Amy L. Rossi, Executive Director
Richard Huddleston, Research and Fiscal Policy Director
James Metzger, Consulting Economist

ARKANSAS ADVOCATES FOR CHILDREN & FAMILIES

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Raising the Sales Tax to Pay for Education:
What Would Be the Impacts on Arkansas Families?

One of the major issues the Arkansas General Assembly will have to consider during its December special session is how to pay for education reform. According to a study adopted by the Joint Legislative Committee on Education, the cost of education reform will be $847 million annually. This estimate does not include the cost of facilities, to be determined next year.

While it's unlikely the legislature will raise all of the $847 million during the December session, a major increase in education spending will likely be necessary to show compliance with the Arkansas Supreme Court's mandate in the Lake View case. One of the options the legislature will consider is a one-cent increase in the state sales tax, which would raise an estimated $360–$370 million annually.

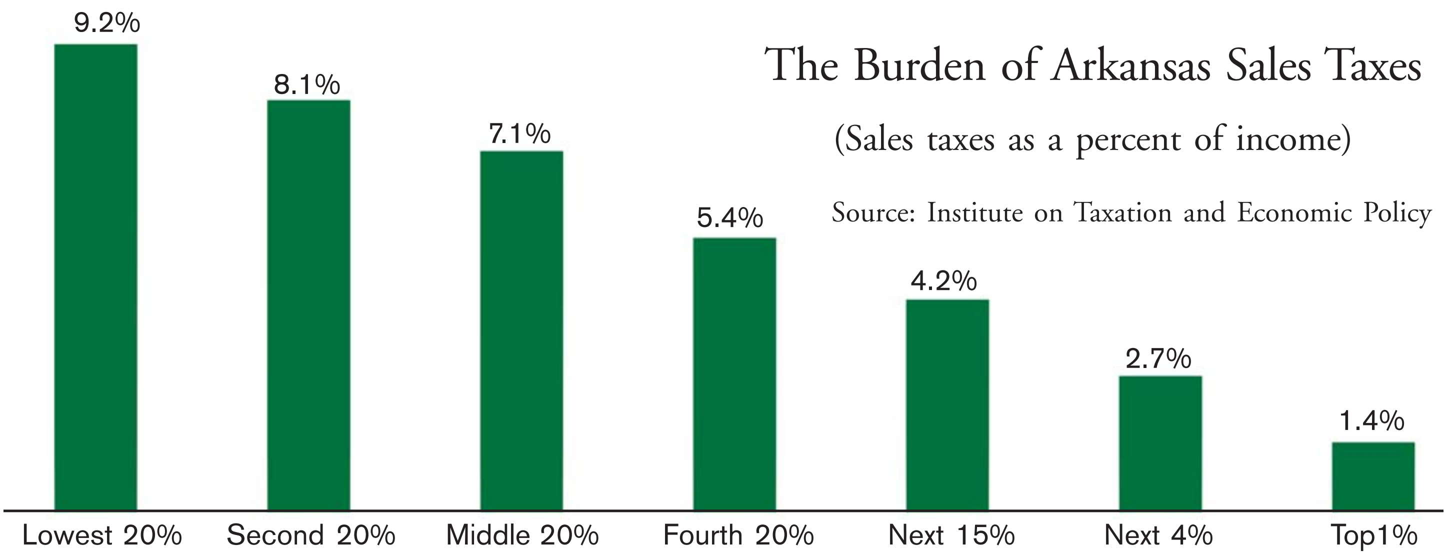
Relying only on a sales tax to fund education would have major impacts for the state's low- and middle-income families. Before examining these impacts, let's briefly review the basics of the current Arkansas tax system.

The Current System

The current Arkansas tax system is already unfair and regressive. That is, low and middle-income families pay a higher share of their income in state and local taxes (11.3 percent and 10.7 percent of their income, respectively) than do the state's wealthiest taxpayers (only 5.8 percent).

The major reason for the state's regressive and unfair tax system is its over-reliance on state and local sales taxes. Arkansas sales taxes are among the highest in the nation (8th highest as a percent of personal income and 11th as a percent of total state and local revenue).

Sales taxes place a disproportionate burden on the state's low- and middle-income families. Nine cents out of every dollar earned by low-income families and 7 cents of every dollar for middle-income families go to sales taxes. In contrast, less than 1½ cents out of every dollar earned by upper-income taxpayers go to sales taxes.



Impact of a One-Cent Increase in the Sales Tax

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than $12,000	$12,001-$20,000	$20,001-$34,000	$34,001-$54,000	$54,001-$104,000	$104,001-$241,000	Over $241,000
Impact of a One Cent Sales Tax Increase							
Percent change	1.0%	0.9%	0.8%	0.6%	0.5%	0.3%	0.2%
Dollar change	$74	$153	$224	$285	$375	$464	$1,018
Impact of a One Cent Sales Tax Increase (excluding food)							
Percent change	0.8%	0.8%	0.7%	0.5%	0.4%	0.3%	0.2%
Dollar change	$58	$124	$183	$231	$307	$383	$890

Note: The projected revenue from a one-cent sales tax increase is $366 million ($324M excluding food).
Source: Institute on Taxation and Economic Policy

Contrary to popular belief, families with low or modest incomes have little control over how much of their income they spend on items subject to sales taxes. Low or middle-income families have to spend a greater share of their income on the basic necessities of life, such as bread, milk, clothing, health care, etc. In turn, they have to spend more on state and local sales taxes. In contrast, upper-income families have much higher incomes and don't have to spend the same share of their income on these necessities.

Because of tax changes in recent years, the Arkansas tax system places a greater burden on low- and middle-income families. From 1989 to 2002, the share of income that low- and middle-income families pay in total state and local taxes has increased by 1.9 percent and 2.3 percent, respectively, compared to just a 0.3 percent increase for the top one percent of families. The reason? General sales taxes have increased from 4.0 percent to 5.125 percent since 1989.

What Would Be the Impacts on Families?

A one-cent increase in the state sales tax would raise at least $360 million in new tax revenue, but would place a disproportionate burden on the state's low- and middle-income families and make the tax system even more regressive.

Under a one-half cent increase in the sales tax, low-income families would bear the greatest burden. As a percent of their income, the poorest 20 percent of families (those making less than $12,000 annually) would see their total state and local tax burden increase by over 1 percent annually. Middle-income families (incomes between $20,000 and $34,000) would see their tax burden increase by almost 0.9 percent, while the top one percent of taxpayers (incomes over $241,000) would see an increase of less than 0.2 percent.

Such an increase would dramatically increase the unfairness of the current system. A one-half cent increase in the sales tax would push the total state and local tax burden of the state's poorest 20 percent of families up to 12.3 percent of their income; middle-income families would now pay 11.6 percent; while the top one percent would pay only 6.0 percent of their income in state and local taxes. **In effect, the poorest 20 percent of families would have a state and local tax burden more than double that of the state's richest.**

Excluding food from a one-cent increase in the sales tax would slightly lessen the impact on low- and middle-income families, but they would still bear the greatest burden of the tax increase. Under that option, the tax burden of the poorest 20 percent families would increase by 0.8 percent, compared to 0.7 percent for middle-income families, and less than 0.2 percent for the top one percent of families.

How Could We Minimize the Burden of a Sales Tax Increase?

There are two things Arkansas's leaders could do to minimize the impacts of a sales tax increase on low and middle-income families.

One would be to adopt a smaller sales tax increase (e.g., only a one-quarter or one-half cent increase) and adopt other, more progressive tax increases, such as increases in personal and corporate taxes. Income taxes are much more progressive and place a greater tax burden on upper-income taxpayers (note: for more information on progressive tax options, see previous editions of Arkansas Advocates' Paychecks and Politics (issues 18 and 20) and the recent study by the Winthrop Rockefeller Foundation).

The second step that could be taken would be to offset the impacts of any sales tax increase with targeted tax relief for low- and middle-income families. While these options would reduce the revenue gained by raising the sales tax, they would increase the fairness of the tax system and reduce or eliminate the burden of a sales tax increase on low and middle-income families.

There are three primary options for providing targeted tax relief to low- and middle-income families. They include: (1) enacting a state earned income tax credit (EITC) equal to some share of the federal EITC; (2) sales tax rebates for low-income families; (3) increasing the personal exemption credit on state income taxes, and (4) exempting food from the sales tax. These options, which are discussed in AACF's *Paychecks and Politics* (issue brief number 21) and the Winthrop Rockefeller study, would provide relief to low- and middle-income families and help offset the burden of any sales tax increase.

For More Information:

Rich Huddleston, Research and Fiscal Policy Director • 501/371-9678

rich.huddleston@aradvocates.org • www.aradvocates.org/finances