Tax Relief for Low-Income Arkansans

What are the options?

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Arkansas Advocates for Children and Families
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There has been much discussion in this legislative session about how to provide tax relief for low-income families. Two proposals are currently being debated in the legislature. One is to immediately cut the grocery tax by 3% and gradually phase it out completely in future years. The second proposal is to establish a state earned income tax credit targeted to low-income families. As the analysis below shows, each proposal has advantages and disadvantages, but the EITC is clearly a more efficient way to provide tax relief to low-income families.

Cutting the Grocery Tax

Arkansas is one of fifteen states that levy sales taxes on food. Only three states – Arkansas, Alabama and Mississippi – fully tax food purchased for home consumption without providing any relief (either through a lower tax rate on food or an offsetting credit) for low- and moderate-income families. The major downside to cutting the grocery tax is that it's not targeted to low-income families. Everyone benefits from cutting the grocery tax, including tourists and taxpayers earning over $1 million who arguably don't need the small tax relief that a cut would provide. Consequently, it would be more expensive to cut the grocery tax than it would be under tax relief targeted to low-income families, such as a state EITC. A 3% cut would cost $128 million in revenues, while a complete phase out would cost $255 million. If revenues get tight in future years with a downturn in the economy, a grocery tax cut or phase out could threaten services for the very same low-income families who would benefit from a grocery tax cut.

A State Earned Income Tax Credit

Arkansas has the distinction of having the highest income tax levied on two parent families of four at the poverty level. Previously ranked third, in the past year, both Alabama and Hawaii have reduced income taxes on low-income families, leaving Arkansas at the top. Other states with income tax burdens on the poor – including Virginia, West Virginia, Oregon and Michigan – have created state EITC's or taken other steps that significantly reduce their low-income tax burdens. The state EITC is limited to working families with less than $40,000 in annual income. Most state EITCs are tied to a percentage of the federal EITC and are refundable (a refundable credit means that a qualifying family would receive a refund if their credit is larger than the taxes they owe). Twenty-one states now have a state EITC. In 2006, under the federal EITC, workers who were raising more than one child in their home and had an income of less than $36,348 (or $38,348 for married workers) could receive a federal credit of up to $4,536.

Grocery Tax Cut vs. State EITC: Impact on Low-Income Taxpayers

3% Grocery Tax Cut versus a 24% state EITC. At roughly the same amount of state revenue that a 3% grocery tax cut would cost ($128 million versus $127 million), a state EITC equal to 24% of the federal EITC would provide substantially more tax relief for low-income taxpayers. Under a 24% state EITC, the bottom 20% of taxpayers (incomes less than $14,000) would receive a tax cut of $102, compared to only $40 (or 77¢ per week on their food bill) for the same group under a 3% grocery tax cut.

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3% Grocery Tax Cut versus a 10% state EITC. It would be much cheaper to cut taxes for low–income families under a state EITC. A 3% grocery tax cut, which would cost $128 million, would provide a $40 tax cut for low-income taxpayers. A state EITC equal to 10% of the federal would provide a comparable tax cut for low-income taxpayers ($47), but would only cost $54 million in lost state tax revenue. The tax savings in the table below are estimates of the average within the income group; families with children are likely to receive significantly higher EITC credits.

Impact of Selected Tax Reform Options for All Arkansas Taxpayers, 2006

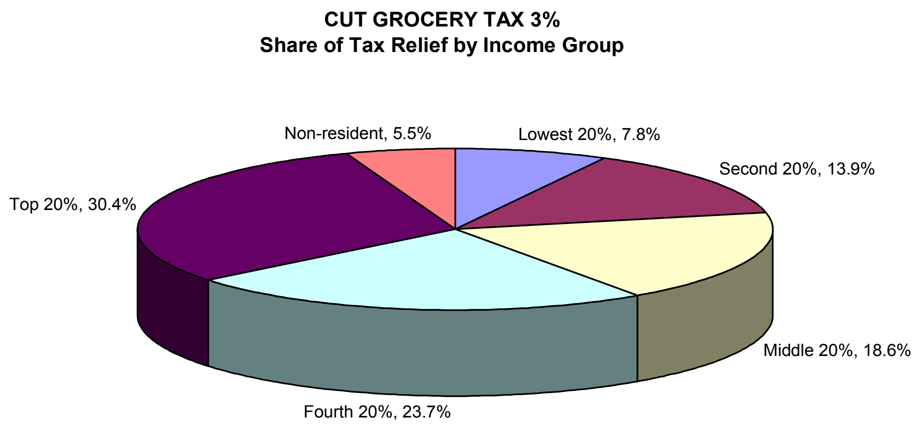
2006 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than $14,000	$14,000 – $24,000	$24,000 – $40,000	$40,000 – $62,000	$62,000 – $130,000	$130,000 – $299,000	$299,000 – Or More
Average Income in Group	$8,000	$18,000	$29,000	$51,000	$86,000	$166,000	$761,000
Cut Grocery Tax By 3%							
Tax Change as % of Income	–0.5%	–0.4%	–0.3%	–0.2%	–0.2%	–0.1%	-0.02%
Annual Tax Savings	-$40	-$78	-$89	-$122	-$150	-$166	-$213
Share of Total Tax Cut	7.8%	13.9%	18.6%	23.7%	21.7%	6.6%	2.1%
Cost to State: $128 million							
Non-residents 5.5%							
24% Refundable EITC							
Tax Change as % of Income	–1.4%	–1.5%	–0.5%	N/A	N/A	N/A	N/A
Annual Tax Savings	-$113	-$272	-$132				
Share of Total Tax Cut	22.2%	49.7%	28.1%				
Cost to State: $127 million							
10% Refundable EITC							
Tax Change as % of Income	–0.6%	–0.6%	–0.2%	N/A	N/A	N/A	N/A
Annual Tax Savings	-$47	-$113	-$55				
Share of Total Tax Cut	22.2%	49.7%	28.1%				
Cost to State: $54 million							

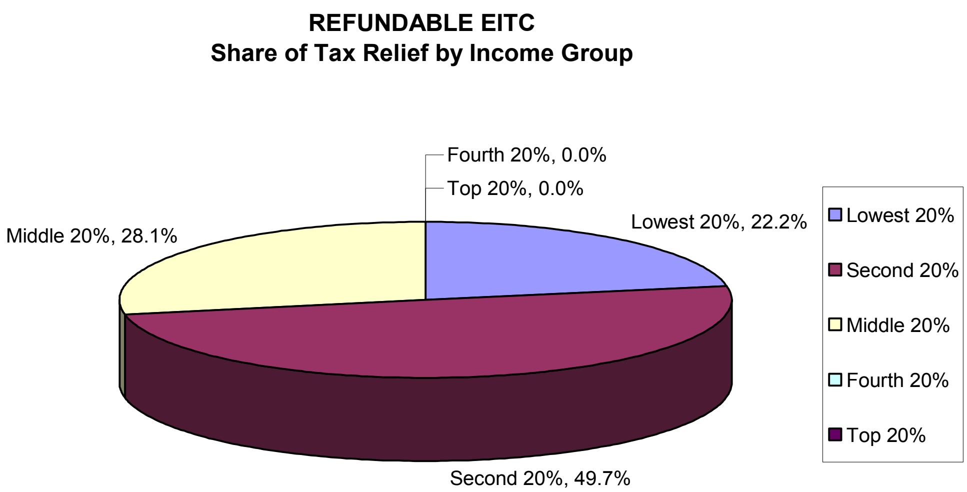
-Data: Institute on Taxation and Economic Policy, January, 2007 and AACF estimates

Grocery Tax Cut vs. EITC Where Would the Benefits Go?

While low-income taxpayers would benefit from a 3% grocery tax cut, a disproportionate share of the total tax benefits would go to upper-income taxpayers. Under a 3% grocery cut, only 22% of the total tax cut would go to the poorest 40% of taxpayers (those making less than $24,000), while 30% of the benefits would to the top 20% of taxpayers alone (those making more than $130,000)

In contrast, low- and middle-income taxpayers would receive nearly all of the benefits under a state EITC. Under a state EITC tied to the federal EITC, the bottom 40% of taxpayers would receive 72% of the total benefits, while the richest 5% of taxpayers would receive nothing under a state EITC.





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Conclusion

This report clearly shows that while a 3% grocery tax cut would provide some benefit to low-income families; it would also benefit those at the very top of the income bracket. A phased out grocery tax would also put a large burden on future state revenues, which could be dangerous during an economic downturn. If the state were to experience a rough financial year, services that benefit low-income families could end up on the chopping block – which would end up hurting the very people the tax was supposed to help.

A state EITC, on the other hand, would only assist those that actually need the help, i.e. those at the low end of the income bracket, and that support would translate into a higher dollar amount that any benefit derived from the grocery tax cut. It would also be a cheaper alternative as certain percentages would cost considerably less than the grocery tax cut. When one weighs the pro's and con's of each, it's apparent that the EITC is the more fiscally sound and financially beneficial alternative for low-income tax relief.

The most encouraging thing about this debate is that it is taking place at all. Whether discussing the grocery tax or the EITC, the important aspect is that there is a focus on low-income tax relief. After that, it all comes down to what is the best way to help these families get ahead while at the same time ensuring that services are protected in future years from economic downturns.

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