calculation assumes that the family does not receive food stamps, since federal law bars taxation of food purchased with food stamps. See "Food Stamp Purchases Provide Only Partial Exemption from the Sales Tax" on page 7 for fuller discussion of this issue.

Food Stamp Purchases Provide Only Partial Exemption from the Sales Tax

The federal food stamp program provides many low-income families with vouchers or electronic accounts with which to buy groceries. Under federal law, states may not charge sales tax on food purchased with food stamps. The law thus protects many low-income families from some of the tax on food.

For most poor families, however, the food stamp exemption covers only a portion of all grocery purchases; taxable cash expenditures remain a major portion of families' total food spending.

- Food stamp recipients are expected to spend 30 percent of their own income (both earned income and payments like Social Security, minus certain deductions) on groceries. Fewer than one-quarter of food stamp recipients have no "countable" income to spend and thus receive the maximum food stamp benefit amount. For the rest, food stamps cover only the difference between 30 percent of the recipient's income and a specified minimum grocery budget based on family size. Most households participating in the program consequently spend a significant portion of their cash income on food, both because they receive less than the maximum food stamp allotment and because the specified minimum budget may be less than the actual cost of purchasing sufficient food for their families.

- In addition, many poor people sufficiently needy to qualify for food stamps do not receive them because they do not know they are eligible, because they are embarrassed to be seen using food stamps, or for some other reason. According to U.S. Department of Agriculture estimates for 1995, of the 15.5 million households that met the income and asset standards for the program, about 33 percent did not apply. Other families with incomes low enough to qualify for the program may be disqualified because they own cars or other items whose value exceeds the program's strict limit on assets.

In addition, the Congressional Budget Office estimated that the 1996 welfare law would reduce total food stamp benefits by almost one-fifth below what they otherwise would have been by the year 2002. Under the law, food stamps have been denied to more than half a million adults and children who reside legally in the United States. More than 400,000 jobless adults between the ages of 18 and 50 who previously would have been eligible for food stamps are now ineligible. In addition, other changes are gradually reducing food stamp benefits to the working poor, the elderly, and others in poverty. Assuming those families compensate for the lost food stamp benefits by spending more cash on groceries, their exposure to sales taxes on food will increase commensurately.

Federal law also bars taxation of food purchased with vouchers from the Supplemental Nutrition Program for Women, Infants and Children, but these WIC vouchers cover a much smaller share of low-income families' food purchases than do food stamps.

proportion of income is consumed and more is saved and invested. The particular structure of state sales taxes, with high reliance on consumption of tangible goods, aggravates this problem. Less well-off families spend a higher proportion of their income on tangible (i.e., taxable) goods than do wealthy families. On the other hand, higher-income families not only save more of their income but also spend a higher proportion of their income on some types of services than do families with more modest resources.

A study of the distribution of state and local taxes on non-elderly married couples shows that low-income families pay an average of 12.5 percent of their income in state and local taxes, including 3.5 percent in general sales taxes, while the highest-income families pay an average of 7.9 percent of their income in state and local taxes, including 0.7 percent in general sales taxes. This regressiveness varies considerably by state, however. There are four states in which the overall tax systems are flat or progressive by some measures; in these states higher-income families pay at least as high a percentage of income in state and local taxes as do lower-income families. Two of the states with flat or progressive state and local taxes have no sales taxes at all. These two states are Delaware and Montana. The two other states, California and Vermont, have highly progressive income taxes that largely offset the effects of sales taxes and other regressive state and local taxes.[11]

Consumer Expenditures on Food

Sales taxes are generally the most regressive component of state and local tax systems, and taxation of food heightens the regressivity. To understand the role of food taxes in making the overall sales tax regressive, it is useful to examine how average families in various income brackets spend their money. Data from the U.S. Department of Labor's Consumer Expenditure Survey, the nation's largest survey of consumer spending patterns, show that low-income families spend a higher percentage of their incomes on food than do wealthier families. An average three- or four-person household with income between $10,000 and $19,999 spends about $3,200 a year on food consumed at home, which represents 21 percent of its income. (See Table 1.) A household with income between $30,000 and $39,999 spends about the same $3,200 a year on food, but that expenditure represents only nine percent of its income. A household with income of more than $70,000 spends about $4,500 or four percent of its income on food.

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[11] Citizens for Tax Justice and the Institute on Taxation & Economic Policy, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States* (Washington, D.C., 1996).

Table 1
Annual Consumer Expenditures by Household Income for Households of Three and Four, 1994-95

Household income	**$10,000 to $19,999**	**$20,000 to $29,999**	**$30,000 to $39,999**	**$40,000 to $49,999**	**$50,000 to $69,999**	**$70,000 and over**
Food for home consumption						
Average spending	$3,190	$3,230	$3,240	$3,770	$4,030	$4,460
Percent of income	*21%*	*13%*	*9%*	*8%*	*7%*	*4%*
Other tangible goods						
Average spending	$7,900	$10,100	$12,500	$14,700	$16,600	$22,400
Percent of income	*53%*	*41%*	*36%*	*33%*	*28%*	*21%*

Note. Spending amounts for income groups shown may be underestimated for all income classes; see the Appendix for a discussion of this and other shortcomings in the data source. "Other tangible goods" include purchased meals, alcohol, tobacco, housekeeping supplies, household furnishings and equipment, clothing, vehicle purchases, gasoline and motor oil, televisions and other entertainment equipment, toys and playground equipment, personal care products and reading materials. These line items represent a typical state sales tax base.

Source. U.S. Bureau of Labor Statistics, *1995 Consumer Expenditure Survey* (Washington, D.C., 1997).

Other types of consumption that make up the sales tax base also are distributed unequally between rich and poor, but not as unequally as food purchases. Table 1 shows that spending on non-food tangible goods — the typical components of a sales tax such as clothing, appliances, and household items — rises more rapidly than spending on food as incomes rise. An average household of three or four with income between $10,000 and $19,999 spends 53 percent of its income on non- food tangible goods, while the household with income exceeding $70,000 spends 21 percent of its income on such goods.[12]

[12] The Consumer Expenditure Survey calculates food spending from biweekly surveys and quarterly interviews with a large sample of individual consumers. The data reported in those interviews are subject to a variety of types of error. (See the Appendix for further discussion.) In particular, data for the very lowest income class, covering those with incomes less than $10,000, may be misleading, partly because this class includes households that are temporarily without income — for instance because of layoffs or business losses — but whose spending patterns may reflect the middle- or upper-class incomes to which they are accustomed. The CES also tends to underreport spending by households of all income levels. Nonetheless, the CES is used widely by academics, state research agencies, and others to understand sales tax incidence because it is the only available source of data on consumption patterns (continued...)

Relative to income, the average family in this low bracket spends five times as heavily on food as the average family in the top bracket but only 2.5 times as heavily on other goods.

Evidence from State Tax Studies

A number of studies examined the potential impact of taxing food in specific states. In Nevada, food and a number of other items are exempt from the sales tax. Bradford Case and Robert D. Ebel, in an analysis performed for a tax study commission in Nevada, found that Nevada households with annual incomes of $5,000 to $9,999 paid 1.2 percent of their income in sales taxes, while residents with income of $40,000 or more paid sales taxes equal to 0.4 percent of income. Case and Ebel also looked at the potential effect of adding food to Nevada's sales tax base. As Table 2 shows, expanding Nevada's sales tax base to include groceries would increase the sales tax burden of the lower-income group by more than half but increase the payments of the wealthier group by only about one-fourth. Case and Ebel studied nine other possible expansions of the sales tax base and found that none would increase the tax's regressiveness as much as the inclusion of food.[13]

The Nevada analysis did not include the effects of a 1985 federal law barring states from applying the food tax to purchases made with food stamps. Since most recipients of food stamps are poor, some analysts argue that this law reduces the regressiveness of the sales tax on food. The ban on taxation of food purchased with

[12] (...continued)
by income class. Some analysts adjust the raw data to overcome its flaws and meet the particular needs of their analyses. For example, the comprehensive tax model developed by the Institute on Taxation & Economic Policy uses the CES but makes adjustments to account for the lack of reliable income and consumption data for consumers at the top of the income scale, apparent misreporting of income among consumers at the bottom of the income scale, missing data from consumers who did not participate in the survey for each of the quarterly interviews, and state-by-state variations in consumption of particular items such as utilities and tobacco. Whether or not such adjustments are made, however, published analyses agree that the sales tax on food is more regressive than the sales tax on other goods.

[13] Bradford Case and Robert D. Ebel, "Using State Consumer Tax Credits for Achieving Equity," *National Tax Journal* 42(3) (1989). The percentages reported here actually reflect the combined effect of two independent tax changes: expanding the sales tax base to include food and raising the rate of an existing tax on hotel lodgings. Case and Ebel's analysis did not separate the effects of those two changes. But their data suggest that the hotel tax increase would be paid mostly by tourists, so for typical Nevada residents, except perhaps for those at very high income levels, the cost of the hotel tax would be almost imperceptible. Had Case and Ebel separated the effects of the two taxes, the difference in the effects of the food tax on low- and high-income households would have appeared slightly more dramatic.

Table 2
Potential Effect of Expanding the Nevada Sales Tax to Include Food: Taxes as a Percentage of Income

Gross Income Group	Current Sales Tax Payment (Food Exempt)	Tax on Food	Total Tax (Including Food)
Taxpayers with incomes of $5,000 to $9,999	1.2%	0.7%	1.9%
Taxpayers with incomes of $40,000 or more	0.4%	0.1%	0.5%

Source: Case and Ebel, 1989.

food stamps is not sufficient, however, to alter substantially the regressive effect of the sales tax on food. (See box on page 7.)

A "micro-simulation" model developed by the Institute on Taxation & Economic Policy to evaluate the effects of state tax systems on families at various income levels takes account of untaxed food stamp purchases.[14] A 1997 ITEP study looked at the effect of Arkansas' sales tax, which includes food, on households of different income levels. The ITEP study found that groceries accounted for a much larger share of taxable purchases for low-income than for higher-income Arkansas taxpayers. Groceries accounted for 29 percent of total sales tax liability for the poorest one-fifth of Arkansas households, but just 18 percent of sales tax liability for the wealthiest one-fifth of households.[15] The higher share of consumption devoted to food adds to the tendency of lower-income families to spend a larger share of total income on consumption than higher-income families. As a result of the interaction of these two factors, the sales tax on food absorbs 1.1 percent of income for the poorest one-fifth of Arkansas families but only 0.3 percent of income for the highest-income one-fifth. As Table 3 shows, the general sales tax on individuals is 2.5 times as burdensome on the

[14] ITEP's micro-simulation model includes data on incomes, demographics, consumption patterns, and other attributes of a representative cross-section of actual households in each state. These data are used to simulate the effects of a tax change on the sample households. The effects on the individual sample households are then combined to yield the effect on taxpayers.

[15] Unlike the nationwide ITEP study described on page 8, the Arkansas study describes the tax burdens on all Arkansas taxpayers, including unmarried individuals and the elderly.

Table 3
Potential Effect of Exempting Food from the Arkansas Sales Tax:
Taxes as a Percentage of Income

Arkansas Gross Income Group	Current Sales Tax Payment (Includes Food)	Tax on Food	Sales Tax with Food Exempt
Bottom one-fifth of taxpayers (less than $10,000)	4.5%	1.1%	3.4%
Top one-fifth of taxpayers (more than $47,000)	1.7%	0.3%	1.4%

Source: ITEP, 1997.

poor as on the wealthy, while the tax on food is almost four times as burdensome on the poor as on the wealthy.[16]

Like the studies in Nevada and Arkansas, other state-specific studies have found that expanding the sales tax to include food makes the tax more regressive, while eliminating food from the sales tax makes it less regressive. Examples include the 1988 *Nebraska Comprehensive Tax Study* and the 1986 *Final Report of the Minnesota Tax Study Commission*. The Nebraska study found that a family of four in the second decile of the income distribution would pay an effective sales tax rate on food more than eight times as great as would a comparable family that was among the wealthiest families in the state.[17] By contrast, the existing Nebraska sales tax is only about three times as high on lower-income families as on upper-income families. The Minnesota study similarly found that taxing food would make the state's tax system more regressive.

John F. Due, who co-wrote a portion of the Nebraska study, and John L. Mikesell, who contributed to the Minnesota study, cited those analyses in their 1994 book-length overview of state sales taxes. They concluded that exempting food from the sales tax makes the tax less regressive because "lower-income groups spend relatively higher percentages of their income on food than do those in the upper income groups."[18]

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[16] Robert S. McIntyre, Michael P. Ettlinger, and Robert G. Lynch, *Building a Better Arkansas Tax System: Evaluating the Options*, (Washington, D.C.: Institute on Taxation & Economic Policy, January 1997).

[17] The Nebraska study found that a tax on food would cost a Nebraska family of four in the second-poorest decile of the income distribution an additional 2.51 percent of its income, while it would cost a family in the second-wealthiest decile an additional 0.32 percent of its income.

[18] Due and Mikesell, pp. 77-78.

Looking at all 50 states, a study by Citizens for Tax Justice and the Institute on Taxation & Economic Policy found that sales taxes tended to be more regressive in states that tax food than in states that did not tax food. The study identified 12 states in which the sales tax was particularly regressive in 1995 and found that 10 of those states taxed food. In the remaining 33 states in which the sales tax was somewhat less regressive, only eight taxed food while the other 25 did not.

This analysis highlights the two main reasons that states should consider reducing or eliminating sales taxation on food. If food is included in the sales tax base, the sales tax becomes significantly more regressive. In addition, the taxation of food is a drag on the growth rate of state tax revenue relative to economic growth.

II. Exempting Food from the Sales Tax

The analysis in the preceding chapter suggests that state and local revenue systems could be improved by exempting food from the sales tax. There is, however, considerable controversy over whether an exemption for food is the most effective and efficient way to relieve burdens on lower-income households and maintain adequate revenues.

Doubts typically have centered around three issues.

- Can the state afford to exempt such a large share of consumption purchases — in either the short or the long run — without raising its general sales tax rate?

- Do low- to moderate-income families — including those who receive federal food stamps — reap a significant portion of the benefits from a food exemption? Or does the exemption largely benefit the more expensive food items purchased by higher-income residents (the "caviar effect")?

- Is the exemption worth the administrative difficulties it creates?

Most states do exempt food and generally have found positive answers to these questions.

- As noted in the previous chapter, a sales tax that exempts food tends to grow more rapidly without rate increases than a sales tax that includes food. As a result, the historical record suggests that rate increases have been less frequent in states exempting food than in states taxing food.

- An exemption is the most certain way to provide relief from the food tax to lower-income households, without the barrier of application procedures. As discussed below, states can use income taxes or other taxes to recoup the taxes that higher-income households would have paid on food purchases.

- Finally, all sales tax exemptions create potential problems for tax administration. States can minimize the difficulties of administering a food tax exemption by adopting categories and classifications already in use for the federal food stamp program and by using uniform state and local tax bases.

The Impact on State Revenues and Tax Rates

History shows that at least half of the states have regularly met their revenue needs without taxing food; 25 states plus the District of Columbia have exempted food since the 1970s or earlier. But from the early 1980s until Georgia's 1996 enactment of a phased-in exemption, the movement to exempt food stalled. Indeed, the number of states taxing food increased during this period as three states chose to tax food as a way to plug budget gaps: West Virginia repealed its food tax exemption; Louisiana enacted a series of "temporary" taxes on food; and Illinois instituted a food sales tax at a rate lower than its general sales tax.[19] These additions brought the number of states that tax food at the state level to 20. (In addition to those 20 states, Alaska, Arizona, and Colorado allow local governments to tax food.)

Food purchases remain an important part of many states' actual or potential sales tax bases, and exempting food from the sales tax does take a large bite out of a state's revenue stream. According to a Department of Agriculture estimate, consumers in 1994 paid $4.7 billion in direct state and local sales taxes on food for home consumption — an amount equal to 1.4 percent of all food purchases nationwide that year and, of course, a much larger share of food purchases in the states that tax food.[20] A 1992 National Conference of State Legislatures survey found that in states that taxed food revenue from the food tax equaled anywhere from five percent to 30 percent of a state's total sales tax revenues; on average, food provided about 15 percent of sales tax revenue in states that taxed food. In the states that now tax food, policymakers would have to weigh the substantial revenue loss that would result from the complete exemption of food when choosing strategies to ease the food-tax burden. In states that now exempt food, the amount of revenue that could be gained by reinstating the tax would be somewhere between eight percent and 30 percent of current sales tax revenues and would average about 16 percent of revenue.[21] The cost of the exemption makes adding food to the sales tax a tempting option for legislators seeking new revenues.

Tax Rates and Tax Rate Changes

[19] In the early 1980s, Illinois set the sales tax rate for food (as well as certain other categories of goods) at zero percent, effectively exempting food. The rate for food was raised to one percent in 1990.

[20] U.S. Department of Agriculture, Economic Research Service, unpublished data from the ERS food expenditures model.

[21] Arturo Perez, "Food Purchases Add Weight to State Sales Tax Collections," *The Fiscal Letter* (National Conference of State Legislatures), May/June 1992.

Some analysts have suggested that the revenue lost by exempting food tends to force the general sales tax rate upward, largely wiping out the benefits of the exemption for low- and moderate-income families.[22] The evidence for such an assertion is mixed, as Table 4 shows.

- States that exempt food do tend to have higher state sales tax rates than states without food exemptions. For 1996, the unweighted average of state sales tax rates for states that tax food was 4.6 percent, as compared with 5.5 percent in states that exempt food, a difference of 0.9 percent. This difference may have reflected states' need to compensate for revenue lost owing to the food exemption. Alternatively, it may have resulted because many of the states that tax food — mostly Southern and mountain states — generally impose relatively low taxes and provide relatively low levels of public services. In these states the lower sales tax rates may have reflected less effort to raise revenues. In addition, the average tax rates exclude local government sales taxes, which are more common and raise relatively more revenue in states that tax food than in states that exempt food.[23]

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[22] See, for example, Roy W. Bahl and Richard Hawkins, "Does a Food Exemption Lead to a Higher State Sales Tax Rate?" *State Tax Notes*, January 5, 1998.

[23] Of the 17 states that fully taxed food at the state level from 1984 to 1996, 14 permitted local sales taxes; in those 14 states, U.S. Census data for 1994 show that the local sales taxes raised about one-third as much revenue as the state taxes. Of the 25 states that fully exempted food at the state level, 15 permitted local sales taxes; in those 15 states, local sales taxes raised about one-fifth as much revenue as the state taxes.

Table 4
State Sales Tax Rates in 1984 and 1996 by Presence of Food in Sales Tax Base

States That Exempt Food	**1984**	**1996**	**Change**
Texas	4%		2.25%
Michigan	4	6	2
California	4.75	6	1.25
Rhode Island	6	7	1
Maine	5	6	1
Kentucky	5	6	1
Florida	5	6	1
Vermont	4	5	1
North Dakota	4	5	1
Iowa	4	5	1
Nebraska	4	5	1
Nevada	5.75	6.5	0.75
Minnesota	6	6.5	0.5
Washington	6.5	6.5	0
Pennsylvania	6	6	0
New Jersey	6	6	0
Wisconsin	5	5	0
Ohio	5	5	0
Indiana	5	5	0
Arizona	5	5	0
Maryland	5	5	0
Massachusetts	5	5	0
New York	4	4	0
District of Columbia	6	5.75	-0.25
Colorado	3.5	3	-0.5
Connecticut	7.5	6	-1.5
Average in states that exempt food	5.04	5.52	0.48

States That Fully Tax Food	**1984**	**1996**	**Change**
Oklahoma	2%	4.5%	2.5%
Kansas	3	4.9	1.9
Tennessee	4.5	6	1.5
New Mexico	3.75	5	1.25
Mississippi	6	7	1
South Carolina	4	5	1
Georgia[a]	3	4	1
North Carolina[a]	3	4	1
Wyoming	3	4	1
Idaho	4.5	5	0.5
Arkansas	4	4.5	0.5
Virginia	3	3.5	0.5
Utah	4.625	4.875	0.2
Missouri[a]	4.125	4.225	0.1
South Dakota	4	4	0
Hawaii	4	4	0
Alabama	4	4	0
Average in states that fully tax food	3.79	4.62	0.82

Note. Not shown are five states (Alaska, Delaware, Montana, New Hampshire, and Oregon) with no state sales taxes and three states (Illinois, Louisiana, and West Virginia) that changed their treatment of food in the general sales tax between 1984 and 1996. Rates and exemptions shown are as of January 1 of each year.
[a] Georgia, Missouri and North Carolina have reduced their sales taxes on food since 1996.

Sources. Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism* (Washington, D.C., 1985); Commerce Clearing House, *State Tax Guide* 1996 (Chicago, Ill).

- Moreover, the sales tax rate gap between states that do and do not tax food is narrowing. In a recent 12-year period, the average food-tax state increased its general sales tax rate more frequently and more steeply than the average state that exempted food. Of the 17 states that fully taxed food throughout the 1984-to-1996 period, all but three increased their general sales tax rates. Of the 25 states plus the District of Columbia that maintained sales tax exemptions for food during that time, just half (13 states) raised rates. And while the average rate increase in the 17 states that fully taxed food was 0.8 percentage points, the average increase for the states with food exemptions was less than 0.5 percentage points.

Why have states that tax food tended to raise their rates more than other states? One possibility is that the rate changes were responses to slow growth in the sales tax base. As discussed in Chapter I, from 1970 to 1996 state sales tax rates nationwide increased from an average of 3.5 percent to more than five percent, but the actual revenue collected rose much more slowly, from 1.8 percent to 2.2 percent of personal income. As noted in Chapter I, research suggests that slow revenue growth is more pronounced in states that tax food because food acts as a drag on the sales tax base.

Many states that tax food recognize the failure of their sales taxes to keep pace with economic growth. State fiscal expert Steven D. Gold asked state tax officials in 1993 to estimate the percentage increase in sales tax revenue, barring legislative action, for every one-percent expansion of the state economy — a statistic that economists call "elasticity." Of the officials that responded, those in states that taxed food generally predicted that their sales tax revenues would grow more slowly than the economy. By contrast, officials in states that exempted food from the sales tax generally predicted that tax revenue would grow at close to the same rate as the economy or faster. Table 5 provides details.[24]

Revenue Stability

Some states may choose to tax food because it adds stability to the sales tax base. Taxing food reduces the extent to which sales tax revenue rises and falls with the business cycle. Hence, the argument goes, including food in the sales tax base reduces the need for tax hikes or program cuts during recessions. Since food is a necessity rather than a luxury, it makes sense that families would make purchases of food a priority even during recessions.

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[24] Steven D. Gold, *The Income Elasticity of State Tax Systems: New Evidence* (Albany, NY: Center for the Study of the States, Nelson A. Rockefeller Institute of Government, State University of New York, 1995).

Table 5
Tax Officials' Estimate of State Sales Tax Growth Relative to Economic Growth, 1993

	Number of States			
State Sales Treatment of Food	**Revenue Grows Slower than Economy (Elasticity Below 0.95)**	**Revenue Grows as Fast as Economy (Elasticity of 0.95 to 1.05)**	**Revenue Grows Faster than Economy (Elasticity Above 1.05)**	**Average Elasticity**
Tax food	8	2	1	0.87
Exempt food	6	7	4	0.97

Note. Not all states reported results. This table excludes three states (Hawaii, New Mexico, and South Dakota) that tax food and also tax most services; the officials' responses in those states reflect the stronger revenue growth resulting from taxing the services that are the growing sector of consumption.

Source. Center on Budget and Policy Priorities calculations based on survey of state revenue departments and legislative fiscal offices by the Center for the Study of the States.

The stability added by taxing food must be weighed, however, against the additional regressivity from taxing food. High tax burdens on low-income households are particularly problematic during a recession, when more people become unemployed and poor. The added stability obtained during recessions from taxing food must also be weighed against the drag that food taxation exerts on total sales tax revenue growth during healthier economic times.

Taxing food is far from the only way states can weather recessions. States have a number of options for maintaining revenue stability. For instance, states can broaden their sales tax base to include a variety of services and utilities; in general, the more diverse a tax base, the more stable it is during a recession. University of Illinois researchers Richard Dye and Therese McGuire estimated the "variability" of various sales tax bases as a percentage of revenue over a 20-year period in an average state. They found that adding food to a narrow, tangible-goods sales tax base results in about the same improvement in stability as adding services and utilities: both alternatives reduce variability to the same degree. But the impacts on growth are quite different: adding services and utilities to the sales tax base improves sales tax revenue growth, while adding food reduces revenue growth.[25]

States can also make better use of "stabilization" or "rainy-day" funds, in which states save money in good times so that they can withdraw funds to support budgets in future recessions. All but five states and the District of Columbia have such funds, although not

[25] Dye and McGuire, p. 175.

all states maintain the recommended balances of at least five percent of spending in these funds. At the end of fiscal year 1997, following a number of years of strong economic growth, only 11 such funds contained an amount equal to at least five percent of general fund appropriations; the average was 3.5 percent.[26] A state with an appropriately funded stabilization fund can compensate for the somewhat greater variability of sales tax revenues over the business cycle that results from exempting from sales taxation.

Will an Exemption Benefit Low- and Moderate-Income Families?

Chapter I reviewed the evidence that low- and moderate-income families spend higher portions of their income on food than wealthy families. It follows that the largest proportional benefits of a sales tax exemption for food are received by families with low or moderate incomes. As Table 1 in Chapter I shows, an average three- or four-person household with an annual income of $10,000 to $19,999 may be expected to spend about 21 percent of earnings on food, while a family earning more than $70,000 may be expected to spend four percent of income on food. An exemption of food from the sales tax thus would provide five times as much benefit, relative to income, to a lower-income family as to a higher-income family. It should be noted, however, that the full differential would not apply to a poor family that purchased a significant portion of its food using food stamps provided by the federal government because since 1985 Congress has barred states from imposing the sales tax on food stamp purchases. On the other hand, many low-income working families do not receive food stamps, and food stamps do not cover all of a family's food purchases. Despite the federally mandated exemption of food purchased with food stamps, a full exemption of food from state and local sales tax benefits low- and moderate-income working families disproportionately.

[26] The jurisdictions without stabilization funds are Arkansas, the District of Columbia, Hawaii, Illinois, Montana, and Oregon. Corina Eckl, "States Broaden the Scope of Rainy Day Funds," *The Fiscal Letter*, 17(2), (March / April 1995). The 11 states with five percent or more in their funds in 1997 were Alaska, Delaware, Indiana, Iowa, Maryland, Michigan, Minnesota, Mississippi, Nevada, Ohio, and Oklahoma. National Conference of State Legislatures, *State Budget Actions 1997* (Denver, 1997), p. 35.

Georgia's Food Exemption: Who Will Pay the Price?

Under recent legislation, Georgia reduced its tax on food for home consumption from the four percent general sales tax rate to two percent on October 1, 1996, and then to one percent on October 1, 1997. Taxation of food is scheduled to be eliminated on October 1, 1998. The exemption for food reduced tax receipts by $125 million in fiscal 1997 and will reduce revenue by $500 million annually — about four percent of total state revenue — when fully phased in. Local sales taxes enacted before October 1, 1996, and all special-purpose local sales taxes may follow the exemption at the option of the local government.

The bill was passed partly in response to complaints that Georgia's tax system was highly regressive. Georgia's income tax fails to redress this problem; it has a virtually flat rate structure and offers only a modest credit to offset the burden of other taxes on low-income taxpayers.

During the last two years, the state considered several ways to cut taxes other than exempting food from the sales tax. A legislative study commission recommended raising the personal exemption and standard deduction for the income tax; this change would have distributed the tax cut relatively evenly among families earning more than $15,000 but would have provided no relief to most families earning less than $11,000. (The personal exemption was increased in 1998.) The commission also recommended expanding the sales tax to include more services. A proposal to offer tax credits to property owners of up to $250 for property taxes paid to local governments passed the legislature in 1995 but was vetoed on the grounds that it violated the state constitution.

The exemption of food will make Georgia's tax structure somewhat less regressive and compares favorably with the alternatives considered at the time by the legislature. However, neither the governor nor legislative leaders have indicated how they will compensate for the $500 million in lost revenue. Even without the tax cut, the legislative study commission predicted in 1995 that revenues will grow more slowly than government expenditures for the rest of the decade, resulting in a $2.2 billion deficit — 14 percent of revenues — in the year 2000 unless changes are made.

The fiscal 1997 budget financed the initial reduction in sales tax revenue in part with large cuts to the state's Department of Human Resources, including cuts to programs for low-income families. Further cuts in these and other programs so far have been averted by unusually strong economic growth and caseload decline, circumstances that may or may not continue in future years. Unless the state finds other ways to compensate for the revenue loss, the effectiveness of the food exemption in providing relief to low-income households could be blunted.

Sources. "Final Report of the Joint Study Commission on Revenue Structure," reprinted in *State Tax Notes*, April 10, 1995. *Atlanta Journal and Constitution*, various articles.

A sales tax exemption is well targeted toward lower-income families in another way as well. To receive a tax reduction, a family need not file any forms. As discussed n the next chapter, a filing requirement poses a significant barrier to lower-income families that are eligible to receive tax relief. In addition, with a sales tax exemption, a family need not wait for a refund to be processed; the benefits show up immediately in reduced weekly grocery bills. For families struggling to make ends meet or to remain off welfare, immediate tax relief may be more useful than a lump-sum credit that is received once a year.

Critics of a food-tax exemption note that because well-off families spend more *absolute* dollars on food than poor families — purchasing steak, exotic produce, and fancy cheese in addition to milk and bread — the majority of the benefits from a tax exemption go to families earning above the median income.[27] This criticism is true to some degree. The data in Table 1 show that an average family of three or four with income of at least $70,000 spent about $4,500 on food for home consumption, while a family with income between $20,000 and $29,999 spent less than $3,300. There are a variety of ways other than taxing food, however, in which a state can recover some or all of the income lost by exempting higher-income households from the food tax. For example, states can adjust their income tax rates or can tax services used primarily by higher-income residents.

Finally, the extent to which an exemption for food purchases under the sales tax benefits low- and moderate-income families may depend on how the state budget accommodates the revenue lost by exempting food. (See "Georgia's Food Exemption: Who Will Pay the Price?" on page 22.) If the revenue is replaced by making the income tax more progressive, for example, the exemption will benefit the low-income population. Similarly, if the lower revenue resulting from a food exemption is accommodated by reducing spending on programs that do not primarily assist low- and moderate-income households, it is likely that low-income households will receive the intended benefits of the food exemption.

Caution should be exercised, however, in considering proposals to pay for a food exemption by raising the general sales tax rate on the remaining items covered by the sales tax. Although states vary in the specific consumption items they tax, all state sales taxes — with or without a food tax — are regressive. The primary reason is that households at higher incomes levels tend to save more and consume less as a proportion of their income than do families at lower income levels. As a result, a dollar-for-dollar swap of a food exemption for a rate hike would lighten the tax load on low- and moderate-income families only slightly. If the revenue loss cannot be offset through substitution of income tax revenues or other progressive means, it might be possible to offset the revenue loss by broadening the tax base to include more services. Depending on the services included, expanding the sales tax base to include services could be a less regressive choice than raising the sales tax rate, and it would have the added benefit of increasing revenue growth.

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[27] Efforts to narrow the exemption to food "necessities" have tended to focus on taxing snack foods, a focus that creates administrative problems without necessarily improving the distributional consequences.

With most states in relatively solid fiscal condition, many state policymakers believe that tax cuts can be enacted without the need to enact offsetting tax increases or spending cuts. In effect, these states have already made the decision to cut taxes and are in the process of deciding which tax to cut. The taxes chosen for reduction will have a major impact on whether the resulting tax relief is targeted toward low- and moderate-income taxpayers or toward higher-income taxpayers. The tax systems of most states are already significantly regressive; that is, they take a larger proportion of the income of lower-income families than of more affluent families. This regressivity is largely because states derive about half of their revenues — 49 percent in 1995 — from sales and excise taxes. States that choose to cut top income tax rates or reduce income tax rates across the board will benefit higher-income taxpayers disproportionately and will exacerbate the regressive nature of state and local taxes. Alternatively, eliminating the sales tax on food can provide some tax relief to all taxpayers while giving low- and moderate-income taxpayers a higher proportion of benefits relative to income.

Administrative Issues

Difficulty of administration is a third issue sometimes cited as a problem associated with exempting food from the sales tax. Sales tax exemptions can create headaches for tax administration because they lead to classification and compliance problems. For example, New York (like many other states) exempts food but taxes candy and many soft drinks. State administrators have interpreted this law to mean that chocolate-covered peanuts and large marshmallows are taxed but plain peanuts and small marshmallows are not.[28] Retailers often object to enforcing such fine distinctions. Similar problems arise from the need to differentiate food for home consumption from take-out meals, particularly since many grocery stores now offer take-out food.

One solution to this problem — the approach selected by Georgia, Missouri, and North Carolina — is to follow the classification system set up by the U.S. Department of Agriculture to identify items eligible for purchase under the federal food stamp program. Under federal law, food stamps may be used only to purchase "food," and the Department of Agriculture defines such items broadly to include most edible grocery store items, including snack food and non-alcoholic drinks but excluding prepared meals. The vast majority of grocery stores accept food stamps, and in most cases have programmed their store scanners to recognize which items are defined by the federal government as "food" and which are not. By piggybacking on the federal definition, states should find it

[28] Steven D. Gold, "Simplifying the Sales Tax: Credits or Exemptions?" in William F. Fox, ed., *Sales Taxation: Critical Issues in Policy and Administration* (Westport, Conn: Praeger, 1992), p. 162.

relatively easy to determine what counts as food and what does not, and most stores should find it relatively easy to determine which purchases to tax and which not to tax.[29]

Another practical barrier to exempting food is the practice in most states of "piggybacking" local sales taxes onto the state-defined sales tax base. Of the 20 states that tax food at the state level, 17 allow local governments to levy sales taxes. In 13 of those states, the local sales tax base is required by law to conform to the state tax base. In the other four states, conformity is the traditional practice but is not required by state law. (See Table 6.) Conformity makes the sales tax easier to administer and easier for retailers to collect.

But conformity also means that if a state chooses to exempt food, local governments stand to lose a significant amount of revenue. In many of the states that tax food, local governments depend heavily on sales taxes; the average city or county in Alabama, Oklahoma, and Louisiana, for instance, derives over one-third of its tax revenue from general sales taxes. Those local governments may object vigorously to losing the portion of tax revenue that comes from taxing food, especially because state law often constrains the revenue options available to localities.

At the same time, high local sales taxes mean that a state-only exemption would go only partway toward lifting the food-tax burden on residents. In some places (certain cities in Alabama and Louisiana, for instance), a state exemption would eliminate less than half of the total tax on food. Exempting food at the state level thus often requires a legislature to weigh carefully the fiscal difficulty of lost revenue for local governments, the practical difficulty of administering different state and local sales tax bases, and the possibility that a state-only exemption might reduce benefits to families.

One compromise to the state/local dilemma — the alternative selected by Georgia — is to allow local governments to choose as a local option whether to tax groceries. Such a compromise, however, may provide more relief to the wealthy than to the poor. Localities with low-income residents may be unable to absorb the revenue loss and thus may keep the food tax, while those with wealthier residents may have a

[29] Georgia and Missouri are including some minor modifications to the food stamp rules. For instance, vending-machine food may not be purchased with food stamps but is covered by the Georgia and Missouri exemptions; on the other hand, vegetable seeds for gardening are eligible for food stamps but will continue to be taxed in Georgia.

Table 6
State and Local Sales Taxes and Exemptions for Food

	No State Sales Tax	State Sales Tax — Food Exempt	State Sales Tax — Food Not Exempt
No local sales tax	Delaware Montana New Hampshire Oregon	Connecticut Indiana Kentucky Maine Maryland Massachusetts Michigan New Jersey Rhode Island Vermont	Hawaii Mississippi West Virginia
Local sales taxes follow state law on food exemption		California Florida Iowa Minnesota Nebraska Nevada New York North Dakota Ohio Pennsylvania Texas Washington Wisconsin	Arkansas Georgia (until 1998[e]) Illinois[a] Kansas Missouri[b] New Mexico North Carolina[b] Oklahoma South Carolina Tennessee Utah Virginia Wyoming
Local governments have option to tax food	Alaska	Arizona Colorado Georgia (beginning in 1998)[e]	Alabama[c] Idaho[d] Louisiana[f] South Dakota[g]

Note. The District of Columbia has a sales tax that exempts food.
[a] Illinois taxes food at the state level at a lower rate than other goods. State law excludes food from the sales tax base for some local governments and includes it for others.
[b] Missouri and North Carolina tax food at lower rates than other goods. Food remains fully taxable under local sales taxes.
[c] Alabama cities must follow state law on exemptions. Counties may follow their own enabling legislation, but most follow state law.
[d] In Idaho the three cities with general sales taxes are not required to tax all goods taxed by the state sales tax, but none have specific food exemptions.
[e] Georgia taxes food at a lower rate than other goods. As of October 1, 1998, Georgia will exempt food from the state sales tax and from newly enacted local taxes. Local governments may choose whether to exempt food from sales taxes enacted before October 1, 1996.
[f] Louisiana taxes food at the state level at a lower rate than other goods. Local governments set their own sales taxes, but most tax food at the same rate as other goods.
[g] In South Dakota cities that choose to tax food are subject to a lower tax limit for food for consumption at home (one percent) than for other items (two percent).

Sources. Commerce Clearing House, *State Tax Guide.* Individual state revenue departments.

stronger tax base and therefore can afford to exempt food. An example is provided by Arizona, where three-fourths of the 81 cities tax food as a local option. A 1991 study showed that Arizona cities with lower per capita incomes were more likely to tax food. Thus, if an option is provided, cities with the largest concentrations of residents likely to benefit from a food exemption could be the least likely to choose the exemption.[30]

A better solution to the problem of local exemptions might be for the state to require exemption of food at the local level but to replace lost local revenue with increased state aid or to authorize an additional source of revenue for local governments, such as a sales tax on services or a local income tax.

[30] Helen F. Ladd and Dana Weist, "General Sales Taxes," in Theresa J. McGuire and Dana Wolfe Naimark, eds., *State and Local Finance for the 1990s: A Case Study of Arizona* (Tempe, AZ: School of Public Affairs, Arizona State University, 1991).

III. Tax Credits to Offset the Sales Tax on Food

Despite the benefits of sales tax exemptions for food noted in the previous chapters, the public finance literature often views such exemptions as an expensive and ill-targeted instrument by which to improve the sales tax. The alternative most commonly suggested by tax experts is a targeted, refundable food-tax credit for low-income consumers. Credits do little or nothing to improve the growth of sales tax revenue over time. Instead, they address the second major problem with the sales tax on food — its regressiveness.

In theory, a food-tax credit can provide comparable benefits to low-income families at a substantially lower cost than a food exemption. A study in Minnesota, for instance, found that the state could create a broad sliding-scale credit, targeted to low-income families, for one-third the cost of its food exemption.[31] For practical reasons, it generally is not recommended that such a credit be tied to actual food purchases. Rather, credits generally are based on a fixed per-family or per-person amount, sometimes adjusted the basis of family income. Even so, the ability to target can provide substantial benefits to low- and moderate-income families at a relatively low cost.

Credits can have other benefits. A credit for groceries can be targeted directly to residents of a state, while an exemption for groceries may provide benefits to a significant number of out-of-state visitors as well (especially in a major tourist state). Furthermore, a credit avoids the complication of ensuring that retail stores properly distinguish between food and non-food items.

States' Experiences with Credits to Offset the Food Tax

In practice, credits have performed less well than their theoretical promise. Four states — Georgia, Hawaii, Idaho, and Oklahoma — now offer modest credits on income tax

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[31] Steven D. Gold, "Simplifying the Sales Tax: Credits or Exemptions?" p. 160.

returns designed explicitly to offset some part of the grocery sales tax; the credits are "refundable" so that families with no income tax liability may nonetheless claim the credits.[32] Three other states — South Dakota, Wyoming, and Kansas — offer direct rebates that are administered outside of an income tax. Table 7 shows the structures of these credits. The experiences of states that have created credits or rebates to offset the sales tax on food have raised a number of issues.

- Will a state structure the credit to provide significant relief to low-income households?
- Will the credit reach all or nearly all of its intended recipients, including households that otherwise would not be required to file income tax returns?
- Can the credit be sustained over time, including periods in which tight fiscal conditions make it an attractive target for cutbacks?

Structuring the Credit

Existing credits and rebates designed to offset the sales tax often fail to provide significant relief for many low-income families. To offset fully the sales tax on food for the low- and moderate-income families on which it imposes a significant burden, a credit or rebate should meet two tests. First, it should be available to all poor and near-poor individuals and families who are exposed to the tax. Second, it should be large enough to offset the sales tax on a family's grocery purchases. None of the seven states now administering sales tax credits or rebates meet these two tests.

Credits Are Not Available to All Low- and Moderate-Income Households

In five of the seven states, the credit or rebate is so narrowly targeted that it is unavailable to many needy families; the exceptions are Hawaii, where all residents are

[32] Until recently, New Mexico and Vermont also had tax credits designed to offset sales taxes, but these have been repealed in both states. Louisiana has had a provision on the books since 1984 providing a $50 per person credit or rebate to those deemed "certified poor," but this provision has never taken effect; see Steven D. Gold and David S. Liebschutz, *State Tax Relief for the Poor*, 2nd ed., (Albany, NY: Nelson A. Rockefeller Institute of Government, 1996), p. 88.

Table 7
States with Refundable Credits or Rebates to Offset Food or Other Sales Taxes, Tax Year 1995

State (General Sales Tax Rate)	Rebate or Income Tax Credit	Amount of Credit	Major Eligibility Requirements	Annual Cost to State
Hawaii (4%)	Credit	$27 per exemption	Available to all residents	$24 million (calendar year 1995)
Oklahoma (4.5%)	Credit	$40 per exemption	Gross household income < $12,000; for welfare recipients, credit is folded into monthly payment	$13.4 million[a] (calendar year 1995)
Idaho (5%)	Credit	$15 per individual ($30 for elderly)	Available to all residents *except* non-elderly households with income lower than state income tax filing requirement ($5,400 for married filing jointly)	$18.2 million (calendar year 1996 estimate)
Georgia (4%)	Credit	$5 to $26 per exemption	Income < $20,000	$15 million (fiscal year 1995-96)
South Dakota (4%)	Rebate (state has no income tax)	$46 to $258 for individual, $74 to $581 for household.	Elderly or disabled persons with household income < $12,000	$1.4 million (fiscal year 1995-96)
Wyoming (4%)	Rebate (state has no income tax)	Up to $500 for individual, $600 for married couple	Elderly or disabled persons with limited assets and with household income < $11,000 for joint filers, $7,500 for single.	$1.7 million (fiscal year 1995-96)
Kansas (4.9%)	Rebate (separate from state income tax)	Up to $40 per head of household, $30 per dependent.	Families with children and elderly or disabled persons; income < $13,000.	$2.2 million (fiscal year 1994-95)

Note. Tax rates shown do not include local sales taxes.
[a] Includes $5.6 million paid directly to families through the tax system and $7.8 million distributed to low-income households by the Department of Human Services.

Sources. State revenue and human services departments; Steven D. Gold and David S. Liebschutz, *Sales Tax Relief for the Poor* (1996).

eligible for the credit, and Georgia, where most low-income families are eligible for the credit.[33]

- Two states, Wyoming and South Dakota, offer rebates only to the impoverished elderly; other poor individuals and families are not eligible.

- The other three states — Kansas, Oklahoma, and Idaho — make credits or rebates available to non-elderly persons but exclude many needy families from receiving the credit. The Kansas rebate is available only to families with children, the elderly, and the disabled.[34] Kansas and Oklahoma each has an income ceiling for the credit that is well below the poverty line for families of four. And Oklahoma bans low-income families from receiving the credit if they receive certain forms of public assistance — even if that assistance is a small part of a family's income or is received for only part of the year.[35] Idaho provides the credit only to families that meet the state's minimum income tax filing requirement ($5,400 for married couples filing jointly); this eliminates working and non-working poor families with incomes below this threshold.

Credits Tend to Be Inadequate

South Dakota and Wyoming offer substantial rebates to low-income elderly households; these rebates are intended to offset not only the sales tax on groceries but also other sales taxes and, in the case of Wyoming, property taxes as well. In the five states in which the credit or rebate is not restricted to the elderly, however, the amount of the credit

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[33] Until 1997, Georgia state law denied the credit to families that received food stamps, but this restriction has been removed.

[34] This chapter describes the structure of the Kansas food tax rebate as it existed in March 1998. At the time this report was completed, the Kansas legislature had passed an expansion of its food tax rebate. If signed by the governor, this legislation will increase the amount of the rebate, expand its availability to more poor and near-poor families, and allow eligible families to claim the rebate on their income tax forms. However, the amount of the credit will remain insufficient to offset the full sales tax on food for a typical family with poverty-level income.

[35] Oklahoma denies the credit to families that receive welfare through Temporary Assistance to Needy Families (the successor to Aid to Families with Dependent Children) for any part of the year, thus increasing the cost of living for families on welfare and diminishing the effectiveness of that program in bringing children out of poverty. The source of this provision was a 1992 decision to offset a proposed cut in benefits by folding the sales tax credit for welfare recipients into the welfare payment. By cutting the credit rather than the welfare benefit, the state avoided a loss of federal matching funds.

is inadequate to offset the sales tax on food paid by a typical family. On average, only half of the sales tax on food paid by eligible families is rebated in these states.

The federal government each year estimates the bare minimum amount of spending necessary for a family to purchase what the government considers an adequate diet. In 1995 for a family of four, the cost of this diet — known as the "Thrifty Food Plan" — was about $382 per month, or nearly $4,600 per year. (The cost of the Thrifty Food Plan in Hawaii, where food prices are dramatically higher than in the continental United States, was estimated at $7,950.) State sales tax rates in the five states with general sales tax credits or rebates range from four percent to five percent, so a household of four following the Thrifty Food Plan (in a state other than Hawaii) would pay about $180 to $230 per year in sales on food ($4,600 x .04 = $184; $4,600 x .05 = $230). But the maximum available credit or rebate in the five states ranges from $60 to $160, generally much less than needed to offset the cost of the sales tax on food. As Table 8 shows, the credit or rebate available to a "thrifty" family of four in any of the states offering credits in 1995 offset only between one-quarter and three-quarters of the state tax on groceries.

Moreover, none of the sales taxes on food that are levied by *local* governments in four of the five states were offset or rebated. Local sales taxes on food are as high as two percent in Kansas, Georgia, and Idaho and four percent in Oklahoma. (Hawaii has no local sales tax.)

Some states offer credits on a sliding scale — that is, credits that decline in value as incomes rise. The practice of offering sliding-scale credits that begin to phase out at relatively low income levels tends to erode further the value of the offsets available to low- and moderate-income families. Thus, poor families with incomes over $6,000 in Georgia or over $5,000 in Kansas are eligible for only a portion of the maximum credit, which itself covers less than the full amount of the food tax. As a result, a family of four with an income of $10,000 in Kansas receives a credit of just $65, one-half the maximum credit. For that family, the credit could have offset only 29 percent of taxes paid on groceries.

Credits Diminish or Erode over Time

At times in the last 15 years, a few states offered exemplary credits. Notable among these states were Hawaii, until 1995, and New Mexico, until 1986. Hawaii has a broad four percent sales tax that covers not just food and tangible goods but also medical and other services. For several years, the state offered a credit of $55 per family member to offset the tax on food, providing substantial relief. In 1991 the credit covered 80 percent of the tax on groceries paid by a family of four abiding by the Thrifty Food Plan for Hawaii, despite the extraordinarily high cost of groceries in that state. The food credit, along with other sales tax credits for medical services and other necessities, cost the Hawaii treasury about $85 million, or 6.7 percent of the state's sales tax revenue in 1991. Of that amount, about $18

Table 8
Food Sales Tax Credits/Rebates Available and Actual Sales Taxes Paid by a "Thrifty" Family of Four in 1995

State	Maximum Available Credit or Rebate	State Sales Tax on Groceries[a]	Portion of Tax Offset by Credit or Rebate
Idaho	$60	$229	26%
Hawaii	$108	$318	34%
Georgia[b,c]	$104	$183	57%
Kansas[b]	$130	$224	58%
Oklahoma	$160	$206	78%
Average	$112	$232	51%

Note. This table excludes the effects of local sales taxes on food. Local sales taxes are as high as four percent in parts of Oklahoma and two percent in parts of Kansas, Georgia, and Idaho, and they are not offset by credits or rebates. Hawaii has no local sales tax.
[a] Based on the federal government's "Thrifty Food Plan" for a family of four, which for 1995 was $4,584 ($7,950 in Hawaii).
[b] Figures reflect the maximum credit amounts, which in 1995 were available only to families with very low income (below $6,000 in Georgia, below $5,000 in Kansas). Other eligible families received smaller amounts.
[c] Georgia taxed food fully at the general four percent rate in 1995 but reduced the rate in 1996.

million was targeted directly to the poor.[36] Unfortunately, these credits were scaled back sharply beginning in the 1995 tax year. (See discussion at the end of this chapter.)

New Mexico, which like Hawaii has a broad four percent sales tax on goods and services, also used to have an exemplary credit program. The state offered two excise tax rebate programs, one for medical and dental expenses and one for food. The credit for food purchases was $45 per exemption for residents with incomes up to $30,000 and smaller amounts for residents with incomes between $30,000 and $45,000. Because of fiscal

[36] State of Hawaii, Department of Taxation, *Tax Credits Claimed by Hawaii Residents, 1991* (Honolulu, 1992) and U.S. Department of Commerce, Bureau of the Census, *State Government Finances: 1991* (Washington, D.C. , 1993).

problems, the food credit was suspended in 1986 for all families with incomes above $10,000 and was repealed in 1993.[37] (See discussion below.)

New Mexico continues to have a "Low-Income Comprehensive Tax Rebate" that is intended to offset the burden of all state and local taxes on the poor. The rebate is limited in scope. In March 1998, the state enacted the first expansion of the rebate in a number of years, increasing the credit to $85 for a family of three at the poverty line and to $80 for a family of four at the poverty line. The credit is not adjusted for inflation automatically, so it is likely to erode in value over time.

In any state, credits that are not automatically adjusted for inflation fail to keep up with the sales tax burdens they were intended to offset. For example, from 1987 to 1998 Kansas failed to adjust for inflation either its $13,000 household income limit or the amount of the refund. As a result, the eligibility limit — once 12 percent *higher* than the federal poverty threshold for a family of four — fell to 19 percent *lower* than the federal poverty threshold, resulting in the exclusion of increasing numbers of poor households from the program. For households that still qualified, the value of the rebate eroded as a result of food price inflation and a general increase in the sales tax rate in the early 1990s. In 1987, the maximum refund offset about 95 percent of the state sales tax that a family of four would pay if they purchased the U.S. Department of Agriculture's minimally adequate Thrifty Food Plan; in 1995 the credit offset about 58 percent of the tax on that family's groceries. As a result of the failure to adjust either the income eligibility criteria or the value of the credit for inflation, the total amount of rebates provided to Kansas residents declined steadily from $3.8 million in 1988 to about $2.2 million in 1995. The amount of state funds devoted to the credit declined even though both the number of Kansans in poverty and the amount of food taxes paid by each Kansas household increased.

In theory a credit can be designed and funded at a level sufficient to offset the cost of the sales tax on food for low- and moderate-income households. Nevertheless, experience suggests that credits of this level either are not enacted or cannot be sustained. The difficulty in sustaining credits is discussed further below.

Reaching the Intended Recipients of a Credit or Rebate

Another challenge to the success of a credit or rebate in offsetting the sales tax on food is the difficulty in reaching the intended recipients. Rebates are administered outside existing tax systems and thus depend wholly on public awareness. Tax credits are easier to bring to the attention of potential recipients because they are typically administered through the income tax, which most people file anyway. Many poor families who are

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[37] Steven D. Gold, *State Tax Relief for the Poor*, (Denver: National Conference of State Legislatures, 1987), pp. 76-77.

among the intended beneficiaries of the credits, however, do not normally file state income tax returns because their incomes are too low.

To be successful, therefore, a credit or rebate generally has to be large enough to be worth the effort of filing a tax return or rebate claim and has to be accompanied by an aggressive outreach campaign that publicizes the availability of the credit and the method by which it can be claimed. The contrast between participation in the Kansas rebate and in the New Mexico and Hawaii credits illustrates the importance of these two features.

- The Kansas credit to offset sales tax paid on food is a classic example of failure to achieve participation. Since 1986, the Kansas Food Sales Tax Refund Program has covered households that have income less than $13,000 and that contain at least one child under the age of 18 or an elderly, blind, or disabled person. The refunds are administered separately from the state income tax, so that anyone who qualifies must file separately. Kansas officials originally estimated that 38 percent of the 246,000 eligible households would participate. Even this conservative estimate proved too high. After three years, only 34 percent of eligible households were claiming the credit. Participation rates rose modestly during the recession of the early 1990s but then fell again, to about 33 percent in 1994.[38]

- New Mexico and Hawaii, on the other hand, had considerable success encouraging participation in their rebate programs. New Mexico estimates that between 85 percent and 95 percent of the eligible population receive the Low-Income Comprehensive Tax Rebate, the state's only remaining credit. New Mexico officials attribute their success to extensive outreach efforts, including the maintenance of 10 field offices throughout the state to assist residents in filing for the rebates. This participation rate was achieved after 16 years of experience with the Low-Income Comprehensive Tax Rebate in a relatively small state. It is unclear whether the larger excise tax credits that were formerly available along with the rebate also played a role in attracting participation.

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[38] The Kansas Department of Revenue reports that 47,000 households filed for refunds in 1994. A Center on Budget and Policy Priorities analysis of microdata from the federal Current Population Survey shows that about 143,000 Kansas households in 1994 met the eligibility standards, for a 1994 participation rate of about 33 percent. Comparable analyses of data for 1990 and 1992 show participation rates of 44 percent and 46 percent respectively. Since Current Population Survey data are subject to substantial sampling error, the apparent fluctuation might be simply the result of such errors. In any case, the actual participation rate clearly remains well below 50 percent. The participation rate will likely increase in future years as a result of new legislation increasing the size and scope of rebates and allowing taxpayers to claim the rebate as a credit on their income tax forms.

- Hawaii conducts an extensive outreach and information campaign for its credits. For the tax year 1994, the latest year for which data are available, Hawaii's tax department reported 92-percent participation in its food credit, which was the refundable $55 credit per exemption available to all residents (since reduced to $27 per exemption). That participation rate reflects the percentage of income tax filers that claimed the credit. A more accurate estimate might be obtained by dividing the total number of credits claimed, about 950,000, by the state's 1994 civilian population of 1.13 million, for a participation rate of 84 percent. Analyst Steven D. Gold points out, however, that the non-participants were likely to be found disproportionately among lower-income groups because lower-income households are not required to file tax returns.[39] In addition, although data are not yet available, the reduction of this credit and the elimination of the other two credits effective in tax year 1995 probably reduced the financial incentives for low-income people who did not owe taxes to file returns to claim the credit. As a result, participation is likely to have declined.

- The experience with the federal Earned Income Tax Credit, which is claimed by about 80 percent to 85 percent of eligible families, is also instructive. This high participation rate results largely from extensive outreach efforts over many years by the Internal Revenue Service and an annual outreach campaign conducted by more than 6,000 nonprofit and business organizations nationwide. The number of families with children receiving the credit nearly doubled from 1988 to 1995, partly owing to expansions of the credit and increases in the number of working poor families, but also owing in large part to expanded outreach efforts.

These examples suggest that unless a state is willing to make a commitment to aggressive outreach and promotion of a credit, the credit is unlikely to act as an effective offset to the sales tax on food.

Credits Are Vulnerable During Fiscal Crises

Another issue is whether credits will be sustained or cut when a state faces fiscal difficulties. States have a history of frequently modifying tax credits. During periods of fiscal stress, such as when revenues decline in a recession, credits often have been suspended, reduced, or eliminated as a readily available means of increasing revenues. Although the repeal of a food exemption would require a long lead time to allow retailers to reprogram their equipment and would impose costs of adjustment on state businesses, a

[39] Gold, "Simplifying the Sales Tax," pp. 162-167.

credit could simply be suspended any time before the filing season begins. Furthermore, since credits generally are claimed in the year following the one in which expenditures were made, suspension of a credit late in the year still would yield revenue equivalent to the entire year's intended tax relief. In contrast, an exemption may be repealed only prospectively.

The sales tax credit programs in Hawaii and New Mexico in the 1980s were in many ways models for the nation, as was a comparable property tax credit for renters in California. All three, however, have now largely fallen victim to fiscal stress.

- New Mexico's tax credits were broadly targeted in the 1980s to families of modest means but were narrowed in 1986 to apply to only the poorest families. The limited medical and food credits were fully repealed during the fiscal crisis in 1993; the money saved was said to be used to finance Aid to Families with Dependent Children and health programs.

- California's property tax credit for renters provides another example of repeal or suspension during times of fiscal distress. The renters' credit program, a refundable tax credit intended to offset the cost of property taxes passed from landlords to tenants through rents, was limited to low- and moderate-income households in fiscal years 1991 and 1992 and has been suspended entirely since fiscal year 1993.

- Hawaii, unlike the other two states, expanded its credits in the late 1980s to cover more taxpayers. But in 1995, facing fiscal strain, Hawaii eliminated two of its tax credits (the credit for medical services and the low-income excise tax credit) and halved the food credit from $55 to $27 per family member.[40]

The examples of New Mexico and California suggest that narrowly targeted credits may not have sufficient political support to be sustained during a fiscal crisis. The experience of Hawaii, however, shows that even broad-based credits are not immune to fiscal pressures.

Designing a Credit That Works

States have confronted substantial problems in implementing sales tax credits. But these problems are not insurmountable. A model credit to offset the sales tax on groceries would have the following features:

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[40] The credit for medical services was maintained for nursing facility care only.

- The credit would be either (a) available to all households or (b) available in the full amount to households with incomes below 150 percent or 200 percent of the poverty line, and would be phased out gradually as household income increased above 200 percent of the poverty line.

- The credit would vary with the number of individuals in a household to reflect the greater amount of food purchased by large families.

- If possible, the credit would be administered through a state income tax and would be fully refundable to offset the sales tax on groceries for all eligible families. (A credit that is not refundable would offset only income tax liability, not sales tax payments.) A rebate program outside of an income tax is also a viable option.

- Intensive outreach efforts would accompany the credit.

- The credit would be large enough to offset the full amount of state and local food taxes paid by a family at the poverty line and would be adjusted automatically each year to reflect food cost inflation. These goals would be accomplished by linking the credit to the federal government's Thrifty Food Plan, which computes the lowest possible cost of a nutritious diet for a family of a given size and composition. (In 1997, the Thrifty Food Plan for a two-parent family of four in the lower 48 states cost $4,950 per year; for a single person it cost $1,400.) Since the Thrifty Food Plan is adjusted annually for changing food prices, such links would prevent inflation from eroding the credit's value.

- The credit would be built on a strong base of political support to ensure it survives in the long run.

- Since the credit would not alleviate the drag on revenue growth created by the food tax, other steps to improve revenue growth — such as broadening the sales tax base to include services — would be considered as well.

IV. Comparing an Exemption with a Credit

We can compare a food-tax exemption with a food-tax credit by considering the effects of alternative approaches on typical families. The comparison below considers a hypothetical food-taxing state with a five percent state sales tax and a two percent local sales tax that taxes food in the same manner as the state tax, for a total sales tax rate of seven percent. Three possible legislative proposals to ease the burden of the sales tax on food are examined.

- *Proposal One* would exempt food from state and local sales taxes altogether.

- *Proposal Two* would enact a targeted tax credit that resembles the credits now available to families in Georgia, Idaho, Kansas, and Oklahoma, the four states with tax credits targeted to low-income elderly and non- elderly families. Such a credit is assumed here to equal $30 per person, available to taxpayers with incomes of $15,000 or less.

- *Proposal Three* would offer a credit to low- and moderate-income families based on the federal government's Thrifty Food Plan and on the state's sales tax rate of seven percent. The full credit would equal $350 for a family of four ($4,950 x .07) and $100 for a single person ($1,400 x .07). Families with incomes below 150 percent of the poverty line would be eligible for the full credit. Half of the credit would be available to families between 150 and 300 percent of the poverty line, and no credit would be available to families above 300 percent of the poverty line. This proposal is designed to overcome the shortcomings of existing credits.

Table 9 shows the effects these proposals would have on five households of varying size and income levels.

- To a family of four with an income of $15,000 and a yearly grocery bill of $4,900, an exemption from the sales tax on food would provide an annual tax break of $343. That benefit would be comparable to the value of the model credit ($350) but well above the value of a credit similar to those existing in other states ($120).

- Moderate-income families also would benefit from either the exemption or the model credit; a family of four with an income of $30,000 (about 180 percent of poverty) would receive a tax break of about $364 from an exemption and about $175 from a model credit. A moderate-income family would receive no food-tax offset from a credit that resembled the credits now available in other states.

- An exemption would provide the largest benefit, in dollar terms, to the highest-income family — giving nearly $500 to a family earning $100,000, as compared with nearly $350 to the family earning $15,000. As a percentage of income, however, the benefit from an exemption would be greater for a poor family than for a higher-income family.

The different benefit patterns provided by an exemption and a credit must be weighed in tandem with the other advantages and disadvantages of each strategy. A tax exemption is less well targeted and more expensive, but it reaches all intended consumers. Furthermore, relative to income, the tax relief it provides is proportionally greatest for lower-income households. Exempting food also improves the long-term growth of sales tax revenue by removing a declining segment of consumption from the sales tax base. A tax credit or rebate can target benefits closely to a specific population and costs less than an exemption, but existing credits are inadequate to offset the full food costs of poor families and may not reach all of the intended recipients. In addition, history suggests that states will allow credits or rebates to erode in value with inflation and will reduce or repeal credits during times of fiscal shortfalls.

Table 9
How a Food Sales Tax Exemption or a Credit
Would Affect Families of Different Sizes and Income Levels in 1997

	Family of Four			Single Person	
Income	**$15,000**	**$30,000**	**$100,000**	**$7,500**	**$45,000**
Food spending (cash)	$4,900	$5,200	$7,000	$1,600	$1,840
Current tax on food @ 7 percent	$ 343	$ 364	$ 490	$ 112	$ 129
Tax saving from:					
Proposal 1 (exemption)	$ 343	$ 364	$ 490	$ 112	$ 129
Tax cut as percent of income	*2.3%*	*1.2%*	*0.5%*	*1.5%*	*0.3%*
Proposal 2 (typical credit)	$ 120	$ 0	$ 0	$ 30	$ 0
Tax cut as percent of income	*0.8%*	*0.0%*	*0.0%*	*0.4%*	*0.0%*
Proposal 3 (model credit)	$ 350	$ 175	$ 0	$ 100	$ 0
Tax cut as percent of income	*2.3%*	*0.6%*	*0.0%*	*1.3%*	*0.0%*

Note. Estimates of food spending are drawn from 1994-95 Consumer Expenditure Survey data, adjusted upwards to reflect systematic underreporting of food purchases in the survey (see Appendix for discussion of the underreporting issue) and adjusted for inflation to 1997.

V. Conclusion

State tax systems typically have two major shortcomings. First, they place an unnecessarily heavy tax burden on low- and moderate-income households. Second, in many states the revenue they generate does not grow at an adequate pace without periodic increases in tax rates. These shortcomings are exacerbated in states that levy their sales taxes on the purchase of grocery food because food consumption as a percentage of income is particularly high among the poor and because food purchases in the economy as a whole are declining as a share of total consumer spending.

Many states have addressed these shortcomings by exempting food from the sales tax or taxing it at a lower rate. Such exemptions make tax systems less regressive and improve revenue growth. Although full exemptions are not simple to implement, especially given the large loss of revenue associated with such a tax cut, the experiences of the 25 states that have full exemptions for food and the five that have lower rates for food suggest that the barriers to implementation may be overcome. Once sales tax exemptions for grocery food are enacted, they are not often repealed.

An alternative method of relieving the food tax is for a state to offset the tax payments with credits or rebates. Although this alternative does not improve revenue growth, it can reduce the regressiveness of state taxes and would cause less loss of revenue to the state than would an exemption. In practice, however, state credits and rebates have often been too small and too narrowly targeted to relieve the food tax on the poor fully. Credits and rebates are also less effective than exemptions because of low participation rates and because they have proved vulnerable to elimination in times of fiscal crisis. After more than a decade of experiments in more than half a dozen states, no state has yet developed and maintained a credit that even comes close to fully offsetting the food tax for all or most poor residents.

Appendix: Sources of Data on Food Expenditures

Data on food expenditures in this report are drawn from three major sources: the U.S. Department of Agriculture's annual publication *Food Consumption, Prices and Expenditures;* the U.S. Department of Commerce's National Income and Product Accounts; and the U.S. Department of Labor's Consumer Expenditure Survey. The Agriculture Department uses a detailed model, based on surveys of food producers and retailers plus Census Bureau data, to compute total food expenditures nationwide. The Commerce Department relies on similar sources. The Agriculture Department's aggregate results are probably the most reliable available, but they lack consumer-level detail that would show the differences in spending patterns by different groups of consumers; they also lack state-by-state breakdowns.

The Consumer Expenditure Survey calculates food spending from interviews with individual consumers. The CES is thus the only reliable source of information on how different households choose to spend their money, and almost all studies of food- spending patterns rely on CES data. A further advantage for state-level analysis is that CES data are available broken down by four regions. Nonetheless, the CES has some significant drawbacks.

- *The CES underreports income.* Because CES income estimates are drawn from interviews with individual households, income tends to be underreported. Compared with the Census Bureau's Current Population Survey, generally a more reliable source for income data, the CES understates income by 10 percent to 15 percent.

- *Expenditures may appear greater than income.* In the low-income ranges of the CES, the average family spends more money than it has in income, which seems illogical. Besides underreporting of income, there are several possible explanations. Households going through a period of unemployment or business losses may be spending down their savings. Students may be living off college loans. And retirees may be drawing down their pension funds.

- *Food purchases are underreported.* The CES asks households to keep a diary of food and other purchases over a two-week period. These diaries may vary in reliability, and they tend to understate total food purchases. For instance, the CES estimates that in 1993 100 million U.S. consumer units spent an average of $2,735 on food consumed at home (excluding alcohol); this implies nationwide food spending of $274 billion. The Department of Agriculture, using mostly producer and retailer sources of data, estimates that 1993 expenditures on food for consumption at home totaled $339 billion. The U.S. Department of Commerce's National Income and Product Accounts, from the *Survey of Current Business*, estimates 1993 food spending — food purchased for off-premises consumption, excluding alcohol and pet food — at $368 billion; the Commerce data are derived from Census Bureau surveys conducted every five years. The CES underestimates most other categories of spending as well.[41]

For purposes of understanding the relationships between food, other expenditures, and income, these shortcomings of the CES do not really matter, because the underestimations of income and food spending generally cancel each other out. The basic conclusions about food spending are not affected significantly. These conclusions are that food spending is a higher portion of income for low-income families than for high-income families and two, that the difference between the consumption patterns of low- and high-income families is greater for food than for other goods.

For calculating absolute dollar amounts — for instance, the appropriate size of a food-tax credit — the weaknesses of the CES data do matter. To design a state credit, it might be more appropriate to offset not what a typical family *reports* spending but rather what it *needs* to spend to purchase a nutritious diet. The federal Thrifty Food Plan estimates the minimum spending for a nutritious diet. As it turns out, the adjusted CES estimate of actual spending by low- to moderate-income families, adjusted upward to account for

[41] The Department of Agriculture figure includes purchases with food stamps. Other estimates of food purchases vary even more widely and are based on varying sources and methodologies. Two supermarket trade publications, *Supermarket Business* and *Progressive Grocer*, estimated 1993 food spending at $242 billion and $224 billion respectively, figures that do not include purchases at small food stores. See E. Raphael Branch, "The Consumer Expenditure Survey: A Comparative Analysis," *Monthly Labor Review*, December 1994; and *Consumer Expenditure Survey Bulletin* No. 2462 (September, 1995), pp. 10-11.

systematic underreporting in the CES, is not very different from the Thrifty Food Plan's recommended minimum spending. Food spending for the average low- to moderate-income family of four in 1994-95, estimated from the adjusted CES, was about $4,400; the Thrifty Food Plan for a family of four in the continental United States was $4,600.