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Education Reform and Tax Relief for Families:

What Are the Options?

When the General Assembly meets in its special session on education reform, one of the funding options it will seriously consider is a one-cent increase in the state sales tax. While this would raise significant revenue for education ($360-$370 million), it would also have major implications for the tax burden of low and middle-income families and the fairness of the Arkansas tax system.

As discussed in previous issues of *Paychecks and Politics* (see issue #17) the Arkansas tax system is regressive. That is, low and middle-income families pay a higher share of their income in state and local taxes than do the richest families in the state. The poorest 20 percent of taxpayers (those with annual incomes of less than $12,000) already pay 11.3 percent of their income in state and local taxes; the middle 20 percent of families (those with incomes between $20,000 and $34,000 pay 10.7 percent; and the top 1 percent of taxpayers (those with average incomes over $241,000) pay only 5.8 percent. The major reason for this is the state's heavy reliance on sales taxes, which consume more of the income of low- and middle-income taxpayers.

A one-cent increase in the state sales tax increase would dramatically increase the unfairness of the Arkansas tax system (see *Paychecks and Politics* issue #22). The tax burden of the poorest 20 percent of families would jump from 11.3 percent of their income to 12.3 percent. In contrast, the burden of the top 1 percent of taxpayers would remain virtually unchanged, increasing from just 5.8 percent to 6.0 percent. The state and local tax burden of Arkansas' poorest families (as a percent of their income) would be more than double that of the state's richest families.

Low and middle-income families obviously would fare much better if the legislature adopted more progressive tax increases to fund education (such as increases in personal income, corporate income, and severance taxes). Another option — if the legislature decides to rely primarily on the sales tax to fund education — would be to offset the burden of a sales tax increase on low and middle-income families with targeted tax relief. Although each of these options would reduce the amount of new revenue for education, they would help promote greater fairness in the Arkansas tax system. Here are some of the tax relief options available to help families.

Sales tax rebates. One option for offsetting the burden of a sales tax increase for low- and middle-income families is a sales tax rebate. A rebate could be targeted to families with incomes below a certain level. A $50 sales tax rebate for families with incomes below $20,000 would provide significant tax relief for low-income families (a tax cut equal to more than 1 percent of their income), while only costing the state treasury $43 million. A more generous $150 credit for families with incomes below $30,000 would also provide significant relief (a tax cut of over 3 percent for the state's poorest families) at a cost of $190 million.

State earned income tax credits (EITCs). Another option would be to adopt a state-level version of the federal EITC, long regarded as one of the most successful supports for low-income working families with children. A state EITC is usually refundable, meaning that if a family's credit is larger than the state income taxes owed, the family gets the difference back through a cash refund. Most states piggyback onto the federal credit, usually structuring their credit as some percentage of the federal EITC (at rates usually between 10 and 40 percent). A state EITC would cost the state anywhere from $47 million (at 10 percent of t he federal EITC) to $188 million (40 percent credit). A state EITC has the advantage of being easily administered through the state income tax.

Cutting the sales tax on food. Another option for tax relief is cutting or eliminating the sales tax on food. At this time, the legislature is unlikely to consider the complete elimination of the sales tax on food because it is too costly (the revenue gained from a one-cent sales tax increase would be lost if the sales tax on food were eliminated). However, a less expensive option might be to simply reduce the sales tax rate paid on food, e.g., reducing

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the state sales tax on food by a cent or two from the 5.125 cents consumers currently pay on food. A one cent reduction in the sales tax on food would reduce the tax burden on the poorest taxpayers about $19 annually (at a revenue loss of $70 million), while a 2 cent reduction would save them about $39 (at a revenue loss of $140 million). The major disadvantage of this approach is that much of the benefits would go to wealthy (the top 1 percent of families would see savings of $140 to $300 annually), thus reducing the amount of new revenue that would be available for education.

Increasing the personal income tax exemption credit. Currently, families are eligible for a $20 per household member credit on their state income tax. Increasing this credit to $40 per person would provide relief for moderately poor families ($17 per family) and middle-income families ($35 per family), but no relief for the poorest families (only $2). Increasing the credit would cost the state about $40 million in lost tax revenues. By itself, this option would not provide significant relief for the state's poorest families. However, it could be combined with another option that does — such as a $50 sales tax relief or a 10 percent state EITC — to provide tax relief for the full spectrum of low- and middle families.

The two options that would appear to offer the greatest tax relief for the families who need it the most, but without imposing a revenue loss for the state at a time when it can ill afford it, are a sales tax rebate and a state earned income tax credit. However, all tax relief options should be on the table when the legislature convenes in December, especially if the legislature decides to raise new revenue through a sales tax increase rather than more progressive taxes such as personal income, corporate income, and severance taxes. Low and middle-income families should not be asked to bear the burden of any tax increase to fund education.

Options for Providing Tax Relief to Low- and Middle-Income Families

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
Average Income	$7,400	$16,300	$26,900	$44,500	$73,200	$141,400	$574,600
$50 Sales Tax Rebate for families below $20K income ($43M)*							
Tax Cut as Percent of Income	-1.1%	-0.4%	0.0%	0.0%	0.0%	0.0%	0.0%
Tax Cut in Dollars ($)	-$78	-$72	-$4	—	—	—	—
$150 Sales Tax Rebate for families below $30K income ($190M)*							
Tax Cut as Percent of Income	-3.2%	-1.6%	-0.7%	-0.1%	0.0%	0.0%	0.0%
Tax Cut in Dollars ($)	-$234	-$264	-$192	-$31	—	—	—
10% State EITC ($47M)*							
Tax Cut as Percent of Income	-0.5%	-0.6%	-0.2%	0.0%	0.0%	0.0%	0.0%
Tax Cut in Dollars ($)	-$37	-$96	-$41	-$20	—	—	—
20% State EITC ($94M)*							
Tax Cut as Percent of Income	-1.0%	-1.2%	-0.3%	-0.1%	0.0%	0.0%	0.0%
Tax Cut in Dollars ($)	-$73	-$191	-$83	-$39	—	—	—
40% State EITC ($188M)*							
Tax Cut as Percent of Income	-2.0%	-2.3%	-0.6%	-0.2%	0.0%	0.0%	0.0%
Tax Cut in Dollars ($)	-$147	-$382	-$165	-$79	—	—	—
Increase Personal Exemption ($40M)*							
Tax Cut as Percent of Income	0.0%	-0.1%	-0.1%	-0.1%	-0.1%	0.0%	0.0%
Tax Cut in Dollars ($)	-$2	-$17	-$35	-$46	-$53	-$48	-$47
Cut Food Tax by 1 cent ($70M)*							
Tax Cut as Percent of Income	-0.3%	-0.2%	-0.2%	-0.1%	-0.1%	-0.1%	0.0%
Tax Cut in Dollars ($)	-$19	-$35	-$50	-$64	-$80	-$92	-$150
Cut Food Tax by 2 Cents ($140M)*							
Tax Cut as Percent of Income	-0.5%	-0.4%	-0.4%	-0.3%	-0.2%	-0.1%	-0.1%
Tax Cut in Dollars ($)	-$39	-$70	-$99	-$127	-$159	-$185	-$300
Exempt Food From Sales Tax ($366M)*							
Tax Cut as Percent of Income	-1.3%	-1.1%	-0.9%	-0.7%	-0.6%	-0.3%	-0.1%
Tax Cut in Dollars ($)	-$99	-$180	-$254	-$327	-$408	-$473	-$769

*Option (Revenue Impact in Millions)
Note: "—" means tax cut is zero or less than $5.
Source: AACF calculations based on ITEP data