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Should Arkansas Keep the Income Tax Surcharge?

By Richard Huddleston

The 2003 Arkansas General Assembly defied the odds and passed a 3 percent state income tax surcharge to help plug a $110 million dollar budget shortfall for Medicaid, a critical state program that provides health care for children and other vulnerable populations. Under the law establishing the surcharge, however, it could disappear if certain revenue growth conditions are met and the 2005 General Assembly doesn't reauthorize it. This comes at a time when Arkansas will need all the revenue it can find to meet critical needs such as K-12 school facilities, pre-school education, higher education, and Medicaid.

What's the impact of the income tax surcharge?

One of the major tax changes Arkansas levied in 2003 was a new 3 percent income tax surcharge for individuals and corporations. The income tax surcharge raised valuable revenue to help plug a Medicaid budget shortfall during the 1st special session of 2003. During state fiscal year 2005, the surcharge is projected to generate about $52 million in state tax revenue ($47 million in personal income taxes and $5 in corporate income taxes).

The surcharge works this way. A 3 percent income tax surcharge is levied on the net income tax liability of individuals and corporations. If an individual had a net tax liability of $800, that person would pay an additional $24 in Arkansas income taxes because of the surcharge.

The surcharge was progressive and fair. For most individuals, the surcharge had little impact on their state and local taxes. In fact, 60 percent of Arkansas taxpayers had an average tax increase of $18 dollars or less as a result of the surcharge (including any corporate increases passed on to individuals). For the bottom 20 percent of Arkansas taxpayers (those making less than $13,000) the average income tax surcharge was $0. For middle-income taxpayers, the average surcharge was only $18.

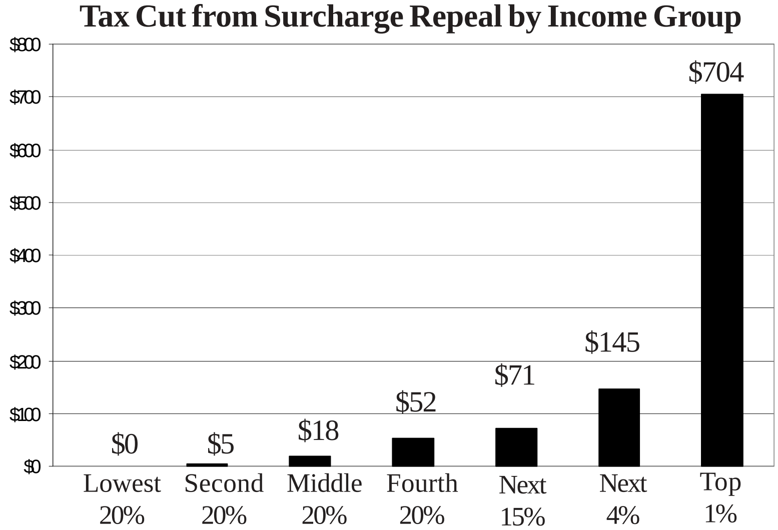
The impact of the surcharge was really only felt by the top 1 percent of taxpayers (those with incomes more than $237,000). Their average surcharge was $704. Even for this group, the net effect of the surcharge (as a percent of their income) was almost zero after deducting state taxes on their federal returns.

Impact of Surcharge Repeal by Income Group

Income Group	Income Range	Average Income	Avg. Tax Cut	Share of Tax Cut
Top 1%	> $237,000	$546,000	$704	18.3%
Next 4%	$103,000 - $237,000	$141,000	$145	15.1%
Next 15%	$56,000 - $103,000	$74,000	$71	27.7%
Fourth 20%	$35,000 - $56,000	$45,000	$52	27.0%
Middle 20%	$21,000 - $35,000	$27,000	$18	9.4%
Second 20%	$13,000 - $21,000	$16,900	$5	2.6%
Lowest 20%	> $13,000	$7,600	$0	0.0%

Source: AACF calculation based on ITEP data, August 2004

Tax Cut from Surcharge Repeal by Income Group

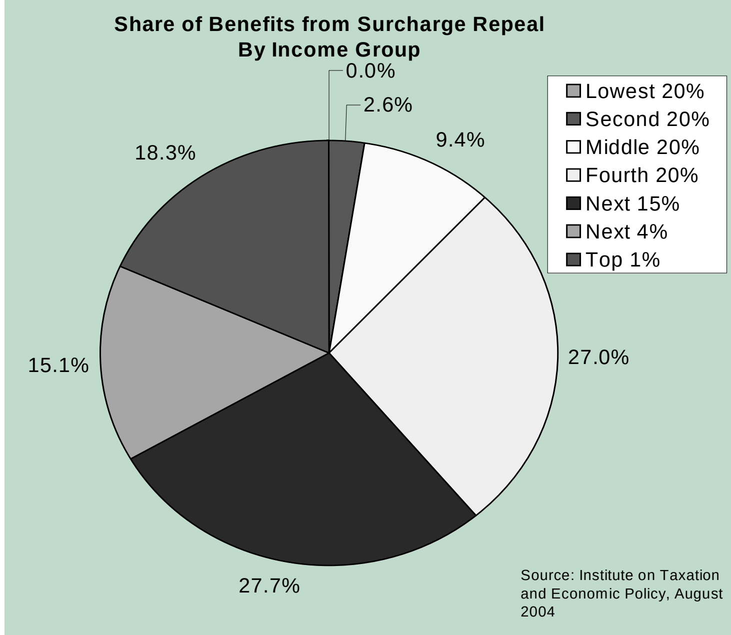


Source: Institute on Taxation and Ecomoic Policy, August 2004

Who benefits if the surcharge goes away?

Under Act 38, if the Department of Finance & Administration revenue forecast for SFY 2006 is $156 million or more than anticipated revenues for 2005, the surcharge would disappear. Since the surcharge mostly impacts high-income families, this group would benefit the most from repeal of the income tax surcharge. The lowest 20 percent of taxpayers would see no benefit from the tax cut, while the top 1 percent would realize a tax cut of $704.

As a group, most of the benefits from such a tax cut would go to upper-income taxpayers. In fact, the top 5 percent of taxpayers (those with incomes more than $103,000) would realize 33 percent of the benefits if surcharge were repealed. The top 1 percent alone would see 18 percent of the total tax cuts!

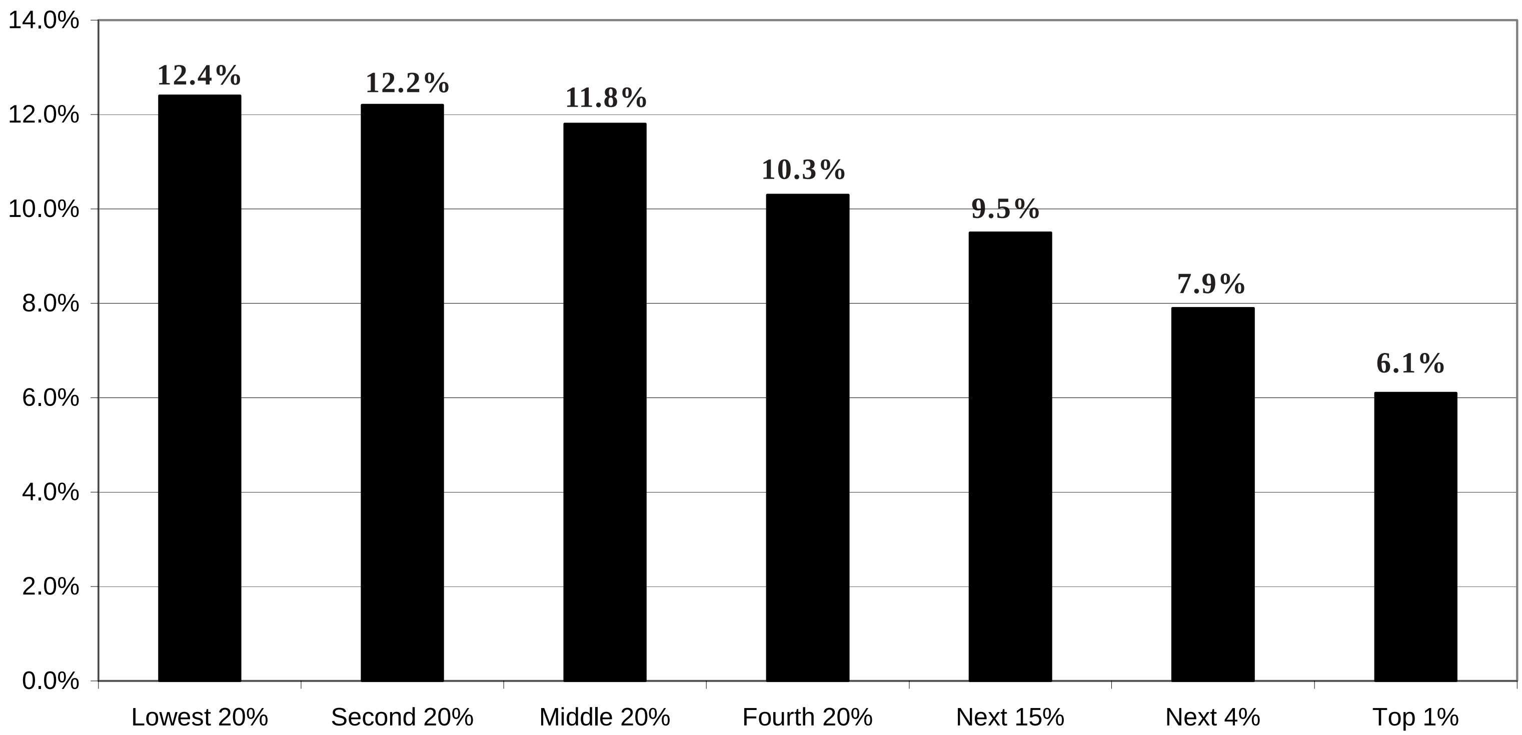


Would repealing the surcharge hurt fairness?

The Arkansas tax system already places a disproportionate share of the tax burden on low- and middle-income families. New data shows that sales tax changes enacted during 2004 have worsened the tax burden on low- and middle-income families. As a result of these changes, the poorest 20 percent of families pay more than 12 cents in state and local taxes for every dollar they earn, compared to just 6 cents on every dollar for the top 1 percent of families. In other words, our low income families have a state and local tax burden that is twice that of Arkansas's richest families.

The surcharge was the most progressive tax change (in terms of requiring upper-income families and corporations to pay their fair share) enacted the last two years. Repealing the surcharge would eliminate the one change that did not increase the burden on low-income families, but that required upper-income families and corporations to pay their fair share of taxes to protect health care and reform education.

Arkansas State and Local Taxes After 2003-04 Legislative Changes As Shares of Family Income for Non-Elderly Taxpayers



Source: Institute on Taxation and Economic Policy, 2004

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