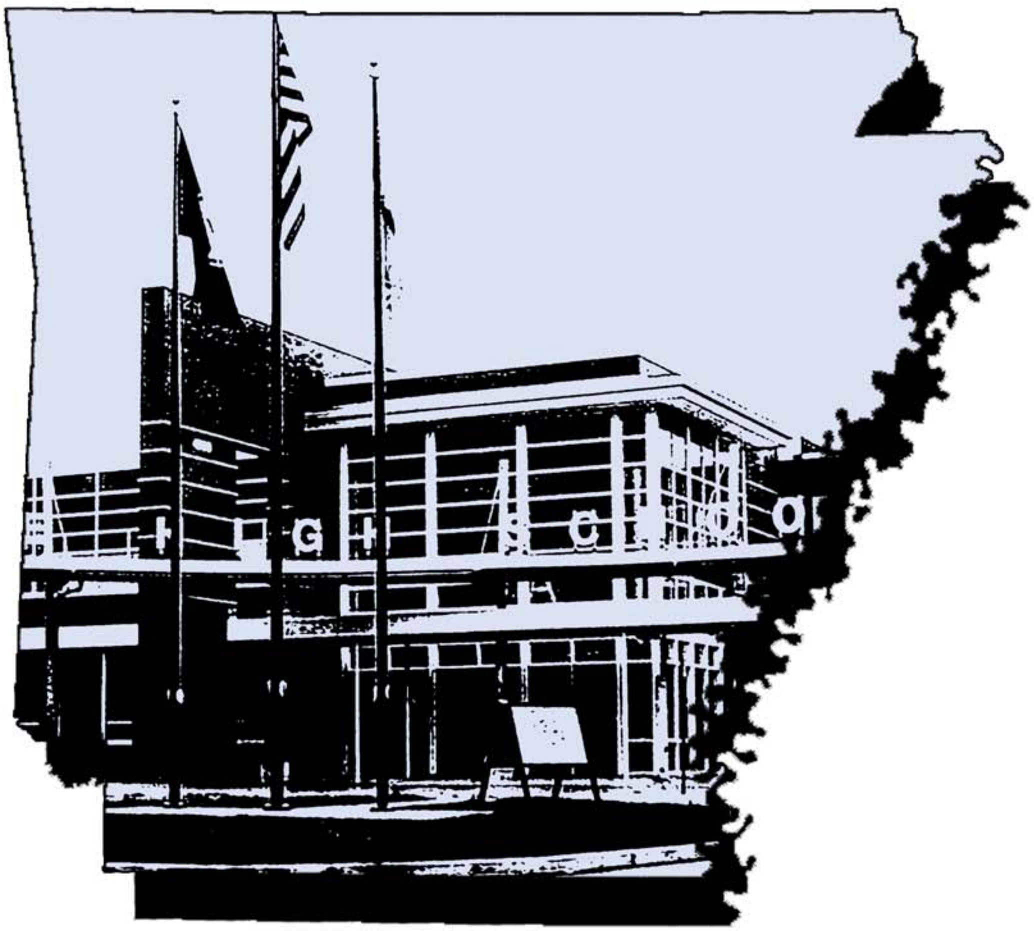
Tax Options for Arkansas

Funding Education After the *Lake View* Case

SUMMARY REPORT



Winthrop Rockefeller Foundation
July 2003

TAX OPTIONS FOR ARKANSAS

The Winthrop Rockefeller Foundation commissioned *Tax Options for Arkansas* to provide a useful resource for understanding the impact of recent school finance legislation on the state's tax and education system. The study examines options available to Arkansas policy makers as they seek to adequately fund the state's system of elementary and secondary schools.

WINTHROP ROCKEFELLER FOUNDATION

In 1974, the Trustees of Governor Winthrop Rockefeller's estate endowed the Winthrop Rockefeller Foundation to continue the work of the Rockwin Fund. Governor Rockefeller established the Rockwin Fund in 1954 and, on an annual basis from 1956 until his death in 1973, funded projects and programs he believed were important to improving the quality of life in Arkansas.

The Winthrop Rockefeller Foundation is a private, nonprofit foundation whose mission is to improve the lives of Arkansans by funding programs and projects that improve education; economic development; and economic, racial, and social justice. During the past 29 years, the Foundation has awarded over $65 million in grants.

The study could not have been completed without the assistance of the staffs at HISTECON Associates, Inc., the Institute on Taxation and Economic Policy (ITEP), and Arkansas Advocates for Children and Families (AACF). Research assistance was provided by Jeremiah Gardner and Robert Wolfe.

Crucial direction and many helpful comments were provided by the study's Advisory Committee, which met throughout 2002 and reviewed the final report. Grateful acknowledgment is also given to many state agencies, especially the Arkansas Department of Education, legislators, and school officials whose support was vital in preparing the analysis.

All conclusions or interpretations in this report are those of the authors and not the Winthrop Rockefeller Foundation.

Tax Options for Arkansas: Funding Education After the *Lake View* Case

This policy brief summarizes the findings of a larger Winthrop Rockefeller Foundation study: Tax Options for Arkansas, released in July of 2003. The companion study provides an overview of the recent Arkansas Supreme Court ruling that finds Arkansas's education system both inadequate and inequitable, focusing on the options available to lawmakers as they seek to improve the quality of the state's education system. The companion study is available from the Winthrop Rockefeller Foundation.

Arkansas is at a fiscal crossroads. In November of 2002, the Arkansas Supreme Court ruled that the state's education system is both inequitable and inadequate—and therefore unconstitutional. The *Lake View* decision signals conclusively to Arkansas policymakers that they must enact unprecedented increases in state spending on elementary and secondary education. The court's decision also imposes a strict deadline on the legislature's response to this court mandate: policy makers have until January 1, 2004 to address the court's constitutional concerns.

The *Lake View* decision comes at an especially challenging time for Arkansas. As the state deals with a nationwide recession and slow state revenue growth, the additional funding for public schools required by *Lake View* (potentially more than $680 million annually) will have to compete with the funding needs of other important state and local spending programs, many of which serve low-income families. The decision also comes at a time when few policymakers have publicly indicated a willingness to raise the state and local taxes that may be needed to fund the *Lake View* mandates for educational improvements.

This broad court mandate could result in far-reaching changes to the state's approach to tax and education policy. However, the court's decision leaves many urgent questions unanswered for most Arkansans:

- What education policy changes must legislators enact in order to make Arkansas public schools constitutionally "adequate" and "equitable"?
- How much will these education policy changes cost?
- Can this new education spending be paid for through reductions in other government spending programs?
- Could school consolidation generate sufficient savings to help fund educational adequacy?
- What tax reform options are available to Arkansas policymakers—and how would these options affect taxpayers at different income levels?
- What impact will these substantial spending and tax changes have on the long-term health of the Arkansas economy?

This policy brief—along with the larger study to which it is a companion—provides information to help all Arkansans seeking to understand the implications of the *Lake View* decision for the future of education and tax policy in Arkansas.

Achieving educational "adequacy" in Arkansas will potentially cost at least $680 million annually.

Important Policy Concepts

Policy makers responding to the *Lake View* mandate will likely enact major changes in two very different public policy areas—state tax policy and education finance. This section provides a brief overview of the basic concepts that are essential to an understanding of the tax and education policy reforms currently being discussed.

One important tax policy concept that will be central to the education funding debate is the fairness of the tax system and of proposed tax changes. Tax fairness can be thought of in two very different, yet equally important, ways. The first idea of tax fairness that most people think of intuitively has to do with the way a tax system treats people at different income levels.

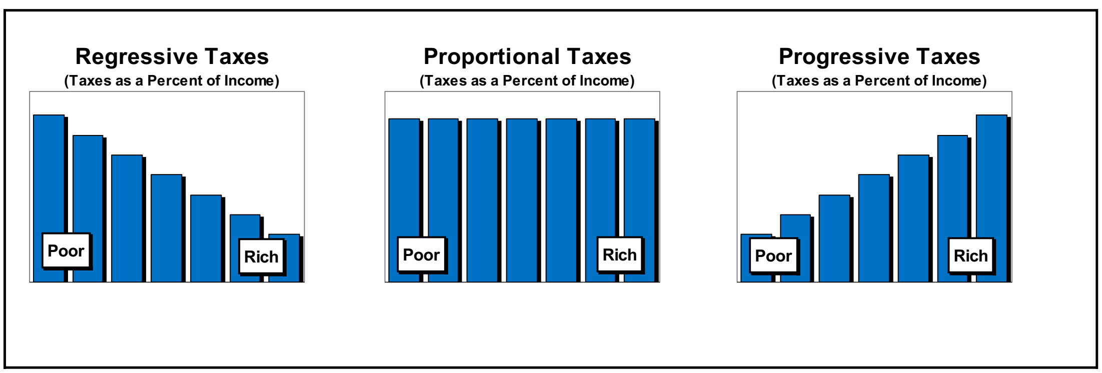
Three terms are used to describe how well tax systems meet this idea of tax fairness:

- *Regressive* tax systems require that low- and middle-income families pay a higher share of their income in taxes than do upper-income families.
- Proportional or *flat* tax systems take the same share of income from taxpayers at all income levels.
- *Progressive* tax systems require upper-income families to pay a larger share of their incomes in taxes than those with lower incomes.

Historically, there has been widespread acceptance of the notion that, at a minimum, tax systems should not be regressive. In other words, poorer families should not pay a larger share of their incomes in taxes than the wealthiest families.

The Arkansas tax system is regressive. As shown in Chapter Four of the companion report, low-income Arkansas families pay, on average, a higher share of their income in state and local taxes than do upper-income families.

A second, equally important measure of tax fairness is how a tax system treats taxpayers who are essentially similar in terms of their ability to pay. The Arkansas tax system is riddled with loopholes that violate this second conception of tax fairness, including income tax breaks for capital gains, property tax breaks for agricultural property and sales tax exemptions for services. Each of these tax breaks was created by state lawmakers seeking to provide preferential tax



treatment, often for legitimate public policy purposes. However, these tax breaks create inequities between otherwise identical taxpayers—and reduce the yield of Arkansas taxes for important public services.

State tax systems do not operate in a vacuum. Changes in Arkansas tax policy may affect the federal tax burdens paid by Arkansans. This **federal interaction** is important in understanding the impact of tax reform on Arkansans and in evaluating the different overall effects of sales tax and income tax increases on Arkansas taxpayers.

How does state tax policy affect federal tax burdens? Any Arkansas resident who itemizes their federal tax return is allowed to deduct their Arkansas income and property taxes. Because these deductions reduce federal income tax liability, part of the state income and property tax initially paid by itemizing Arkansans is ultimately exported to the federal government.

The deductibility of Arkansas income and property taxes on itemized federal tax returns has two important implications for Arkansas taxpayers. First, the already-regressive Arkansas tax system becomes even more so when the deductibility of income and property taxes on itemized federal returns is taken into account. This is because the federal itemizers who can take advantage of these deductions tend to be among the wealthiest residents, while non-itemizing low-income Arkansans are unable to offset their Arkansas taxes in this way.

This federal interaction also means that Arkansas's heavy reliance on non-deductible sales and excise taxes makes the state less able to "export" its tax burden to the federal government in the form of increased itemized deductions than other states that rely more heavily on deductible income and property taxes. This is also true of potential tax increases: if Arkansas raises income or property taxes to pay for education, a substantial portion of the tax hike will not be paid by Arkansas taxpayers at all, but will be offset directly by the federal government. If, on the other hand, Arkansas raises sales or excise taxes to fund education, none of the additional taxes paid by Arkansans would be offset by federal tax cuts.

While tax policy is central to the question of how education revenues are raised, the *Lake View* case also involves two basic education policy concepts. The Arkansas Supreme Court's decision affirmed that the state's education system fails to meet the constitutional requirements of equity and adequacy. What do these terms mean—and how do Arkansas schools fail to achieve these requirements?

Equity is what people have in mind when they evaluate whether a state's education system is fair to all of its students. Evaluating the equity of a school funding system means measuring the treatment of any particular student compared to any other student. This can mean looking at the treatment of students in different school districts or at the treatment of students with different needs within the same district.

Adequacy means providing sufficient levels of school funding to allow all children to attain a certain level of education.

The basic problem confronting local governments seeking to fund schools is that property wealth is distributed unequally between districts.

Definitions of equity also differ on a more fundamental level: what ought to be equalized? And what does "equal" mean? As it applies to school funding, courts have defined equity as:

- equal access to education;
- equality of educational outcomes;
- equal dollars per pupil;
- equal tax rates for taxpayers;

to list only a few approaches.

Adequacy means providing sufficient levels of funding to allow all children to attain a certain level of education. While equity compares school districts to each other, adequacy measures education funding relative to an absolute standard for the quality of education across the state. For example, if state and local spending on Arkansas public education were allocated between school districts in a way that did not provide enough money to pay for each district's needs but provided a similar quality of education to children across the state, it could be said that the Arkansas education system was equitable but not adequate. If, on the other hand, policymakers provided large amounts of funding for poor school districts but provided even larger amounts for wealthy districts, the education system would be adequate but not equitable.

Like equity, adequacy is hard to define: courts have generally defined an adequate education only vaguely, as one that enables students to participate productively in society and to lead a fulfilling life.

Most states have not explicitly defined precise standards for adequacy. This is a challenge that Arkansas currently faces: what educational standards will result in an adequate Arkansas education? State lawmakers have not yet answered this question conclusively. However, the state legislature will report the findings of a new adequacy study in September of 2003.

Why is it so difficult to achieve educational adequacy and equity? The basic problem confronting local governments seeking to fund schools is that the main source of local funding for education, property wealth, is distributed unequally between districts. The less property wealth in a given district, the less revenue that district can raise in taxes. As a result, property-poor districts are not able to fund the costs of education as easily as property-wealthy districts. For example, in 2000 the Lake View district raised only $827 per student in local revenue—just over a quarter of the $3,200 per student raised by the Little Rock district that year. And even property wealthy districts can find it difficult to raise enough money to fund schools adequately using property taxes. Financing public schools using local property taxes therefore introduces problems of *equity* between districts and *adequacy* for almost all districts.

The Arkansas school finance system is designed to remedy both of these problems by providing state funding to low-property-wealth districts. (The most important finding of the *Lake View* case is that the current system does not remedy either of these problems, and is therefore both inequitable and inadequate. This case is described in more detail in Chapter Two of the companion report.)

All Arkansas school districts are required to tax property at a basic rate of at least 25 mills (that is, 2.5 percent of assessed value). Each year the state determines the "base level revenue," which is the amount of spending per pupil that would be achieved by dividing all state and local school funding equally between students. In 2003, that number is $4,916 per pupil. If local school districts are unable to provide enough property tax revenue to achieve this $4,916 per-pupil target, the state provides enough additional aid to each district to ensure that the sum of local tax effort and state aid will reach the target.

What can go wrong with a school funding system that works in this way? First, the equalized amount of spending per pupil—$4,916 in this case—may be well short of the amount required to achieve an adequate education. Second, property-wealthy districts can often raise *more* than this state-sponsored amount per pupil without relying on state help—which means that the amount spent on elementary and secondary education will differ between poor and wealthy districts, even after taking account of state aid. The low levels of education spending statewide and the disparities in spending between poor and wealthy districts are why the Arkansas Supreme Court found the state's education finance system both inadequate and inequitable.

The *Lake View* Decision

The Arkansas Supreme Court's November 2002 *Lake View* decision found the Arkansas education system inadequate and inequitable—and explained what the state Constitution requires of the education system. The opinion outlined five elements of a constitutional education system that were developed in earlier stages of the case:

- The state is solely responsible for the education system.
- The tax effort to support this system should be evenly spread.
- The system must provide the necessary resources to fund education throughout the state.
- The system must provide an *adequate* education.
- The system must be properly managed.

Having identified these characteristics of an adequate education finance system, the court identified five remedies that must be enacted to achieve adequacy:

First, school districts throughout the state must provide **substantially equal educational opportunities** for children.

Second, the state must provide **substantially equal facilities** throughout the state.

Third, Arkansas **teachers' salaries should be raised** to attract and retain qualified teachers while maintaining salary equity between school districts.

Fourth, the state must improve its method of **measuring equity**. The court ruled that

The November 2002 Lake View decision found the Arkansas education system both inadequate and inequitable.

equity ought to be measured not by reference to the amount of revenue available to school districts but by the amount actually spent on education in each district.

Fifth, the state must quantify the costs of achieving a constitutional education system by **conducting an adequacy study**.

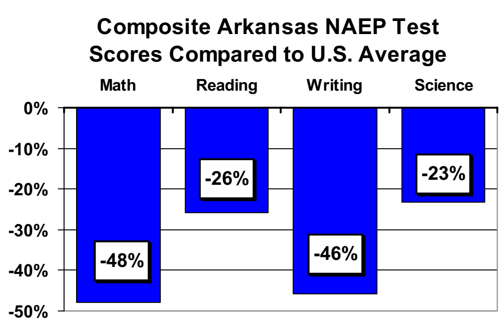
Arkansas students continue to lag behind most states in academic performance.

Why Is Adequacy Needed?

Responding to the court's demand for educational adequacy is critical because Arkansas continues to lag behind the rest of the nation in its commitment to education and in academic performance. In particular:

- The state ranks fiftieth in the percentage of its adult residents graduating from college.
- Arkansas students score consistently lower—and sometimes significantly lower than the national average—on proficiency tests such as the NAEP and the ACT.
- Arkansas ranks 47th nationally in state and local spending on education per pupil.
- The state ranks 43rd nationally in teacher salaries.

Teacher salaries in Arkansas are below the national average—making it difficult to attract teachers to the state.



How Much Will Adequacy Cost?

While the *Lake View* decision specifies a set of criteria for achieving educational adequacy, the decision does not specify how much educational adequacy is likely to cost—or how the state should pay for it. However, as of May 2003 several attempts have been made to estimate the cost of achieving educational adequacy in Arkansas. The most comprehensive recent estimate, released by the Blue Ribbon Commission on Education in 2002, puts this cost at $689 million annually. The Commission's recommendations included:

- Increasing Arkansas teacher salaries to equal the regional average (Cost: $405 million).
- Establishing early childhood education programs, especially for low-income children (Cost: $100 million).
- Expanding teachers' health insurance benefits to conform with the benefits available to all state employees (Cost: $60 million).

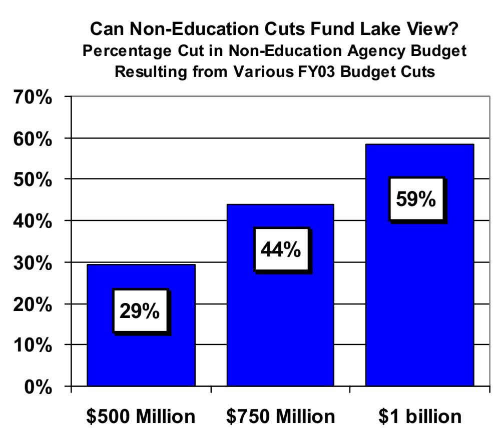
However, the Blue Ribbon Commission estimate does not include critical areas of spending such as renovating school facilities, which could push the annual cost to nearly $1 billion.

Lessons from Other States

Arkansas is not the first state to face a major restructuring of its school finance system. Many states have confronted similar dilemmas—and have met with varying degrees of success in attempting to improve education. Chapter Two of the companion report describes notable successes—and failures—of attempts to reform school finance systems and state tax systems in several states. One especially successful case is Kentucky, where the legislature responded immediately to a court mandate by increasing revenues and spending. Within a decade, student performance had increased substantially. At the same time, other states have been unable to achieve either of these goals. For example, Alabama's legislature has not responded to a court mandate for wholesale changes in education finance. Finally, Michigan has moved closer to achieving educational adequacy by increasing its reliance on state-level revenue sources to fund education—but has made its tax system more regressive in the process.

Non-Tax Options

Tax increases are rarely a popular policy choice for elected officials—which means that Arkansas policymakers seeking to meet the *Lake View* requirements will be increasingly interested in reallocating state spending from non-education sources—or in achieving greater efficiency from the state's current education spending. Chapter Three of the companion report assesses the prospects of complying with *Lake View* using each of these alternatives—and finds that while each of these approaches could help fund education, each would raise only a fraction of the funds required to achieve educational adequacy in Arkansas. Other revenue-raising alternatives appear unavoidable in order to satisfy the *Lake View* mandate for educational adequacy.

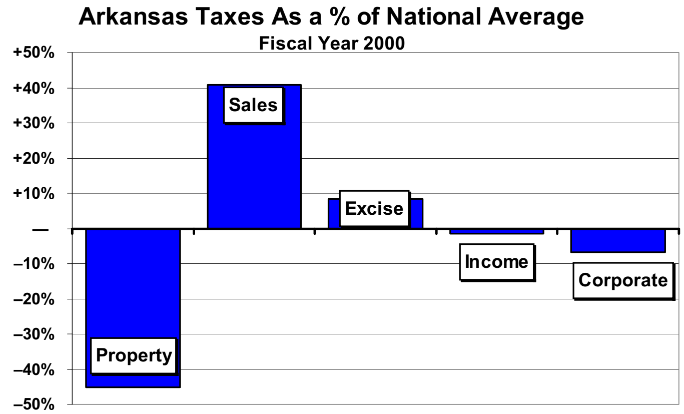


Lawmakers could seek to fund schools through **across-the-board spending cuts in non-education areas**. However, this strategy can offer at most a partial solution. The pool of non-education spending available for such cuts in 2003 is about $1.7 billion. This means that across-the-board spending cuts of, for example, $500 million, would reduce non-education funding by 29 percent. As the chart on this page shows, a $750 million cut would have an even more dramatic impact: these departments would see cuts of more than 44 percent of their budgets. Spending cuts on this scale could severely impair the state's ability to fund other essential services.

A frequently overlooked consequence of budget cuts is that state spending reductions often result in the loss of additional "matching" revenue from the federal government. For example, our system of low-income health care, known as Medicaid, is paid for by a federal-state partnership. For every dollar of Medicaid spending by a particular state, the federal government provides an additional amount of financial support. Poorer states receive a larger matching grant. Arkansas currently receives

Funding education through budget cuts in other areas can have a larger cost—the loss of federal "matching" funds for programs such as Medicaid.

a 3-for-1 match: every $100 million spent on Medicaid by Arkansas brings in $300 million of additional federal spending on Arkansas health care.



This federal matching grant makes it easier for Arkansas to provide adequate health care to low-income Arkansans—but it also means that balancing the Arkansas budget with Medicaid cuts is a costly proposition. If the state spends $100 million less in Medicaid, it loses $300 million in federal grants. Such a loss would reduce the state's ability to provide quality health care for low-income families—a high price to pay for adequately funding education.

Critics of public education in Arkansas frequently point to the unusually high number of school districts in the state as a cause of inefficiency, and see a reduction in the number of districts as a potential source of savings. The companion report surveys recent estimates of the savings that would result from reducing the number of school districts, and finds that the most Arkansas lawmakers can raise by **restructuring Arkansas school districts** is $40 million. The impact of various plans to consolidate schools on the resulting quality of education are being heavily debated and go beyond the scope of this report.

The Arkansas sales tax burden is exceptionally high—and the Arkansas property tax burden is especially low.

The limited yield of these alternatives to revenue raising means that tax increases may be essential to any solution to the *Lake View*-induced funding crisis.

The Arkansas Tax System

Arkansas is not a high tax state. Measured as a share of personal income, the Arkansas state and local tax burden is 10.4 percent—35th highest nationally and 4 percent below the national average.

This average tax burden conceals wide variation in the burden of individual Arkansas taxes:

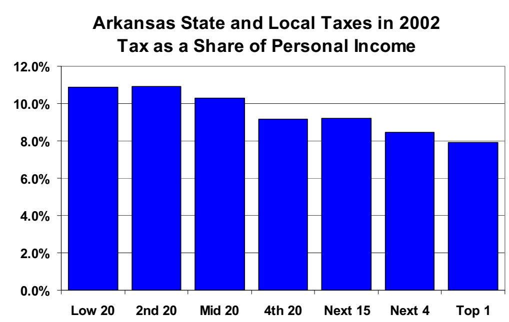
- The Arkansas property tax burden is among the lowest in the nation. At 1.7 percent of personal income, Arkansas property taxes are just over half the national average. Only four states had a lower property tax burden than Arkansas in 2000.
- Arkansas sales taxes, by contrast, are among the *highest* in the nation. At 3.8 percent of personal income, the Arkansas sales tax burden is eighth highest in the nation—and 40 percent higher than the national average.
- Personal income tax and corporate income tax burdens are each somewhat below the national average in fiscal 2000. Arkansas is also unusual in the very small share of total tax revenues that are levied at the local level—a direct consequence of the state's low property taxes.

A Regressive Tax System

Despite its relatively low tax burden, the Arkansas tax system is *regressive*. That is, it requires middle- and lower-income taxpayers to pay a higher portion of their incomes in taxes than the wealthy:

- The poorest fifth of Arkansas taxpayers, with incomes less than $15,000 per year, pay 10.7 percent of their income in Arkansas state and local taxes.
- Middle-income families pay 10.5 percent of their income in Arkansas taxes.
- The wealthiest one percent of Arkansans, with an average income of $1.2 million, pay only 7.8 percent of their income in Arkansas taxes.

The regressive nature of the Arkansas tax system stems from the interplay among its major taxes: income taxes, property taxes, and sales and excise taxes. These three taxes differ markedly in their impacts on families at different income levels:

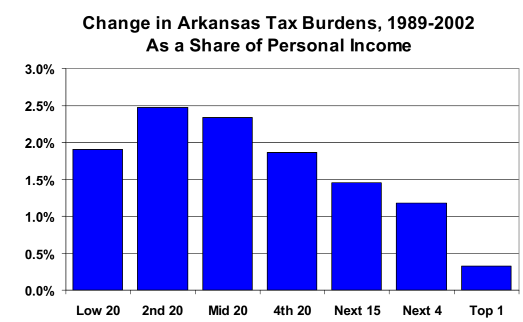


- The personal income tax is progressive.
- Property taxes are regressive.
- Sales and excise taxes are extremely regressive.

When the federal deductibility of income and property taxes is taken into account, Arkansas taxes are even more regressive. After taking account of federal deductibility, the wealthiest Arkansas taxpayers pay just 5.8 percent of their income in Arkansas taxes—less than half the burden paid by the poorest Arkansans.

No one pays a higher effective tax rate than the very poorest residents—and no one pays a lower rate than the very wealthiest Arkansans.

The Arkansas tax system is steadily becoming more regressive. A January 2003 ITEP study found that tax changes in the 1990s had a regressive effect on tax burdens in Arkansas. All Arkansans face, on average, a higher effective tax rate in 2002 than they did in 1989—but that tax increase is smallest, as a share of income, for the very wealthiest taxpayers.



In summary, while Arkansas is not a high-tax state, Arkansas taxes are more burdensome for low- and middle-income taxpayers than for the wealthy—and recently enacted tax changes have made the tax system even more inequitable.

The Arkansas tax system is steadily becoming more regressive due to changes enacted in the past decade.

Personal Income Taxes

The Arkansas income tax is an important source of tax progressivity, and it can be pivotal in raising revenues to help achieve adequacy. However, a variety of tax breaks limit the state's ability to fund education using this tax. Chapter Five of the companion report describes a number of factors that make the tax system less progressive than it formerly was.

The Arkansas corporate income tax is in decline—but lawmakers can take steps to close tax loopholes and shore up the tax base.

When the Arkansas income tax was introduced in 1929, the top tax bracket was set at $25,000 of taxable income. The brackets were unchanged for 70 years, until 1999 legislation indexed the brackets for inflation. In 2002, the revised top bracket was $27,500. The top bracket is worth much less today than when it was initially set: the original 1929 top bracket equaled $263,000 in today's dollars—similar to the current top federal tax bracket. This decline in the value of the top bracket means that more than a quarter of all Arkansans paid at the top rate in 2000—substantially more than would be paying the top rate if Arkansas had indexed its brackets for inflation.

The Arkansas income tax has also become less progressive due to a tax break that disproportionately benefits the wealthiest Arkansans: an exemption for 30 percent of capital gains. Among the notable features of the capital gains tax break are that:

- 63 percent of the state tax cuts from the capital gains exclusion go to the wealthiest 1 percent of taxpayers.
- 25 percent of the state revenue losses from this tax exclusion are never received by Arkansans, but are captured by the federal government in the form of higher federal income taxes.

Many states have recently introduced Earned Income Tax Credits based on the federal credit. Allowing such a credit in Arkansas would reduce the impact of tax increases on low-income working families.

Corporate Income Taxes

The Arkansas corporate income tax is in decline. As shares of both tax revenues and the Arkansas economy, the state's corporate taxes have fallen in the past two decades—similar to the experience of most other states. This decline appears to have been at least partially due to corporate tax avoidance strategies rather than the conscious design of Arkansas policymakers. Chapter Six of the companion report shows that this decline has meant that an increasing proportion of the tax burden has been shouldered by individual taxpayers.

Some of the tax loopholes that have reduced Arkansas corporate revenues are easily identifiable. Many states have shored up their corporate tax base by repealing the Passive Investment Corporation (PIC) loophole. PICS are subsidiary corporations, located in states (especially Delaware and Nevada) that do not tax corporate profits (or certain types of profits). Corporations can currently shift their Arkansas profits to Delaware PICs—and thereby reduce the profits that are taxed in Arkansas. By repealing this unintended tax loophole, lawmakers can revitalize the corporate income tax and help reduce the pressure to increase other, less progressive taxes on Arkansans.

There are no currently-available estimates of the impact of this tax break—or of the other tax breaks that reduce corporate taxes in Arkansas—on individual corporations in Arkansas. Yet there is reason to be concerned that profitable Arkansas corporations may be paying little or nothing in state income taxes, simply because some of these corporations pay very little in federal income taxes. An October 2000 ITEP analysis of 250 of the largest and most profitable corporations in America found that four profitable corporations with large employment bases in Arkansas paid an effective corporate tax rate of less than six percent during at least one year between 1996 and 1998—and that one of these corporations paid a *negative* federal income tax rate in 1998. While it is not currently possible to determine if these corporations have been equally successful in evading Arkansas taxes, some states have enacted disclosure laws that require corporations to provide details on the state or local tax breaks they receive. Greater disclosure would allow policy makers to evaluate the fairness of the corporate tax.

Sales and Excise Taxes

Arkansas relies more heavily on sales and excise taxes, or consumption taxes, than most other states. The state's sales and excise tax burden has risen from twentieth highest nationally in 1980 to eighth highest in 2000. Chapter Seven of the companion report describes the causes and consequences of this trend.

Sales and excise taxes are among the most regressive taxes levied in Arkansas. These taxes consume 8.6 percent of the income of the poorest Arkansas taxpayers—and just 1.4 percent of the income of the wealthiest Arkansans. Because these taxes are not deductible on federal tax forms, none of the taxes paid initially by Arkansans are offset by federal tax cuts.

The Arkansas sales tax rate has increased substantially since the introduction of the tax in 1941. The state tax rate has risen from 2 percent to 5.125 percent during this period—and has risen by 1.125 percent in the past twenty years. Since 1990, only one other state—Michigan—has increased its state sales tax rate by more than Arkansas.

The state's high sales tax burden conceals a source of structural weakness—the prevalence of expensive, untargeted sales tax exemptions. Eliminating sales tax exemptions for personal and professional services would increase the perceived equity of the sales tax by treating all retail transactions alike—but it would also make the tax system more regressive.

While taxes based on consumption are inherently regressive, several states have instituted low-income "sales tax credits" designed to offset the burden of sales taxes on those least able to afford them. This approach can be designed to offer the same low-income protection as a sales tax exemption at a fraction of the cost.

Property Taxes

Like most states, Arkansas relies on local property taxes as one mechanism for funding education. The uneven distribution of property tax wealth among Arkansas school districts contributes to the inequities of Arkansas's education finance system. Arkansas is unusual, however, in its very low property tax burdens. Chapter Eight describes options available to state lawmakers seeking to increase the state's reliance on property tax burdens in a way that does not increase funding inequities between school districts.

Arkansas property taxes are regressive: lower-income taxpayers pay more, as a share of income, than do better off taxpayers. The chief reason why property taxes are regressive is that they are based on home values rather than on income levels, and home values represent a much larger share of income for middle- and low-income families than for the wealthy.

The major Arkansas property tax relief program, the $300 tax credit, does little to reduce the regressivity of the property tax. This is because the credit is available to homeowners at all income levels, not just low-income Arkansans. The credit's impact is also limited by the exclusion of renters. Even though it is generally accepted that a substantial portion of property taxes on rental properties are passed through to renters, Arkansas renters are not eligible for the property tax credit. Until 1999, Arkansas allowed a low-income property tax credit that was more effective than the current $300 credit in reducing the regressivity of the property tax—at a much lower cost.

The state's low property tax burden means that property taxes will likely be part of any revenue-raising solution—but steps can be taken to protect low-income homeowners and renters.

The state's low current property tax burden means that the tax may be central to any revenue-raising solution enacted in Arkansas. However, increasing the rate of the statewide Arkansas property tax would require a vote of the people.

Other Revenue-Raising Options

In addition to the "big three" revenue sources traditionally relied upon by state governments (income, sales and property taxes), several lesser revenue sources could be harnessed to help fund education. These include increasing the severance tax rate on extracting natural gas (which is currently lowest in the nation among producing states) and introducing a lottery. In addition, Arkansas lawmakers can help fund education by taking action to avoid the federally-induced repeal of the Arkansas estate tax—one of the few truly progressive taxes levied on the state level. The companion report assesses the virtues and shortcomings of these and other options.

None of these alternatives can play more than a supporting role in constructing a revenue-raising plan for Arkansas. Instituting a lottery is potentially troublesome as a long-term revenue source both because of its potential for decline and its extreme regressivity. But each of these options would provide some help in meeting the spending requirements facing the state.

Tax Reform Options

The inability of the current Arkansas tax system to adequately fund education—and the limited savings offered by the non-tax options available in 2003—mean that state policymakers will have to make tough decisions about how to raise sufficient revenues to satisfy the *Lake View* mandates. Chapter Ten of the companion report—attached as an appendix to this summary report—describes twenty five tax changes that can be used as building blocks for tax reform in Arkansas. Impacts at different income levels and revenue estimates are provided for each option, along with an analysis of its advantages and disadvantages.

The Economic Impact of Adequacy

Complying with the *Lake View* requirements could mean substantial amounts of new state spending on education—and substantial additional tax revenues to support this spending. It is important to estimate the effect of these spending and tax changes on the state's future economic development.

Chapter Eleven of the companion report analyzes the impact of a representative package of new spending and new tax revenues that could be implemented in compliance with *Lake View* and shows that these policy changes would have, on balance, a stimulative effect on economic growth in Arkansas.

The analysis shows that if adequacy were achieved by phasing in the additional spending and tax revenues needed to meet the *Lake View* requirements, the year-2014 Arkansas economy would have:

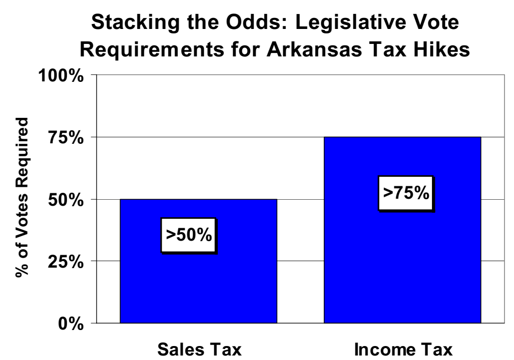
- Almost 35,000 more jobs statewide;
- $1.9 billion more personal income;
- $1.1 billion in additional tax revenues.

At a time when many policymakers may wish to avoid burdening the state's lagging economy with additional tax revenues, ITEP's analysis reinforces an important point: tax revenues are used to provide important public services, which make Arkansas a more attractive place to live. In other words, the negative economic impact of new taxes must be measured against the positive economic impact of additional state and local government spending. This analysis is presented in Chapter Eleven of the companion report.

ITEP's analysis shows that the additional spending and taxes necessary to comply with Lake View would have a positive impact on the Arkansas economy.

Barriers to Tax Changes

The social benefits of spending and tax packages described in the companion report can only be enacted through bold decisions by Arkansas policy makers. Yet several institutional barriers could make implementing these plans more difficult.



Amendment 19 of the Arkansas Constitution requires a three-fourths supermajority vote of both legislative houses to pass rate increases in any of the taxes in place when the amendment was passed—in 1934. For example, this means that the legislature must marshal substantially more votes to pass increases in the personal income tax, which was in effect in 1934, than to pass an increase in the general sales tax.

The "rules of the game" make it easier for Arkansas lawmakers to pass sales tax increases—and much harder to pass increase in most other taxes.

This amendment, which applies different rules for enacting tax increases depending on the year in which each tax was created, creates an arbitrary bias toward greater reliance on sales taxes, increasing the tax burden on low-income Arkansans. Arkansas lawmakers have responded to these incentives by increasing sales tax rates much more frequently than income tax rates.

The Amendment 19 rules, however, apply only to increases in tax *rates*. Measures to broaden the tax *base* by eliminating tax exemptions would not fall afoul of the Amendment 19 rules and can be enacted with a simple majority vote. Other more recent constitutional amendments limit the growth of property tax revenues by capping the level of personal property tax revenue in districts that have not equalized real and personal property tax rates (Amendment 59) and limit annual growth in assessed value (Amendment 79).

There is evidence that many Arkansans do not recognize the basic inequity of the Arkansas tax system.

Perhaps the most daunting constraint facing state lawmakers is public opinion. Many lawmakers fear the political repercussions from raising taxes or spending. However, Chapter Twelve of the companion report presents survey results indicating that the public favors tax increases when the resulting revenues are designated for particular purposes. The report also shows that Arkansans favor certain tax hikes over others. In particular, public support is highest for tax increases perceived as voluntary, narrow in scope, or that taxpayers believe will not affect them personally.

Raising public awareness on the pros and cons of various revenue-raising approaches is essential to meeting the *Lake View* requirements. There is evidence that many Arkansans do not recognize the basic inequity of the Arkansas tax system. A greater public understanding of equity issues may facilitate informed decision-making on how to fund Arkansas schools.

Conclusion

The Arkansas Supreme Court's decision in the *Lake View* case could result in a fundamental change in how the state pays for education. Implicit in the court's decision is that just as all Arkansans share in the benefits of education, so we must share the burden of paying for these benefits.

Accepting this shared responsibility could require major changes in the Arkansas tax structure. The *Lake View* decision tells us not only that Arkansas does not currently provide an adequate education for its children, but also that this educational failure is partially attributable to the state and local tax structure. By combining tax reform with the effort to raise sufficient funds for education, Arkansas can help ensure the long term viability of the state's fiscal structure—and avoid crises of school funding adequacy in the future.

The companion report demonstrates that alternatives to raising taxes—for example, cutting the budgets of other state agencies or consolidating school districts—cannot, by themselves, resolve the state's funding quandary. This means that new state revenue will be needed to adequately fund education in Arkansas. The companion report's analysis also shows that tax reform can help fund adequacy while making the tax system fairer.

The companion report identifies a series of options available to lawmakers as they seek to fund educational adequacy but does not recommend any particular solution to the state's current fiscal crisis. The study does provide analyses of many options that could be part of a funding solution in compliance with the *Lake View* requirements, including:

- **Imposing "across the board" budget cuts in areas of Arkansas spending other than education.** In fiscal 2003, Arkansas will spend about $1.7 billion on these other areas. Relying only on budget cuts to fund *Lake View* would result in draconian reductions in non-education spending—and would endanger federal "matching grants" that depend on the level of Arkansas spending.
- **Restructuring Arkansas school districts.** Continuing the long-term trend toward reducing the number of Arkansas school districts by consolidating the smaller, rural districts could potentially yield up to $40 million for use in achieving adequacy. But some education experts have presented evidence that this policy change could adversely affect the quality of Arkansas education.
- **Eliminating certain personal income tax deductions.** Current income tax exclusions for capital gains and Social Security benefits reduce the yield—and the perceived fairness—of the tax system. Making the income tax base broader will help fund education and other services in the long run.
- **Making the personal income tax more progressive**. When the income tax was adopted in 1929, the top tax rate applied only to the wealthiest taxpayers. The top tax bracket has been adjusted only slightly since then, and many more Arkansans are now subject to the top tax rate than in 1929. Introducing a new top income tax rate would help raise revenues and would restore the former progressivity of the tax.
- **Eliminating corporate income tax loopholes.** The state corporate income tax is in decline, in Arkansas and across the nation. Creative accounting loopholes have reduced the yield of the corporate tax in recent years, but loophole-closing measures could help restore the tax. Public disclosure of tax breaks would help inform this process.
- **Decoupling from recent corporate tax cuts**. Accelerated depreciation provisions in recent federal "stimulus" legislation threaten to further reduce the yield of the Arkansas corporate tax. Decoupling from the federal legislation would prevent these losses.
- **Broadening the sales tax base to include more goods and/or services.** Arkansas excludes many personal and professional services from its sales tax base. These services are a growing part of the economy—which means that the long-term vitality of the sales tax depends on including these services in the tax base. The state could also eliminate expensive, poorly targeted exemptions for various goods. The net impact of this change would still be regressive, and any further sales tax expansion would exacerbate the current imbalance in the Arkansas tax structure.

Tax reform can help fund adequacy in Arkansas while making the tax system fairer.

- **Increasing excise taxes on cigarettes, gasoline or alcohol.** These options have become increasingly popular in other states—but are slow-growth taxes that are likely to be insufficient to fund education in the long run. These options are also regressive.
- **Increasing the state's reliance on property taxes.** Arkansas's property tax burden is among the lowest in the nation. This forces the state to rely more heavily on sales and excise taxes, which are among the highest in the nation. This imbalance could be rectified by bringing the state's property taxes closer to the national average through a state property tax increase, repealing tax breaks for farmland, or improving assessment practices.
- **Offsetting regressive tax hikes with low-income protection**. Many states reduce the regressivity of their tax systems through low-income Earned Income Tax Credits, sales tax credits, or property tax "circuit breakers." These options would reduce the impact of regressive taxes on low-income Arkansans, at a minimal cost to the state.
- **Increasing natural gas severance taxes**. Arkansas currently imposes the lowest tax burden in the nation on the extraction of natural gas. Increasing the rate and calculating the tax as a percentage of market value could help increase revenues while exporting much of the tax burden to residents of other states.
- **Preserving the estate tax.** Recent federal estate tax repeal threatens the Arkansas tax. Acting to "decouple" the state tax from the federal estate tax would preserve one of the few progressive taxes levied by the state.
- **Introducing an Arkansas lottery.** Unlike Arkansas, most states now allow a state lottery. The revenue yield of this approach is uncertain in the short run, and likely to decline in the long run—and a lottery is among the most regressive revenue-raising options available to the state.
- **Repealing Amendment 19.** This provision makes it easier to increase sales taxes—and harder to increase any other major tax—for reasons that have no rational basis. Repealing this amendment would allow lawmakers to evaluate tax proposals on their merits rather than basing these important decisions on arcane parliamentary rules.
- **Repealing constitutional limits on property tax growth.** A series of constitutional amendments have reduced the importance of the property tax in Arkansas. Repealing these amendments would help fund schools using property tax revenues and would increase the perceived equity of the property tax.

Failing to adequately fund education now will impose much greater costs on the next generation of Arkansans.

None of these revenue-raising options would be easy to enact: as we have seen, institutional and political obstacles make tax increases unlikely and true tax reform even more unlikely. However, if the inability of policymakers to agree on an equitable solution to revenue-raising prevents adequately funding public education, this failure will impose a much larger social cost on the next generation—one that will have consequences beyond any dollar amounts that are currently under discussion.

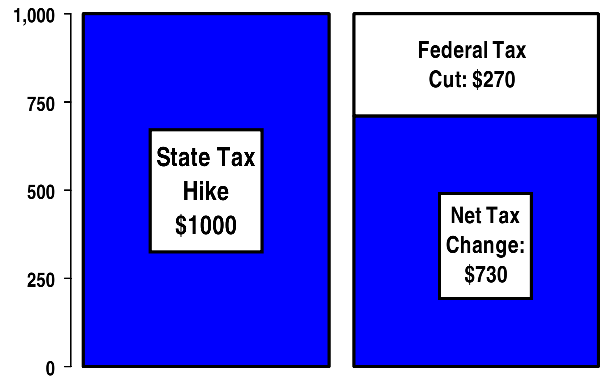
Appendix: Options for Funding Education in Arkansas

The spending requirements imposed by the *Lake View* case represent a substantial challenge for lawmakers seeking to raise adequate revenues to comply with the ruling. Arkansas lawmakers have three broad tax policy choices in meeting these revenue-raising demands: they can raise tax rates on existing taxes, broaden the base of these taxes to include currently exempt items (for example, expanding the income tax to include all capital gains or broadening the sales tax base to include more services), or enact entirely new revenue sources, such as a lottery. This appendix describes options that could help legislators resolve the state's fiscal needs.

While most of the proposals described here would increase Arkansas tax revenue, several revenue-reducing options are included to show the impact of tax relief strategies that could be adopted in conjunction with revenue-raising reforms to mitigate the impact of these new tax revenues on low- and middle-income taxpayers. In each case, this appendix presents the annual revenue impact of the proposals.

For each option described below, the accompanying bar charts show the impact of these options on each Arkansas income group, expressed as a percentage of personal income. The solid portion of each bar represents the net tax change (after taking federal tax changes into account) for each income group. The transparent portion of each bar shows the amount of state tax change that is offset immediately by federal tax changes. We have presented our data in this way because for those Arkansans who itemize deductions on their federal tax return, changes in state income and property taxes can produce offsetting changes in federal tax liability. When state and federal taxes interact in this way, it is important to assess the effect of tax proposals on the *total* taxes paid by Arkansans, including federal state taxes. The example below shows how to interpret these charts.

How Increases in Federally Deductible Taxes Reduce Federal Tax Burdens: An Example



Suppose an itemizing Arkansas taxpayer in the 27 percent federal tax bracket is subject to a $1,000 increase in Arkansas income taxes. The value of her federal itemized deductions will increase by $1,000. This means that $1,000 *less* of this taxpayer's income will be subject to federal tax after the Arkansas tax cut. Since this last increment of income was originally taxed at 27 percent, this person's federal tax liability decreases by $270. So the net *overall* tax hike for this itemizing Arkansas taxpayer from a $1,000 increase in state tax liability is actually $730, not $1,000. Our distributional analysis of this proposal (the second column in the chart above) shows that taxpayers do not pay the full $1,000 tax hike, since $270 of that hike is directly offset by federal tax cuts. An analysis that looked only at the *state* tax impact of the proposal (the first column in the chart) would overestimate the additional tax burden on Arkansans from this proposal. Since sales and excise taxes are not federally deductible, the consumption tax options do not show a federal tax impact.

Building Blocks for Tax Reform

This section shows the impact of a variety of individual tax changes that could be implemented to raise (or reduce) Arkansas tax revenues.

Revenue Raising Options

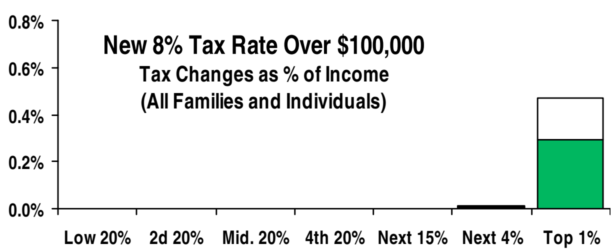
1. New 8% Top Tax Bracket Over $100,000.

Principal Features

- Increases Arkansas taxes by $34 million.
- Decreases federal taxes by $12 million.

Discussion

This option creates a new top personal income tax bracket above $100,000 of taxable income, imposing state tax hikes on just over 1 percent of the wealthiest Arkansas taxpayers. This option would raise $34 million for elementary and secondary education, of which about $12 million, or thirty seven percent of the state tax hike, would be offset by lower federal income tax payments for itemizers.



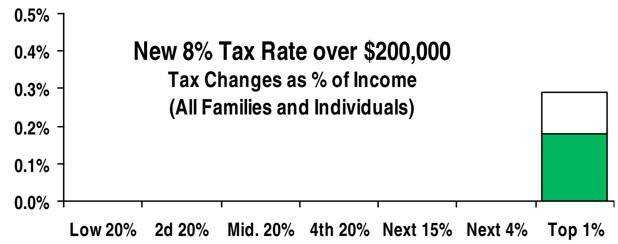
2. New Top Tax Bracket Over $200,000

Principal Features

- Increases Arkansas taxes by $20/ $40 million.
- Decreases federal taxes by $8/ $15 million.

Discussion

This option creates a new top tax bracket over $200,000 of taxable income. This approach imposes state tax hikes on just 0.4 percent of the wealthiest Arkansas taxpayers. This option would raise $20 million if an 8 percent top rate were used, and $40 million with a 9 percent rate. Thirty eight percent of the state tax hike would be offset by lower federal income taxes for Arkansas itemizers.



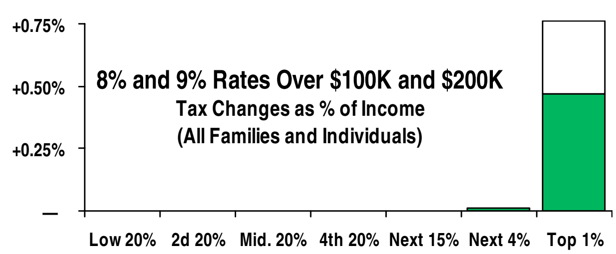
3. Two New Tax Brackets over $100,000, $200,000

Principal Features

- Increases Arkansas taxes by $54 million.
- Decreases federal taxes by $20 million.
- Affects 1 percent of Arkansas taxpayers.

Discussion

This option creates not one but two new top income tax rates, with an 8 percent marginal tax rate applying to taxable income between $100,000 and $200,000, and a 9 percent rate applying to taxable income over $200,000. Thirty eight percent of the state tax hike from this option would be offset by lower federal income taxes for Arkansas itemizers.



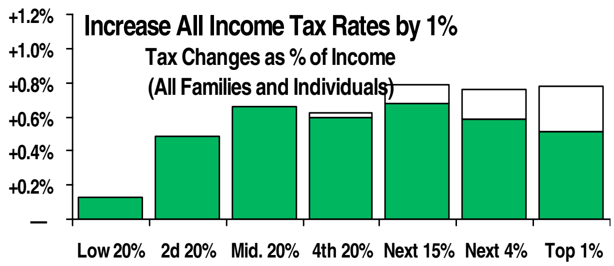
4. "Across the Board" Income Tax Increase

Principal Features

- Progressive tax change.
- Increases Arkansas taxes by $344 million.
- Decreases federal taxes by $50 million.

Discussion

This option increases each marginal income tax rate by 1 percentage point (for example, the bottom rate increases from 1 to 2 percent). This change would make the state tax system more progressive, but would result in a tax hike for all those paying income taxes. Fourteen percent of the state tax hike would be offset by federal tax cuts for itemizers.



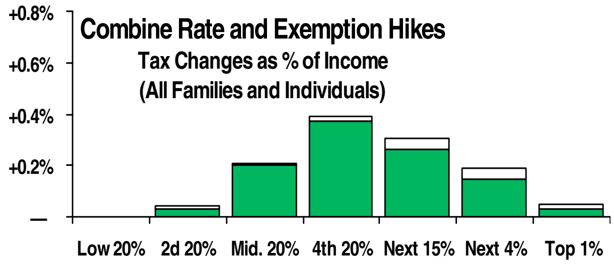
5. "Across the Board" Income Tax Increase Combined with Exemption Credit Hike

Principal Features

- Increases Arkansas taxes by $303 million.
- Reduces federal taxes by $46 million.

Discussion

This option is more progressive than the "across the board" income tax hike in option 4 because part of the tax hikes on low-income taxpayers are offset by an expansion of the personal exemption credit. This change combines a 1 percent income tax hike with an increase in the personal exemption credit from $20 to $40. Fifteen percent of the state tax hike would be offset by federal tax cuts for itemizers.



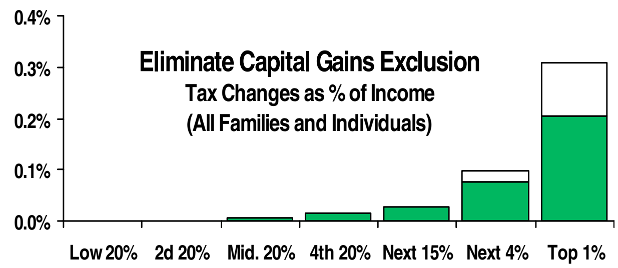
6. Repeal Capital Gains Tax Exclusion

Principal Features

- Increases Arkansas taxes by $34 million.
- Reduces federal taxes paid by $9 million.

Discussion

This option eliminates the income tax exclusion for capital gains income. The wealthiest one percent of Arkansans receive 63 percent of the benefits from the current tax break. A substantial portion of this tax break goes directly to the federal government in the form of higher federal tax liability.



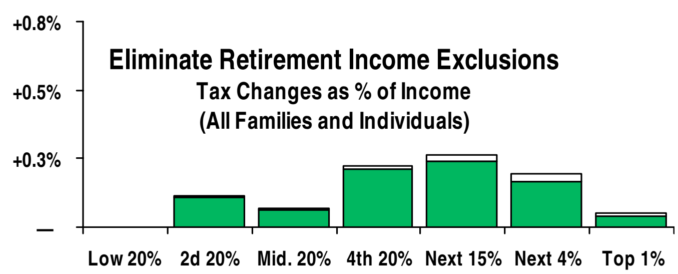
7. Eliminate Retirement Income Exclusions

Principal Features

- Conforms Arkansas's tax treatment of pensions and Social Security benefits to federal rules.
- Simplifies the Arkansas tax system.
- Increases Arkansas tax revenues by $85 million.
- Decreases federal taxes by $7 million.

Discussion

This option simplifies the Arkansas income tax by conforming to the federal income tax treatment of Social Security and pension income. Arkansas currently exempts all social security income and the first $6,000 of pension and military income.



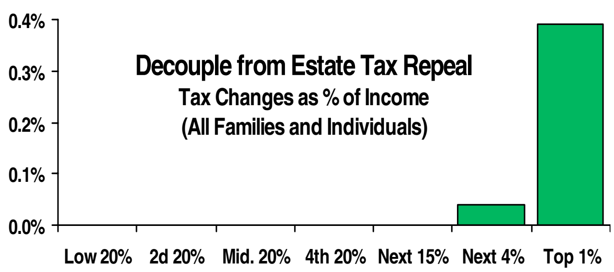
8. Decouple from Federal Estate Tax Repeal

Principal Features

- Preserves the Arkansas estate tax.
- Affects less than two percent of decedents.
- Increases Arkansas tax revenues by $20 million.

Discussion

Decoupling from the federal estate tax would have very little impact on the taxes owed by most Arkansans, because of generous exemptions in the federal estate tax as it existed prior to 2001. The impact of decoupling would be borne primarily by the top one percent of taxpayers. While the precise revenue yield of this change is uncertain, it has been estimated that decoupling from the federal estate tax could yield more than $25 million annually.



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9. Increase Corporate Income Tax Rate

Principal Features

- Creates a new top tax rate on corporate income.
- Progressive tax change.
- Most of tax is exported to non-Arkansans.
- Increases Arkansas tax revenues by $15 million.

Discussion

This option sets a new top tax bracket above the current top rate of 6.5 percent. Because most of the corporate tax burden is exported to non-residents, the impact of this option on Arkansans is minimal.

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10. Increase Natural Gas Severance Tax

Principal Features

- Convert Arkansas severance tax to "percentage of value" taxation approach.
- Most of tax is exported to non-Arkansans.
- Increases Arkansas tax revenues by $35 million.

Discussion

Arkansas has the lowest severance tax rate on natural gas of any producing state. Because severance taxes are largely exported to residents of other states, the incidence of this tax increase on Arkansans is minimal. Converting to a market-value based tax would ensure that the state's severance tax revenues will grow with inflation in future years.

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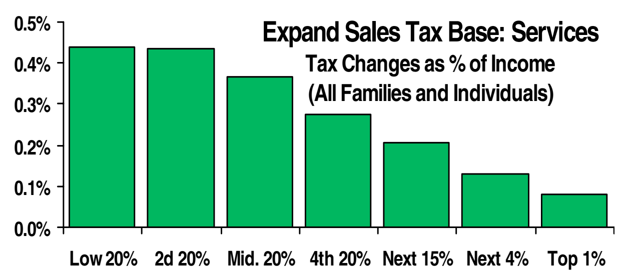
11. Eliminate Sales Tax Exemptions (Services)

Principal Features

- Regressive tax change.
- Increases Arkansas revenues by $163 million.
- Federal taxes are not affected by this change.

Discussion

This option expands the state sales tax base by taxing various business services. The option would raise $163 million. Although this change makes the sales tax less regressive, it is nonetheless clearly regressive. This proposal would increase the yield of the sale tax, but it could also encourage businesses to produce these services themselves, leading to artificially high levels of vertical integration. Because sales taxes are not deductible on federal income tax forms, none of this tax hike would be offset by federal tax cuts.



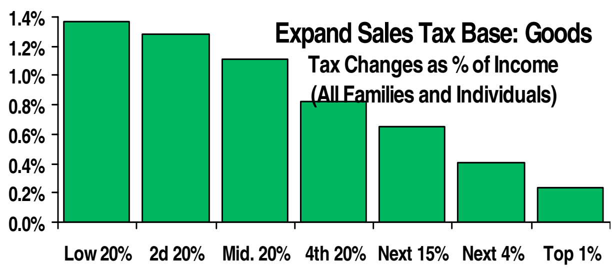
12. Eliminate Sales Tax Exemptions (Goods)

Principal Features

- Eliminates exemptions for tangible property.
- Regressive tax increase.
- Increases Arkansas revenues by $582 million.
- Federal taxes are not affected by this change.

Discussion

This option augments the state sales tax base by eliminating exemptions for various goods. This is a regressive sales tax change—but one that yields $582 million to help fund adequate schools. Because sales taxes are not deductible on federal income tax forms, none of this tax hike would be offset by federal cuts.



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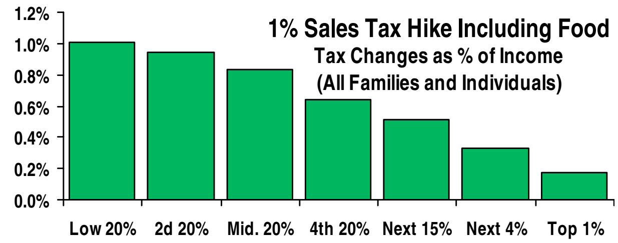
13. Sales Tax Rate Hike (Including Food)

Principal Features

- Raises state sales tax rate by 1 percent.
- Regressive tax increase.
- Increases Arkansas revenues by $366 million.
- Federal taxes are not affected by this change.

Discussion

The general sales tax is the most regressive major tax levied by the state—and Arkansas already has a relatively high state sales tax rate. Including sales of groceries in the tax base makes this tax hike even more regressive. Increasing the sales tax rate without broadening the tax base to include currently exempt services exacerbates the differential treatment between the low-income taxpayers who tend to consume goods and the upper-income taxpayers who are more likely to consume untaxed services. Because sales taxes are not deductible on federal tax forms, none of the added sales tax burden would be offset by federal tax cuts.



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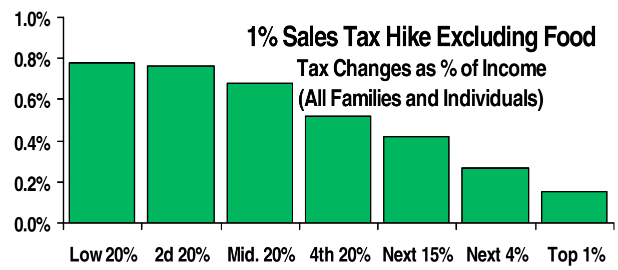
14. Sales Tax Rate Hike Excluding Food

Principal Features

- Raise sales tax rate by 1% on non-food items.
- Regressive tax increase.
- Increases Arkansas revenues by $324 million.
- Federal taxes are not affected by this change.

Discussion

Excluding sales of groceries from this 1 percent sales tax rate hike makes this option less regressive than option 13—but also reduces the yield of this tax option by more than ten percent. This option introduces the same "horizontal equity" problems as option 13. Because sales taxes are not deductible on federal income tax forms, none of this tax hike would be offset by federal tax cuts.



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15. Property Tax Increase

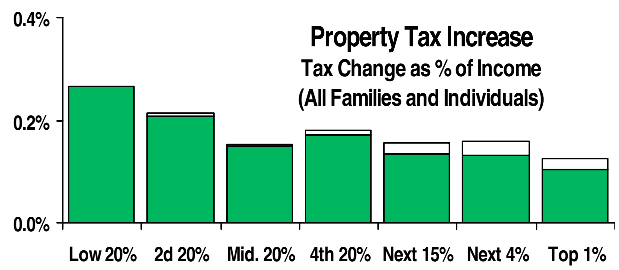
Principal Features

- Increase statewide property tax rate by 5 mills.
- Regressive tax increase.
- Increases Arkansas revenues by $125 million.
- Federal taxes decrease by $5 million.

Discussion

This option increases the tax rate on real and personal property. This is a regressive tax hike.

Because property taxes are deductible on federal income tax forms, some of the added property tax burden would be offset by federal tax cuts.



16. Cigarette Tax Increase

Principal Features

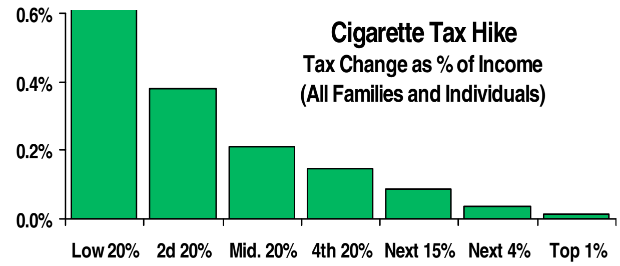
- Raise cigarette tax by $0.34 per pack to $0.93.
- Regressive tax increase.
- Increases Arkansas tax revenues by $83 million.
- Federal taxes are not affected by this change.

Discussion

This option increases the state cigarette tax to 93 cents per pack. Because cigarette taxes are highly regressive, this tax hike would impact low-income taxpayers most heavily. However, increases in cigarette taxes may discourage smoking, and high cigarette tax rates may encourage tax evasion.

Cigarette taxes are a poor choice for long-term revenue raising, since they are calculated based on the volume of sales rather than as a percentage of the sales price. This means that revenues will only grow when the rate increases or when consumption grows. The recent decline in cigarette consumption means that the revenue yield of this tax at any particular rate is likely to decline over time.

Because excise taxes are not deductible on federal income tax forms, none of the added excise tax burden would be offset by federal tax cuts.



17. Increase Gasoline Excise Tax

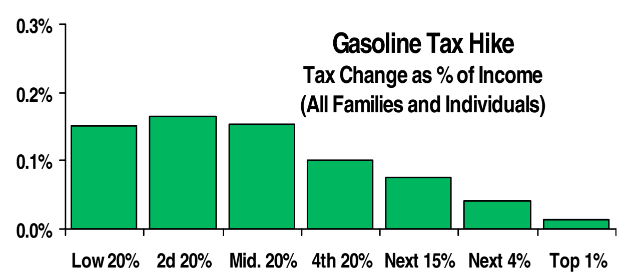
Principal Features

- Impose 5 cents per gallon tax hike on gasoline.
- Regressive tax increase.
- Increases Arkansas taxes by $100 million.
- Federal taxes are not affected by this change.

Discussion

Currently, all of the revenue from the motor fuel tax goes to special revenue funds for highway aid or highway construction. This option would levy an additional five cents per gallon excise tax on motor fuels, with the revenues devoted to state general revenue funds. While this option is less regressive than the cigarette tax hike modeled above, this excise tax hike still hits low-income taxpayers most heavily.

Because excise taxes are not deductible on federal income tax forms, none of the added excise tax burden would be offset by federal tax cuts.



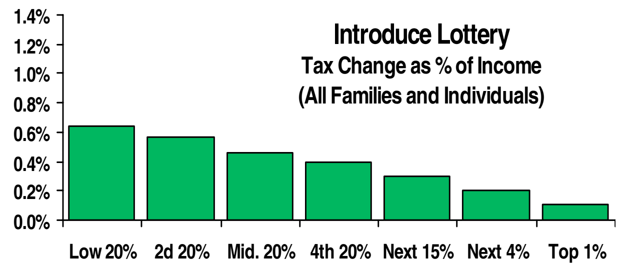
18. Impose Arkansas Lottery

Principal Features

- Increases Arkansas revenues by $55 million.
- Federal taxes are not affected by this change.

Discussion

Lotteries are an increasing popular revenue-raising choice for states. However, a lottery is also among the most regressive revenue-raising options available to lawmakers. Low-income taxpayers would account for 16 percent of total in-state lottery spending. Establishing an Arkansas lottery could yield in excess of $50 million annually for education.



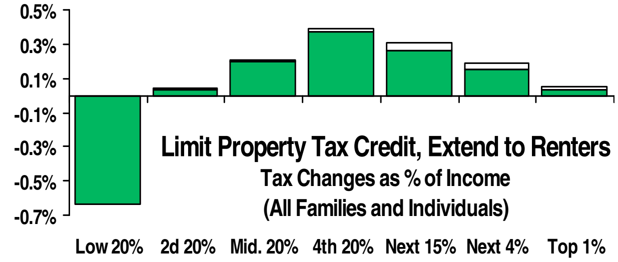
19. Add Income Limits to Property Tax Credit, Extend to Renters

Principal Features

- Increases Arkansas revenues by $100 million.
- Reduces federal taxes by $13 million.

Discussion

This option makes the Arkansas $300 property tax credit better targeted to achieve low- and middle-income property tax relief. The credit is currently available to homeowners at all income levels but is not available to renters—even though it is generally accepted that renters pay property taxes indirectly in the form of higher rents. This option corrects this omission by limiting eligibility to homeowners earning less than $30,000 and allowing a $300 credit for renters under the same income limits. Because property taxes are deductible on federal income tax forms, some of the added property tax burden would be offset by federal tax cuts.



Tax Relief Options

Many of the options described in this chapter would increase tax burdens on low-income Arkansans. Some options would even make the state tax system more regressive. Recognizing that lawmakers may wish to shelter low-income taxpayers from some of the additional tax burdens imposed by the *Lake View* spending requirements, this section looks at several approaches to targeted low-income tax relief that could be used in conjunction with the revenue-raising options described above. Options are presented for each of the three major taxes levied in Arkansas—personal income, property and sales taxes.

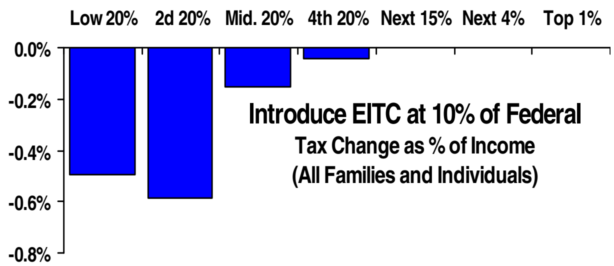
20. Enact an Earned Income Tax Credit

Principal Features

- A refundable EITC based on the federal credit.
- Reduces administrative costs of tax relief.
- Targeted to lower-income working families.
- Reduces Arkansas tax revenues by $47, $94 and $188 million if enacted at 10, 20 and 40 percent.

Discussion

The Earned Income Tax Credit (EITC) is one of the most popular approaches to targeted state tax relief for working families. Seventeen states currently allow an EITC based on the federal credit. Most of these credits are refundable, meaning that if a family's credit is larger than the amount of taxes owed, the family receives a cash refund. The credit is easy for taxpayers to calculate and easy for the state to administer, since it is designed as a flat percentage of the federal EITC.



21. Enact a $150 Sales Tax Rebate

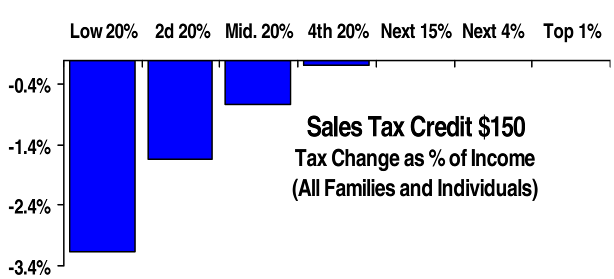
Principal Features

- $150 per-exemption refundable tax rebate.
- Restricted to taxpayers earning under $30,000.
- Targeted to lower-income working families.
- Reduces Arkansas tax revenues by $190 million.

Discussion

This option partially offsets the regressivity of the Arkansas sales tax by allowing a grocery tax credit for taxpayers earning less than $30,000. According to USDA data, a $150 sales tax credit represents about two-thirds of the state sales tax that would be paid by a family of three on food purchases equivalent to the "Thrifty Food Plan," the food plan determined by USDA to provide a minimally-adequate diet.

Because eligibility is limited to low-income taxpayers, the sales tax credit is a less expensive way of reducing sales taxes than an exemption for groceries. However, sales tax credits must be applied for, while sales tax exemptions are automatically granted to all eligible consumers. Taxpayers who are not aware of a sales tax credit will not receive its benefits.



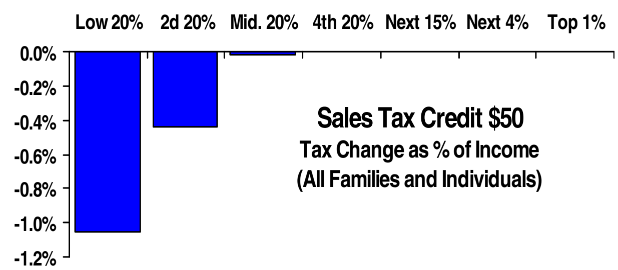
22. Enact a $50 Sales Tax Rebate

Principal Features

- Restricted to taxpayers earning under $20,000.
- Reduces Arkansas tax revenues by $43 million.

Discussion

This option allows a less generous sales tax credit than the previous option, limiting eligibility to $20,000 and the maximum credit to $50. An income limit of $20,000 would be equivalent to the 2003 federal poverty line for a family of four; 40 percent of Arkansans would be eligible. While still progressive, this credit provides less tax relief than option 21.



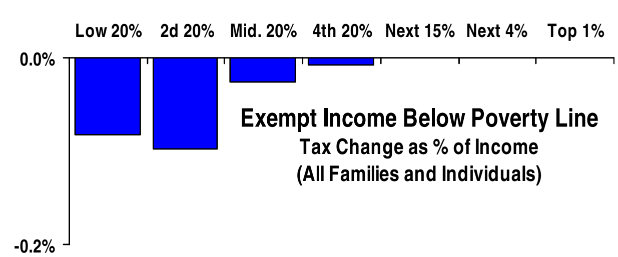
23. Exempt Poor Families from Income Tax

Principal Features

- Creates a "poverty exemption" by raising the income tax threshold to equal the poverty line.
- Provides low-income targeted tax relief.

Discussion

Arkansas currently imposes one of the highest income tax burdens on a family of four with an income at the federal poverty line ($326 in 2001). This option raises the tax filing threshold so that all families with incomes below the federal poverty line would be exempt from state income taxes.



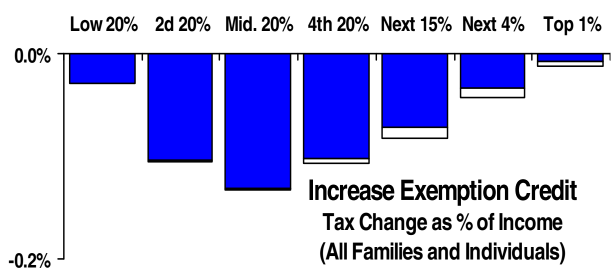
24. Increase Personal Exemption Credit

Principal Features

- Reduces Arkansas tax revenues by $40 million.
- Increases federal taxes by $3 million.

Discussion

The personal exemption credit offers valuable tax relief to low- and middle-income Arkansans. However, the credit's value has declined since the credit was last adjusted in 1987. This option doubles the credit, providing progressive tax relief. Because the credit is available to all Arkansans, this tax cut is more expensive than the credits described so far.



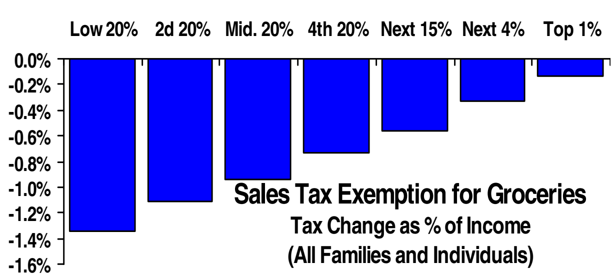
25. Exempt Food from Sales Tax

Principal Features

- Exempts sales of groceries from sales taxes
- Reduces Arkansas revenues by $360 million.

Discussion

This is a progressive option for Arkansas—but an expensive one. The largest tax cut, as a share of income, goes to the very poorest Arkansans. Yet all Arkansas taxpayers receive a tax cut under this plan.



Putting It All Together:

As the charts at the beginning of this chapter make clear, none of the building blocks described so far can generate sufficient revenue to meet the *Lake View* requirements. This section presents a variety of ways in which revenue-raising and tax-relief options could be combined to yield $650 million or more.

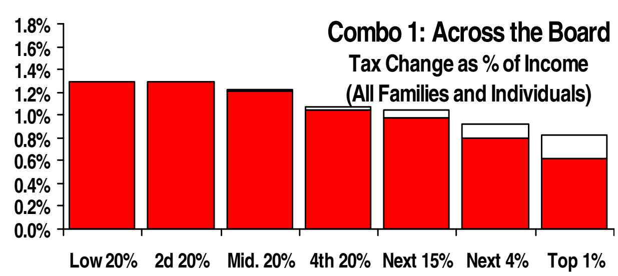
Combination 1: Across-the-Board Hikes

Principal Features

- Increases sales tax rate by 1 percent on all goods, but does not expand the sales tax base.
- Increases property tax rates statewide.
- Increases all personal income tax rates by 10%.
- Increases Arkansas revenues by $655 million.
- Decreases federal taxes paid by $36 million.

Discussion

This option takes the simplest possible approach to revenue-raising—it increases statewide tax rates in each of the "big three" revenue sources relied upon by Arkansas. This plan does not broaden the base of the personal income or sales taxes, but simply increases the tax rates applied to the existing base. Because regressive revenue sources constitute the lion's share of the revenue from this plan, and because the income tax increase included in this plan simply increases rates on all taxpayers, the overall impact is regressive: the very poorest Arkansans would pay the most, as a share of income, if these tax increases were adopted to fund *Lake View*.



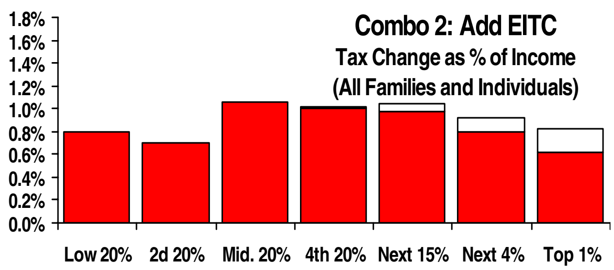
Combination 2: Add an EITC

Principal Features

- Adds a 10 percent EITC to Combination 1.
- Increases Arkansas revenues by $608 million.
- Decreases federal taxes paid by $36 million.

Discussion

This option adds one feature to the regressive Combination 1: a ten percent refundable EITC. This addition makes this option less regressive, although wealthy Arkansans still pay the least. Because the low-income beneficiaries of the EITC do not itemize federal tax returns, this option results in the same federal tax change as Combination 1—yielding a greater "bang for the buck" than the first option.



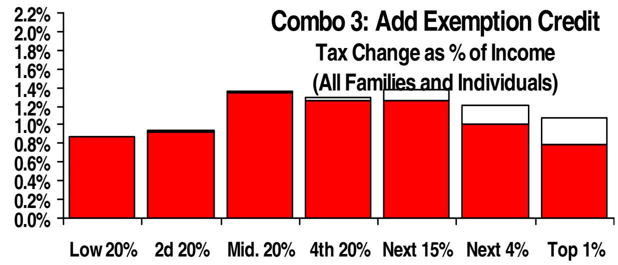
Combination 3: Increase Income Tax

Principal Features

- Changes from Combination 1: an EITC, a 14% income tax hike, and a $20 exemption hike. Increases Arkansas revenues by $747 million.
- Decreases federal taxes paid by $54 million.

Discussion

This option starts with Combination 1, and increases income tax rates by an additional 4 percent, to a top rate of 8 percent. This change increases state taxes by an additional $139 million over Combination 1. A substantial portion of this added state revenue is offset by federal tax cuts for itemizers.



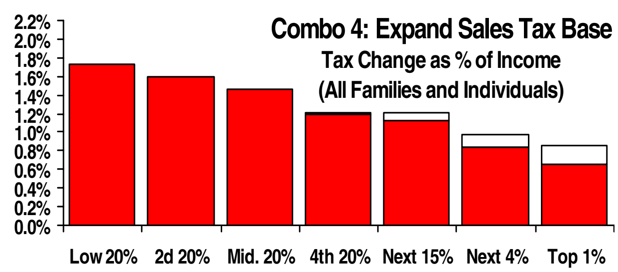
Combination 4: Sales Tax Base Broadening

Principal Features

- One change from Combination 1: instead of increasing the sales tax rate, broadens the tax base to include more goods.
- Increases Arkansas revenues by $871 million.
- Decreases federal taxes paid by $36 million.

Discussion

This option makes one change from the basic Combination 1: instead of increasing the state's already-high sales tax rate, the option broadens the sales tax base to include currently exempted goods. The distributional effects of this plan are quite similar to Combination 1, showing that sales tax hikes remain regressive no matter how they are designed.



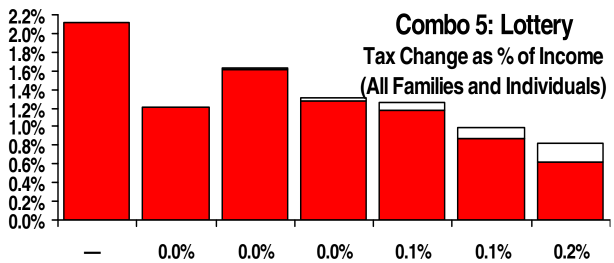
Combination 5: Lottery and EITC

Principal Features

- Imposes lottery; allows 20 percent EITC.
- Increases Arkansas revenues by $658 million.
- Decreases federal taxes paid by $36 million.

Discussion

This option adds a very regressive element to the basic Combination 1: a state lottery. Even with the addition of a 20% refundable EITC—one of the more generous credits currently allowed on the state level —this package remains regressive overall, a testament to the underlying regressivity of the sales tax and the lottery as revenue raising options.



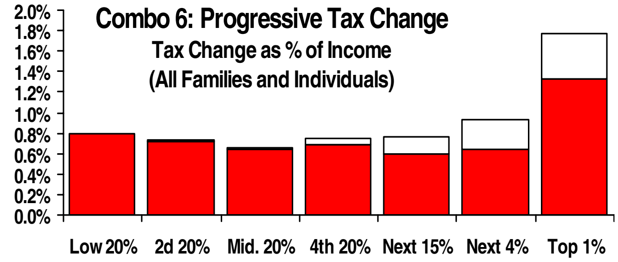
Combination 6: Progressive Tax Increase

Principal Features

- Increases income tax rates, but provides tax relief through exemption hikes and EITC.
- Increases property tax rates statewide.
- Retains estate tax.
- Increases Arkansas revenues by $766 million.
- Decreases federal taxes paid by $80 million.

Discussion

This study has shown that the major source of imbalance in the Arkansas tax structure is an over-reliance on regressive sales taxes. This option takes this lesson to heart, confining the tax increases to non-sales sources. The resulting tax increase is clearly progressive—alone among the combinations examined here.



Conclusion

Arkansas lawmakers can choose from a wide variety of tax options to satisfy the *Lake View* mandates, including options that reform the tax structure and options that simply raise rates. Any revenue-raising package that fully funds education in Arkansas will likely require some combination of these options, rather than relying on one tax source.

This report does not recommend any particular option or combination of options—rather, the tax changes modeled here should be understood as representative of the range of options available to Arkansas lawmakers.

ABOUT THE AUTHORS

Matthew Gardner is State Tax Policy Director at the Institute on Taxation and Economic Policy. ITEP is a non-profit, non-partisan tax policy research group focusing on the impact of federal, state and local tax policy on low- and middle-income taxpayers. ITEP's Microsimulation Tax Model can estimate the impact of tax systems—and tax change proposals—on taxpayers at different income levels in all fifty states and at the federal level.

Rich Huddleston was Research Director at Arkansas Advocates for Children and Families during the writing of this report. The mission of Arkansas Advocates for Children & Families is to protect and promote through research, education and advocacy the rights and well-being of Arkansas children and their families, to assure that they have the opportunity to lead healthy and productive lives.

James Metzger is President of HISTECON Associates, Inc. HISTECON is a research and consulting firm specializing in economic and statistical studies. Since 1980, HISTECON has conducted more than 230 studies for businesses, government agencies, and not-for-profit groups nationally, involving economic development, educational finance, employment, and other social and economic data. HISTECON study teams have provided management advice and consulting numerous times to determine the appropriate responses to their analyses.

Richard Sims is the former State Tax Policy Director at the Institute on Taxation and Economic Policy. Over his career, he has worked as a tax and budget analyst for several state governments, including Arkansas.