

Building A Better Arkansas Tax System

Evaluating The Options

Winthrop Rockefeller Foundation Arkansas Tax System Study Advisory Committee

This study benefitted greatly from the expertise and experience of a diverse group of Arkansans. The final report is intended to provide objective information about the Arkansas tax system, and does not reflect a consensus among the advisory group members about the recommended future direction of tax policy in Arkansas.

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A Study Conducted for
The Winthrop Rockefeller Foundation

January 1997



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The authors want to thank our advisory committee for their wonderful interest and counsel. We also want to thank Sybil Hampton and Dianne Williams of the Winthrop Rockefeller Foundation for overseeing this project, Jim Metzger for invaluable research and coordination in Arkansas, John O'Hare of the Urban Institute, and various officials of the Arkansas government for technical advice.

Contents

INTRODUCTION	1
SUMMARY OF FINDINGS	2
CHAPTER ONE. ECONOMIC & SOCIAL INDICATORS	6
GENERAL ECONOMIC INDICATORS	6
INFRASTRUCTURE	9
EDUCATION	10
HEALTH	12
ENVIRONMENT	12
CRIME	14
SUMMARY	14
CHAPTER TWO. STATE & LOCAL PUBLIC SPENDING IN ARKANSAS	15
CHAPTER THREE. AN OVERVIEW OF THE CURRENT ARKANSAS TAX SYSTEM	16
ARKANSAS: A LOW-TAX STATE	16
TRENDS IN OVERALL ARKANSAS TAXES	18
TRENDS IN PARTICULAR ARKANSAS TAXES	18
THE CONSTITUTIONAL BIAS TOWARD CONSUMPTION TAXES	19
THE OVERALL DISTRIBUTION OF ARKANSAS TAXES	20
MORE DETAILED ANALYSES OF SPECIFIC ARKANSAS TAXES	21
I. THE ARKANSAS PERSONAL INCOME TAX	21
II. SALES AND EXCISE TAXES IN ARKANSAS	23
III. THE ARKANSAS CORPORATE INCOME TAX	26
IV. ARKANSAS PROPERTY TAXES	28
V. OTHER ARKANSAS TAXES	29
CHAPTER FOUR. OPTIONS FOR TAX REFORM IN ARKANSAS	30
REVENUE-RAISING OPTIONS	30
REVENUE-REDUCING OPTIONS	38
REVENUE NEUTRAL OPTIONS	42
CONCLUSION	45
STATISTICAL APPENDICES	46
ABOUT ITEP & THE ITEP MICROSIMULATION MODEL	53

BUILDING A BETTER ARKANSAS TAX SYSTEM

EVALUATING THE OPTIONS

State and local services and the taxes that pay for them are perennial—and contentious—issues all across the country. In recent years, these issues have become even more important, in Arkansas as well as elsewhere.

The federal government’s ongoing policy of shifting more and more governmental responsibilities to the states has forced almost every state, including Arkansas, to increase taxes over the past decade and a half, and that “devolutionary” trend is, if anything, accelerating in recent years. Demographic developments, as well as legal mandates and equity concerns, have created new pressures on public school finance. Tight government budgets in the past have left a decaying and sometimes inadequate infrastructure in many states, including Arkansas, that will soon need major repairs and improvements.

A rapidly changing world marketplace is requiring workers and businesses to acquire new skills to compete effectively, with major implications for educational policies. Heightened public concern about the environment offers opportunities to improve the quality of life, but not without both public and private costs. Vast improvements in health technology and knowledge have been a boon to those who can afford coverage, but have also been costly to both public and private budgets—and those growing costs, ironically, threaten to leave too many people without adequate care.

Meanwhile, with the economic boom of recent years, some states find themselves with surpluses in their treasuries. This has led some policymakers and members of the public to call for improved public services, while others advocate significant tax cuts.

As in other states, it is the job of Arkansas’s elected representatives, including the Governor and the legislature, to evaluate these conflicting claims. They must measure needs and set priorities. And ultimately, they have the responsibility to pay for necessary and important public programs adequately, fairly and in ways that allow Arkansas to be competitive with other states for the skills and investments that a prosperous economy demands.

This report attempts to provide Arkansas’s policymakers with a framework for making those critical decisions about tax policy in the upcoming years.

We begin with an overview of Arkansas’s economic and social indicators, with an eye to suggesting where Arkansas has done well, where it has fallen short, and where it may need to focus public resources in upcoming years. We then offer an assessment of Arkansas’s tax system as it now stands and how it has changed over the past decade and a half. And finally, we offer a number of detailed options for possible tax reforms in Arkansas, including ones designed to increase revenues to pay for public services, others that would cut taxes if revenues are deemed to exceed spending needs, and still others that shift taxes among income groups without adding or subtracting from receipts.

Due to the Institute on Taxation & Economic Policy’s extensive state-by-state computer tax microsimulation capabilities, we are able to offer new insights into the distributional impact of various tax policies on residents of Arkansas. Since the purpose of public policy is to improve the lives of the state’s citizens, we believe these insights should be especially useful to policymakers.

Summary of findings

Economic & Social Indicators

Over the past decade and a half, **income growth** in Arkansas has outpaced the national average. The bulk of this growth has been generated not by higher average wages, however, but rather by a sharp increase in the percent of the adult population in the workforce. In fact, average annual pay in Arkansas is little changed (in constant dollars) since 1981, and has actually fallen as a percentage of the national average. But Arkansas's employment as a percent of the population aged 16 to 64 has skyrocketed, from 75 percent in 1984 to 88 percent in 1994. As a result, employment as a percent of the population aged 16 to 64 is now slightly *higher* in Arkansas than in the nation as a whole.

As the share of Arkansas's adults working nears its maximum possible amount, the growth in the adult employment rate must slow down from the rapid growth rate of the past decade. This fact has important implications for the nature of future economic growth in Arkansas. Specifically, continued strong economic growth in Arkansas in the future will have to depend not on more people working more hours, but on workers becoming more productive. And that in turn, will require better skills and education and an improved public infrastructure, which together should attract more private investment.

Infrastructure, the adequacy and quality of roads, bridges, sewage systems and so forth, are among the primary factors that businesses consider when making investment location decisions. In terms of the condition of its existing infrastructure, Arkansas's situation is mixed. In areas such as bridge and sewer quality, Arkansas ranks equal to or better than other states. But when it comes to highways, it's another story. Although they may be adequate in the short term, they are likely to need significant repairs and improvements in the near future.

When it comes to **education**, Arkansas ranks very low by a number of measures, but it has made significant progress in recent years. The low level of average education in today's workforce is largely a function of Arkansas's failure to educate its population in keeping with national norms *prior to 1980*. Indeed, Arkansas's high school dropout rate is now approximately equal to the national average and its rate of school enrollment of five through 17 year-olds is the sixth highest in the nation, well above the national average. These latter trends bode well for the future.

In recent years, Arkansas's policymakers have apparently recognized that without a substantial increase in the

percentage of its population with college degrees or better, Arkansas will experience difficulty in creating and attracting high-skilled, high-paying jobs in the future. As a result, there have been some recent dramatic improvements in higher education. For example, the number of science and engineering graduate students in Arkansas grew at one of the most rapid rates of any state in the nation from 1989 to 1993. Research and development expenditures at doctorate-granting institutions likewise grew quickly from 1989-94. In both these areas, the gaps between Arkansas and the national averages are beginning to narrow, although Arkansas's rankings remain near the bottom compared to other states.

Unless these improvements accelerate, however, Arkansas's continued low rankings on higher education do not bode well for the state's regional and national competitiveness. Indeed, without improvements in the quality of Arkansas's labor force, the current boom in the economy will be difficult to sustain.

Health conditions of a state's population and the availability of medical care have major effects on the quality of life. They influence decisions about where to live and where to start a business, and they affect the quality and productivity of labor. Hence, health is one of the keys to economic growth and development, as well as a significant measure of a society's general well-being. Several measures indicate that health care is much less available in Arkansas than in most other places, although there is some evidence that Arkansas is catching up.

- In 1993, Arkansas ranked 42nd and had 72 percent of the U.S. average number of doctors per capita. That's an improvement, however, from 1981, when Arkansas had only 66 percent of the national average number of doctors per capita and ranked 46th.
- The percentage of Arkansas residents without health insurance has risen over the past five years, albeit at a slower pace than for the country as a whole. Arkansas health insurance coverage currently ranks 40th in the country.
- Finally, Arkansas ranks 38th in the percentage of its population that lacks primary health care within ready economic and geographic reach.

Environmental conditions like health conditions, have an obvious impact on the quality of life of citizens. They also influence economic conditions, although their effects on the economy are more subtle than their impact on quality of life. Businesses, like people, prefer safe, clean, and stable communities. Indeed, many businesses require clean environments in order to thrive. More and more, people are understanding that economic growth and environmental protection are often complementary and that a healthy environment can be essential to long-term,

sustainable economic growth. Indicators of environmental quality suggest that the quality of Arkansas's air is very good, while the quality of its water and soil are about average.

High crime rates discourage economic activity, contribute to community disintegration and cause businesses and families to flee. The good news is that the crime rate in Arkansas is well below the national average. Unfortunately, however, the crime rate in Arkansas has increased significantly from its 1980 level while it fell for the nation as a whole. In 1980, Arkansas had the 7th lowest crime rate in the country. By 1993, Arkansas ranked just 23rd. What is perhaps most disturbing about the rise in crime in Arkansas is that the violent crime rate has more than doubled since 1980.

Arkansas's future economy: In the past, Arkansas has largely pursued a low-wage path toward economic development. This path has now largely run its course. If Arkansas is to continue to make the transition from a low-wage to a high-wage economy, it must invest in its workforce and other assets to improve their quality. This means that further attention must be paid to improvements in infrastructure, education, health, safety and the environment.

Public Spending in Arkansas

Arkansas ranks 49th in total state and local expenditures per capita—30% below the national average. As a share of income, Arkansas's spending on public services ranks 40th among all states. From health care to workers' compensation, to welfare and to the arts, Arkansas is failing to close the public services gap with the rest of the nation in many areas. Yet that does not mean that Arkansas is failing to catch up in all areas. Education is an area in which Arkansas has made some progress in recent years.

Between 1980 and 1993, Arkansas's expenditures per pupil for elementary and secondary education rose significantly and much faster than the national average. As a result, Arkansas no longer ranks dead last in this area, as it did in 1980. But, Arkansas still spends far less per pupil than the national average. Between 1980 and 1993, expenditures for higher education grew faster in Arkansas than in all but one other state. Indeed, by 1993, Arkansas's per capita expenditures for higher education were roughly equal to the national average and its spending relative to personal income on higher education was above that of the average state. These trends in education expenditures should eventually help alleviate the shortage of Arkansans with college degrees or better, and help lead to more high-skilled, high-paying jobs.

Arkansas's Current Tax System

Arkansas: A Low Tax State

By any of the most commonly used measures, Arkansas ranks as one of the lowest taxing states in the nation.

- **On a per capita basis**, state and local taxes in Arkansas are only 69 percent of the national average, placing the state 48th among the 50 states.
- **As a share of total personal income**, Arkansas taxes, at 9.9 percent, are 10 percent below the national average, ranking it 43rd among all states.
- **As a share of gross state product**, Arkansas's taxes rank 39th in the nation. Total state and local taxes in Arkansas come to 8.5 percent of total output in the state, which is 11 percent below the national average. Between 1980 and 1993, tax revenues per capita and tax revenues relative to personal income grew slightly faster in Arkansas than they did in the nation as a whole. As a result, state and local taxes in Arkansas, while still low, have been slowly catching up to the national average.

Trends in Specific Taxes

The tax levels and growth trends of specific Arkansas taxes vary markedly:

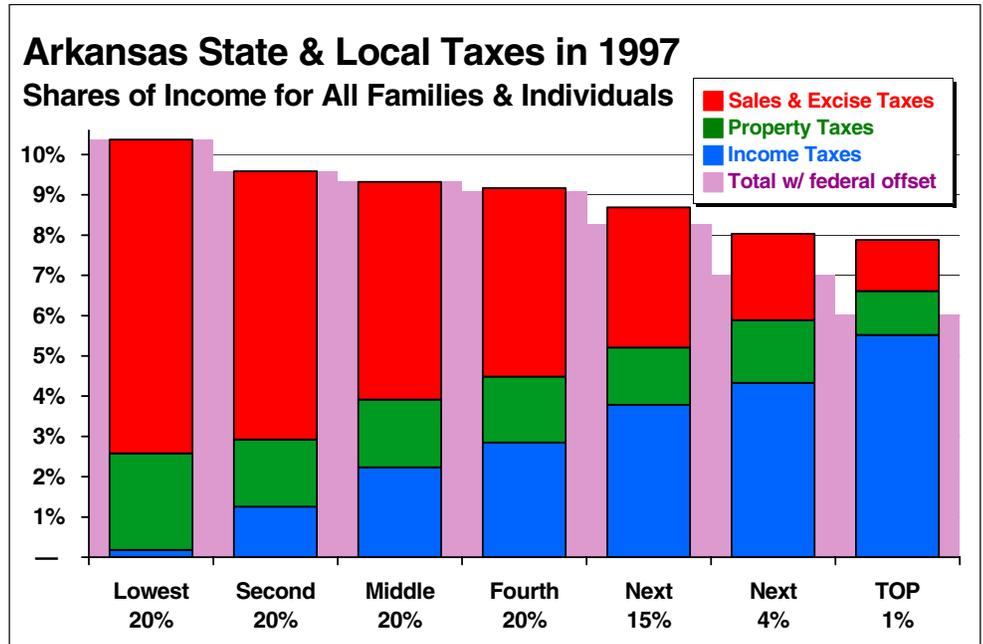
- Arkansas sales & excise taxes are high compared to other states, ranking 11th nationwide as a share of personal income and 9th as a share of total tax revenues. Between 1980 and 1993, Arkansas's sales and excise taxes grew from 4 percent of personal income to 4.9 percent—placing them 25 percent above the national average. As a share of total taxes, Arkansas's consumption taxes rose from 43 percent in 1980 to 50 percent in 1993, far higher than the 36 percent share nationwide. Arkansas's experience is contrary to the national trend, where consumption taxes have *not* risen either as a share of total taxes or as a share of income.
- Personal income taxes in Arkansas are the same share of personal income as the national average for all states—and slightly below average if states without income taxes are excluded.
- Property taxes are very low in Arkansas relative to average national property taxes, both as a share of personal income (1.6 percent) and as a share of total state and local revenues (16 percent). Between 1980 and 1993, property taxes in Arkansas *fell* by 12 percent as a share of personal income, while property taxes nationwide *rose* by 11 percent as a share of income. In 1993, Arkansas ranked 47th in property taxes as a share of personal income, lower than all of its neighboring states.

- Arkansas's corporate income taxes are about 10 percent below the national average as a share of the state's economy. As has been the case nationally, Arkansas's corporate taxes have declined over the years. Currently, Arkansas's corporate income taxes as a share of GDP are about 11 percent below their level in fiscal 1980, which tracks the national trend.

- Sales and excise taxes are extremely regressive. In total, these taxes take more than six times as large an income share from low-income Arkansans as they take from the very well off, and they hit Arkansans in the middle of the income scale more than four times as hard as the wealthy. Arkansas's heavy reliance on these kinds of taxes is a chief reason why its tax system is so much harder on ordinary families than on those at the top of the income scale.

Arkansas's Constitutional Bias Toward Consumption Taxes

The sharp rise in Arkansas sales taxes compared to other taxes reflects the state constitutional rule allowing a 25 percent minority in either house of the General Assembly to block any tax rate increase *except* an increase in the sales tax. The antiquated rule, dating back to the mid-1930s, is a major obstacle to providing Arkansas with a fairer and more stable tax system.



A Regressive Overall Tax System

Arkansas's overall tax system is regressive. That is, it requires middle and low-income families and individuals to pay a higher share of their incomes in taxes than the very well-off have to pay. Our microsimulation analysis of Arkansas's taxes finds that:

- The poorest fifth of all Arkansas taxpayers pays 10.4 percent of its income in total Arkansas taxes.
- Families and individuals in the middle of the income scale pay 9.3 percent of their income in Arkansas taxes.
- But the very best-off Arkansans, the top one percent, pay only 7.9 percent of their income in Arkansas taxes.

As this report describes in detail, not all the major elements of Arkansas's tax system are regressive. On the contrary, Arkansas's different kinds of taxes differ markedly in their impacts on families at different income levels:

- The personal income tax is progressive, with effective tax rates ranging from close to zero on the lowest-income taxpayers up to 5.5 percent on the best-off Arkansans.
- Property taxes on families are somewhat regressive, although very low.

Tax reform options

This report presents dozens of detailed options for tax changes in Arkansas. Some increase revenues to pay for public services. Others would require reductions in government programs. And still others would shift taxes among income groups. Readers can evaluate these options based on their own notions of tax fairness.

Notes on presentation:

The distributional tables in this report were produced using the Institute on Taxation & Economic Policy Microsimulation Tax Model.¹ They look not only at Arkansas taxpayers by income levels, but when relevant, also at categories of Arkansas families, broken down by family type and age:

- Most of Arkansas’s population (57.1 percent) live in non-elderly married-couple families. These families earn an even larger share (60.5 percent) of Arkansas’s total personal income.
- Unmarried non-elderly taxpayers, a group that includes single people with and without children, represent 27.5 percent of Arkansas’s population, and 20.9 percent of total income.
- Elderly Arkansas couples and individuals constitute 15.4 percent of Arkansas’s population and have 18.6 percent of total income.

When our distributional charts and tables divide the Arkansas taxpaying population by percentage groups (as in the chart on the previous page), we subdivide the top fifth of the taxpayers into three subgroups to aid our analysis. As the table to the right illustrates, the top 20 percent is both a very important and a very heterogenous group:

- Just over half of all personal income in Arkansas goes to the best-off fifth of all taxpayers.
- Taxpayers in the first 15 percent of the top fifth have average incomes of \$61,000. In contrast, the average income of the top 1 percent is \$474,000.

Finally, in our tables and analysis, we define “income” to include all cash earnings and transfers, including items (such as tax-exempt interest or most Social Security benefits) that are not included in “adjusted gross income” or other narrow tax-law-based income definitions.

Arkansas Family Demographics

	% of Adult Population	% of Total Population	% of Total Income
Married non-elderly	53.8%	57.1%	60.5%
Unmarried non-elderly	24.8%	27.5%	20.9%
Elderly	21.4%	15.4%	18.6%
<i>Addendum:</i>			
Married, all	68.2%	67.4%	74.1%
Unmarried, all	31.8%	32.6%	25.9%

**The Distribution of Income in Arkansas
All Families and Individuals, in 1997**

Income Group	Income Range	Average Income	Share of Total Inc.
Lowest 20%	Less than \$10,000	\$ 6,100	6.1%
Second 20%	\$10,000 to \$18,000	\$ 14,300	9.0%
Middle 20%	\$18,000 to \$28,000	\$ 22,800	13.7%
Fourth 20%	\$28,000 to \$47,000	\$ 36,700	20.9%
TOP Next 15%	\$47,000 to \$86,000	\$ 61,000	27.1%
Next 4%	\$86,000 to \$176,000	\$ 116,500	12.7%
TOP 1%	\$176,000 or more	\$ 474,000	10.5%

¹The ITEP Model is described in the last appendix. For a more detailed description of the model and its methodologies, see ITEP’s June 1996 report, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*.

CHAPTER ONE

ECONOMIC AND SOCIAL INDICATORS

The economic and social well-being of a state is a function of many often interrelated and interdependent factors. Precisely determining the well-being of a state is difficult, of course.² Nevertheless, chosen and evaluated carefully, economic and social indicators can paint a picture of how well a state economy is performing, allow state-by-state comparisons and show trends over time. Most important, such an analysis can provide useful insights into what can be done to promote greater social and economic well-being in the future.

After reviewing hundreds of indicators, we selected a number of measures of economic and social well-being to help assess the state of Arkansas. These indicators are grouped into six categories: General Economic, Infrastructure, Health, Education, Environment and Crime. The primary criterion for selecting these indicators was their ability to reflect economic and social well-being, but they were also chosen based on the availability of data over time and the ability to compare data across states. When possible, we have compared Arkansas to the national average and to its six neighboring states— Louisiana, Mississippi, Missouri, Oklahoma, Tennessee and Texas—and we have looked at trends over time.

Ideally, Arkansas would like to rank high in the nation in quality of life and strength of its economy. At minimum, economic and social conditions in Arkansas should improve over time. In addition, in those areas where Arkansas lags behind the national averages, the gaps between Arkansas and the U.S. averages should be narrowing.

Our analysis finds that Arkansas lags behind the national averages on many measures of economic and social attainment. Over the past fifteen years, however, Arkansas has made progress in narrowing these gaps in many areas. In addition, we find that Arkansas is in the early transitional stages of moving from a low-wage, low-skill economy to a higher-wage, higher-skill economy. Whether the process of transition stalls or continues will depend in part on the policies and strategies that the people of Arkansas and their elected representatives choose to pursue.

²First, all of the data useful for such an analysis may not be available. Second, time constraints may oblige researchers to be selective in their analysis. Third, for data that are available and that are selected for analysis, judgments have to be made as to how to interpret them and how to weigh their relative importance. For example, if Arkansas has a lower poverty rate than Texas while Texas has a higher per capita income, which state is better off?

I. General Economic Indicators:

Over the last fifteen years, Arkansas has experienced steady—and at times spectacular—improvements in its economic well-being. In 1980, most indicators of well-being suggested that Arkansas ranked at or near the bottom of all fifty states. Today, many indicators place Arkansas near the middle in the 50-state rankings. Even for those important measures that continue to rank Arkansas near the bottom, there is a significant difference between today and fifteen years ago: the gaps between Arkansas and the national average have, in most cases, narrowed considerably. In addition, the gaps between Arkansas and several states that rank just ahead of it are now often quite small. Hence, if the trends of the last decade and a half continue, we can expect Arkansas to leap ahead of many states in a variety of measures of economic well-being.

Since 1980, Arkansas's *total* personal income has grown at approximately the same rate as the national average. However, Arkansas's population has grown at only about

	1980-95 Growth in		
	Total Personal Income*	Population	Per Capita Income*
United States	+44.7%	+15.6%	+25.1%
Tennessee	+59.9%	+14.2%	+40.0%
Texas	+50.9%	+30.6%	+15.6%
Arkansas	+42.3%	+8.5%	+31.2%
Mississippi	+39.3%	+6.7%	+30.4%
Missouri	+36.6%	+8.1%	+26.3%
Louisiana	+20.3%	+2.7%	+17.1%
Oklahoma	+14.6%	+7.7%	+6.4%

*Changes in inflation adjusted dollars

half the national rate. As a result, Arkansas's *per capita personal income*, one of the most commonly used measures of the relative affluence of states, has shown great improvement over the last fifteen years. In fact, Arkansas's per capita income has grown at a faster rate than that of all but 15 states, and has grown faster than that of all of its neighboring states, except Tennessee. While Arkansas still ranks only 48th in per capita income nationally (as opposed

1995				
	Per Capita Income	% of US Average	Rank	Compare: 1980 Rank
United States	\$ 23,208	100%		
Missouri	\$ 21,819	94%	24	29
Texas	\$ 21,206	91%	30	19
Tennessee	\$ 21,038	91%	32	40
Louisiana	\$ 18,981	82%	40	34
Oklahoma	\$ 18,580	80%	44	28
Arkansas	\$ 18,101	78%	48	49
Mississippi	\$ 16,683	72%	50	50

to 49th in 1980), its per capita income is now 78 percent of the U.S. average—up from 74 percent in 1980.³

Growth in Total Employment					
	1980-91	1991-95	Rank	1980-95	Rank
United States	+18.5%	+6.1%		+25.8%	
Texas	+27.9%	+10.1%	14	+40.8%	11
Tennessee	+17.1%	+13.9%	7	+33.4%	16
Missouri	+15.8%	+8.8%	20	+26.0%	26
Arkansas	+11.8%	+12.6%	8	+25.9%	27
Mississippi	+10.6%	+8.8%	20	+20.3%	30
Oklahoma	+7.5%	+5.4%	34	+13.2%	39
Louisiana	+6.6%	+2.5%	42	+9.3%	45

Employment growth is an important indicator of the relative health of an economy. The Arkansas economy has added approximately 250,000 new jobs since 1980, growing at about the same rate as the U.S. average. In the past five years, however, the job growth has been spectacular. Since 1991, Arkansas has added nearly 150,000 jobs. Between 1991 and 1995, the job growth rate was the 8th fastest among the states and more than double the national average.

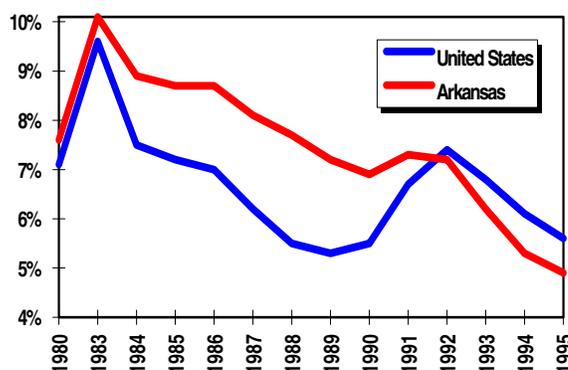
What is notably impressive about the recent employ

³Median household income is another common measure of economic well-being. It differs from *average* income per capita in that it measures the *typical* rather than average income. Between 1984 and 1995, Arkansas's median household income grew 12 percent, the 10th fastest growth rate in the country. Thus, while Arkansas continues to rank 49th in the nation in median income, its median household income has grown from 70 percent of the national average in 1984 to 76 percent in 1995. This is one of the most significant improvements shown by any state in the country over that period.

ment growth is that Arkansas has added 25,000 jobs in manufacturing, up by 11 percent since 1991 (the fastest growth in the nation). In contrast, manufacturing jobs declined 3 percent in the nation as a whole. Growth in manufacturing jobs can help economic vitality because such jobs tend to be higher paying than most. When manufacturing workers spend their relatively high salaries, sales and earnings are increased throughout the economy.

The recent dramatic rise in Arkansas manufacturing jobs has translated into higher pay for manufacturing workers. Although Arkansas still ranks 47th in average hourly earnings in manufacturing, Arkansas's average manufacturing wage has risen at the fifth highest rate in the nation

Unemployment Rates, 1980-95



since 1990. Thus, while manufacturing wages in Arkansas were 78 percent of the U.S. average in 1990, they are about 81 percent of the average today.

Arkansas's rapid job growth has had a notable and predictably salutary effect on its unemployment rate. Dropping dramatically from a recent high of 10.1 percent in 1983, the unemployment rate in Arkansas fell to 4.9 percent in 1995, the lowest rate in more than twenty years. Above the national average through the 1980s, Arkansas's unemployment rate has instead been below the U.S. average every year since 1992.

The growth in jobs since 1991 appears to have had a favorable impact on poverty rates in Arkansas, as well. Throughout the 1980s and up to 1993, the poverty rate in Arkansas hovered near 20 percent, among the worst of all fifty states. Although still above the national average, in 1994 and 1995 Arkansas's poverty rate fell significantly. As a result, Arkansas now ranks 36th among the states—better than any of its neighboring states except Missouri.

Despite rapid job growth, falling unemployment and rising manufacturing pay, overall average annual pay in Arkansas has not kept pace with U.S. average annual pay. In 1981, wages in Arkansas were 82 percent of the national average. By 1994, wages were only 78 percent of the U.S. average. Arkansas's falling relative wages suggest that

Percent of People in Poverty						
	1980		1993		1995	
	%	Rank	%	Rank	%	Rank
United States	13.0%		15.1%		13.8%	
Missouri	13.0%	29	16.1%	36	9.4%	8
Arkansas	21.5%	49	20.0%	46	14.9%	36
Tennessee	19.6%	45	19.6%	44	15.5%	38
Oklahoma	13.9%	33	19.9%	45	17.1%	44
Texas	15.7%	40	17.4%	37	17.4%	45
Louisiana	20.3%	46	26.4%	50	19.7%	46
Mississippi	24.3%	50	24.7%	49	23.5%	49

Lower poverty rate equals higher rank.

Source: U.S. Bureau of the Census, March 1995 and 1996 CPS

many of the new jobs created in Arkansas were not “good” jobs; that is, they were not high-paying jobs.

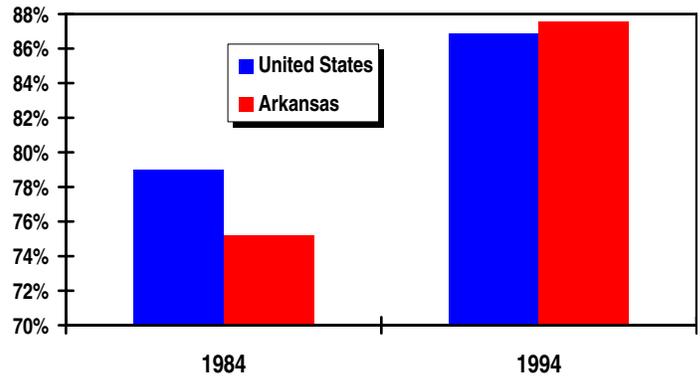
How can one explain Arkansas’s falling relative wages in the face of employment and per capita income rising faster than the national average? The explanation centers on the fact that until rather recently the share of Arkansas’s adult population that was working was much lower than the national average. As jobs increased, unemployment fell, but what is more important, the number of adults entering the workforce grew (a reflection, at least partly, of the nationwide trend toward two-earner couples, but starting later in Arkansas). Instead of lagging far behind as was typical in the 1980s, Arkansas’s employment as a percent of the population aged 16 to 64 skyrocketed from 75 percent in 1984 to 88 percent in 1994. Thus, employment as a percent of the population aged 16 to 64 is now slightly

higher in Arkansas than in the nation as a whole. The dramatic increase in job seekers and adult employment rates in Arkansas increased the supply of labor and apparently kept wages down relative to the nation. Low and relatively-falling wages, in turn, may have attracted employers.

The trend toward fuller employment in Arkansas cannot continue at the pace of the last decade. As the share of adults working nears its maximum possible amount, the growth in the adult employment rate must slow down from the rapid growth rate of the past decade. This fact has important implications for the nature of future economic growth in Arkansas.

Over the past fifteen years, Arkansas’s low and, relative-to-the nation, falling wages may have encouraged

Employment as a % of the Population Age 16-64, 1984 & 1994



local employers to hire more workers and may have attracted employers from out of state. But given that Arkansas is now at or above the national average in its adult employment rates and given that the growth in Arkansas’s adult employment rates must slow down, there is likely to be an increase in wages (relative to the national average) in response to further increases in the demand for labor. Indeed, this upward pressure on wages is already manifesting itself in the manufacturing sector, as noted above. Wage increases at rates faster than the national average are likely to spread to other sectors of the economy in the near future. Just as falling wages (relative to the national average) may have encouraged job and economic growth in Arkansas, rising wages (relative to the national average) may hamper job and economic growth *unless* the quality of labor and other assets in Arkansas improve.

A rising quality of labor and other assets can both *encourage* employers to expand employment opportunities (despite Arkansas’s wages rising relative to the U.S. average) and *enable* employers to

Average Annual pay for All Workers Covered by Unemployment Insurance, 1981 and 1994						
	1981			1994		
	Average Pay*	% of US Average	Rank	Average Pay	% of US Average	Rank
United States	\$ 25,579			\$ 26,939		
Texas	26,433	103%	13	25,959	96%	18
Missouri	24,415	95%	27	24,625	91%	25
Tennessee	22,378	87%	41	24,106	89%	28
Louisiana	26,118	102%	15	23,176	86%	32
Oklahoma	25,336	99%	20	22,292	83%	41
Arkansas	20,934	82%	47	20,898	78%	46
Mississippi	20,512	80%	48	20,382	76%	47

*In 1994 inflation-adjusted dollars.

Source: U.S. Dept Of Labor, Bureau of Labor Statistics.

pay higher wages. If this occurs, of course, workers and their families will be better off.

An analysis of economic and job expansion in Arkansas over the past fifteen years indicates that it has been spurred in part by business investments in new structures and equipment, especially for food processing plants, retail outlets, customer service centers and distribution centers. The jobs that have been created by these investments are, for the most part, low paying. But the potential for new high paying jobs exists. For example, new industries in the biotechnology field with applications in medicine, pharmaceuticals, agriculture, environmental cleanup and manufacturing are starting to develop. If a healthy, well-educated and skilled labor force is available, these industries have the potential to generate thousands of high-paying jobs in Arkansas.

II. Infrastructure:

The physical infrastructure of an economy is fundamental to its health and growth potential. The infrastructure's role in the economy is similar to the role of the skeletal structure, the nervous system and the cardiovascular system in the human body. Each needs to be in good condition in order for a body to function well. Likewise the various components of the physical infrastructure (roads, bridges, sewage systems, telecommunication networks, etc.) need to be adequately developed and well maintained in order for an economy to grow rapidly and efficiently.

Infrastructure plays a key role in attracting and retaining business. In particular, the adequacy and quality of roads, bridges, and sewage systems are among the primary factors that businesses consider when making investment location decisions.

Percentage of Bridges Rated as Deficient

	1988		1994	
	Percent	Rank	Percent	Rank
Texas	34%	22	25%	13
Tennessee	40%	26	29%	24
Arkansas	45%	32	30%	26
Louisiana	45%	33	38%	38
Oklahoma	56%	42	40%	40
Mississippi	53%	40	41%	41
Missouri	64%	47	46%	44

Lower % deficient equals higher rank.

Source: U.S. Dept of Transportation, FHA, *Status of the Nation's Highway Bridges*, GPO, June 1995 and 1989

In terms of the condition of its existing infrastructure, Arkansas's situation is mixed:

- With regard to the quality of its bridges, Arkansas ranked right at the national median (26th) in 1994.
- One measure of the quality of the sewage system suggests that Arkansas ranked fifth best in the United States in 1992.
- But when it comes to highways, it's a different story. Although they may be adequate in the short term, they are likely to need significant repairs and improvements in the near future.

While the percentage of Arkansas's highways rated in "poor" condition was only 3 percent in 1994 (fourth best among the states), the percentage of highways rated in "poor or mediocre" condition was 77 percent (47th worst in the country). In other words, three-quarters of Arkansas highways are in mediocre condition.

Percentage of Highway Mileage Rated Poor or Mediocre

	Poor	Mediocre	Poor or Mediocre	
			%	Rank
US Average			31.4%	
Missouri	6.1%	0.0%	6.1%	11
Tennessee	6.2%	5.4%	11.6%	16
Oklahoma	11.0%	2.6%	13.6%	17
Louisiana	18.7%	3.5%	22.2%	24
Texas	6.5%	47.2%	53.7%	42
Arkansas	3.0%	74.2%	77.2%	46
Mississippi	15.8%	77.2%	93.0%	49

Higher rankings equal lower percentage in poor or mediocre condition.

Source: U.S. Dept of Transportation, FHA, *Highway Statistics*, 1993 & 1994.

Despite the apparent upcoming need for major highway repairs, Arkansas's infrastructure rankings have risen over time relative to other states. Thus, while Arkansas's physical infrastructure is far from being in excellent condition, it has been improving both absolutely and relative to the nation.

Although these measures indicate the condition of some of the existing infrastructure, they do not indicate whether this infrastructure is sufficiently comprehensive. Unfortunately, there are few statistics available to provide that information, but this issue warrants further study.

III. Education:

Education is arguably the single most important factor determining long-term economic growth. The productivity and growth of an economy are directly related to the level of education and training of its workforce. For

High School Diploma or Higher*				
	1980		1990	
	%	Rank	%	Rank
United States	66.5%		75.2%	
Oklahoma	66.0%	35	74.6%	36
Missouri	63.5%	37	73.9%	38
Texas	62.6%	38	72.1%	39
Louisiana	57.7%	41	68.3%	43
Tennessee	56.2%	44	67.1%	45
Arkansas	55.5%	46	66.3%	48
Mississippi	54.8%	47	64.3%	50

*% of population 25 or older

economic circumstances. In light of the employment data discussed earlier, it is particularly important for Arkansas to improve the skills of its labor force if the transition to a high-pay, high-skill economy is to proceed smoothly.

Perhaps the broadest indicators of the skill levels of the workforce are measures of educational attainment. In today's economy, a minimum requirement for most jobs is a high school diploma or often, a college degree. Arkansas's record in providing its citizens with these requirements is mixed.

In 1990, Arkansas ranked 48th in the percentage of its adult population with a high school diploma or higher degree, down from 46th in 1980. Yet Arkansas has narrowed its education gap in this area compared to the U.S.

Percent of persons 16-19 not in school and without a high school degree, 1990		
	%	Rank
United States	11.2%	
Oklahoma	10.4%	24
Missouri	11.4%	33
Arkansas	11.4%	33
Mississippi	11.8%	38
Louisiana	12.5%	40
Texas	12.9%	43
Tennessee	13.4%	45

Lower drop-out rate equals higher rank.

Source: U.S. Bureau of the Census, 1990 Census.

a state to maintain its economic competitiveness it must develop a workforce that has the skills needed by employers. The workforce, furthermore, must be able to adapt to ever changing economic

Percent of persons 5-17 enrolled in primary and secondary schools, 1993		
	%	Rank
United States	91.4%	
Texas	97.8%	1
Arkansas	95.5%	6
Oklahoma	95.1%	9
Tennessee	93.4%	15
Mississippi	91.7%	28
Louisiana	87.9%	42
Missouri	87.4%	46

Source: U.S. National Center for Education Statistics, Digest of Education Statistics.

average, from only 83.5 percent of the national average in 1980 to 88.2 percent of the U.S. average by 1990. In other words, Arkansas has been catching up (although, obviously, the states that have recently surpassed Arkansas in the rankings have been catching up even faster).

An important point to recognize in assessing Arkansas's progress is that Arkansas's low ranking today is primarily a function of its failure to educate its population in keeping with national norms in the past. Indeed, Arkansas's high school dropout rate is now approximately equal to the national average and its rate of school enrollment of five through 17 year-olds is the sixth highest in the nation, well above the national average. These latter trends bode well for Arkansas's future.

Of course, the fact that a growing percentage of Arkansas's young people are enrolled in school and finishing high school does not tell us much about the quality of Arkansas's schools relative to those in

Public School Students' Attainment

Reading, 4th Grade		
	Score	Rank*
United States	213	
Missouri	218	15
Tennessee	214	19
Texas	213	24
Arkansas	210	28
Mississippi	203	36
Louisiana	198	38
Oklahoma	No Report	

* Only 39 states reporting

Math, 4th Grade		
	Score	Rank**
United States	217	
Missouri	221	14
Oklahoma	219	19
Texas	217	21
Arkansas	209	36
Tennessee	209	36
Louisiana	203	40
Mississippi	200	41

** Only 41 states reporting

Math, 8th Grade		
	Score	Rank**
United States	266	
Missouri	270	16
Oklahoma	267	18
Texas	264	25
Tennessee	258	34
Arkansas	255	38
Louisiana	249	40
Mississippi	246	41

** Only 41 states reporting

Source: U.S. Dept. of Education, National Center for Education Statistics, NAEP Reading 1994; NAEP Mathematics 1992.

other states. Although it has been argued that the quality of education in Arkansas is improving, some data suggest that Arkansas's students are still not performing up to par.

Measurements of math proficiency for fourth and eighth graders in 1992 scored Arkansas's students below average. These measurements ranked Arkansas 36th and 38th, respectively, out of the 41 states surveyed. Likewise, a measurement of reading proficiency of fourth graders in 1994 showed Arkansas's students performing below average—ranking Arkansas 28th out of the 39 states that participated in the study.

Other indicators of education quality show improvement but suggest that Arkansas is still generally lagging behind the nation in its commitment to educating its workforce. For example, expenditures per pupil have risen significantly and faster than the national average since 1980. As a result, Arkansas no longer ranks last in this area, as it did in 1980. But Arkansas still spends far less per pupil than the national average. In 1993, Arkansas spent only 74 percent (as opposed to 69 percent in 1980) of the national average on its students, placing it 44th among the fifty states.

Numerous studies have shown that students benefit from smaller class sizes and more individual attention from school staff. Arkansas has made important strides in this area, but so have other states. As a result, Arkansas's per-pupil ratio is still about the same as the U.S. average.

Teachers' salaries are another indicator of a state's commitment to education. During the 1979-80 school year, average teacher salaries in Arkansas were only 77 percent of the national average. Since then, teachers' salaries in Arkansas have stayed at about the same share of the national average, putting Arkansas's national ranking at 45th. More indicative of very recent trends is the fact that while average teachers' salaries nationwide have essentially stagnated since 1991-92, in Arkansas they fell by nearly 4 percent.

Arkansas has only recently begun to make progress in higher education enrollment and graduation. In 1990, Arkansas ranked 49th in the percent of its adult population with a college degree or higher, the same ranking it had in 1980. Although the percentage with bachelor's degrees rose in Arkansas, it rose less than the national average. In addition, in 1990 Arkansas tied for last in the percent of its adult population with advanced degrees.

Poor rankings on higher education in the past are reflected in the relatively low number of high-skilled, high-paying jobs in Arkansas. For example, the number of employed doctoral scientists and engineers per 1,000 workers is far lower in Arkansas than anywhere else in the nation.

Bachelor's degree or higher*				
	1980		1990	
	%	Rank	%	Rank
United States	16.2%		20.3%	
Oklahoma	15.1%	28	17.8%	32
Missouri	13.9%	37	17.8%	32
Texas	16.9%	23	20.3%	22
Louisiana	13.9%	37	16.1%	42
Tennessee	12.6%	44	16.0%	43
Mississippi	12.3%	45	14.7%	47
Arkansas	10.8%	49	13.3%	49

*% of population 25 or older

In recent years, Arkansas's policymakers have apparently recognized that without a substantial increase in the percentage of its population with college degrees or better, Arkansas will experience difficulty in creating and attracting high-skilled, high-paying jobs in the future. As a result, there have been some recent dramatic improvements in higher education

in Arkansas. For example, the number of science and engineering graduate students in Arkansas grew at one of the most rapid rates of any state in the nation since from 1989 to 1993. Research and development expenditures at doctorate-granting institutions likewise grew quickly from 1989-94. In both these areas, the gaps between Arkansas and the national averages are beginning to

Advanced degree, 1990*		
	%	Rank
United States	7.2%	
Texas	6.5%	23
Missouri	6.1%	29
Oklahoma	6.0%	31
Louisiana	5.6%	36
Tennessee	5.4%	40
Mississippi	5.1%	46
Arkansas	4.5%	49

*% of population 25 or older

narrow, although Arkansas's rankings remain near the bottom compared to other states.

Unless these improvements accelerate, however, Arkansas's continued low rankings on higher education do not bode well for the state's regional and national competitiveness. Indeed, without improvements in the quality of Arkansas's labor force, the current boom in the economy will be difficult to sustain. Studies of new business creation have found that most new companies are founded by locally educated and trained entrepreneurs. Only by educating its people, is Arkansas likely to create the entrepreneurs it will need to be competitive in the future.

IV. Health:

Health conditions of a state’s population and the availability of medical care have major effects on the quality of life. They influence decisions about where to live and where to start a business, and they affect the quality and productivity of labor. Hence, health is one of the keys to economic growth and development, as well as a significant measure of a society’s general well-being.

Statistics on health and health care cover a wide variety of issues. We have selected several indicators that reflect the average health of states’ populations and the availability of care at the state level.

Many indicators suggest that health conditions in Arkansas are below the national average, and that the gap has not been narrowing over time.

■ Death rates due to heart disease and cancer, the two leading causes of death nationwide, are higher in Arkansas than they are in the nation as a whole. The rate of death due to heart disease has declined in Arkansas, but not as rapidly as has the national rate, while the cancer death rate has risen faster than the national average. As a result, Arkansas’s ranking on avoiding heart disease deaths has fallen from 40th in 1981 to 45th in 1992, and its cancer death ranking has fallen from 41st to 46th. The fact that Arkansas’s population is older than the national average may explain part of this trend, but not all of it.

■ Infant mortality rates fell by 30 percent in Arkansas from 1980 to 1996. But the national rate declined by near-

ly 40 percent. Thus, despite a dramatic decline in Arkansas’s infant mortality rate, Arkansas is further below the national average today than it was 16 years ago, and its national rank has fallen to 35th.

■ The percentage of babies with low birth weights is not only an indicator of current health conditions, but also a predictor of health in the future (since low-birth weight babies tend to have health problems later on). Unfortunately, the percent of babies with low birth weights in Arkansas rose faster than the national average between 1980 and 1992. In 1980, Arkansas ranked 38th in avoiding low-birth-weight babies; in 1992, it ranked 42nd.

Four Health Indicators			
	U.S.	Arkansas	Rank
% with no health insurance, 1995	15.4%	17.9%	40
% with primary care shortage, 1994	na	13.7%	38
Number of doctors/100,000, 1993	225	162	42
% low-birth-weight babies, 1992	7.1%	8.2%	42

Several measures indicate that health care is much less available in Arkansas than in most other places, although there is some evidence that Arkansas is catching up.

- In 1993, Arkansas ranked 42nd and had 72 percent of the U.S. average number of doctors per capita. That’s an improvement, however, from 1981, when Arkansas had only 66 percent of the national average number of doctors per capita and ranked 46th.
- The percentage of Arkansas residents without health insurance has risen over the past five years, albeit at a slower pace than for the country as a whole. Arkansas health insurance coverage currently ranks 40th in the country.
- Finally, Arkansas ranks 38th in the percentage of its population that lacks primary health care within ready economic and geographic reach.

V. Environment:

Environmental conditions, like health conditions, have an obvious impact on the quality of life of citizens. They also influence economic conditions, although their effects on the economy are more subtle than their impact on quality of life.

Businesses, like people, prefer safe, clean, and stable communities. Indeed, many businesses require clean environments in order to thrive. For example, the fishing industry and much of the tourist industry cannot survive with excessively polluted rivers, lakes, oceans, and streams. Hence, the old conventional wisdom that economic growth and environmental protection were incompatible is giving way to the understanding that they are often complementary and that a healthy environment can be essential to long-term, sustainable economic growth.

As the relationship between environmental decay and community health has become clearer, the American public has demanded that its drinking waters be safe and the air it breathes be free of dangerous contaminants. It is now also understood that the costs associated with maintaining a safe and clean environment in a community frequently pale in comparison to the costs of reestablishing a safe and clean environment, as the enormous cost of cleaning up the superfund dump sites illustrates.

Indicators of environmental quality reflect the general conditions of water, air and soil. These indicators suggest that the quality of Arkansas’s air is very good, while the quality of its water and soil are about average. Since statistics on environmental quality have been regularly collected only recently, it is very difficult to determine

whether the quality of Arkansas’s environment has been improving.

It should be kept in mind that some of the following statistics on pollution are not necessarily good indicators of the health risks from pollution in particular states. For example, the negative effects of toxic chemicals released in a state may not be felt in that state because the chemicals may be carried by winds or water flows to other states. Similarly, the amount of hazardous waste generated in a state does not convey the degree of toxicity of that waste, nor does it indicate how much of that waste escapes into the state’s environment. Likewise, the number of dump sites in a state does not reflect the size and condition of each of those sites, although qualifying as superfund dump sites does suggest that the sites are considered to be among the worst dump sites in the nation.

In 1995, Arkansas ranked first (tied with 13 other states) in an important measure of the quality of its air. Specifically, the Environmental Protection Agency found that none of the residents of Arkansas lived in areas that exceeded national air quality standards for ozone or carbon monoxide.

More and more, people are understanding that a healthy environment can be essential to long-term, sustainable economic growth.

In 1995, 7 percent of Arkansas’s surface water discharges were not in compliance with water quality standards, ranking 31st in the nation. This is an improvement over 1990, when 13 percent of Arkansas’s water discharges were in noncompliance (ranking 39th worst in the nation).

In terms of the miles of its rivers and streams that are polluted, Arkansas likewise fares somewhat worse than the national average, but it ranks better than most states. In 1992, according to the EPA, more than half of all the miles of rivers and streams

in Arkansas were unsafe for fishing and swimming compared to the national average of 44 percent.

Adjusted for the size of its population, Arkansas had almost exactly the national average number of superfund dump sites within its borders in 1994, and ranked 24th on this indicator of pollution. In 1993 Arkansas released more toxic chemicals into its air, water and earth than did 38 other states. Its per-capita release of toxic chemicals was nearly 50 percent higher than the national average. In sum, while the quality of air in Arkansas is good, other measures of environmental quality suggest that Arkansas is at or somewhat below the national average.

Five Environmental Indicators

	Air Quality (% of residents living with excess ozone or CO ²)		% of Surface Water Discharges Substandard		% of Rivers & Stream Miles Polluted		Superfund Dumpsites per 1,000,000 Population		Release of Toxic Chemicals into the Environment	
	%	Rank	%	Rank	%	Rank	#	Rank	Lbs/capita	Rank
United States	<i>na</i>		<i>na</i>		44.0%		4.98		10.8	
Mississippi	—	1	2.9%	12	94.0%	45	1.87	4	44.7	47
Arkansas	—	1	7.0%	31	51.3%	21	4.89	24	15.3	39
Tennessee	—	1	7.2%	33	52.9%	22	3.48	17	36.9	46
Oklahoma	—	1	9.9%	41	91.9%	44	3.38	14	6.8	21
Texas	1.7%	34	7.0%	32	26.4%	10	1.63	2	19.5	43
Louisiana	0.5%	21	10.7%	42	73.7%	33	3.24	11	105.1	50
Missouri	0.9%	28	16.9%	49	16.9%	49	4.36	22	9.5	29

Lower numbers rank higher.

Sources: U.S. Environmental Protection Agency, various documents and reports.

VI. Crime:

Crime has an impact on economic and social well-being. High crime rates discourage economic activity, contribute to community disintegration and cause businesses and families to flee.

The crime rate in Arkansas is well below the national average. Unfortunately, however, the crime rate in Arkansas has increased significantly from its 1980 level while it fell for the nation as a whole. In 1980, Arkansas had the 7th lowest crime rate in the country. By 1993, Arkansas ranked just 23rd. What is perhaps most disturbing about the rise in crime in Arkansas is that the violent crime rate has more than doubled since 1980. Arkansas has a lower crime rate than all of its neighboring states except Mississippi. However, the crime rate has been rising faster in Arkansas than in all of its neighbors except Mississippi and Louisiana.

Number of murders, rapes, robberies, assaults, burglaries, larceny thefts, and motor vehicle thefts per 100,000 population

	1980		1993		% Change
	Rate	Rank	Rate	Rank	
United States	5,931		5,483		-8%
Mississippi	3,417	3	4,418	16	+29%
Arkansas	3,811	7	4,811	23	+26%
Missouri	5,433	26	5,095	28	-6%
Tennessee	4,498	10	5,240	30	+16%
Oklahoma	5,053	24	5,294	31	+5%
Texas	6,143	35	6,439	46	+5%
Louisiana	5,454	28	6,847	48	+26%

Source: U. S. Dept. of Justice, FBI, *Crime in the United States*.

VII. Summary:

Improvements in a state's economic well-being are a function of "extensive" and "intensive" development. "Extensive" refers to growth that results from increases in the *quantity* of various factors of production. In simple terms, this means that output generally expands in response to increases in employment, factories, machinery, tools, equipment and infrastructure. "Intensive" refers to growth that results from improvements in the *quality* of the factors of production. Hence, intensive development refers to output growth in response to improvements in the health, education and training of workers, infrastructure enhancements, and technological innovations.

Some kinds of extensive development are by their very nature limited. For example, increases in employment are limited because as employment grows the pool of potential workers is gradually exhausted; that is, at any given moment there are only so many people available to work. Once full employment is achieved, output expansion due to employment growth proceeds only if population grows.

Unless the quality of Arkansas's labor force and other factors improve, the economic expansion of the past 15 years may grind to a halt.

In contrast, there are no known limits to intensive development. The health, education, and training of workers can always be improved. Technological advances and infrastructure enhancements have no apparent bounds.

Like all states, Arkansas has experienced both intensive and extensive development. Some intensive development stems from improvements in parts of Arkansas's public infrastructure and certain areas of education, as discussed

above. The most obvious manifestation of extensive development in Arkansas is the very dramatic increase in the ratio of its adult population that is working. This extraordinary surge in the share of the population that is working has increased Arkansas's per capita output and kept wages down relative to the national average.

With its unemployment rate relatively low and an employment/population ratio above national norms, it is unlikely that Arkansas's wage growth will continue to lag behind U.S. wage growth for much longer. In fact, manufacturing wages in Arkansas are already rising faster than the national average. If the quality of the labor force and other critical factors do not measurably improve and average wages in Arkansas start to catch up with the national average, employers may experience declining profits and they will have less of an incentive to expand employment opportunities in Arkansas. Job growth could slow down and the economic expansion of the past fifteen years may grind to a halt. On the other hand, if the quality of the Arkansas labor force improves significantly, businesses will remain profitable and employers will be willing and able to pay higher wages and further expand employment opportunities. Arkansas's workers and families will be better off and the economic expansion may continue unabated.

In short, Arkansas has largely pursued a low-wage path toward economic development. This path has now largely run its course. If Arkansas is to continue to make the transition from a low-wage to a high-wage economy, it must invest in its workforce and other assets to improve their quality. This means that further attention must be paid to improvements in health, education, safety, infrastructure and the environment.

CHAPTER TWO

STATE AND LOCAL PUBLIC SPENDING IN ARKANSAS

Compared to other states, Arkansas provides relatively low levels of public services. In fiscal 1993, Arkansas ranked 49th in total state and local expenditures per capita—30 percent below the national average and little changed from its ranking of 50th in 1980. As a share of personal income, Arkansas’s spending on public services is about 9 percent below the national average, ranking 40th among all states.

The relatively low level of spending on public services in Arkansas is even more dramatic when one considers the state’s extra burdens, such as its large elderly, poor and school-age populations. In fact, a study by State Policy Research found that Arkansas would have to spend 14 percent *more* per capita than the national average in order to match the national average level of public services adjusted for differences in population needs.

Expenditures for health and hospitals illustrate how Arkansas is failing to close the public services gap with the rest of the nation. In 1980, state and local expenditures per capita for health and hospitals in Arkansas were 82 percent of the national average. By 1993, these expenditures had fallen to just 80 percent of the U.S. average. Arkansas’s declining per capita spending on health and hospitals relative to the national average is particularly notable given Arkansas’s large elderly population and the relatively poor health of its infants and mothers, since these are groups that are especially in need of health care.

There are numerous other examples of the low level of public services in Arkansas. Consider, for example, the Workers’ Compensation program, spending for the arts, and the AFDC program.

- The maximum weekly benefit to a worker who was temporarily unable to work due to a job-related injury was only \$270 or 59 percent of the national average in 1995. Arkansas ranked 49th in the nation, ahead of only Mississippi.
- Arkansas ranked 42nd in 1994 in per capita state spending for the arts. At 42 cents per capita, Arkansas expenditures for the arts were only 45 percent of the national average.
- Arkansas ranked 44th in typical monthly AFDC pay-

ments for a family of three in 1994. The monthly payment of \$204 was less than half of the national average. The combination of AFDC assistance and the cash equivalent of food stamps brings the typical Arkansas welfare recipient to only 52 percent of the poverty level, compared to 69 percent of the poverty level for welfare recipients nationwide.

The fact that Arkansas provides relatively low levels of public services and has generally failed to close the public services gap with the rest of the nation, does not mean that

Arkansas ranks 49th in public spending per capita and 40th as a share of income among all states. With public services so low, those who want to cut Arkansas taxes—and therefore provide even less public services—have a

Arkansas is failing to catch up in all areas. As noted in the previous section on economic and social indicators, education is an area in which Arkansas has made some progress in recent years.

Between 1980 and 1993, Arkansas’s expenditures per pupil for elementary and secondary education rose significantly and much faster than the national average. As a result, Arkansas no longer ranks dead last in this area, as it did in 1980. But, Arkansas still spends far less per pupil than the national average. In 1993, Arkansas spent only 74 percent (as opposed to 69 percent in 1980) of the national average on its students, placing it 44th among the fifty states.

Between 1980 and 1993, expenditures for higher education grew faster in Arkansas than in all but one other state. Indeed, by 1993, Arkansas’s per capita expenditures for higher education were roughly equal to the national average and its spending relative to personal income on higher education was above that of the average state. These trends in education expenditures should eventually help alleviate the shortage of Arkansans’ with college degrees or better, and help lead to more high-skilled, high-paying jobs.

With public services so low in Arkansas, those who want to cut Arkansas taxes—and therefore provide even less public services—have a heavy burden to meet. A wealth of economic evidence shows that while overall tax levels in a state have little disincentive effects in discouraging business, a lack of public services and investments can be a crucial indicator of low incomes and low growth.

CHAPTER THREE

AN OVERVIEW OF THE CURRENT ARKANSAS TAX SYSTEM

This section of the report takes a hard look at Arkansas's current tax system. It examines:

- Overall taxes in Arkansas compared to other states and trends over the past two decades.
- Levels and trends for particular Arkansas taxes.
- Constitutional biases in Arkansas toward regressive taxes and restrictions on tax reform.
- The overall current distribution of Arkansas's taxes.
- And finally, it offers detailed analysis of specific Arkansas taxes.

Arkansas: a low-tax state

By any of the most commonly used measures, Arkansas ranks as one of the lowest taxing states in the nation.⁴

- **On a per capita basis**, state and local taxes in Arkansas are only 69 percent of the national average, placing the state 48th among the 50 states.
- **As a share of total personal income**, Arkansas taxes, at 9.9 percent, are 10 percent below the national average, ranking it 43rd among all states.
- **As a share of gross state product**, Arkansas's taxes rank 39th in the nation. Total state and local taxes in Arkansas come to 8.5 percent of total output in the state, which is 11 percent below the national average.

⁴We focus here and throughout this report on total taxes raised by states and their local subdivisions. Because states vary widely and somewhat serendipitously in the proportion of their revenues raised at different government levels (i.e., state versus local), limiting our analysis to only state (or only local) revenues would greatly distort the relationships among the various states.

State and local taxes include all tax revenues raised by state and local governments, mostly from sales and excise taxes, property taxes, personal income taxes and corporate income taxes. Excluded from taxes are (1) offsetting receipts from user fees charged for government-provided services, gross interest income, and amounts paid into employee pension, workers's compensation and unemployment trust funds; (2) a small amount of miscellaneous non-tax revenues; and (3) funds from federal assistance.

The most recent state and local tax figures cited here are for fiscal 1992-93, the last year for which the U.S. Bureau of the Census has published data for combined state and local taxes for all states. It should be noted that Census's *state-only* tax data through fiscal 1994-95 show little or no change in the trend of Arkansas's taxes compared to national trends.

Which measure is the most appropriate one? Actually, each is instructive, but each has certain problems. First of all, while Arkansas's low *per capita taxes* clearly mean low per capita dollars spent on government services, they also in part reflect Arkansas's low per capita income and quite likely a lower cost of providing public services in Arkansas due to a lower cost of living than the national average.

For this reason (and because recent data are readily available), most analysts commonly use *taxes as a share of personal income* as their benchmark.⁵ Because it is widely accepted and generally valid, this is the measure of taxes that we use most often in this report.

⁵Estimates of personal income by state are published by the U.S. Commerce Department's Bureau of Economic Analysis (BEA) as part of the National Income and Product Accounts, and are released soon after the national figures for Gross Domestic Product and personal income are published. The BEA definition of "personal income" is quite broad, including not only most cash income, but also many types of in-kind income, e.g., food stamps, employee fringe benefits such as health insurance and accrued pension benefits, as well as certain "imputed" income, primarily the rental value of owner occupied housing. Personal investment income includes a large amount for certain types of imputed investment income (included as part of "personal interest"), but excludes both realized and unrealized capital gains (which are supposedly reflected in the reported income from the corporate sector of the GDP). These disparities from the common notion of "personal income" are not thought to create any significant distortions in state by state comparisons.

In computing taxes as a share of personal income, some analysts mistakenly divide *fiscal year* revenues by personal income in the *calendar year* that begins (typically) half-way through a state's fiscal year. Of course, if all state economies grow at exactly the same rate, then this error would simply understate the computed percentages across the board by, say, four or five percent without affecting the relative comparisons among states. But if states vary significantly in their growth rates (and they do, because of, among other things varying population growth rates), then this error can sometimes change state rankings noticeably. In addition, because the BEA periodically revises its past estimates of state personal income (most recently in Sept. 1996), figures for taxes as a share of personal income can also change somewhat when the revisions are taken into account. The figures presented in this report for taxes as a share of personal income avoid these common errors, by dividing fiscal year tax receipts by the most recent estimates of *fiscal year* personal income in each state.

But measuring taxes as a share of personal income also can produce anomalies, since many taxes do not initially come out of the pockets of individuals, but instead are

By any commonly used measure, Arkansas is one of the lowest taxing states in the nation.

paid, at least initially, by businesses. For example, Alaska’s total taxes are equal to 22.2 percent of personal income in the state, double the national average. Yet no one would think of Alaska as a high-tax state from the point of view of its residents. Instead, most of those “high taxes” in Alaska reflect severance and corporate income taxes on oil extraction.

That brings us to the third measure, taxes as a share of gross state product (GSP),⁶ which addresses the “Alaska problem” to a large degree. While Alaska still ranks near the top in taxes as a share of gross state product, at 11.1 percent, its gigantic discrepancy with the national average mainly disappears. The same is true in other states that rely heavily on taxes on natural resources. For example, Wyoming is a “high-tax” state measured by taxes as a share of personal income, but is a very low-tax state when it comes to taxes as a share of gross state product.

Looking at taxes as a share of gross state product, almost by definition, probably offers the best measure of the potential impact of a state’s taxes on economic activity in a state (although, as Alaska again illustrates, high taxes may not create economic problems). We use this measure in this report in comparing state corporate taxes with one another.

Finally, in the microsimulation computer tax analyses undertaken for this report, we look at Arkansas taxes paid by Arkansas residents, directly or indirectly, as shares of their incomes. Arkansas taxes that are paid by visitors or otherwise “exported” to out-of-state consumers and

⁶Gross state product measures total economic output in a state. The concept is similar to the Gross Domestic Product figures published by the Bureau of Economic Analysis for the United States as a whole.

business owners are not included. In our June 1996 study, *Who Pays? A Distributional Analysis of the Tax Systems of All 50 States*, we calculated similar tax figures for non-elderly married couples in every state (in 1995). When we compare the average state tax burdens on non-elderly married couples in each state, we find Arkansas’s taxes overall to be slightly below average compared to other states.⁷

So, is Arkansas a low-tax state?

State & Local Taxes In Arkansas & Its Neighbors						
	% of Personal Income				Per Capita, FY93	
	FY80	Rank	FY93	Rank	\$	Rank
All States	10.4%		11.1%		\$ 2,307	
Mississippi	9.7%	33	10.6%	30	\$ 1,542	50
Oklahoma	9.3%	37	10.4%	34	\$ 1,784	41
Texas	8.7%	43	10.2%	39	\$ 1,958	35
Louisiana	10.2%	26	10.1%	40	\$ 1,687	46
Arkansas	9.1%	41	9.9%	43	\$ 1,599	48
Tennessee	8.5%	46	9.1%	48	\$ 1,696	45
Missouri	8.5%	47	8.9%	50	\$ 1,728	44

Sources: U.S. Dept. of Commerce, Census Bureau & Bureau of Economic Analysis.

■ Yes, Arkansas is a very low-tax state in terms of taxes as a share of economic activity in the state, ranking 39th in the nation by this measure.

■ And yes, Arkansas has very low tax resources to pay for public services, whether measured in per-capita terms (48th) or as share of personal income (43rd).

■ When it comes to how Arkansas’s taxes affect Arkansas residents and how those residents perceive their tax system, however, it’s plausible to conclude that Arkansas’s taxes, on average, are

only slightly on the low side of typical. This suggests that the most fruitful focus may be on the different kinds of taxes Arkansas imposes and how those taxes are allocated among various income groups.

⁷We must offer two cautions here, however. First of all, our current research only allows us to compare states using our measure by the taxes they impose on non-elderly married couples. While these families include more than half of all people (counting children) and earn about three-fifths of the total income, their tax situations may not always be fully representative of the population at large. Second, the purpose of our approach is to analyze the distributional effects of a state’s taxes among its residents and to compare state tax systems to one another on that basis. As such, our analysis is not particularly sensitive to our estimates regarding tax “exporting.” In terms of comparing overall state tax levels to one another, however, our exporting assumptions loom considerably larger.

Thus, while we believe our measure works very well for distributional analysis and can offer useful rough insights into relative overall state and local tax levels among the states, at this point we are not prepared to offer it as a precise ranking device for this latter purpose.

Trends in overall Arkansas taxes

Between 1980 and 1993, tax revenues per capita and tax revenues relative to personal income grew slightly faster in Arkansas than they did in the nation as a whole. As a share of personal income, taxes grew by 9 percent in Arkansas compared to 7 percent nationally. In per capita, inflation-adjusted terms, Arkansas taxes are up by 33 percent, compared to a 27 percent increase nationwide. (Real per capita income went up by 21 percent in Arkansas compared to a 19 percent increase nationally.)

As a result, state and local taxes in Arkansas, while low, have been slowly catching up to the national average by these measures. Arkansas's tax revenues as a share of personal income were 88 percent of the national average

in 1980 and just under 90 percent of the national average in 1993 (9.9 percent versus 11.1 percent). On the other hand, as a share of GSP, Arkansas's taxes grew at exactly the same rate as the national growth rate (+11 percent). On a regional basis, Arkansas's taxes as a share of personal income remain below all of its neighbors except Tennessee and Missouri.

Arkansas's rankings among the states in terms of taxes per capita and taxes as a share of personal income have not significantly changed since 1980. Arkansas ranked 48th in state and local tax revenue per capita in both 1980 and 1993. Similarly, Arkansas ranked 41st in 1980 and 43rd in 1993 in state and local tax revenue as a share of personal income.

Arkansas State & Local Taxes, Trends as Shares of Personal Income										
FY 1980 to FY 1993										
	FY 1980			FY 1993			Changes, FY 1980-93			Note: FY95 state only
	S&L	State	Local	S&L	State	Local	S&L	State	Local	
All Taxes	9.0%	7.0%	2.0%	9.9%	7.6%	2.4%	+0.9%	+0.6%	+0.3%	7.7%
Property taxes	1.9%	0.0%	1.8%	1.6%	0.0%	1.6%	-0.2%	-0.0%	-0.2%	0.0%
Sales & excise taxes	4.0%	3.8%	0.2%	4.9%	4.2%	0.7%	+1.0%	+0.4%	+0.5%	4.3%
General sales	2.3%	2.3%	0.0%	3.4%	2.9%	0.5%	+1.2%	+0.6%	+0.5%	3.0%
Selective sales	1.7%	1.5%	0.2%	1.5%	1.4%	0.2%	-0.2%	-0.2%	+0.0%	1.3%
Personal income taxes	1.9%	1.9%	—	2.3%	2.3%	—	+0.4%	+0.4%	—	2.4%
Corporate income taxes	0.5%	0.5%	—	0.4%	0.4%	—	-0.1%	-0.1%	—	0.4%
All other taxes*	0.8%	0.8%	0.0%	0.6%	0.6%	0.0%	-0.2%	-0.2%	+0.0%	0.5%

*Primarily motor vehicle and business license fees. Also includes various other license fees, inheritance taxes and severances taxes.

Trends in particular Arkansas taxes

The overall tax trends just discussed mask significant differences in the tax levels and growth trends of specific Arkansas taxes: sales and excise taxes, personal income taxes, property taxes and corporate income taxes. In particular:

- Arkansas sales & excise taxes are quite high compared to other states, ranking 11th nationwide as a share of personal income and ninth as a share of total tax revenues. Between 1980 and 1993, Arkansas's sales and excise taxes grew from 4 percent of personal income to 4.9 percent—placing them 25 percent above the national average. As a share of total taxes, Arkansas's consumption taxes rose from 43 percent in 1980 to 50 percent in 1993, far higher than the 36 percent

share nationwide. Arkansas's experience is contrary to the national trend, where consumption taxes have *not* risen either as a share of total taxes or as a share of income.

- Personal income taxes in Arkansas are the same share of personal income as the 2.3 percent national average for all states—and slightly below average if states without income taxes are excluded. Between 1980 and 1993, Arkansas's personal income taxes as a share of personal income grew by 21 percent. This was very similar to the 18 percent average growth rate nationwide.
- Property taxes are very low in Arkansas relative to average national property taxes, both as a share of

personal income (1.6 percent) and as a share of total state and local revenues (16 percent). Between 1980 and 1993, property taxes in Arkansas *fell* by 12 percent as a share of personal income, while property taxes nationwide *rose* by 11 percent as a share of income. As a consequence, property taxes in Arkansas fell from 58 percent of the national average (as a share of income) to only 46 percent of the national average. In 1993, Arkansas ranked 47th in property taxes as a share of personal income, lower than all of its neighboring states.

- As a share of state GSP, Arkansas's corporate income taxes are about 10 percent below the national average. As has been the case nationally, Arkansas's corporate taxes have declined over the years. They fell sharply in the early eighties as a result of federal tax legislation, and then recovered somewhat after the 1986 federal tax reforms took hold. Currently, Arkansas's corporate income taxes as a share of GSP are about 11 percent below their level in fiscal 1980, which tracks the national trend.

The levels and growth trends of these various taxes have considerable effects on the distribution of Arkansas's taxes by income level and on the overall effective tax levels faced by Arkansas residents.

First of all, these taxes differ considerably in their incidence. Sales and excise taxes, for example, hit low- and middle-income families much harder than the wealthy, while income taxes are progressive. Property taxes on individuals tend to be regressive, although less so than sales taxes, while business property taxes, insofar as they fall on owners, tend to be progressive.

These taxes also vary in how much of them can be "exported" to residents of other states. Tax exporting can occur in several ways:

- By raising the price of Arkansas products sold out of state or purchased by visitors to Arkansas
- By taxing non-resident business owners (including corporate shareholders) on their earnings or property holdings in Arkansas; and
- Through the itemized deductions the federal government allows federal taxpayers to take for state income and property taxes (but not for sales taxes).

Except for the tax exporting that occurs through federal itemized deductions, however, there are potential costs as well as gains from tax exporting, particularly the possibility that it could make Arkansas products less competitive than they otherwise might be.

The constitutional bias toward consumption taxes

A amendment 19 to the Arkansas Constitution (adopted in 1934) allows a one-quarter-plus-one minority of the members of either house of the General Assembly to block any increase in the rate of any "property, excise, privilege or personal tax" in effect as of 1934, unless that minority veto is overridden by a direct vote of the people. State taxes covered by Amendment 19 include the personal and corporate income taxes (adopted in 1929), the beer gallonage tax (1933),⁸ the gasoline tax (1921), cigarette taxes (1929)⁹ and severance taxes (1923). Taxes enacted after 1934, most notably the general sales tax (1935), can be increased by a simple majority vote of the legislature.

Amendment 19 creates a bias in the Arkansas tax system toward making it more regressive over time. Most obviously, it is much easier for the legislature to pass a sales tax increase or to enact a new selective sales tax in Arkansas than to, say, raise income tax rates on high-

income people. Yet because it applies only to tax *rates*, Amendment 19 does not restrict tax increases that do not require legislative action, such as income tax increases caused by inflation pushing low- and middle-income families into higher tax brackets.

Amendment 19 can make it difficult to enact even a revenue-neutral income tax reform plan in Arkansas. For example, a plan to increase income tax exemptions and expand tax brackets, paid for by a new top tax bracket on the very well off, would require a three-quarters majority in the legislature, even if it actually would cut taxes on most Arkansas families.

In recent years, a number of constitutional issues have arisen regarding the property tax. Amendment 59, adopted in 1980, made it difficult or impossible in many cases for local property taxes to keep up with the economy and school financing needs. More recently, Arkansas's entire school financing system has been judicially declared to be unconstitutionally unequal. These issues are generally beyond the scope of this report but are discussed briefly in a later section.

⁸Amendment 19 does not apply to other alcohol gallonage taxes adopted two years after the beer tax.

⁹Amendment 19 does not apply to the 25% tobacco tax wholesale tax enacted in 1969.

The Overall Distribution of Arkansas Taxes

Arkansas's overall tax system is regressive. That is, it requires middle and low-income families and individuals to pay a noticeably higher share of their incomes in taxes than the very well-off have to pay. Our microsimulation analysis of Arkansas's taxes finds that:

- The poorest fifth of all Arkansas taxpayers pays 10.4 percent of its income in total Arkansas taxes.
- Families and individuals in the middle of the income scale pay 9.3 percent of their income in Arkansas taxes.
- But the very best-off Arkansans, the top one percent, pay only 7.9 percent of their income in Arkansas taxes.

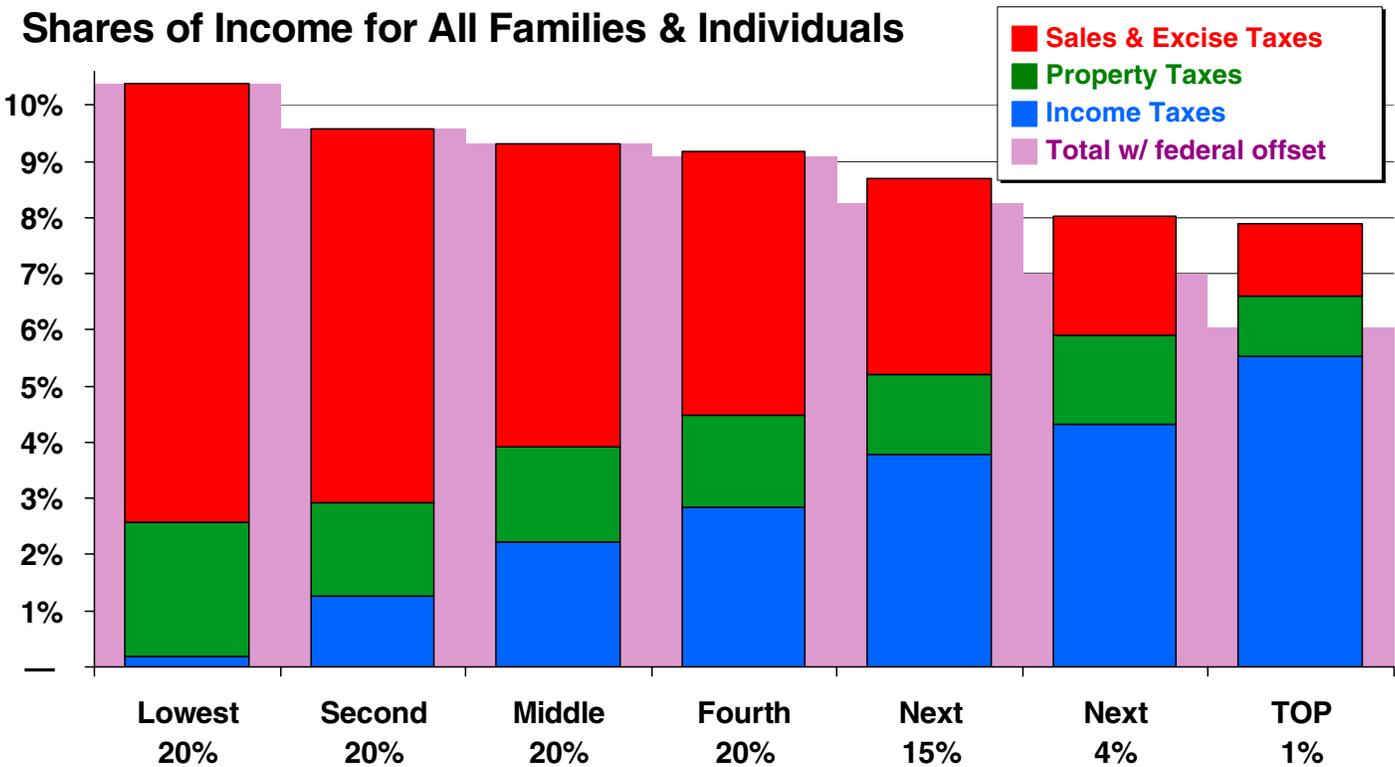
As this report describes in detail, not all the major elements of Arkansas's tax system are regressive. On the contrary, Arkansas's different kinds of taxes differ markedly in their impacts on families at different income levels:

- The personal income tax is progressive, with effective tax rates ranging from close to zero on the low-income taxpayers up to 5.5 percent on the best-off Arkansans.
- Property taxes on families are somewhat regressive, although very low.

- Sales and excise taxes are extremely regressive. In total, these taxes take almost eight times as large an income share from low-income Arkansans as they take from the very well off, and they hit Arkansans in the middle of the income scale more than four times as hard as the wealthy.
- The overall regressivity of the Arkansas tax system applies to demographic subgroups of taxpayers as well, as the tables and charts for non-elderly married couples, unmarried non-elderly people and the elderly in the appendix illustrate.

Arkansas's personal income tax and property taxes paid by individuals can be deducted in computing federal taxable income by Arkansans who itemize deductions. This results in a substantially lower net Arkansas tax burden. At the same time, however, because the benefits of itemized deductions go disproportionately to higher income people, the real burdens of Arkansas's taxes are actually even more regressive than before the federal deductions.

Arkansas State & Local Taxes in 1997 Shares of Income for All Families & Individuals



More Detailed Analyses of Specific Arkansas Taxes

I. The Arkansas Personal Income Tax

Arkansas's graduated-rate personal income tax was established in 1929. Its rate structure has been changed only once since then, under Governor Dale Bumpers in 1971, when the top tax rate was increased from 5 percent to 7 percent above \$25,000 in taxable income per taxpayer. (Spouses are allowed to report their earnings separately, so that the top bracket for two-earner married couples can effectively be as high as \$50,000 in taxable income). Because the tax brackets have never been adjusted for inflation since 1971 (except for special rules for low-income taxpayers adopted in 1991), "bracket creep" has had a major impact on Arkansas's income tax over the past 25 years, both in increasing the revenues the income tax generates and in reducing the income tax's progressivity.

Personal income taxes account for 23 percent of total state and local tax revenues in Arkansas. Between 1980 and 1993, Arkansas's personal income taxes as a share of personal income grew by 21 percent. This was very similar to the 18 percent national average growth in state personal income taxes as a share of personal income. Since there were no legislated increases in Arkansas's personal income tax over this period, the increase appears largely to reflect the erosion of tax brackets due to inflation. Personal income taxes as a share of personal income in Arkansas in 1993 were almost exactly equal to the national average.

A. The personal income tax base:

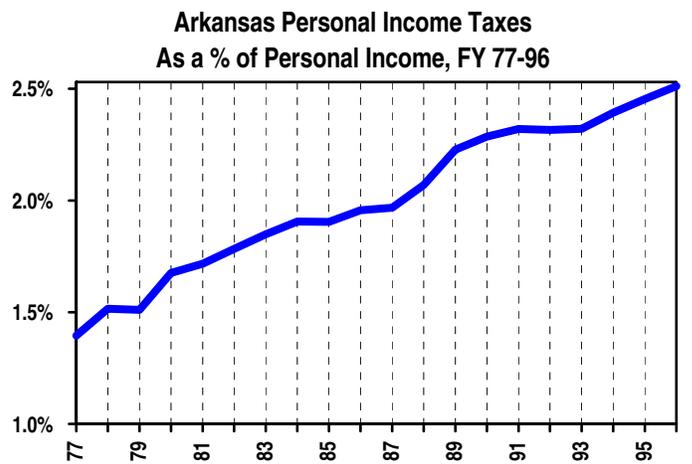
The base of the Arkansas income tax is roughly like the federal income tax with several notable differences:

- Personal exemptions/credits: The federal personal exemption for 1997 will be \$2,650 per taxpayer and dependent, and is allowed for all but the very best-off taxpayers. Rather than an exemption, Arkansas allows a \$20 per taxpayer and dependent tax credit.¹⁰ (The credit is deducted from tax otherwise due rather than from taxable income.) The \$20 credit is the same as a \$2,000 exemption for the lowest bracket taxpayers (those making less than \$3,000), and gradually declines to the equivalent of a \$286 exemption for taxpayers with taxable incomes greater than \$25,000.
- Standard deduction: For non-itemizers, the federal standard deduction in 1997 will be \$6,900 for married couples, \$6,100 for single parents, and \$4,150 for individuals without children. Arkansas's standard de-

duction is 10 percent of adjusted gross income, with a maximum deduction of \$1,000 for unmarried taxpayers and \$500 per taxpayer for married people (Arkansas's "marriage penalty").

Because the standard deduction is so low, almost twice as many Arkansas taxpayers itemize deductions on their state tax returns as do so on their federal returns.¹¹

- Unemployment compensation is not subject to Arkansas income tax.
- Social Security benefits are not taxed in Arkansas. Under federal law, higher-income Social Security recipients pay tax on a portion of their benefits.
- Arkansas exempts the first \$6,000 per taxpayer in pensions and military pay.
- The federal government taxes long-term capital gains at a maximum rate of 28 percent, compared to a 39.6 percent top tax rate on wages and other income. Arkansas offers a 6 percent maximum capital gains rate, instead of the normal 7 percent top rate. (Most other states tax capital gains the same as other income.)
- Arkansas exempts the residents of Texarkana, AR from personal income tax. The federal government does not.



¹⁰The credit was last increased in 1987. From 1957 to 1986, the credit was \$17.50 per taxpayer and \$6 per dependent.

¹¹This is despite the fact that allowable federal itemized deductions include a deduction for state income taxes, which, of course, are not deductible in computing Arkansas taxable income.

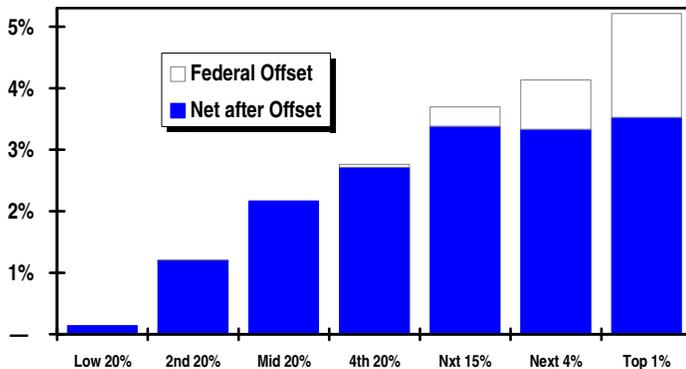
B. The rate structure:

Arkansas's income tax rate structure is very different from the federal rate structure, and far less progressive. Arkansas's 7 percent marginal tax rate on a person earning \$30,000, for example, is almost half the federal 15 percent marginal rate. At \$50,000 in income, however, Arkansas's marginal rate is only a quarter the federal rate, and the ratio continues to decline as incomes rise (to only 18 percent for the very highest earners). In contrast, for example, Rhode Island, whose income taxes are a similar share of income, has marginal tax rates that are a constant percentage of the federal tax rates. And California's rates are actually a rising percentage.

C. Progressivity:

Despite its low exemptions and the relatively low level of its top tax bracket, Arkansas's income tax, like virtually all state income taxes, is somewhat progressive, taxing the well-off at higher effective rates than poor and middle-income families. Although some state income taxes are less progressive than Arkansas's, many other states have considerably more progressive income taxes. While

The Arkansas Personal Income Tax



there are various measures of progressivity, the income tax systems in California, Rhode Island, Vermont, Idaho, Maine, Nebraska, and South Carolina, for example, are noticeably more progressive than Arkansas's, as are the income taxes in a number of other states, depending upon which measure of progressivity is used.

D. "Tax Exporting"—And Cost-Free!

A notable advantage of state personal income taxes (shared by property taxes) is that part of their cost is, in effect, paid by the federal government. That's because many taxpayers are allowed to deduct their state income taxes from their federal taxable income. For individuals who itemize, that means that the federal government will offset a considerable share of their state income tax bill—typically 28 percent for most itemizers, but as much as 39.6 percent for the highest earners.

Examples of How the Federal Tax Code Offsets Part of State Income Taxes*

Income Tax Paid to State	Federal Tax Bracket	Net State Income Tax After Offset
\$ 1,000	15%	\$ 850
3,000	28%	2,160
6,000	31%	4,140
13,000	36%	8,320
25,000	39.6%	15,100

*For taxpayers who itemize federal deductions.

From the point of view of a state's economy, the federal itemized deduction offset means that part of the personal income taxes used to pay for state government imposes no cost at all on a state's private economy.

We estimate that about \$165 million of Arkansas's personal income taxes will be offset by federal itemized deductions in 1997, equal to about one out of every seven dollars in total Arkansas personal income taxes paid by Arkansas taxpayers.¹²

It should be noted that the federal itemized deduction offset for state income taxes reduces the effective progressivity of Arkansas's income tax, since high-income families get the greatest benefit from the offset.

¹²Arkansas's exporting percentage for its personal income tax is lower than in many other states because (1) Arkansas's relatively low income status means that its taxpayers are in lower federal tax brackets, on average, than taxpayers in most states; and (2) Arkansas's relatively low reliance on taxes that are deductible at the federal level compared to other states, in conjunction with Arkansas's low-income status, means that a lower share of Arkansas taxpayers itemize deductions on their federal tax returns.

II. Sales and Excise Taxes in Arkansas

Arkansas's sales and excise taxes, which account for half of total Arkansas state and local tax revenues, are very high compared to the national average, ranking 11th nationwide as a share of personal income. Between 1980 and 1993, Arkansas's sales and excise taxes grew from 4 percent of personal income to 4.9 percent—placing them 25 percent above the national average.

As a share of total taxes, Arkansas's sales and excise taxes rose from 43 percent in 1980 to 50 percent in 1993. (Most of the shift has been away from property taxes.) This is contrary to the national trend, where consumption taxes have not risen as a share of total taxes, or as a share of income. At 50 percent of total state and local revenues, Arkansas's consumption taxes are far higher than the 36 percent share nationwide. In fact, only eight states raise a higher share of their total revenues from consumption taxes than does Arkansas.

All of the growth in Arkansas consumption taxes reflected increases in *general sales taxes*, that is, the broad-based tax on a wide range of goods and services (as opposed to selective *excise taxes* limited to particular products.)

Arkansas's general sales taxes rose from 2.3 percent of personal income in 1980 to 3.4 percent in 1993. This 51 percent increase was the fastest general sales tax growth rate of any state in the nation. Almost half of this rapid growth in Arkansas's general sales taxes stemmed from an explosive growth in *local sales taxes*—up from essentially zero in 1980 to more than half a percent of personal income by 1993. (Local-option sales taxes have continued to climb since 1993.)

- While Arkansas ranked 27th and was 5 percent below the national average in *general sales taxes* as a share of personal income in 1980, it ranked 10th and was 32 percent *above* the national average in 1993.

Arkansas's *selective sales and excise taxes* are also well above the national average as a share of personal income. In 1993, they were 15 percent higher than the national average, ranking 14th among all states.

A. Arkansas's general sales tax:

Arkansas's decision to rely so heavily on sales taxes to pay for government services has led to frequent increases in the sales tax over the years, involving both rate

changes and expansion of the list of items subject to tax. To a larger degree than most states, Arkansas's sales tax raises a significant portion of its revenues initially from businesses (who then usually—albeit hiddenly—pass the taxes on to customers in higher prices).

As sales tax rates have risen, however, Arkansas's relatively high reliance on business sales taxes has caused concerns to be raised by some. The legislature has responded by providing an array of sales tax exemptions and credits for certain kinds of businesses. Whether these exemptions and credits are sensible tax and economic development policies is an issue of considerable controversy in Arkansas.

At 50% of total revenues, Arkansas's consumption taxes are far higher than the 36% share nationwide. Low-income Arkansans pay more than 6 times as large a share of their incomes in sales and excise taxes as do the best-off people in the state, and middle-income people pay more than four times the share of income that the

1. Rising sales tax rates:

Over the past decade and a half, the state general sales tax rate in Arkansas has risen from 3 percent to 4½ percent. Meanwhile, local-option sales taxes, hardly used at all before the 1980s, now add about 1.3 percentage points to the total sales tax rate in the state. Arkansas total state and local general

sales tax rate has almost doubled since 1980, from about 3 percent to about 5.8 percent today.

2. A rather broad, but declining tax base:

Technically, the Arkansas general sales and use tax applies to sales of tangible property (excluding real estate) unless specifically exempted, plus sales of certain specified services. The sales tax is not simply a tax on retail sales to individuals for personal consumption, but also applies in many cases to goods and services (including even some capital goods) purchased by businesses.

Arkansas's sales tax base is considerably broader than the base in most other states due to two factors. First of all, Arkansas taxes many items of personal spending that most or some other states exempt. Most notably, Arkansas is one of only 19 states that applies its general sales tax to groceries (2 other states partially tax groceries). In fact, about three-quarters of the U.S. population lives in a state with no sales tax on groceries. Ten of the 46 states with general sales taxes exempt some or all over-the-counter drugs, but Arkansas taxes these purchases. Six states exempt most or all clothing purchases from their general sales tax, but Arkansas does not. And in recent years, Arkansas's sales tax base has been extended to a number of services that many states do not tax.

Second, Arkansas raises a relatively large share of its sales tax from taxes on business purchases. In fact, we calculate that almost 40 percent of Arkansas's general sales tax is initially paid by businesses. (A little over half that business amount ends up falling on Arkansas residents, with the rest "exported" to non-residents.) The business share of total general sales tax payments in Arkansas ranks 13th in the country—and that rank is actually deceptively low, since almost all of the states that show a higher business share of their total sales tax revenues apply their general sales taxes to a much lower share of personal purchases than does Arkansas.¹³

Thus, looking at tax revenues as a share of personal consumption, Arkansas's sales tax is considerably higher than might first appear given the exemptions and exclusions allowed for certain types of personal spending.

Some notable items of personal consumption and their treatment under the Arkansas sales tax are:

- **A portion of housing costs** are not subject to sales tax. Sales of new homes and rents are not directly subject to the sales tax, but construction materials used in building homes and apartments (as opposed to labor costs) are generally taxable.
- **Many transportation services**(e.g., taxis, buses, certain delivery charges, etc.) are not subject to the sales tax, but the purchase of vehicles used to provide the services may be taxable.
- **Health care services** are generally not taxable, nor are prescription drugs.
- **Legal services** are not taxed.
- **Personal services**, such as hairdressing, are not taxed.
- **Newspapers and magazine subscriptions** are exempt.
- **Utilities, such as electricity, natural gas, water, and telephone**, are among the highest taxed items, because they are generally taxable both at various levels of production and all the way to final consumption. Moreover, many of the business inputs used to produce utility services are also subject to sales tax. Residential customers with incomes of \$12,000 or less, however, are exempt from personal-level tax on the first 500 kilowatt hours of electricity each month.
- **Gasoline** is not subject to the general sales tax but is instead subject to a (higher) excise tax.
- **Groceries are generally taxable**, but certain grocery purchases, including purchases with food stamps (as mandated by federal law) and purchases of fresh produce by consumers directly from growers, are exempt.

¹³Mathematically, a narrow personal spending sale tax base can make the business share of the tax base look relatively large, even if a state includes relatively few business purchases in its tax base.

Applying the sales tax to business purchases at first blush seems inconsistent with the concept that a sales tax is a tax on personal consumption. After all, businesses buy things in order to produce goods and services that eventually are sold to people, so applying another layer of sales tax on businesses' costs of production would seem, in theory, unnecessary and underhanded.

But Arkansas's low property taxes, including low taxes on business property, and relatively low corporate income taxes (each discussed below) have left the sales tax as the main available way to get businesses to appear to pay a reasonable share of the tax burden.

Besides the government's need for revenues, there are two principles—albeit not applied with consistency—that often appear to underlie Arkansas's sales-tax treatment of business purchases.

a. The sales tax typically (but not always) applies to purchases by businesses whose sales to customers are not subject to sales tax. For example, construction materials are taxable, since home sales are not subject to tax.

b. The sales tax often does *not* apply to purchases by businesses whose sales to customers are subject to sales tax. The most obvious example of this rule is sales to retailers for resale to consumers, but the rule also applies to certain kinds of manufacturing inputs.¹⁴

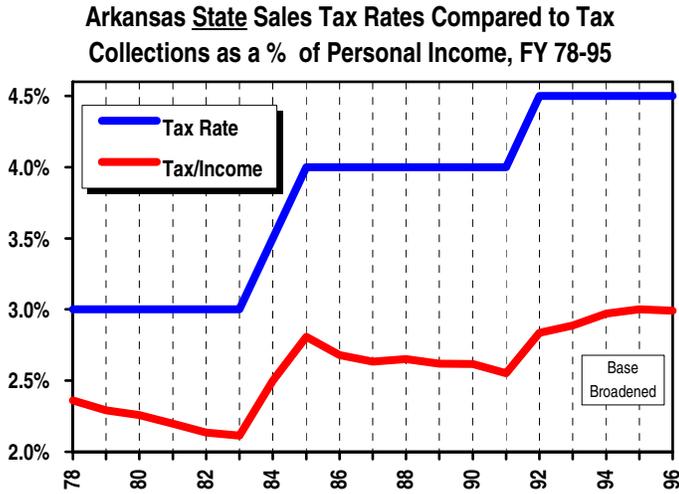
There are also a number of "business incentive" programs implemented as refunds or credits against the sales tax. These programs are similar in effect to direct government spending programs, except that rather than showing up in the expenditure budget, they show up as reduced sales tax collections. (For a discussion of these programs, see the box on page 27.)

The shrinking general sales tax base:

As noted, despite its exclusions and credits, Arkansas's total sales tax base is a quite high percentage of total personal spending in the state—in part because the tax applies to things other than personal consumption. But over the years that share has been fairly steadily declining, apparently reflecting in large part a shift in purchases toward non-taxable services such as health care.

¹⁴The Bureau of Legislative Research's Office of Economic and Tax Policy has published a list of various statutory exemptions under the sales tax, with estimates of the value of many of them. (A sorted version of this list is reproduced in an appendix.) Most of these "exemptions," however, are rather normal rules to avoid double taxation. In fact, two-thirds of the \$331 million worth of "exemptions" for which estimates are given reflect various business-input exemptions, with most of these exemptions for various farm inputs (seeds, machinery, etc.) Of the approximately \$100 million in other exemptions, \$77 million reflects the exemption for gasoline (on which a higher excise tax applies instead).

In fact, we calculate that over the past decade and a half, the Arkansas sales tax base as a share of personal consumption has declined by about a fifth (despite some legislated base broadening in recent years). As a result, while the current state sale tax rate is up by 50 percent since 1978 (from 3 percent to 4.5 percent),¹⁵ state sales tax collections as a share of personal income have risen by only 31 percent.



This trend suggests that if Arkansas continues to rely so heavily on sales taxes for revenues, it will be forced to keep ratcheting up the sales tax rate or face revenues that fall far short of keeping up with the growth of the state's economy.

B. Other sales and excise taxes in Arkansas

Selective sales and excises taxes account for about 15 percent of total state and local tax revenues in Arkansas (a higher share than in all but nine states). The major selective sales and excise taxes in Arkansas include the 18.7 cents-a-gallon gasoline tax, the roughly 50 cents-a-pack cigarette tax,¹⁶ taxes on insurance premiums,¹⁷ various taxes on alcohol and soft drinks,¹⁸ and local public utility taxes.

¹⁵As noted previously, the combined *state and local* sales tax rate in Arkansas is up by 90% since 1980.

¹⁶The cigarette tax is 31½ cents per pack, plus a 23% wholesale tobacco tax.

¹⁷Tax rates on insurance premiums are generally 2½ to 3 percent.

¹⁸These taxes include: a \$5/fifth tax on liquor; about a 25 cent per bottle tax on wine; about a 13 cent per six pack tax on beer; a 3% tax on retail sales of alcoholic beverages (in addition to the general sales tax); a 14 percent tax on sales of mixed drinks in bars and restaurants; and about a 12 cents per six pack tax on soft drinks.

The current gasoline tax rate was set in 1991, when the tax was increased by 5 cents a gallon. The current tax rate on cigarettes was adopted in 1992, when the cigarette tax was increased by 43 percent.¹⁹ There have not been significant changes in alcohol taxes or taxes on insurance premiums in recent years. The tax on soft drinks (which now raises more revenues than alcohol taxes) was adopted in 1992.

C. Regressive Distribution

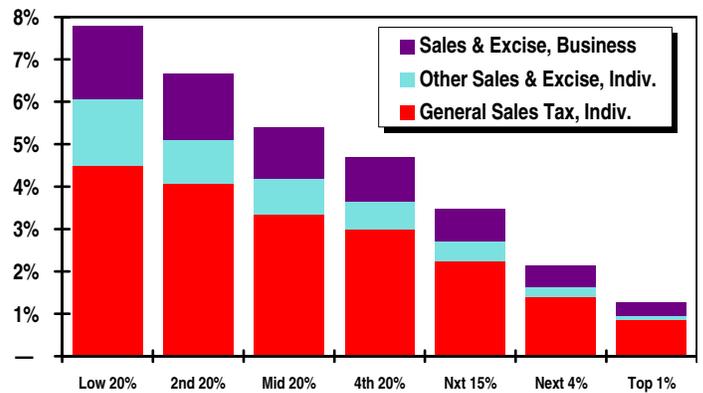
Sales and excise taxes are the most regressive kinds of taxes that states can impose. In Arkansas:

- Combined sales and excise taxes take 7.8 percent of the income of the lowest 20 percent of Arkansans.
- Middle-income Arkansans pay 5.4 percent of their earnings in sales and excise taxes.
- But the best-off one percent of Arkansans pay only 1.3 percent of their incomes in sales and excise taxes.

In other words, low-income Arkansans pay more than 6 times as large a share of their incomes in sales and excise taxes as do the best-off people in the state, and middle-income people pay more than four times the share of income that the very well-off pay.

In the mix of sales and excise taxes, the selective excise taxes—gasoline, cigarettes, etc.—loom especially regressive, in part because they are generally a fixed amount per unit purchased. These excise taxes hit the poor 19 times as hard as the wealthy, while middle-income people pay about 10 times as much as the rich, as a share of income.

Arkansas Sales & Excises Taxes



¹⁹The changes increased the per-pack tax from 22 cents to 31.5 cents (34.5 cents temporarily), and increased the wholesale tobacco tax from 16% to 23% (25% temporarily).

III. The Arkansas Corporate Income Tax

Arkansas taxes corporate profits earned in the state at a 6.5 percent top rate. (Graduated rates apply to corporations with in-state profits below \$100,000 a year.) This is the 33rd lowest statutory corporate tax rate of any state, and 36th lowest when state quasi-corporate income taxes (usually on corporate capital) are counted.



Corporate income taxes in Arkansas account for only about 4 percent of state and local tax revenues, but they constitute a source of revenue that is both progressive and highly exported (since most shareholders in major companies live out of state). As a share of gross state product, Arkansas's corporate income taxes are about 10 percent below the national average—and are almost 20 percent below the national average when other states' corporate capital taxes are included.

As has been the case nationally, Arkansas's corporate income taxes have declined as a share of the state's economy over the years. They fell sharply in the late seventies and early eighties as a result of a poor national economy and federal legislation narrowing the corporate tax base. Corporate income taxes then blipped upward as the economy recovered in the mid-eighties, but they failed to sustain that brief surge even after the 1986 federal tax reforms took hold and the economy prospered.

In 1991, Arkansas's top corporate tax rate was increased from 6 percent to a flat 6.5 percent on companies with profits greater than \$100,000. That and the economic recovery since then have boosted corporate income tax payments somewhat. Nevertheless, by fiscal 1995, Arkansas's corporate income taxes were almost a fifth below their level in the late seventies as a share of GSP.

The fact that Arkansas's corporate taxes have failed to keep up with the Arkansas economy despite the recent rate hike may be attributable in part to the adoption of various business incentive tax credits over the past decade. In calendar 1994, these income tax credits reduced Arkansas corporate tax revenues by more than 7 percent.

Of course, these various tax credits, primarily for "enterprise zones" and recycling and waste reduction, are defended as economically and socially useful—just as the incentive credits against sales taxes are defended. But as we noted above, such claims ought to be evaluated just as carefully as if these subsidies were accomplished through direct spending programs rather than tax credits. The list of suggested review standards included in the box on page 27 offers suggestions on how that evaluation might be undertaken.

Arkansas Corporate Income Taxes in CY 1994									
(\$-millions)									
Net Taxable Income Range After Apportionment	Number of Corps.	Net Taxable Income*	Tax Before Credits	Tax before credits / Income**	Business Incentive Credits†	Net Tax Liability	% Tax Cut from BICs	Tax after credits / Income**	% of Bus. Incentive Credits†
\$1 to \$50,000	10,485	\$ 136.5	\$ 5.0	3.7%	\$ 0.0	\$ 5.0	-0.0%	3.7%	0.0%
\$50,000 to \$100,000	1,804	127.5	6.6	5.2%	0.0	6.6	-0.4%	5.2%	0.2%
\$100,000 to \$200,000	958	134.0	8.7	6.5%	0.1	8.6	-0.8%	6.4%	0.4%
\$200,000 to \$500,000	718	224.6	14.5	6.5%	0.1	14.4	-0.7%	6.4%	0.7%
\$500,000 to \$1 million	308	213.7	13.8	6.5%	0.1	13.7	-0.9%	6.4%	0.8%
\$1 million +	439	2,482.0	161.1	6.5%	14.7	146.4	-9.1%	5.9%	97.8%
All Corporations	14,712	\$ 3,318.5	\$ 209.7	6.3%	\$ 15.0	\$ 194.7	-7.2%	5.9%	100.0%

* Taxable income after apportionment. (Note: taxable income is usually less than actual profits). ** Tax as a % of taxable income.

† Note: includes only credits against corporate income taxes (excludes sales tax credits and exemptions).

Sales tax refunds and credits & corporate income tax credits as economic development tools

Since the mid-eighties, Arkansas has provided certain kinds of businesses with hundred of millions of dollars in selective sales tax relief and corporate income tax relief, under the rubric of economic development. The major programs in this area include:

■ **A seven-percent state subsidy for the cost of construction projects or expansions** (including land costs), if the project costs more than \$5 million and is undertaken by certain manufacturers. The subsidy is provided as a credit against sales and use taxes paid.

■ **Enterprise zones** are an alternative state subsidy for certain business facilities. Under this program, certain businesses can obtain a refund of sales taxes paid on machinery, equipment and materials connected with plant or facility construction or expansion in a designated “economically distressed area,” plus an income tax credit of up to \$2,000 per new hire. To qualify, the facility must cost more than \$5 million and must hire a certain number of new employees (25 to 100, depending on business type).

Manufacturers eligible for the 7% sales tax credit can choose the enterprise zone program instead, if they wish. In addition, the program also applies to businesses building or expanding wholesale distribution centers, data processing facilities, corporate headquarters, telemarketing centers or facilities for several other eligible activities.

■ **Waste reduction & recycling income tax credits** pay for up to 30% of the cost of equipment used in these activities.

From 1984 to the beginning of 1996, Arkansas issued \$394 million in sales tax credits and refunds and \$120 million in income tax credits under these programs, with \$282 million actually utilized by businesses so far.

Have these large expenditures served useful economic and social purposes? Should they be continued? The ideological fault lines on this issue are intriguing. On one side are those who see government subsidies to business as an expensive diversion from government’s true responsibilities. On the other side are those ideologically disposed toward central planning plus businesses that simply want the cash.

Among one group of experts, i.e., economists who have studied state business tax incentives in depth, there is a broad consensus that state tax credits have at best only modest effects in achieving their claimed goals.²⁰ Most economists start with a free-market bias. Their training inclines them to believe that business decisions are best made by businesses, and that government’s job is to

provide public services, not dictate private activities.

We do not propose to resolve this debate in this report. But, at minimum, it would not seem excessive to hold these tax-based business incentive programs to the same standard of review as direct spending programs.

In other words, they should be undertaken only if they are affordable and their benefits, appropriately adjusted for risk, outweigh their costs. These principles suggest the following standards for review:

1. States should compile accurate tax expenditure reports so that the costs of tax-based incentive programs in terms of lost public revenues are determined.

Arkansas has issued \$394 million in sales tax credits and refunds and \$120 million in income tax credits to businesses so far. The ideological fault lines on the merits of all this are intriguing. On one side are those who see subsidies to business as an expensive diversion

2. States should formulate rigorous and standardized approaches for calculating the benefits of incentive programs, such as the number of jobs created or retained.

3. States should establish benchmark “return on public investment” targets and evaluate assistance programs based on whether these goals are met. For example, states may want to specify that no public assistance will be provided unless a project generates at least one new job for every “X” dollars in foregone tax revenues.

4. States should impose “sunset” reviews to assess the effectiveness and impact of public assistance. Why should school funding, for example, be an appropriation, but business subsidies, an entitlement?

5. States should require recipients to achieve specified objectives in order to continue receiving assistance.

6. States must safeguard their investments. This means that clear, contractual agreements must be signed that specify conditions under which restitution of incentives must be paid, such as in cases where goals are not met as a result of bad faith on the part of a targeted firm.

7. States should require full public disclosure of all incentive benefits. This will reduce opportunities for corruption and other unfair practices, improve public oversight and encourage compliance with the terms of incentive deals.

8. States should periodically consider whether spending on tax incentive programs might be better understood, implemented and evaluated if done directly, rather than through the tax system.

²⁰For a comprehensive review of the economics literature and critique of the various political arguments, see Robert G. Lynch, *Do State and Local Tax Incentives Work?* (Washington, D.C.: Economic Policy Institute, 1996).

Arkansas's Major Tax-Based Business Incentive Programs

\$-millions

Calendar Years	Total Income Tax Credits		Total Sales & Use Credits & Refunds		Manufacturers 7% Sales & Use Tax Credits		Enterprise Zones (old & new)			Recycle & Waste Reduc. Income Tax Credits	
	Issued	Used*	Issued	Used*	Issued	Used	Sales Tax Refunds	Income Tax Credits		Issued*	Used
								Issued	Used		
1984	\$ 2.2	\$ —	\$ 0.0	\$ 0.0	\$ —	\$ —	\$ 0.0	\$ 2.2	\$ —	\$ —	\$ —
1985	4.4	0.2	0.4	0.4	—	—	0.4	4.4	0.2	—	—
1986	5.8	1.1	14.9	7.2	14.2	6.5	0.7	5.8	1.1	—	—
1987	9.1	1.7	23.8	9.9	22.1	8.2	1.6	9.1	1.7	—	—
1988	9.4	3.1	20.7	12.3	18.5	10.1	2.2	9.4	3.1	—	—
1989	6.4	5.5	23.4	14.2	21.8	12.6	1.6	6.4	5.5	—	—
1990	5.7	3.5	39.5	18.0	37.8	16.3	1.7	5.7	3.5	—	—
1991	10.6	7.8	54.9	23.8	52.9	21.9	2.0	6.7	7.8	3.9	—
1992	16.7	6.1	51.4	26.7	50.1	25.3	1.4	4.6	5.2	12.0	1.0
1993	30.6	5.1	41.1	29.2	39.5	27.6	1.6	4.3	4.7	26.4	0.4
1994	11.1	9.1	38.4	32.1	37.4	31.1	1.0	5.7	3.9	5.4	5.3
1995†	7.5	15.6	40.9	37.5	38.0	34.6	2.9	2.5	3.6	5.0	11.9
1996, 1st Q	0.1	0.8	44.9	10.7	44.3	10.0	0.7	0.0	0.6	0.1	0.2
Totals so far	\$ 119.6	\$ 59.7	\$ 394.3	\$ 222.1	\$ 376.6	\$ 204.4	\$ 17.7	\$ 66.8	\$ 40.9	\$ 52.8	\$ 18.8

* Many credits are limited to a portion of tax liability and/or must be used over several years after they are issued. ** Tax years.

† Income tax credits used were generally taken on calendar year 1994 tax returns (filed in 1995). (Likewise for earlier years.) Corporations used \$15 million of the \$15.6 million in business income tax credits used on 1994 tax returns, with the remainder used by unincorporated businesses.

Source: Arkansas Bureau of Legislative Research, Office of Economic & Tax Policy, Arkansas Tax Databook 1996.

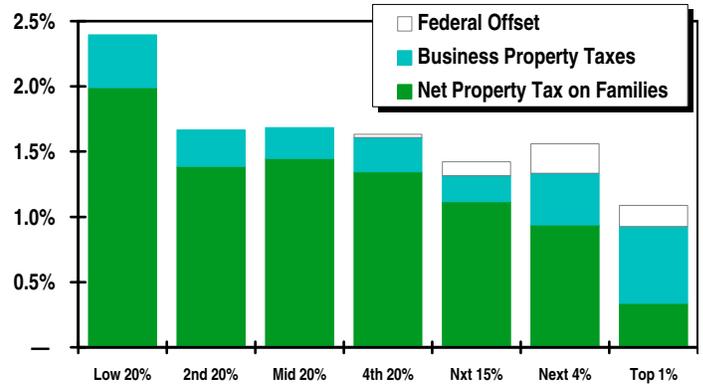
IV. Arkansas Property Taxes

Arkansas's property taxes include both taxes on real estate (homes, factories, etc.) and taxes on "personal property," e.g., motor vehicles and business equipment. Property taxes are very low in Arkansas relative to average national property taxes, both as a share of personal income (1.6 percent) and as a share of total state and local revenues (16 percent). In fact, the share of revenues that Arkansas gets from property taxes is less than half the national average.

Between 1980 and 1993, property taxes in Arkansas fell by 12 percent as a share of personal income, while property taxes nationwide rose by 11 percent as a share of income. As a consequence, property taxes in Arkansas fell from 58 percent of the national average (as a share of income) to only 46 percent of the national average. In 1993, Arkansas ranked 47th in property taxes as a share of personal income, lower than all of its neighboring states.

Arkansas's property tax on individuals is regressive, although less so than the sales tax, while the business portion of the tax is somewhat progressive. Some targeted relief is provided to low-income elderly homeowners through an income-based "circuit breaker" that refunds a

Arkansas Property Taxes



portion of the property tax to eligible taxpayers.

As is the case with Arkansas's personal income tax, a portion of Arkansas's property taxes on individuals are offset by federal income tax deductions—we calculate that percentage to be about 6 percent. The percentage federal offset is much lower than for the personal income tax because the property tax is not progressive, and thus a far smaller share of it is paid by better-off itemizers.

Currently, property taxes in Arkansas are in turmoil, reflecting the interaction of a constitutional amendment in 1980 limiting annual property tax revenue increases and a recent court decision declaring Arkansas’s school financing system unconstitutionally unequal. The Arkansas General Assembly has enacted legislation to address both these

sometimes conflicting constitutional requirements, but how things will all sort out remains in doubt. Evaluating these complicated property tax and school finance reform issues is beyond the scope of our report, but fortunately a new report from the Winthrop Rockefeller Foundation addresses these issues in depth.

*A New Winthrop Rockefeller Foundation
Report on School Finance*

EDUCATING ARKANSAS

Like many other states, Arkansas has faced a number of successful challenges to the constitutionality of its school-funding system during the last twenty years. As a result, state-government support for public schools has increased and local property-tax support has relatively decreased. Even when adjusted for the state’s lower incomes, Arkansas school districts rank 39th in the nation for their local support of public schools, while the state’s efforts have increased its rank to 15th. In the 1990s, almost 50 percent of state general revenues went to fund public elementary and secondary schools.

The state remains under court review since education funding was declared unconstitutionally unequal in 1994. The 1995 legislature endeavored to correct the inequalities with a new formula that seeks to serve two masters. It attempts to not only equalize revenue per student among the districts, but also guarantee a minimum amount of revenue per student to those districts that remain well below the wealthiest districts. This meets the goal of

reducing inequity according to one simplistic but commonly-used measure. Yet while achieving a short-term goal of lessening the inequality of revenue between the wealthier and poorer districts, the funding mechanisms have created a host of longer-term disincentives that discourage local effort at the district level.

A new Winthrop Rockefeller Foundation report, *EDUCATING ARKANSAS*, examines these funding problems and offers potential solutions to them. It demonstrates that financial equity could be achieved in a simple and straightforward way by equalizing the power of local property-tax millages. Insights from its PowerMill analysis can be used to address many of the specific troubles with the present system. By developing and presenting these alternatives, *EDUCATING ARKANSAS* stretches the limits of the possible so that sound and equitable public-school funding may ultimately be accomplished in Arkansas.

V. Other Arkansas Taxes

Arkansas’s other taxes, which amount to about six percent of total state and local tax revenues, consist primarily of motor vehicle and business license fees. Also included in this category are various other license fees, inheritance taxes and severance taxes. Between 1980 and 1993, all other Arkansas taxes fell from 0.8 percent of personal income to 0.6 percent, largely reflecting a decline in oil severance taxes. As a result, all other taxes in Arkansas are now just about equal to the national average as a share of personal income.

One area of other taxes in which Arkansas is extremely—almost ridiculously—low is its severance tax on natural gas. In neighboring states, natural gas is taxed at the wellhead at a rate of about 5 percent. In contrast, Arkansas’s tax rate of 3 cents per 1,000 cubic feet of gas translates into a rate of only 0.14 percent.

If Arkansas taxed natural gas like its neighbors, it would raise an additional \$19 million annually. Of course, as is the case with most Arkansas taxes, it would take a three-quarters vote in both houses of the General Assembly to do so.

Arkansas’s Severance Tax on Natural Gas

	Tax Rate	Revenue
Arkansas’s current severance tax*	0.14%	\$ 0.5 million
Tax with rate used in surrounding states	5%	19.9 million

*Tax is 0.3¢ per 1,000 cubic feet, shown here as a % of wellhead price.
Source: Arkansas Dept. of Finance & Administration.*

CHAPTER FOUR

OPTIONS FOR TAX REFORM IN ARKANSAS

There are many possible ways to change the Arkansas tax system. This section looks at a number of them. We include tax increase options, tax cut options and revenue neutral options. We examine several options that have been already proposed with much fanfare and others that are less well-known or talked about.

In some cases, if a combination of options were adopted, there would be interactions that would affect the net revenue estimate. If, for example, a homestead exemption that costs \$100 million were paired with an income tax proposal that raises \$100 million, the net result would raise revenue. That's because the homestead exemption would reduce the amount of property tax deductions from the state income tax and result in more than a \$100 million income tax hike. For several options, we have shown what the combined effect would be.

The charts accompanying the text show tax changes as a percent of income by income group. The solid portion of each bar represents the tax changes after offset for change in federal tax liability. The dotted lines on the charts show the tax changes without consideration of changes in federal tax liability.

We have presented our data in this way because for those who itemize deductions on their federal tax return, changes in state income tax or property taxes can produce substantial changes in federal tax liability.

For instance, if an itemizing taxpayer in the 28% federal tax bracket gets a \$1,000 cut in property taxes, his federal itemized deductions will fall by \$1,000. That will require him to pay tax on \$1,000 more of his income and increase his federal tax liability by \$280. Thus, the net tax cut would be \$720, not \$1,000.

Property tax changes are shown net of resulting changes in state income tax liability (because of the state itemized deduction for property taxes paid) and the homestead property tax relief program.

The charts are generally for all families and individuals. Where specific groups are affected in substantially different ways, we include charts showing this.

Earlier sections of this report, plus an appendix, show the incomes and current tax information that underlie these charts. Another appendix provides numerical details for each of the options.

All sales tax revenue estimates and distributions are for calendar year 1997. Property tax estimates and distributions are for taxes paid in calendar year 1997. Personal income tax estimates and distributions are for tax year 1997.

TABLE OF CONTENTS FOR OPTIONS

Revenue-Raising Options	p. 30
Revenue-Reducing Options	p. 38
Revenue Neutral Options	p. 42

Revenue-Raising Options

In this section we offer several revenue-raising tax reform options. A primary value to the public of these proposals is that they increase available funds for public services. The primary objections to any of these proposals is that those paying more in taxes will have lower after-tax incomes and that higher taxes may have an adverse impact on economic growth.

It is important to note that there is little evidence that higher state taxes have significant adverse economic impacts. The benefits of well-funded public services appear play at least as significant a role in a state's economic well-being.

In addition, when a state tax change causes more state and local taxes to be deducted on federal tax returns, there can be a substantial benefits to the state. Lower federal taxes means more money staying in the state instead of flowing into federal coffers. For example, the first option described below raises Arkansas state taxes by \$85 million, but causes federal taxes paid by Arkansans to be \$20 million lower. That leaves \$20 million more to be spent and invested by the people of Arkansas. Hypothetically, if that \$20 million were spent directly on employing people, it could create 500 \$40,000 per-year jobs. An economic development proposal that succeeded that well would undoubtedly be viewed as a significant boon to the economy.

Thus, although economic concerns may be raised regarding some of these options, particularly income tax increases on the well-off, the issue is far from cut-and-dried. Most of the options presented do not change the tax burden at any income level by more than one-percent of income. None of these options change the tax burden by as much as two-percent of income. When these changes are weighed against the federal top personal income tax rate of close to 40% and the other components of the overall tax burden, it would appear that the cries often heard in response to such proposals are somewhat in excess of an appropriate level of concern.

Although the debate on the economic impact of taxes has been centered on income taxes in recent years, it is

important to note that consumption taxes can have adverse economic impacts. Shifting tax burdens to middle-income consumers means they have less to spend at retail establishments in the state. Furthermore, a high sales tax rate can hurt retailers' and other businesses' positions relative to competitors from other states.

This is not to say that taxes can never adversely affect the economy, nor that reasonable minds do not differ on these issues. But, all in all, consideration of the likely

economic impacts of tax proposals should be kept in perspective.

Another issue that arises in analyzing the impact of tax options is whether they are likely to increase or decrease the short- and long-run stability of government finances. As a general rule, options that shift reliance to consumption taxes increase volatility, while options that shift reliance to the personal income tax increase stability.

1. Personal Income Tax Restructuring 1

Principal Features

- Revenue increase of \$85 million
- Tax increases greater at higher incomes
- Federal tax liability reduced by \$20 million
- Adopts joint-filing tax table for married couples
- Top marginal rate goes from 7% to 8% for ordinary income, from 6% to 7% for capital gains
- Standard Deduction increased for married couples

Current Rates and Standard Deductions Compared to Option 1

Standard Deductions		
Filing Status	Current: 10% of Adjusted Gross Income to maximum of:	Option 1: A flat amount of:
Married Filing Jointly	\$1,000	\$2,000
Married Filing Separately	\$500	\$1,000
Single	\$1,000	\$1,000
Head of Household	\$1,000	\$1,000

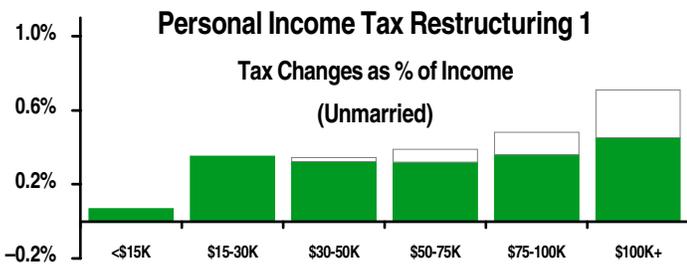
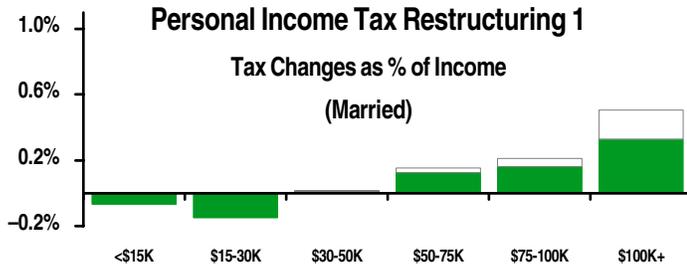
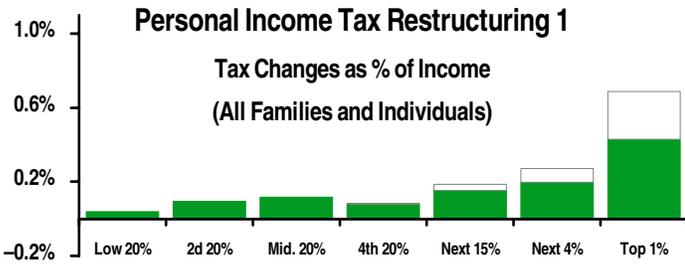
Note that the rate schedules are for taxable income—that is income after deductions and adjustments. On average, taxable income is 74% of total income in Arkansas. Increasing the standard deduction for married couples would make that percentage even lower.

Also, note that the rate schedules apply to “marginal income.” Under the current rate structure, for instance, if taxable income is \$16,000, that entire \$16,000 is not taxed at 6%. Instead, the first \$2,999 is taxed at 1%, the next \$3,000 is taxed at 2.5%, etc. Only \$1,000 of the \$16,000 is taxed at 6%. Also, tax liability at a particular income is not necessarily higher under an option because at that income the marginal rate is higher than under current law. Lower rates in the lower brackets may offset the effect of the higher rates in the higher bracket.

Current Marginal Tax Rate Schedule, All Filers	
Taxable Income Bracket	Marginal Tax Rate
First \$2,999 of taxable income	1.0%
Next \$3,000 (\$3,000 to \$5,999)	2.5%
Next \$3,000 (\$6,000 to \$8,999)	3.5%
Next \$6,000 (\$9,000 to \$14,999)	4.5%
Next \$9,000 (\$15,000 to \$24,999)	6.0%
Income after the first \$24,999	7.0%

Option 1 Marginal Tax Rate Schedule, Singles, Heads-of-Household, Married Filing Separately	
Taxable Income Bracket	Marginal Tax Rate
First \$9,999 of taxable income	2.5%
Next \$5,000 (\$10,000 to \$14,999)	6.0%
Next \$5,000 (\$15,000 to \$19,999)	6.5%
Next \$15,000 (\$20,000 to \$34,999)	7.0%
Next \$15,000 (\$35,000 to \$49,999)	7.5%
Income after the first \$49,999	8.0%

Option 1 Marginal Tax, Rate Schedule, Married Filing Jointly	
Taxable Income Bracket	Marginal Tax Rate
First \$19,999 of taxable income	2.5%
Next \$10,000 (\$20,000 to \$29,999)	6.0%
Next \$10,000 (\$30,000 to \$39,999)	6.5%
Next \$30,000 (\$40,000 to \$69,999)	7.0%
Next \$30,000 (\$70,000 to \$99,999)	7.5%
Income after the first \$99,999	8.0%



Discussion

This option raises \$85 million to provide additional public services. A majority of Arkansas taxpayers who currently pay state personal income tax would see a tax increase under this plan. The tax increases are greater at higher incomes than lower incomes. The top-marginal tax rate is increased by only one point.

Option 1 would, by increasing reliance on the relatively stable personal income tax, make Arkansas government finances more stable.

Another praiseworthy feature of this option is that a substantial portion of this tax increase would be offset by a reduction in federal income tax liability for Arkansans. This tax increase would increase Arkansans' federal tax form deductions for state personal income tax paid. This increase in deductions from the federal personal income tax would lower federal tax liability by \$20 million. Put another way, Arkansans get another \$85 million worth of government services, but it costs them only \$65 million.

Creation of a separate rate schedule for married couples filing jointly is a central feature of Option 1. It is important to note that a joint tax table does not necessarily create a "marriage-penalty." The federal system has a

marriage penalty because of the structure of its joint tax table income brackets relative to its singles table brackets. By contrast, Option 1 does not create any marriage penalty. In other words, two individuals who get married, and continue to have the same incomes as prior to marriage, would not face an increase in tax liability by virtue of the Option 1 tax tables.

Joint filing tables offer several advantages over the current system in Arkansas. One advantage is that married couples with similar combined incomes pay similar amounts of tax. Under current law, married couples that can, for tax purposes, split their income close to equally between spouses, pay less in tax than those who cannot. For example, a couple that has \$50,000 of taxable income composed entirely of interest and dividends, and can split it evenly, pays \$2,260 in tax (before credits). Another couple that cannot do better than split its taxable income \$40,000 to \$10,000 (perhaps because one spouse has substantially higher wages than the other), pays \$2,385.

With a joint table, the couple's combined income is what determines tax liability, not the ability to split unearned income to minimize tax liability or the happenstance of the different relative wage levels of each spouse. A couple comprises a single economic unit and a case can be made that the income type or wage differentials between the spouses, whether caused by choice or by force of circumstances, should not be subject to government imposed tax penalty or reward.

A useful byproduct of a joint-table is that it makes equitable rate structure design easier. Without a joint table, the 8% top rate of Option 1 would have had to apply to married couples with taxable incomes below \$100,000 to raise the \$85 million sought. Which couples would have been subject to that rate would have depended on their income splits. With a joint table, a bright-line distinction can be drawn for all married couples to ensure that only those with taxable incomes in excess of \$100,000 pay the higher rate.²¹

Another advantage of adopting a joint table is that it simplifies tax form preparation for married couples. Most of the lines on the Arkansas form become identical to the federal form under this option—making state tax filing little more than a copying process. The task of determining the split of income and deductions between each spouse is eliminated.

Relative to other taxpayers, Option 1 benefits married couples whose income is particularly concentrated with one spouse and those who are currently affected by the

²¹Note that, this \$100,000 in taxable income typically equates to total income of \$135,000. Also, the 8% rate is a marginal rate that only applies to the income over \$100,000. A couple with \$101,000 in taxable income pays the 8% rate on only \$1,000.

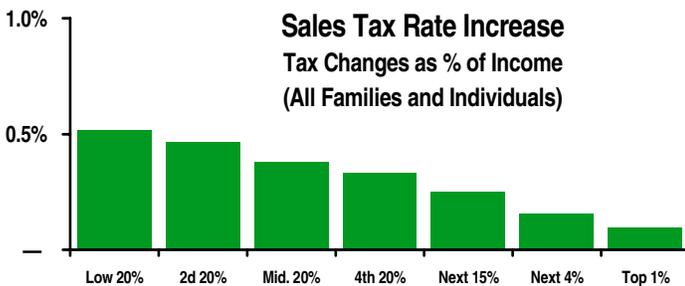
standard deduction marriage penalty. In fact, many of these couples would get a small tax cut notwithstanding the rate hikes. Overall, Option 1 favors married couples over unmarried taxpayers because the inequities it rectifies only affect the married.

Personal Income Tax Restructuring 1				
Income Group	% With Tax Cut	% With Tax Hike	Average Cut	Average Increase
Lowest 20%	0%	20%	\$ 4	\$ 13
Second 20%	15%	50%	32	36
Middle 20%	31%	52%	58	87
Fourth 20%	23%	66%	118	88
Next 15%	18%	81%	203	186
Next 4%	15%	82%	213	425
Next 1%	1%	99%	157	3,307
All	17%	54%	\$ 98	\$ 173

2. Raise the Sales Tax Rate

Principal Features

- Revenue increase of \$160 million
- Tax increases greater at lower incomes
- Raise sales tax rate from 4.5% to 5.0%



Discussion

This option raises \$160 million to provide additional public services. Approximately \$60 billion of this would initially be paid by business. Although the business component of this tax is entirely passed through to individuals, some through higher prices, it is largely hidden from the public (and some of it is exported).

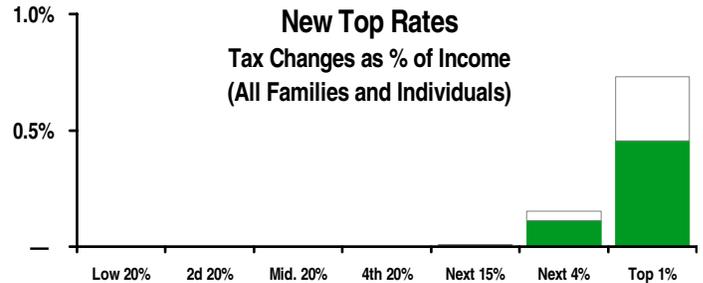
3. Adopt New Top Personal Income Tax Rates

Principal Features

- Revenue increase of \$45 million
- Tax increases only at higher incomes
- Federal tax liability reduced by \$15 million
- Top marginal rate goes from 7% to 9% for ordinary income, remains 6% for capital gains

Rates

This option keeps the current rate schedule but adds a marginal tax rate of 8% after the first \$50,000 of taxable income and 9% after the first \$100,000 of taxable income.



Discussion

This option raises \$45 million to provide additional public services. The tax increase falls entirely on better-off Arkansans.

Arkansas's federal personal income tax liability would decrease by \$15 million under this option because of the increase in the deduction for state personal income taxes.

4. Remove Sales Tax Credits, Exemptions, Etc.

There are a number of exemptions from the Arkansas sales tax, plus some \$40 million a year worth of Business Incentive Credits and refunds. In addition, some consumption items are currently excluded from taxation.

As discussed earlier in this report, most of the current exemptions are consistent with sound tax policy. The largest exemptions are for business purchases. Adding items largely purchased by business to the tax base could, of course, raise substantial revenue. Given the constitutional limitations on raising other taxes, this is an understandable recourse in the quest for adequate government funding. Also, some of the tax paid by business is exported to out-of-state consumers and, to some extent, owners.

On the other hand, most business sales taxes are passed through to consumers—making it a regressive tax. Also, the higher prices required to pay these taxes can hurt businesses competitive position. Thus, although business sales taxes may be a necessary recourse in Arkansas,

because of the constitutional bias towards the sales tax, they should probably not be a first choice.

The sales tax Business Incentive Credits, on the other hand, should be evaluated consistent with the criteria on page 27. If these credits are found to be an inefficient means of promoting economic development there is little justification for their continued use.

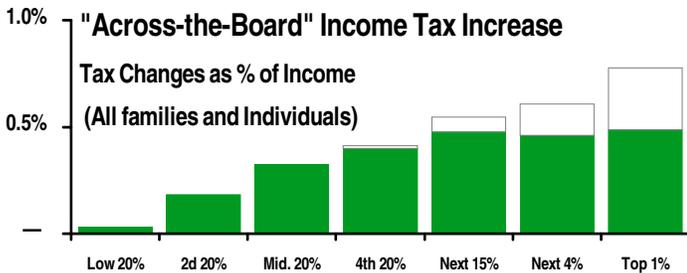
In addition to the exemptions, the Arkansas sales tax excludes from taxation some consumer services. There is usually not a sound rationale for excluding some services while taxing others and taxing most tangible goods. Taxing most services, however, typically places a heavier burden on low- and middle-income families than the wealthy.

A list of sales tax credits and an analysis are on pages 27-28 of this study. A list of selected exemptions is in an appendix.

5. "Across-the-Board" Personal Income Tax Rate Increase

Principal Features

- Raises \$185 million
- All rates increased in a roughly proportional manner
- Federal tax liability reduced by \$30 million



Marginal Tax Rate Schedule, Current and Option 5, All Filers		
Taxable Income Bracket	Marginal Rate Current	Marginal Rate Option 5
First \$2,999 of taxable inc.	1.0%	1.0%
next \$3,000 (\$3,000 to \$5,999)	2.5%	3.0%
next \$3,000 (\$6,000 to \$8,999)	3.5%	4.0%
next \$6,000 (\$9,000 to \$14,999)	4.5%	5.0%
next \$9,000 (\$15,000 to \$24,999)	6.0%	7.0%
Income after the first \$24,999	7.0%	8.0%

Discussion

This option raises \$185 million to provide additional

public services. Although the rate changes are similar in the different brackets (it's a 10% increase in each rate, rounded to the nearest whole percentage point), the overall result is a progressive tax increase. This is because the underlying tax is progressive. An "across-the-board" increase in a progressive tax is a progressive tax increase.

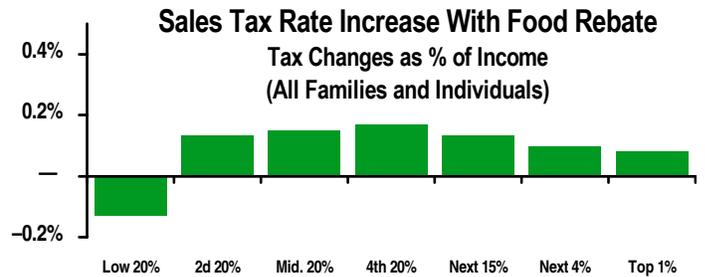
Arkansas's federal personal income tax liability would decrease by \$30 million under Option 5 because of the increase in the deduction for state personal income tax paid. Also, by increasing reliance on the relatively stable personal income tax, Option 5 would make Arkansas government finances more stable.

This option can be criticized for increasing the burden on lower and middle-income families (albeit less than their better-off compatriots).

6. Raise the Sales Tax and Adopt Grocery Credit

Principal Features

- Revenue increase of \$95 million
- Tax increases greater at lower incomes but mitigated by \$25 per-person grocery credit
- Raise sales tax rate from 4.5% to 5.0%



Discussion

This option raises \$95 million to provide additional public services. Approximately \$60 million of this would be initially paid by business.

This proposal can be criticized for increasing taxes on middle-income families more than the wealthy and for increasing reliance on a relatively unstable consumption tax.

Low-income tax breaks such as offered here are often subject to low-utilization rates—particularly for those who don't file tax returns. Hence, in practice, the tax relief mechanism might cost less than estimated (increasing the net revenue from the plan), but provide less relief than shown for those least able to pay.

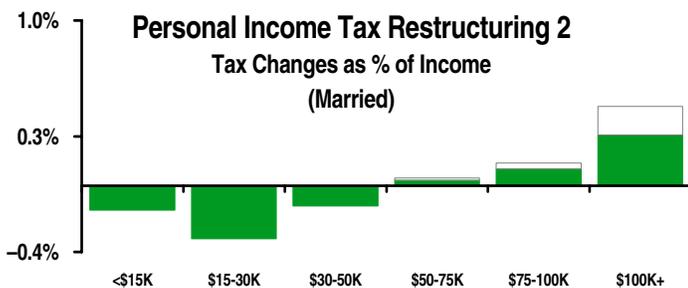
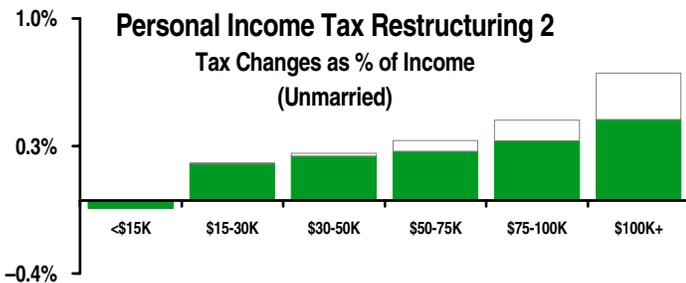
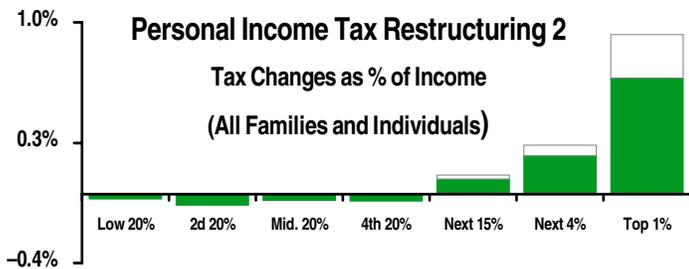
7. Personal Income Tax Restructuring 2

Principal Features

- Revenue increase of \$48 million
- Tax increase almost entirely at higher incomes
- Adopts joint-filing tax table for married couples
- Top marginal rate goes from 7% to 8% for ordinary income, from 6% to 7% for capital gains
- Exemption credit increase to \$40 from \$20
- Standard Deduction increased for married couples
- Federal tax liability reduced by \$19 million

Description

This option uses the same rate structure and standard deduction as Option 1. In addition, the exemption credit is increased from \$20 to \$40. This is to lessen the tax increase for low- and middle-income families found in Option 1. Of course, raising the credit also means that this option raises less revenue than Option 1.



Income Group	% With Tax Cut	% With Tax Hike	Average Cut	Average Increase
Lowest 20%	20%	—	\$ 2	\$ —
Second 20%	40%	24%	17	8
Middle 20%	40%	44%	38	29
Fourth 20%	44%	44%	49	34
Next 15%	23%	76%	50	104
Next 4%	19%	78%	44	302
Next 1%	1%	98%	3	3,193
All	33%	38%	\$ 30	\$ 73

Discussion

This option raises \$48 million to provide additional public services. About equal numbers of Arkansans see tax cuts as see tax increases under this option. Those who face tax increases see smaller hikes than under Option 1. The tax increase is also more concentrated at higher incomes than in Option 1.

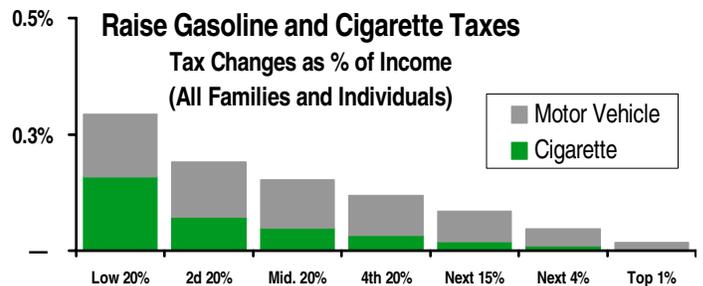
Arkansas's federal personal income tax liability would decrease by \$19 million under Option 7—offsetting almost 40% of the state tax increase. Also, by increasing reliance on the relatively stable personal income tax, Option 7 would make Arkansas government finances more stable.

This option shares with Option 1 the virtues of joint-filing for married couples.

8. Specialty Consumption Tax Increases

Principal Features

- Revenue increase of \$60 million in motor fuels tax
- Revenue increase of \$16 million in cigarette tax
- Tax increases greater at lower incomes
- Raise motor fuels rate 3 cents
- Raise cigarette tax by 6 cents



Discussion

This option raises \$66 million to provide additional public services.

The gas and diesel tax increase could be earmarked for paying for road improvements. Thus, the gas tax has the virtue of, to some extent, taxing those who use the government service the tax is paying for.

This proposal can be criticized for increasing taxes on those with the least ability to pay and increasing reliance on relatively unstable consumption taxes. Also, higher consumption taxes could hurt Arkansas retailers.

9. Corporate Income Tax Rate Increase

Principal Features

- Raises \$35 million
- Increases corporate income tax rates by one point. Top rate becomes 7.5%

Discussion

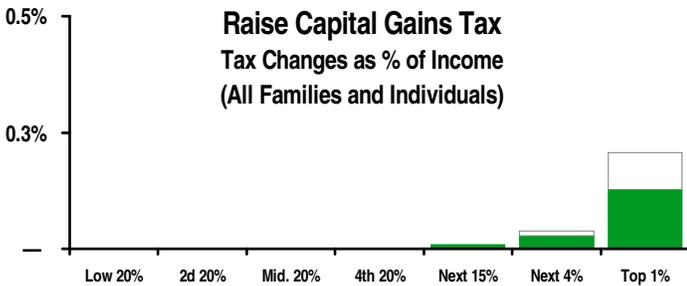
This option raises \$35 million to provide additional public services. Because the corporate income tax is largely passed through to shareholders, many of whom live out-of-state, the burden of this tax is not greatly felt in Arkansas.

Increasing reliance on the relatively unstable corporate income tax would increase the instability of the Arkansas tax system as a whole.

10. Tax Capital Gains at Regular Tax Rates

Principal Features

- Raises \$14 million
- Tax increase primarily on the wealthy
- Increases top tax rate on capital gains to 7% from 6%
- Federal tax liability reduced by \$5 million



Discussion

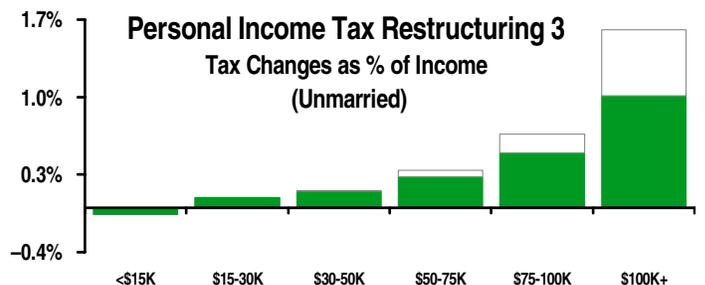
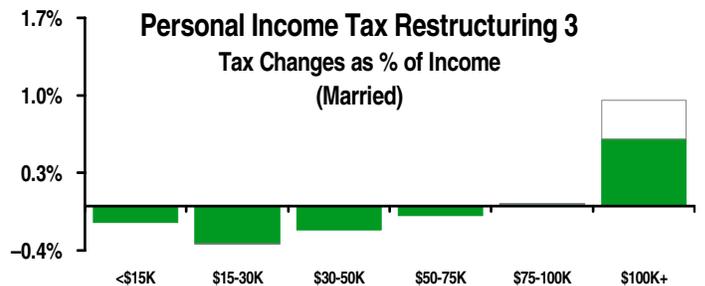
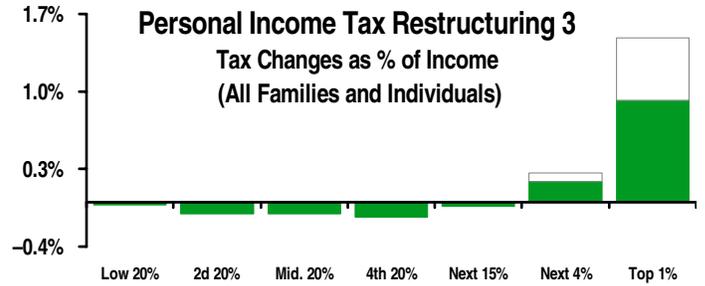
This option raises \$14 million to provide additional public services. Because the wealthy receive a far greater share of capital gains income than middle- and low-income families, this tax hike would impact better-off Arkansans the most.

Arkansas's federal personal income tax liability would decrease by \$5 million under Option 10.

11. Personal Income Tax Restructuring 3

Principal Features

- Revenue increase of \$68 million
- Tax increases almost entirely at higher incomes
- Federal tax liability reduced by \$34 million
- Adopts joint-filing tax table for married couples
- Top marginal rate goes to 9%
- Exemption credit increase
- Standard Deduction increased for married couples



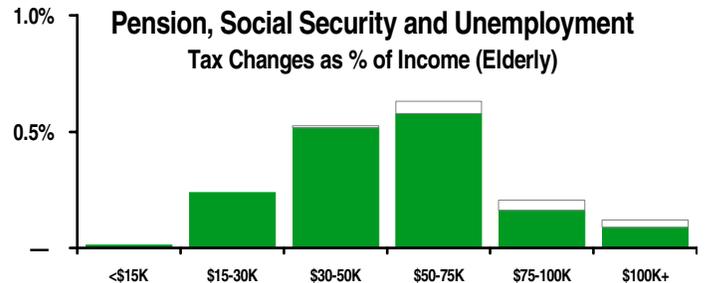
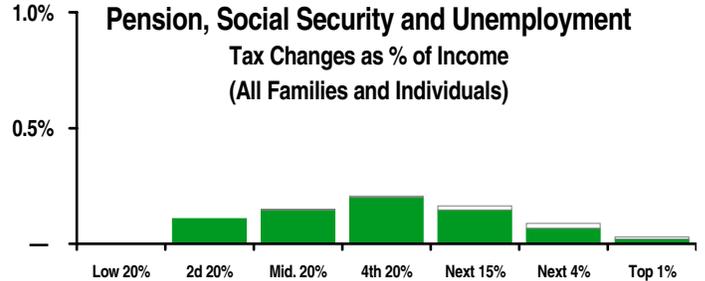
Description

This option is identical to Option 7 but with a different rate schedule that raises more revenue and is more progressive.

12. Remove Exclusions from Personal Income Tax for Pension, Social Security and Unemployment Compensation

Principal Features

- Revenue increase of \$50 million
- Tax increases are greatest on the middle to upper-income elderly and those receiving unemployment compensation
- Federal tax liability reduced by \$4 million



Description

This option eliminates the most substantial differences between income subject to federal personal income tax and that subject to the Arkansas personal income tax. This would make completing the Arkansas tax form somewhat simpler. This simplicity comes at the cost, however, of higher taxes for the elderly and those receiving unemployment compensation.

Not all pension income would be taxable under this option—only that taxable on the federal level. The principle underlying the federal taxation of pension income is that all employment compensation should eventually be taxed. Since many contributions to pension funds, and the investment income from those and other contributions, have never been taxed, the belief is that they should be taxed at the time of receipt by the retiree.

Similarly, only a portion of social security income is taxed under this option. The federal tax system only taxes social security when a recipient's total income rises above approximately \$30,000 for a single person and \$40,000 for a married couple. When half of social security starts to be

Option 11 Marginal Tax, Rate Schedule, Singles, Heads-of-Household, Married Filing Separately	
Taxable Income Bracket	Marginal Tax Rate
First \$9,999 of taxable income	2.5%
Next \$5,000 (\$10,000 to \$14,999)	5.5%
Next \$10,000 (\$15,000 to \$24,999)	6.5%
Next \$12,500 (\$25,000 to \$37,499)	7.0%
Next \$12,500 (\$37,500 to \$49,999)	8.0%
Income after the first \$49,999	9.0%

Option 11 Marginal Tax, Rate Schedule, Married Filing Jointly	
Taxable Income Bracket	Marginal Tax Rate
First \$19,999 of taxable income	2.5%
Next \$10,000 (\$20,000 to \$29,999)	5.5%
Next \$20,000 (\$30,000 to \$49,999)	6.5%
Next \$25,000 (\$50,000 to \$74,999)	7.0%
Next \$25,000 (\$75,000 to \$99,999)	8.0%
Income after the first \$99,999	9.0%

Discussion

This option raises \$68 million to provide additional public services. The tax increase is greater at higher incomes than lower incomes.

Arkansas's federal personal income tax liability would decrease by \$34 million under Option 11 because of the increase in the deduction for state personal income tax paid.

Another important feature of this option is that it adopts a separate rate schedule for married couples filing jointly, the virtues of which are discussed under Option 1.

taxable. Eventually, by about \$50,000 and about \$70,000 for married couples, 85% of social security income is subject to tax.

Unemployment compensation is taxed on the federal level because it is a payment in lieu of taxable wages. It is expected that the progressive nature of the federal personal income tax prevents heavy taxation of unemployment recipients who are impoverished by virtue of their being jobless.

A criticism of this option is that, because Arkansas's rate structure is less progressive than the federal rate structure, people who can ill-afford it would be paying higher taxes. Also, the federal tax system has other tax breaks for the elderly to offset the taxation of pension and social security income. Furthermore, raising taxes on the elderly, even the better-off elderly, faces the criticism that this group has fixed resources for the remainder of their lives and taxation hurts their financial situation in a more permanent way than non-elderly taxpayers.

Finally, Arkansas has been growing as a retirement destination in recent years. It is difficult to ascertain the precise role of the state's relative generosity towards the elderly in its personal income tax in this growth. Nevertheless, those choosing retirement destinations have many options and increasing taxes on the elderly could dampen growth in this sector of the economy.

13. Severance Tax Increase

Principal Features

- Revenue increase of \$20 million
- Tax is largely exported out-of-state
- Adopt a 5% of wellhead price tax for natural gas

Discussion

The severance taxes in Arkansas do not currently raise substantial revenue. Increasing rates to a level similar to neighboring states—5% of wellhead price in the case of natural gas—would provide additional revenue with little threat to Arkansas's competitive position. Furthermore, much of these taxes are exported to out-of-state consumers of the resources taxed.

14. Eliminate Corporate Income Tax Business Incentive Credits

Principal features

- Revenue increase of \$15 million
- Tax is largely exported out-of-state

Discussion

Before this option is considered, careful examination should be taken, under the principles described on

page 27, of whether these credits are the most efficient way to achieve the goals for which they are designed.

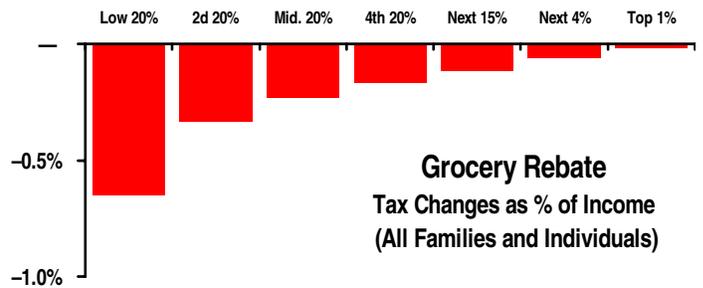
Revenue-Reducing Options

In this section we offer several revenue-losing tax reform options. The primary value to the public of these proposals is that they increase their after-tax income. The primary objection to any of these proposals is that they reduce funds available for providing desired government services.

15. Grocery Tax Rebate

Principal Features

- Revenue loss of \$63 million
- Tax relief greater at lower income levels
- Payment of \$25 per resident in the state to offset part of sales tax on groceries



Discussion

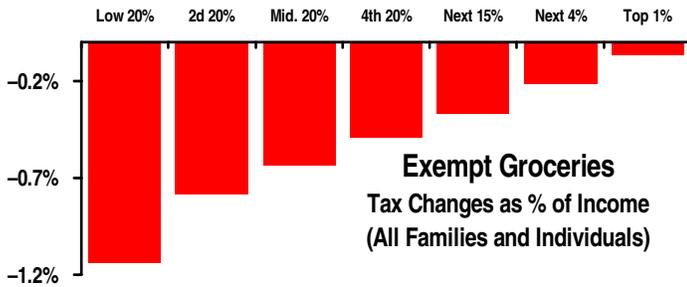
This plan provides progressive tax relief. The fixed amount of the rebate makes it more valuable to those with lower incomes than those with higher incomes.

The connection to the sales tax on food is rather tenuous. The tax paid on groceries is much greater than this credit and the rebate is not targeted by actual grocery purchases. It is essentially a payment of \$25 to every Arkansan. It has four possible advantages, however, over complete removal of the tax on groceries. (1) It has less of an impact on the provision of public services; (2) it is more easily adjustable depending on the state's fiscal circumstances; (3) it leaves groceries, one of the more stable elements of the sales tax base, in the sales tax; and (4) it is more targeted to lower income families than an outright exemption.

16. Eliminate Sales Tax on Groceries

Principal Features

- Revenue loss of \$147 million state and \$43 million local
- Tax relief greater at lower income levels



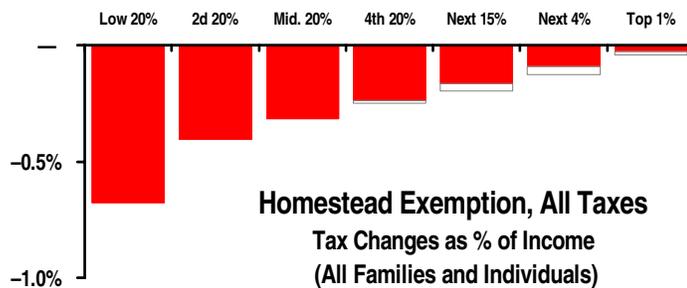
Discussion

This plan provides progressive tax relief. It requires, however, a substantial reduction in state and local government services to pay for it. Also, groceries are one of the more stable elements in the sales tax. Hence, removal of groceries from the tax base would make sales tax revenues more volatile.

17. Homestead Exemption

Principal Features

- School Revenue loss of \$70 million, or
- School and Local Government revenue loss of \$92 million
- \$3,000 homestead exemption on assessed value
- Tax reduction greatest for those with lower value homes



Discussion

The type of homestead exemption offered here is a flat reduction in the taxed amount of residential home value. In other words, each home is assessed and then a fixed dollar amount is subtracted before the tax rate is applied.

The following table shows the property tax calculation on a \$60,000 home with and without a \$3,000 homestead exemption (assuming the jurisdiction is accurately assessing the value of the home):

Homestead Exemption	Without Homestead Exemption	With Homestead Exemption
Home Value	\$60,000	\$60,000
Arkansas Statutory Assessment Factor	x 20%	x 20%
Assessed Value	= \$12,000	= \$12,000
Homestead Exemption	- \$3,000	- \$0
Taxable Value	= \$9,000	= \$12,000
Tax Rate	x 40 Mills	x 40 Mills
Tax	\$360	\$480

Homestead exemptions such as this give a larger tax break, on a percentage basis, to those with lower value homes. In the example above the homestead exemption would give a 25% tax cut. On a \$75,000 home the cut would be 20% and it would be only a 10% cut on a \$150,000 home. Thus, such a homestead exemption tends to give lower income families a bigger tax break. It also, of course, tends to reduce tax collections much more in jurisdictions that have lower value homes.

Two variants of this option are offered. One is to apply the exemption only for school property taxes, the other to apply it to all homeowner property taxes.

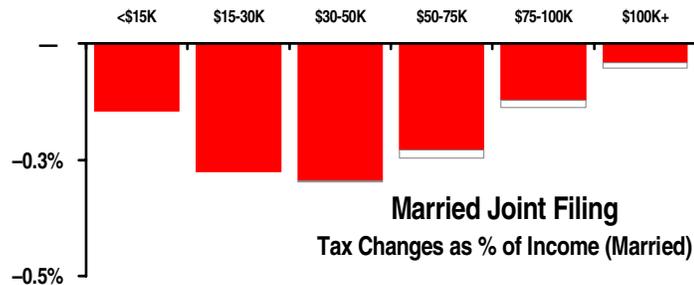
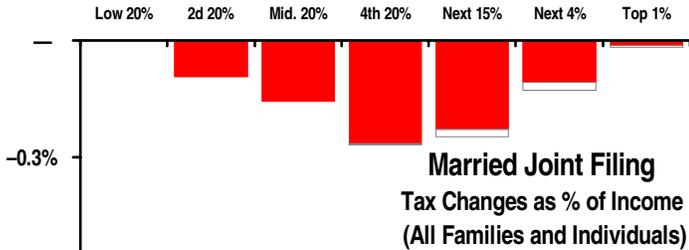
This option would substantially reduce funding for schools and local governments at a time when there is substantial pressure for increased funding, particularly for schools. Furthermore, the property tax is the lowest major tax in Arkansas relative to other states. Even if a homestead exemption could be managed in the short run, in the long run it would probably result in a shift in tax burden from the property tax to the sales and income taxes.

This option would cause state personal income tax liability to increase by \$2.4 million and the cost of homestead property tax relief would thus go down by \$1 million (if the homestead exemption were to apply to all homeowner property taxes). Federal tax liability would increase by \$7 million. Lower deductions on the state and federal forms for property taxes paid are the cause of these personal income tax increases.

18. Separate Tables and Increased Standard Deduction for Married Couples

Principal Features

- Revenue loss of \$55 million
- Adopts joint-filing tax table for married couples
- Increase standard deduction for married couples
- Federal taxes go up by \$3 million



Discussion

This option combines the standard deductions of Option 1 with a rate table identical to the current table except that the bracket amounts are doubled for married couples. The revenue loss is caused by the increase in standard deduction and because married couples that have a division of income between spouses that works to their tax disadvantage under the current system would no longer be penalized.

This option gives greater tax cuts to low- and middle-income than the better off.

19. Across the Board Personal Income Tax Cut

Principal Features

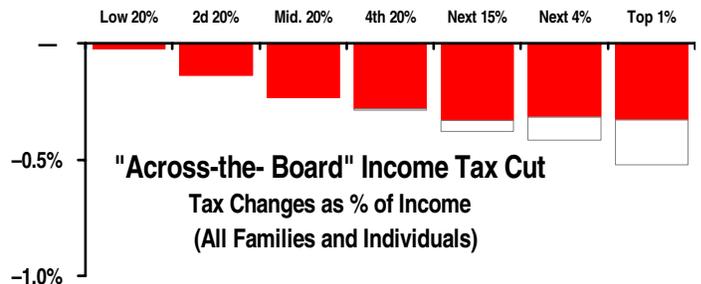
- Reduces revenue by \$128 million
- All personal income tax rates cut in a proportional manner
- Federal taxes go up by \$20 million

Marginal Tax Rate Schedule, Current and Option 19, All Filers		
Taxable Income Bracket	Marginal Tax Rate Current	Marginal Tax Rate Option 18
First \$2,999 of taxable income	1.0%	0.90%
next \$3,000 (\$3,000 to \$5,999)	2.5%	2.25%
next \$3,000 (\$6,000 to \$8,999)	3.5%	3.15%
next \$6,000 (\$9,000 to \$14,999)	4.5%	4.05%
next \$9,000 (\$15,000 to \$24,999)	6.0%	5.40%
Income after the first \$24,999	7.0%	6.30%

Discussion

This option causes a very large reduction of \$128 million in funds available for public services. “Across-the-Board” personal income tax cuts are often misconstrued as even-handed tax cuts. After all, if all tax rates are cut by 10%, then doesn’t everyone get the same break? The flaw in this argument is that the state personal income tax is only a portion of state and local taxes—the most progressive portion. Thus, a cut in that tax while leaving other, regressive, taxes untouched makes the tax system as a whole more regressive. If a 10% cut were proposed in all state taxes that would, indeed, be “across-the-board” and even-handed. It would also, of course, be tremendously expensive and do nothing to reduce the regressivity of the current system.

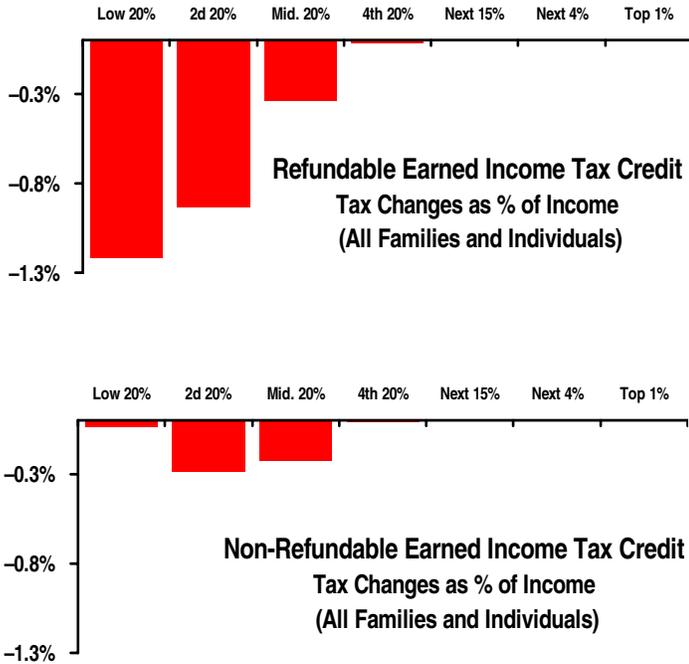
A flaw of Option 19 is that a substantial portion of this tax cut would flow to the federal government. Arkansans’ federal personal income taxes would go up by \$20 million under this option because of the decrease in deductions for state personal income tax paid. Thus of the \$128 million tax cut only \$108 million would stay in-state.



20. Adopt a State Earned Income Tax Credit

Principal Features

- Reduces revenue by \$66 million if “refundable” and \$22 million if “non-refundable”
- Provides relief to low-income working people



Discussion

The Earned Income Tax Credit (EITC) is a federal personal income tax credit that provides tax relief for lower-income working families. The federal credit is refundable—meaning that if the credit exceeds tax liability the government pays the excess credit to the recipient. Thus, this credit creates “negative tax liability” for many families. On the federal level the refundable portion is often viewed as offsetting other federal taxes that lower-income families pay—particularly FICA taxes.

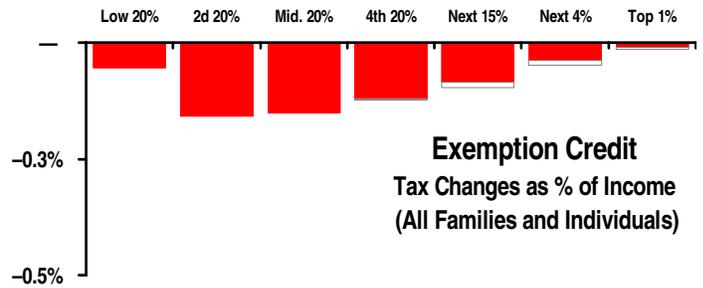
The options presented here include a refundable credit and a non-refundable credit each equal to 20% of the federal credit. Other states that have EITCs typically do it in this way—as a percentage of the federal credit. These options offer targeted tax relief for lower-income working families. The refundable portion of the credit could be seen as offsetting other state taxes in the same manner as Option 15, the food rebate. The non-refundable credit provides no benefit for those whose income is now so low that they don’t owe income tax.

Because this credit exclusively affects lower income families who rarely itemize deductions on their federal return, the impact on federal tax deductions for state income taxes paid is negligible.

21. Increase Exemption Credit on Personal Income Tax

Principal Features

- Reduces revenue by \$37 million
- Provides greater tax cuts for lower-income taxpayers
- Doubles exemption credit from \$20 per person to \$40 per person



Discussion

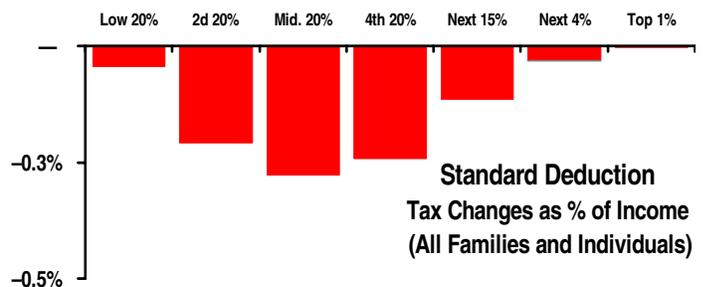
The exemption credit is a flat amount that is subtracted from tax liability before credits to compute final personal income tax liability. This calculation is done for most taxpayers by virtue of its inclusion in the tax tables. This option doubles the exemption credit. The result is a tax cut that is greater, proportionate to income, for low and middle-income taxpayers who owe personal income taxes. Low-income families that currently do not owe income tax do not benefit from this option.

Because this credit is a small portion of tax liability for higher income taxpayers who itemize, the impact on the federal tax deduction for state income taxes paid is relatively small—increasing federal personal income tax payments by only \$2 million.

22. Increase Standard Deduction

Principal Features

- Reduces revenue by \$55 million
- Provides greater tax cuts for lower- and middle-income taxpayers



Discussion

The Arkansas standard deduction is low relative to the federal law and most states. As a result, many individuals who don't itemize on their federal returns do itemize on their state returns. This makes filing in Arkansas more complicated. Also, those without itemized deductions (typically lower income filers) pay tax on more of their income than is common in other states. Changing the standard deduction to a higher flat amount (instead of the current system of 10% of adjusted gross income up to a maximum of \$1,000) is a progressive tax change.

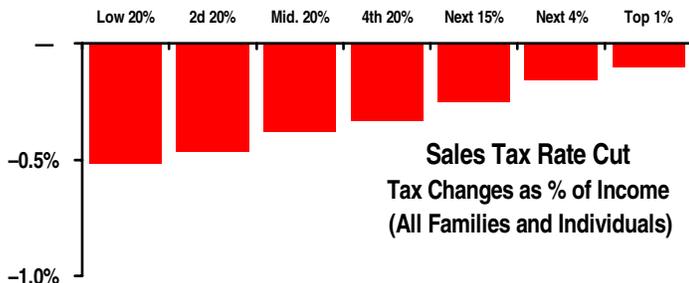
Standard Deductions		
Filing Status	Current: 10% of Adjusted Gross Income to a maximum of:	Option 22: A flat amount of:
Married Filing Jointly	\$1,000	\$4,000
Married Filing Separately	\$500	\$2,000
Single	\$1,000	\$2,000
Head of Household	\$1,000	\$2,000

At \$55 million a year relatively modest changes in the standard deduction are quite expensive.

23. Reduce State Sales Tax Rate

Principal Features

- Revenue loss of \$160 million
- Rate cut from 4.5% to 4%
- Tax cut greater for lower-income families



Discussion

This plan provides progressive tax relief. But it requires a substantial reduction in state and local government services to pay for it.

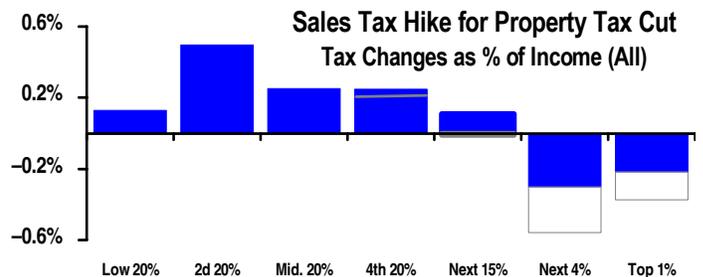
Revenue Neutral Options

In this section we offer several tax reforms that have little impact on total tax collections but significant impact on who pays the taxes. The amount of federal taxes paid by Arkansans is also substantially changed by several of these options.

24. Raise the Sales Tax Rate to Pay for Property Tax Relief

Principal Features

- Eliminates real property taxes
- Raise the sales tax rate from 4.5% to 6.5%
- Increases federal income tax liability by \$37 million



Note: This table includes the Arkansas personal income tax increase that would result from the loss of property tax deductions.

Discussion

This option primarily raises taxes on middle-income taxpayers and cuts taxes for the wealthy. Low-income families are little affected because taxes paid on their homes and through higher rents are quite substantial. Thus, for the poor the trade-off between two taxes that both impose a heavy burden is of relatively small consequence.

For middle-income Arkansans the sales tax increase dominates. And, not surprisingly, the well-off, who spend a relatively small share of their income on items subject to sales tax, yet own valuable homes and businesses, get a tax cut.

This option also has substantially different impacts on groups defined by other criteria than income. For example, renters face a bigger tax hike than homeowners. And those who pay low property taxes, either because of low-home values or low tax rates where they live, would get less benefit than those who live in areas where homes are more valuable or rates are higher.

This option also shifts the funding of government to a tax that has failed to keep up with Arkansas's growth. Relying so heavily on a stagnant tax would make it even more difficult to deal with the complex issues created by shifting from local taxation to statewide taxation, i.e., how

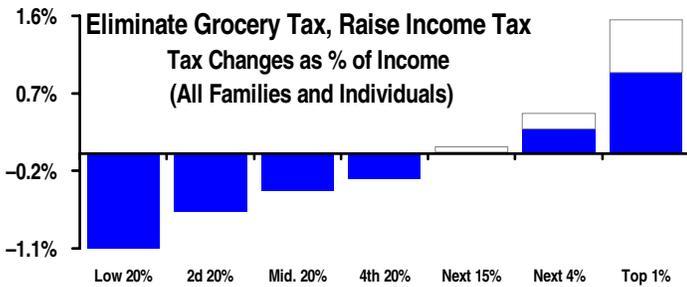
to recompense the local governments and school districts for the loss of property tax revenue.

Arkansas as a whole loses \$37 million in higher tax es to the federal government under this option. The exchange of property taxes, which are deductible from the federal personal income tax, for sales taxes which aren't, causes this increase.

25. Eliminate Sales Tax on Groceries and Raise the Personal Income Tax

Principal Features

- Tax cut for lower- and middle-income taxpayers, tax increase at higher incomes
- Adopts joint-filing tax table for married couples
- Top marginal rates go to 9%
- Eliminates Standard Deduction marriage penalty
- Federal taxes go down by \$49 million



Description

This option raises the personal income tax, adopts joint-filing for married couples, eliminates the standard deduction marriage penalty and eliminates the sales tax on groceries.

Option 25 Marginal Tax, Rate Schedule, Married Filing Jointly	
Taxable Income Bracket	Marginal Tax Rate
First \$19,999 of taxable income	2.5%
Next \$10,000 (\$20,000 to \$29,999)	6.0%
Next \$30,000 (\$30,000 to \$59,999)	7.5%
Next \$20,000 (\$60,000 to \$79,999)	8.0%
Next \$20,000 (\$80,000 to \$99,999)	8.5%
Income after the first \$99,999	9.0%

Option 25 Marginal Tax, Rate Schedule, Singles, Heads-of-Household, Married Filing Separately	
Taxable Income Bracket	Marginal Tax Rate
First \$9,999 of taxable income	2.5%
Next \$5,000 (\$10,000 to \$14,999)	6.0%
Next \$15,000 (\$15,000 to \$29,999)	7.5%
Next \$10,000 (\$30,000 to \$39,999)	8.0%
Next \$10,000 (\$40,000 to \$49,999)	8.5%
Income after the first \$49,999	9.0%

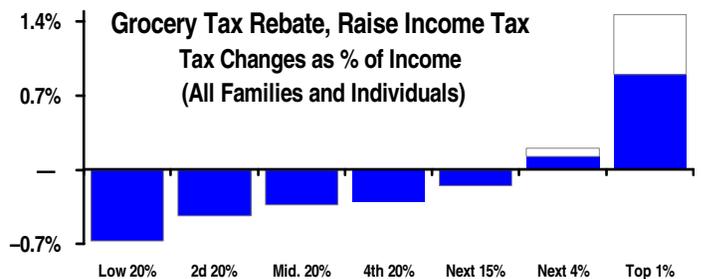
Discussion

This is a progressive tax reform that involves a substantial shift from the sales tax to the personal income tax. Because the sales tax is not deductible but the income tax is, federal tax liability for Arkansans would be reduced by \$49 million.

26. Grocery Tax Rebate and Raise the Personal Income Tax

Principal Features

- Progressive tax reform
- Adopts joint-filing tax table for married couples
- Top marginal rates go to 9%
- Standard Deduction marriage penalty eliminated
- Federal taxes go down by \$34 million
- Payment of \$25 per resident to offset part of sales tax on groceries



Description

This option combines Options 11 (Personal Income Tax Restructuring 3) and 15 (grocery tax rebate)

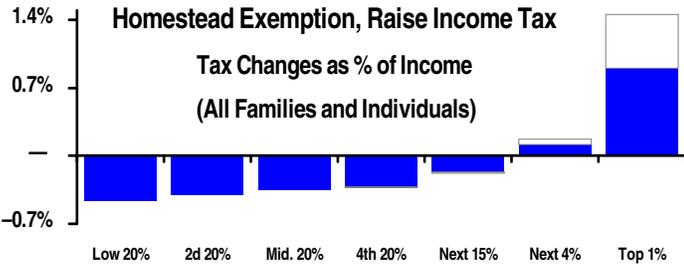
Discussion

Federal tax liability for Arkansans would be reduced by \$34 million.

27. School Homestead Exemption With Personal Income Tax Increase

Principal Features

- Tax increase for better-off; tax cut for others, particularly homeowners
- Tax shift from local to state government
- Federal tax liability reduced by \$29 million



Description

This is a combination of Options 11 and 17

Discussion

Option 27 raises taxes on better-off Arkansans and lowers taxes on the rest. This option shifts taxing responsibilities from the local to the state level. The tax loss for local school districts, however, would vary widely depending on home values and the relative amounts of business and residential properties. Compensation by the state to school districts would have to take this into account.

Option 27 results in a net decrease in federal tax liability of \$29 million. By shifting some of the state tax burden to higher-income taxpayers, the probability of itemizing and the value of the deduction on the federal return are increased.

28. Cut Corporate Income Tax Rate and Remove Business Incentive Credits

Principle Features

- Cut corporate income tax rate by half point
- Remove corporate tax breaks

Discussion

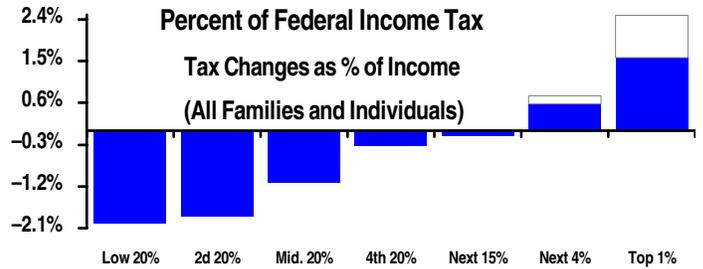
Under this option the various “business incentives” in the corporate income tax would be eliminated and the corporate rate would be reduced. This would redistribute the corporate tax burden among corporations. If the tax breaks in current law are more successful in causing businesses to locate in Arkansas than a lower tax rate would be, then this option would hurt the Arkansas economy. On the other hand, if the higher rate required by

virtue of having the targeted incentives in place has hurt the Arkansas economy, then this option is attractive.

29. Personal Income Tax Reforms

- A selection of revenue neutral personal income tax reforms

a. Tax as a Percent of Federal Liability



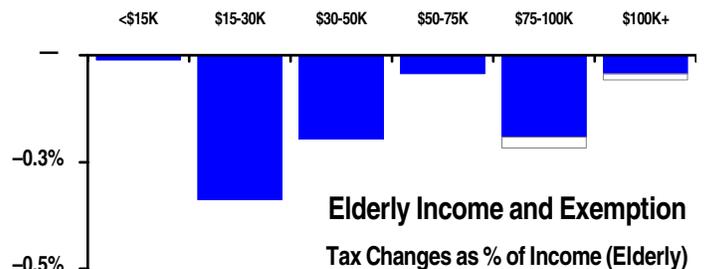
Under this option, Arkansas personal income tax would be calculated by simply multiplying federal tax liability by 33%. This option is very progressive, provides a generous earned income tax credit for lower-income families and makes Arkansas tax filing simple. The Arkansas tax system would, however, be subject to substantial upheaval in the event of federal tax changes. Also the effective top marginal rate in the state (on incomes above about \$350,000) would be more than 13%—the highest state top rate in the country. Finally, Arkansas would be adopting the federal marriage penalty.

Federal tax liability would be \$58 million lower under this option.

b. Tax Social Security and Pension Income Consistent with Federal Rules and Increase Elderly Exemption Credit

This is a generally progressive option that primarily impacts the elderly. The elderly credit would be increased to \$400. This option would make filing somewhat simpler because differences between the federal tax form and the Arkansas tax form would be eliminated.

This option lowers tax liability for many elderly taxpayers. The lowest income elderly are not greatly



affected because they currently pay little tax, do not have to pay tax on their social security income under federal rules and the tax on what little pension income they have is offset by the increased credit. The income groups that benefit the most are those below the threshold for paying tax on social security. In the \$75,000 to \$100,000 range a substantial amount of income was already taxable so removing the pension and social security exclusion has less of an impact. Hence, this group benefits greatly. For the top group, the gain is small because the \$380 increase in credit is a very small portion of total income.

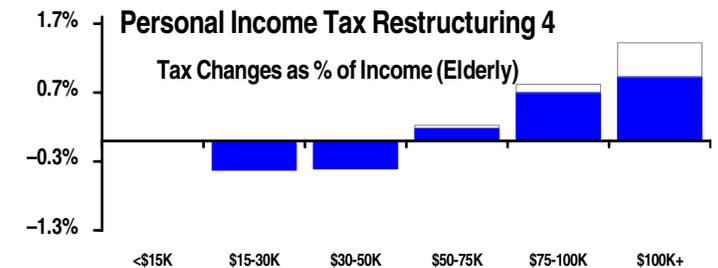
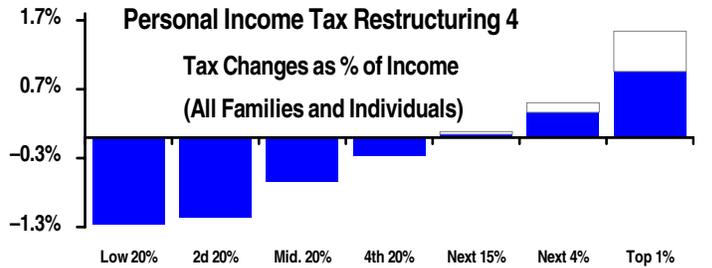
This option causes some shift in taxes from the elderly to the non-elderly. This is because the forms of income made subject to tax, some pension and some social security, are not exclusively received by the elderly. The increase of the exemption credit for the elderly, however, goes exclusively to that group.

This option makes tax liability for the elderly less dependent on the forms their income happens to take. Elderly who, for instance, live off investment income outside pension plans currently pay more in tax than those who have pension plans.

c. Personal Income Tax Restructuring, 4.

This is a comprehensive personal income tax reform option designed to make the tax system more progressive and more equitable overall. It reflects a combination of Option 11 (Personal Income Tax Restructuring 3), Option 20 (Adopt Earned Income Tax Credit), Option 22 (Increase Standard Deductions) and Option 29b (Personal Income Tax Restructuring Affecting the Elderly).

This option reduces federal liability by \$40 million.



CONCLUSION

As the great debate about the proper size and role of the federal government proceeds in Washington, D.C., the demand for quality government services from state and local governments continues to grow. As new responsibilities devolve to the states, important decisions will have to be made on how to pay for fulfilling them.

To date, state and local governments, including Arkansas's, have chosen not to tax those who can best afford it at the same levels that middle- and low-income families are asked to pay. This report marks a point from which the future of Arkansas's approach to taxes can be measured.

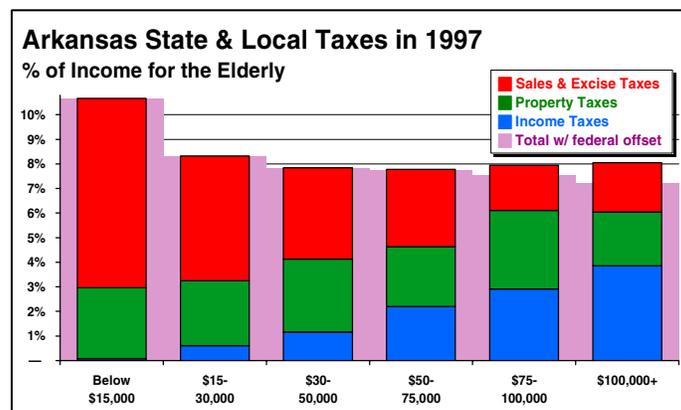
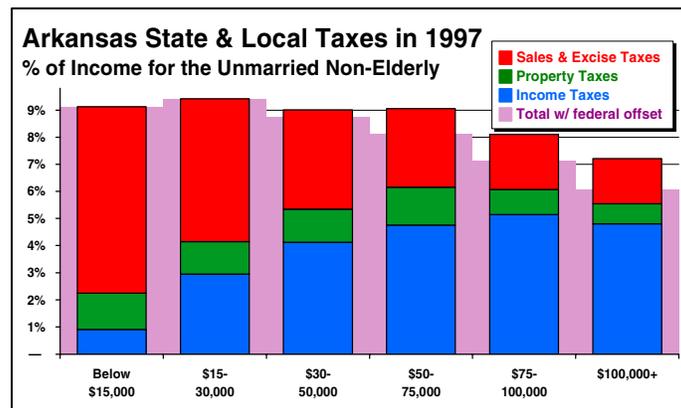
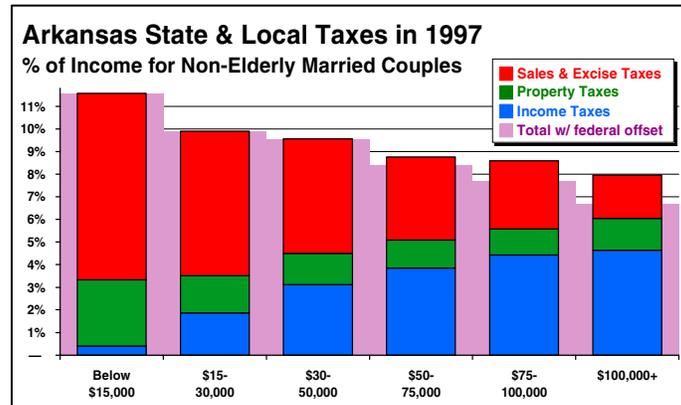
Of course, Arkansas elected representatives may choose to continue to provide low levels of public services. Or instead, they may decide to pay for new services in the same way that it has in the past—regressively. But there is another option: ask wealthier families to pay tax rates more commensurate with their incomes. Whichever path Arkansas chooses will have a major impact on the well-being of Arkansans in the future.

Appendix: Detailed Distributional Tables

The charts on this page illustrate the distribution of Arkansas' taxes for various subcategories of Arkansas families.

These charts are followed on the next two pages by detailed tables covering the same data, plus detailed data by income quintile for all Arkansas taxpayers.

The source for all this data is the Institute on Taxation & Economic Policy Tax Microsimulation Model.



Arkansas State & Local Taxes in 1997

As Shares of Income for All Families & Individuals

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	TOP 1%
Income Range	Less than \$10,000	\$10,000 – \$18,000	\$18,000 – \$28,000	\$28,000 – \$47,000	\$47,000 – \$86,000	\$86,000 – \$176,000	\$176,000 or more
Average Income in Group	\$6,100	\$14,300	\$22,800	\$36,700	\$61,000	\$116,500	\$474,000
Sales & Excise Taxes	7.8%	6.7%	5.4%	4.7%	3.5%	2.1%	1.3%
General Sales—Individuals	4.5%	4.1%	3.3%	3.0%	2.2%	1.4%	0.9%
Other Sales & Excise—Ind.	1.6%	1.1%	0.9%	0.7%	0.5%	0.3%	0.1%
Sales & Excise on Business	1.7%	1.5%	1.2%	1.0%	0.8%	0.5%	0.3%
Property Taxes	2.4%	1.7%	1.7%	1.6%	1.4%	1.6%	1.1%
Property Taxes on Families	2.0%	1.4%	1.4%	1.4%	1.2%	1.2%	0.5%
Property Taxes on Business	0.4%	0.3%	0.2%	0.3%	0.2%	0.4%	0.6%
Income Taxes	0.2%	1.3%	2.2%	2.9%	3.8%	4.3%	5.5%
Personal Income Tax	0.1%	1.2%	2.2%	2.8%	3.7%	4.1%	5.2%
Corporate Income Tax	0.0%	0.1%	0.1%	0.1%	0.1%	0.2%	0.3%
TOTAL TAXES	10.4%	9.6%	9.3%	9.2%	8.7%	8.0%	7.9%
Federal Deduction Offset	—	-0.0%	-0.0%	-0.1%	-0.4%	-1.0%	-1.8%
TOTAL AFTER OFFSET	10.4%	9.6%	9.3%	9.1%	8.3%	7.0%	6.0%

Arkansas State & Local Taxes in 1997

As Shares of Income for Non-Elderly Married Couples

Income Range	Less than \$15,000	\$15,000 – \$30,000	\$30,000 – \$50,000	\$50,000 – \$75,000	\$75,000 – \$100,000	\$100,000 or more
% of Couples in Group	11.2%	23.8%	30.7%	20.8%	6.7%	6.7%
Average Income in Group	\$9,600	\$22,600	\$39,100	\$60,400	\$85,100	\$213,000
Sales & Excise Taxes	8.3%	6.4%	5.1%	3.7%	3.0%	1.9%
General Sales—Individuals	4.8%	3.9%	3.2%	2.4%	2.0%	1.2%
Other Sales & Excise—Ind.	1.8%	1.1%	0.7%	0.5%	0.4%	0.2%
Sales & Excise on Business	1.7%	1.4%	1.1%	0.8%	0.7%	0.4%
Property Taxes	2.9%	1.7%	1.4%	1.2%	1.2%	1.4%
Property Taxes on Families	2.6%	1.4%	1.2%	1.1%	1.1%	1.1%
Property Taxes on Business	0.3%	0.2%	0.2%	0.1%	0.1%	0.3%
Income Taxes	0.4%	1.9%	3.1%	3.9%	4.4%	4.6%
Personal Income Tax	0.4%	1.8%	3.1%	3.8%	4.4%	4.5%
Corporate Income Tax	0.0%	0.0%	0.0%	0.0%	0.0%	0.2%
TOTAL TAXES	11.6%	9.9%	9.6%	8.8%	8.6%	8.0%
Federal Deduction Offset	—	-0.0%	-0.0%	-0.4%	-0.9%	-1.3%
TOTAL AFTER OFFSET	11.6%	9.9%	9.5%	8.4%	7.7%	6.7%

Arkansas State & Local Taxes in 1997

As Shares of Income for the Non-Elderly Unmarried

Income Range	Less than \$15,000	\$15,000 - \$30,000	\$30,000 - \$50,000	\$50,000 - \$75,000	\$75,000 - \$100,000	\$100,000 or more
% of Unmarrieds in Group	47.3%	38.8%	10.3%	2.5%	0.4%	0.4%
Average Income in Group	\$8,200	\$21,000	\$38,000	\$56,800	\$85,600	\$364,000
Sales & Excise Taxes	6.9%	5.3%	3.7%	2.9%	2.0%	1.7%
General Sales—Individuals	4.0%	3.2%	2.3%	1.9%	1.3%	1.0%
Other Sales & Excise—Ind.	1.2%	0.8%	0.5%	0.4%	0.3%	0.2%
Sales & Excise on Business	1.7%	1.2%	0.9%	0.6%	0.5%	0.4%
Property Taxes	1.3%	1.2%	1.2%	1.4%	0.9%	0.7%
Property Taxes on Families	1.0%	1.0%	1.0%	1.2%	0.6%	0.4%
Property Taxes on Business	0.3%	0.2%	0.2%	0.2%	0.3%	0.4%
Income Taxes	0.9%	3.0%	4.1%	4.8%	5.1%	4.8%
Personal Income Tax	0.9%	2.9%	4.1%	4.7%	5.0%	4.6%
Corporate Income Tax	0.0%	0.0%	0.1%	0.1%	0.2%	0.2%
TOTAL TAXES	9.1%	9.4%	9.0%	9.1%	8.1%	7.2%
Federal Deduction Offset	—	-0.0%	-0.3%	-0.9%	-1.0%	-1.1%
TOTAL AFTER OFFSET	9.1%	9.4%	8.7%	8.1%	7.1%	6.1%

Arkansas State & Local Taxes in 1997

As Shares of Income for the Elderly

Income Range	Less than \$15,000	\$15,000 - \$30,000	\$30,000 - \$50,000	\$50,000 - \$75,000	\$75,000 - \$100,000	\$100,000 or more
% of Elderly in Group	42.3%	26.4%	18.6%	7.2%	2.5%	2.9%
Average Income in Group	\$8,800	\$20,500	\$36,900	\$60,100	\$90,500	\$244,000
Sales & Excise Taxes	7.7%	5.1%	3.7%	3.1%	1.8%	2.0%
General Sales—Individuals	4.8%	3.2%	2.4%	2.0%	1.2%	1.3%
Other Sales & Excise—Ind.	1.2%	0.7%	0.5%	0.4%	0.2%	0.2%
Sales & Excise on Business	1.7%	1.1%	0.8%	0.7%	0.4%	0.5%
Property Taxes	2.9%	2.6%	3.0%	2.4%	3.2%	2.2%
Property Taxes on Families	2.6%	2.3%	2.4%	1.7%	2.3%	1.3%
Property Taxes on Business	0.3%	0.4%	0.6%	0.7%	0.9%	0.9%
Income Taxes	0.1%	0.6%	1.2%	2.2%	2.9%	3.8%
Personal Income Tax	0.0%	0.4%	0.9%	1.8%	2.4%	3.4%
Corporate Income Tax	0.1%	0.2%	0.3%	0.4%	0.5%	0.5%
TOTAL TAXES	10.7%	8.3%	7.8%	7.8%	8.0%	8.1%
Federal Deduction Offset	-0.0%	-0.0%	-0.0%	-0.0%	-0.4%	-0.8%
TOTAL AFTER OFFSET	10.7%	8.3%	7.8%	7.8%	7.5%	7.2%

Appendix, Details on the Options

Tax Changes as % of Income and Percentage Change in State and Local Taxes After Federal Offset							
Arkansas, ALL	Low 20%	2nd 20%	Mid 20%	4th 20%	Next 15%	Next 4%	Top 1%
Average Income	\$6,100	\$14,300	\$22,800	\$36,700	\$61,000	\$116,500	\$474,000
Income Range	Less than \$10,000	\$10,000 – \$18,000	\$18,000 – \$28,000	\$28,000 – \$47,000	\$47,000 – \$86,000	\$86,000 – \$176,000	\$176,000 or more
1. Personal Income Tax Restructuring 1							
Arkansas Income Tax Change	0.0%	0.1%	0.1%	0.1%	0.2%	0.3%	0.7%
Federal Income Tax Change	—	-0.0%	-0.0%	-0.0%	-0.0%	-0.1%	-0.3%
Net Change	0.0%	0.1%	0.1%	0.1%	0.2%	0.2%	0.4%
% Change in AR Taxes (Net)	0%	1%	1%	1%	2%	3%	7%
2. Raise the Sales Tax							
Arkansas Sales Tax Change	0.5%	0.5%	0.4%	0.3%	0.3%	0.2%	0.1%
% Change in AR Taxes	5%	5%	4%	4%	3%	2%	2%
3. Adopt New Top Rates on the Personal Income Tax							
Arkansas Income Tax Change	—	—	—	—	0.0%	0.2%	0.7%
Federal Income Tax Change	—	—	—	—	-0.0%	-0.0%	-0.3%
Net Change	—	—	—	—	0.0%	0.1%	0.5%
% Change in AR Taxes (Net)	—	—	—	—	0%	2%	8%
5. "Across-the-Board" Personal Income Tax Rate Increase							
Arkansas Income Tax Change	0.0%	0.2%	0.3%	0.4%	0.5%	0.6%	0.8%
Federal Income Tax Change	—	-0.0%	-0.0%	-0.0%	-0.1%	-0.1%	-0.3%
Net Change	0.0%	0.2%	0.3%	0.4%	0.5%	0.5%	0.5%
% Change in AR Taxes (Net)	0%	2%	3%	4%	6%	7%	8%
6. Raise the Sales Tax And Adopt Grocery Credit							
Arkansas "Sales Tax" Change	-0.1%	0.1%	0.2%	0.2%	0.1%	0.1%	0.1%
% Change in AR Taxes	-1%	1%	2%	2%	2%	1%	1%
7. Personal Income Tax Restructuring 2							
Arkansas Income Tax Change	-0.0%	-0.1%	-0.0%	-0.0%	0.1%	0.2%	0.7%
Federal Income Tax Change	—	—	-0.0%	-0.0%	-0.0%	-0.1%	-0.3%
Net Change	-0.0%	-0.1%	-0.0%	-0.0%	0.1%	0.2%	0.4%
% Change in AR Taxes (Net)	-0%	-1%	-0%	-0%	1%	2%	7%
8. Specialty Consumption Tax Increases							
Gas Tax Change	0.1%	0.1%	0.1%	0.1%	0.1%	0.0%	0.0%
Cigarette Tax Change	0.2%	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%
Total Change	0.3%	0.2%	0.2%	0.1%	0.1%	0.0%	0.0%
% Change in AR Taxes	3%	2%	2%	1%	1%	1%	0%
10. Tax Capital Gains at Regular Tax Rates							
Arkansas Income Tax Change	—	—	—	0.0%	0.0%	0.0%	0.2%
Federal Income Tax Change	—	—	—	-0.0%	-0.0%	-0.0%	-0.1%
Net Change	—	—	—	0.0%	0.0%	0.0%	0.1%
% Change in AR Taxes (Net)	—	—	—	0%	0%	0%	2%
11. Personal Income Tax Restructuring 3							
Arkansas Income Tax Change	-0.0%	-0.1%	-0.1%	-0.1%	-0.0%	0.3%	1.5%
Federal Income Tax Change	—	—	-0.0%	0.0%	-0.0%	-0.1%	-0.6%
Net Change	-0.0%	-0.1%	-0.1%	-0.1%	-0.0%	0.2%	0.9%
% Change in AR Taxes (Net)	-0%	-1%	-1%	-1%	-0%	3%	15%
12. Remove Exclusions from Personal Income Tax for Pension, Social Security and Unemployment Comp.							
Arkansas Income Tax Change	0.0%	0.1%	0.1%	0.2%	0.2%	0.1%	0.0%
Federal Income Tax Change	—	-0.0%	-0.0%	-0.0%	-0.0%	-0.0%	-0.0%
Net Change	0.0%	0.1%	0.1%	0.2%	0.1%	0.1%	0.0%
% Change	0%	1%	2%	2%	2%	1%	0%

Appendix, Details on the Options

Tax Changes as % of Income and Percentage Change in State and Local Taxes After Federal Offset							
Arkansas, ALL	Low 20%	2nd 20%	Mid 20%	4th 20%	Next 15%	Next 4%	Top 1%
Average Income	\$6,100	\$14,300	\$22,800	\$36,700	\$61,000	\$116,500	\$474,000
Income Range	Less than \$10,000	\$10,000 – \$18,000	\$18,000 – \$28,000	\$28,000 – \$47,000	\$47,000 – \$86,000	\$86,000 – \$176,000	\$176,000 or more
15. Grocery Tax Rebate							
Arkansas "Sales Tax" Change	-0.6%	-0.3%	-0.2%	-0.2%	-0.1%	-0.1%	-0.0%
<i>% Change</i>	<i>-6%</i>	<i>-3%</i>	<i>-2%</i>	<i>-2%</i>	<i>-1%</i>	<i>-1%</i>	<i>-0%</i>
16. Eliminate Sales Tax on Groceries							
Arkansas "Sales Tax" Change	-1.1%	-0.8%	-0.6%	-0.5%	-0.4%	-0.2%	-0.1%
<i>% Change</i>	<i>-11%</i>	<i>-8%</i>	<i>-7%</i>	<i>-5%</i>	<i>-4%</i>	<i>-3%</i>	<i>-1%</i>
17. Homestead Exemption							
Arkansas Property Tax Change	-0.6%	-0.4%	-0.3%	-0.3%	-0.2%	-0.1%	-0.0%
Arkansas Income Tax Change	—	0.00%	0.00%	0.01%	0.01%	0.01%	0.00%
Homestead Rebate Change	0.11%	0.02%	0.00%	—	—	—	—
Federal Income Tax Change	—	0.00%	0.00%	0.01%	0.03%	0.03%	0.01%
<i>Net Change</i>	<i>-0.5%</i>	<i>-0.4%</i>	<i>-0.3%</i>	<i>-0.2%</i>	<i>-0.2%</i>	<i>-0.1%</i>	<i>-0.0%</i>
<i>% Change in AR Taxes (Net)</i>	<i>-4%</i>	<i>-4%</i>	<i>-3%</i>	<i>-3%</i>	<i>-2%</i>	<i>-1%</i>	<i>-0%</i>
18. Separate Tables and Increased Standard Deduction for Married Couples							
Arkansas Income Tax Change	-0.0%	-0.1%	-0.1%	-0.2%	-0.2%	-0.1%	-0.0%
Federal Income Tax Change	—	—	—	0.0%	0.0%	0.0%	0.0%
<i>Net Change</i>	<i>-0.0%</i>	<i>-0.1%</i>	<i>-0.1%</i>	<i>-0.2%</i>	<i>-0.2%</i>	<i>-0.1%</i>	<i>-0.0%</i>
<i>% Change in AR Taxes (Net)</i>	<i>-0%</i>	<i>-1%</i>	<i>-1%</i>	<i>-2%</i>	<i>-2%</i>	<i>-1%</i>	<i>-0%</i>
19. Across the Board Personal Income Tax Cut							
Arkansas Income Tax Change	-0.0%	-0.1%	-0.2%	-0.3%	-0.4%	-0.4%	-0.5%
Federal Income Tax Change	—	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%
<i>Net Change</i>	<i>-0.0%</i>	<i>-0.1%</i>	<i>-0.2%</i>	<i>-0.3%</i>	<i>-0.3%</i>	<i>-0.3%</i>	<i>-0.3%</i>
<i>% Change in AR Taxes (Net)</i>	<i>-0%</i>	<i>-1%</i>	<i>-3%</i>	<i>-3%</i>	<i>-4%</i>	<i>-5%</i>	<i>-5%</i>
20. Adopt a State Earned Income Tax Credit							
Arkansas Income Tax Change	-1.2%	-0.9%	-0.3%	-0.0%	-0.0%	—	—
<i>% Change in Arkansas Taxes</i>	<i>-12%</i>	<i>-10%</i>	<i>-4%</i>	<i>-0%</i>	<i>-0%</i>	<i>—</i>	<i>—</i>
21. Increase Exemption Credit on Personal Income Tax							
Arkansas Income Tax Change	-0.1%	-0.2%	-0.2%	-0.1%	-0.1%	-0.0%	-0.0%
Federal Income Tax Change	—	—	0.00%	0.00%	0.01%	0.01%	0.00%
<i>Net Change</i>	<i>-0.1%</i>	<i>-0.2%</i>	<i>-0.2%</i>	<i>-0.1%</i>	<i>-0.1%</i>	<i>-0.0%</i>	<i>-0.0%</i>
<i>% Change in AR Taxes (Net)</i>	<i>-1%</i>	<i>-2%</i>	<i>-2%</i>	<i>-1%</i>	<i>-1%</i>	<i>-1%</i>	<i>-0%</i>
22. Increase Standard Deduction							
Arkansas Income Tax Change	-0.0%	-0.2%	-0.3%	-0.2%	-0.1%	-0.0%	-0.0%
<i>% Change in Arkansas Taxes</i>	<i>-0%</i>	<i>-2%</i>	<i>-3%</i>	<i>-3%</i>	<i>-1%</i>	<i>-0%</i>	<i>-0%</i>
23. Reduce State Sales Tax Rate							
Arkansas Sales Tax Change	-0.5%	-0.5%	-0.4%	-0.3%	-0.3%	-0.2%	-0.1%
<i>% Change in Arkansas Taxes</i>	<i>-5%</i>	<i>-5%</i>	<i>-4%</i>	<i>-4%</i>	<i>-3%</i>	<i>-2%</i>	<i>-2%</i>

Appendix, Details on the Options

Tax Changes as % of Income and Percentage Change in State and Local Taxes After Federal Offset							
Arkansas, ALL	Low 20%	2nd 20%	Mid 20%	4th 20%	Next 15%	Next 4%	Top 1%
Average Income	\$6,100	\$14,300	\$22,800	\$36,700	\$61,000	\$116,500	\$474,000
Income Range	Less than \$10,000	\$10,000 – \$18,000	\$18,000 – \$28,000	\$28,000 – \$47,000	\$47,000 – \$86,000	\$86,000 – \$176,000	\$176,000 or more
24. Raise the Sales Tax Rate to Pay for Property Tax Relief							
Arkansas Sales Tax Change	2.1%	1.9%	1.5%	1.3%	1.0%	0.6%	0.4%
Arkansas Property Tax Change	-2.0%	-1.4%	-1.3%	-1.1%	-1.1%	-1.3%	-0.8%
Arkansas Income Tax Change	—	0.0%	0.0%	0.0%	0.0%	0.1%	0.0%
Homestead Rebate Change	0.1%	0.0%	0.0%	—	—	—	—
Federal Income Tax Change	—	0.0%	0.0%	0.0%	0.1%	0.3%	0.2%
Net Change	0.1%	0.5%	0.3%	0.2%	0.1%	-0.3%	-0.2%
% Change in AR Taxes (Net)	1%	5%	3%	3%	1%	-4%	-4%
25. Eliminate Sales Tax on Groceries and Raise the Personal Income Tax							
Arkansas Sales Tax Change	-1.1%	-0.8%	-0.6%	-0.5%	-0.4%	-0.2%	-0.1%
Arkansas Income Tax Change	0.0%	0.1%	0.2%	0.2%	0.4%	0.7%	1.6%
Federal Income Tax Change	—	-0.0%	-0.0%	-0.0%	-0.1%	-0.2%	-0.6%
Net Change	-1.1%	-0.7%	-0.4%	-0.3%	0.0%	0.3%	0.9%
% Change in AR Taxes (Net)	-11%	-7%	-5%	-3%	0%	4%	16%
26. Grocery Tax Rebate and Raise the Personal Income Tax							
Arkansas "Sales Tax" Change	-0.6%	-0.3%	-0.2%	-0.2%	-0.1%	-0.1%	-0.0%
Arkansas Income Tax Change	-0.0%	-0.1%	-0.1%	-0.1%	-0.0%	0.3%	1.5%
Federal Income Tax Change	—	—	-0.0%	0.0%	-0.0%	-0.1%	-0.6%
Net Change	-0.7%	-0.4%	-0.3%	-0.3%	-0.2%	0.1%	0.9%
% Change in AR Taxes (Net)	-6%	-5%	-4%	-3%	-2%	2%	15%
27. School Homestead Exemption With Personal Income Tax Increase							
Arkansas Property Tax Change	-0.6%	-0.3%	-0.2%	-0.2%	-0.2%	-0.1%	-0.0%
Arkansas Income Tax Change	-0.0%	-0.1%	-0.1%	-0.1%	-0.0%	0.3%	1.5%
Homestead Rebate Change	-0.1%	-0.0%	-0.0%	—	—	—	—
Federal Income Tax Change	—	0.0%	0.0%	0.0%	0.0%	-0.1%	-0.6%
Net Change	-0.7%	-0.4%	-0.4%	-0.3%	-0.2%	0.1%	0.9%
% Change in AR Taxes (Net)	-7%	-5%	-4%	-4%	-2%	2%	15%
28a. Tax as a Percent of Federal Liability							
Arkansas Income Tax Change	-2.0%	-1.9%	-1.1%	-0.3%	-0.1%	0.8%	2.5%
Federal Income Tax Change	—	-0.0%	-0.0%	-0.0%	-0.0%	-0.2%	-0.9%
Net Change	-2.0%	-1.9%	-1.1%	-0.3%	-0.1%	0.6%	1.6%
% Change in AR Taxes (Net)	-19%	-19%	-12%	-4%	-1%	8%	26%
28c. Personal Income Tax Restructuring 4							
Arkansas Income Tax Change	-1.3%	-1.2%	-0.6%	-0.3%	0.1%	0.5%	1.5%
Federal Income Tax Change	—	-0.0%	-0.0%	-0.0%	-0.0%	-0.1%	-0.6%
Net Change	-1.3%	-1.2%	-0.6%	-0.3%	0.1%	0.4%	1.0%
% Change in AR Taxes (Net)	-12%	-12%	-7%	-3%	1%	5%	16%

Unwarranted Sales Tax Exemptions?

Arkansas offers substantial "business incentive" credits and refunds against its general sales tax, totaling hundreds of millions of dollars over the past decade.

In addition, the Bureau of Legislative Research's Office of Economic and Tax Policy has published a list of various statutory *exemptions* under the sales tax, with estimates of the value of many of them. (A sorted version of this list is on this page.) Most of *these* "exemptions," however, are rather normal rules designed to avoid double taxation.

In fact, two-thirds of the \$331 million worth of "exemptions" for which estimates are given reflect various business-input exemptions, with most of these exemptions for various farm inputs (seeds, machinery, etc.) Of the approximately \$100 million in other exemptions, \$77 million reflects the exemption for gasoline (on which a higher excise tax applies instead).

So, while it is entirely appropriate to question the cost-effectiveness of the various sales tax "business incentive" credits and refunds, the list of "exemptions" shown on this page is mainly a red herring.

Arkansas Sales Tax "Exemptions", FY 1996	\$-mill	% of Tot.
ALL ITEMS WITH COST ESTIMATES	\$ 330.9	100.0%
Food exemptions:	\$ 8.0	2.4%
Food purchased with food stamps (required by fed. law)	7.2	
Farm sales to consumers	0.8	
Medical exemptions:	6.7	2.0%
Prescription drugs	6.5	
Medical equipment purchased by doctors	0.2	
Medical equipment rental paid by Medicare or Medicaid	0.1	
Insulin test strips	NE	
Low-income electricity exemption (<\$12K, 500kw)	\$ 1.7	0.5%
Anti-double-tax exemptions:	\$ 77.4	23.4%
Gasoline (subject to higher tax instead)	77.4	
Auto parts, trade-ins	0.0	
Used property	NE	
No double tax on rental vehicles	NE	
Other (largely) individual exemptions:	\$ 5.2	1.6%
Newspapers	4.0	
Magazine subscriptions	0.6	
Decal fee on vending machines in lieu of the sales tax	0.5	
Coin-operated car washes	0.1	
Manufactured homes	0.0	
Telephone repair	0.0	
Transportation, sewer, sanitation and garbage services	NE	
Casual sales	NE	
Border city exemption	NE	
Special cars for disabled veterans	NE	
Sales of cars to blind veterans	NE	
Sales to and by governments and charities:	\$ 6.7	2.0%
Business inputs exemptions:	\$ 224.7	67.9%
Various farm inputs (seeds, machinery, etc.)	171.9	
Unprocessed crude oil	24.2	
Advertising in newspapers, magazines, billboards	23.8	
Enterprise Zone construction materials & bus. equipment	2.7	
Fuels used on commercial vessels and railroads	0.8	
Steel mills, natural gas & electricity	0.7	
Waste fuel used in manufacturing	0.3	
Vessels (including repair parts)	0.2	
Natural gas used to make glass	0.1	
Dies and molds	0.1	
Motion picture equipment, rental of specialized	0.0	
Manufacturing machinery	NE	
Resale exemption	NE	
Railroad cars & equipment, repair	NE	
Aircraft and railroad cars, certain parts and equipment	NE	
Aircraft held for resale, temporarily rented	NE	
Aircraft sold to out-of-state users	NE	
Industrial metal rollers, repair or manufacture of	NE	
Television and radio companies, services purchased by	NE	
Miscellaneous items:	\$ 0.7	0.2%
Mail-order watch repair	0.7	
Christmas tree sales by growers	NE	
Sales to credit unions	NE	

NE = No Estimate Source: Office of Economic & Tax Policy.

About the Institute on Taxation and Economic Policy & the ITEP Microsimulation Tax Model

THE INSTITUTE ON TAXATION & ECONOMIC POLICY has engaged in research on tax issues since 1980, with a focus on the distributional consequences of both current law and proposed changes. ITEP's research has often been used by other private groups in their work, and ITEP is frequently consulted by government estimators in performing their official analyses. Over the past several years, ITEP has built a microsimulation model of the tax systems of the U.S. government and of all 50 states and the District of Columbia.

What the ITEP Model Does

The ITEP model is a tool for calculating revenue yield and incidence, by income group, of federal, state and local taxes. It calculates revenue yield for current tax law and proposed amendments to current law. Separate incidence analyses can be done for categories of taxpayers specified by marital status, the presence of children and age.

In computing its estimates, the ITEP model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to three quarters of a million records. To forecast revenues and incidence, the model relies on government or other widely respected economic projections.

The ITEP model's federal tax calculations are very similar to those produced by the congressional Joint Committee on Taxation, the U.S. Treasury Department and the Congressional Budget Office (although each of these four models differs in varying degrees as to how the results are presented). The ITEP model, however, adds state-by-state estimating capabilities not found in those government models.

Below is an outline of each area of the ITEP model and what its capabilities are:

The Personal Income Tax Model analyzes the revenue and incidence of current federal and state personal income taxes and amendment options including changes in:

- rates—including special rates on capital gains,
- inclusion or exclusion of various types of income,
- inclusion or exclusion of all federal and state adjustments,
- exemption amounts and a broad variety of exemption types and, if relevant, phase-out methods,
- standard deduction amounts and a broad variety of standard deduction types and phase-outs,
- itemized deductions and deduction phase-outs, and
- credits, such as earned-income and child-care credits.

The Consumption Tax Model analyzes the revenue and incidence of current sales and excise taxes. It also has the capacity to analyze the revenue and incidence implications of a broad range of base and rate changes in general sales taxes, special sales taxes, gasoline excise taxes and tobacco excise taxes. There are more than 250 base items available to amend in the model, reflecting, for example, sales tax base differences among states and most possible changes that might occur.

The Property Tax Model analyzes revenue and incidence of current

state and local property taxes. It can also analyze the revenue and incidence impacts of statewide policy changes in property tax—including the effect of circuit breakers, homestead exemptions, and rate and assessment caps.

The Corporate Income Tax Model analyzes revenue and incidence of current corporate income tax law, possible rate changes and certain base changes.

Local taxes: The model can analyze the statewide revenue and incidence of aggregate local taxes (not, however, broken down by individual localities).

Addendum: Data Sources

The ITEP model is a "microsimulation model." That is, it works on a very large stratified sample of tax returns and other data, aged to the year being analyzed. This is the same kind of tax model used by the U.S. Treasury Department, the congressional Joint Committee on Taxation and the Congressional Budget Office. The ITEP model uses the following micro-data sets and aggregate data:

Micro-Data Sets:

IRS 1988 Individual Public Use Tax File, Level III Sample
IRS 1990 Individual Public Use Tax File
Current Population Survey: 1988, 1989, 1990, 1991, 1992, 1993
Consumer Expenditure Survey, 1988, 1989, 1990, 1992, 1993
U.S. Census, 1990

Aggregated Data Sources:

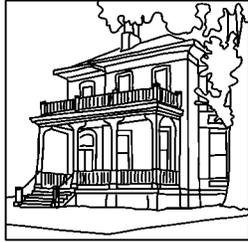
Miscellaneous IRS data.
Congressional Budget Office and Joint Committee on Taxation forecasts.
Other economic data (Commerce Department, WEFA, etc.)
State tax department data.
Data on overall levels of consumption for specific goods (Commerce Department, Census of Services, etc.).
State specific consumption and consumption tax data (Census data on Government Finances, etc.).
State specific property tax data (Government Finances, etc.).
American Housing Survey 1990
1990 Census of Population Housing

Acknowledgments

ITEP would not have been able to build its microsimulation model without the kind cooperation of the staffs of the Congressional Budget Office, the Joint Committee on Taxation, the U.S. Treasury Department and the Internal Revenue Service.

For More Information:

For a complete, detailed explanation of the methodology underlying the ITEP Model, see *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States* (ITEP, 1996).



**WINTHROP
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F O U N D A T I O N

The Winthrop Rockefeller Foundation is a private, nonprofit foundation dedicated to the economic and social well-being of Arkansas. The Foundation is a recipient of an endowment from the estate of Governor Winthrop Rockefeller. This publication and the many other activities of the Foundation are possible only because of the philanthropy of Governor Rockefeller and his dedication to and love for Arkansas.

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