On the Economic Impact of Repealing the Border City Exemption

Dr. Michael Pakko

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- With no significant natural or geographic boundaries, the Texarkana metropolitan area, with its two co-principal cities, is a unique dual-state entity. For the purposes of evaluating economic activity on the two sides of the border, the distinguishing characteristic of the two-state economy can be described as a high elasticity of substitution. Shopping, working and living on the two sides of the border are close substitutes. Hence, small changes in relative prices (or taxes) can generate large swings in consumer demand and labor supply.

- The Border City Exemption has been in place nearly 40 years – long enough to consider it being part of the long-run equilibrium. As a matter of economic impact analysis, its repeal would be the equivalent of imposing a new income tax in a jurisdiction where it did not previously exist.

- Models based on a seminal political-economy analysis of residential location choice among tax districts (the "Tiebout model") suggests that local income taxes lead to "income stratification" in which higher-income households cluster in the jurisdictions with lower tax rates.

    - Income stratification is likely to place additional demands on public services, and can itself be exacerbated by differences across municipalities in the provision of public services.

    - Cities with higher income tax rates will also tend to have lower property values. A tax selectively imposed on one part of an integrated metropolitan area shifts demand away from high-tax areas in favor of low-tax areas. This would be expected to a drop in prices and reduced construction activity going forward.

- Analysis of the labor market demonstrates how an income tax on one side of the border generates a reduction in labor supply, resulting in lower after-tax wages and higher labor costs for employers. The resulting equilibrium is characterized by employers bearing a large share of the tax burden, leading to a scale-back of output and employment. Using reasonable assumptions about supply and demand elasticities, the result could be a decline in employment in the range of 2.5% to 4%.

- An independent effect can be expected from the imposition of a tax on "pass-through" businesses (S-Corporations, Individual proprietorships, Partnerships, LLCs). Applying statewide statistics to Census data for Miller County, approximately 460 firms (64%) are likely to fall into this category. These firms account for over 4,800 jobs (41%) and approximately a one third of total private payrolls. If only 5% of these firms go out of business or move across the border, the total loss in payrolls would amount to approximately $2.7 million.

- Basic supply-demand analysis of the market for residential real estate shows that the imposition of an income tax on one side of the border is expected to result in reduced demand for housing, lowering both the price and quantity/quality of the housing stock. Rough estimates suggest

reductions in the value of residential real estate of about $20 million, with an additional decline of $20 million in the value of the stock of housing over time.

- The elimination of the compensating sales tax in Texarkana, Arkansas would lessen the competitive disadvantage faced by retailers on the Arkansas side of the border, but would still leave sales taxes a full percentage point lower on the Texas side of the state line. As a result, the Texas side would remain a relatively attractive location for retail activity.

- Conclusion: Static estimates of state revenue impacts would be significantly reduced by reactions to the change in tax regimes. More importantly, the economic impact of the change would be disproportionally costly to the residents of Texarkana, Arkansas relative to any efficiency gains that might be attained by overall tax reform.

When the Border City Exemption was established by the Arkansas legislature, lawmakers explicitly recognized that the intent of the law was intended to encourage the development of Texarkana on the Arkansas side of the border:

Arkansas Code §26-52-601.
Legislative findings and intent.

(a) (1) In the passage of this subchapter, the General Assembly is cognizant of the inequities faced by cities and towns in this state and their inhabitants when the cities and towns are divided by a state line from an incorporated city or town in another state in which the tax burden of the citizens of the city or town in the adjoining state is substantially less than the tax burden imposed by the laws of this state upon the citizens of a border city or town in this state.

(2) The General Assembly is also cognizant that these tax inequities offer inducements to citizens who would otherwise settle in Arkansas and operate businesses in Arkansas to move to the border cities in the adjoining states.

(b) The passage of this subchapter is designed to establish a method of equalizing the inequities imposed under the tax laws of this state, thereby offering inducements to persons to establish their homes and businesses in the Arkansas border city or town.