ITEP Responses to Follow-up Questions from July 27, 2018 Meeting of the Arkansas Task Force on Tax Relief & Reform

- **Detailed, step-by-step explanation of how ITEP arrived at the results that are on the slide that indicates benefits for those who were not intentionally targeted by lowered income taxes**

Several lawmakers have expressed confusion at ITEP analysis of recent Arkansas tax cuts that show high-income earners in the state benefitting from what was intended and thought to be tax cuts for middle- and then subsequently low-income taxpayers.

To help understand why this is the case, it is important to keep in mind the following:

1) The following shows a distribution of Arkansas tax units by *total* (or *gross*) income. Quintiles show the income thresholds at which the population (in this case, tax units) is divided equally into 5 groups, each representing 20% of the population. (The top 20% or fifth quintile is broken into the bottom 15, next 4, and top 1 since there is a great deal of variation in the incomes of tax units in this income grouping.)

Distribution of Arkansas Tax Units by Quintile (Total Income)

First	Second	Third	Fourth		Fifth Quintile	
Quintile	Quintile	Quintile	Quintile	Next 15	Next 4	Next 1
$0	$22,000	$36,000	$55,000	$93,000	$199,000	$436,000
$22,000	$36,000	$55,000	$93,000	$199,000	$436,000	>$436,000

From this quintile analysis, one might assume that a tax change that lowered income tax rates for incomes <$21,000 would only impact taxpayers in the first income quintile, since the cutoff for that group is $22,000. By this same logic, one might expect a tax cut that lowered income tax rates for those with incomes $21,000-$75,000 would only benefit taxpayers in the second, third, and fourth income quintiles, as the income cutoffs for that those groups are $22,000-$93,000.

In reality, this expectation is upset by two factors, each discussed further below: distinguishing between *total* and *taxable* incomes; and married households with two income earners filing separately.

2) Total vs. taxable income.

Arkansas does not subject all types of income or all of certain types of income to the personal income tax.

For example, these are types of income exempt from the personal income tax in Arkansas: money received from a life insurance policy, annuity; child support payments received; gifts, inheritances, bequests, or devises; scholarships, fellowships, grants; certain types of bond interest; Social Security, Worker's Compensation, unemployment benefits; disability income; active duty compensation; $6,000 of retirement income from employer sponsored plans.

Additionally, income that is illegally underreported by Arkansas residents is also outside the reach of Arkansas's income tax. This income is included in ITEP's measure of total income, but since it is does not appear on any taxpayer's tax return it is not counted in determining whether any given household qualifies for the state's recent income tax cuts.

Further, taxpayers are allowed to shield additional income from taxation through personal credits, deductions (itemized or standard), and other adjustments as defined by Arkansas Statute (including notably the exemption for 50% of capital gains income and any amount above $10 million).

Because of these various exemptions, deductions, and adjustments, as well as the tax gap, the actual amount of income subject to the personal income tax in Arkansas (that is *taxable income*) can be quite different than a tax unit's *total* (or gross) income. And as a result, certain taxpayers who have high levels of *total income* can end up having much smaller amounts of *taxable income.* Thus, *taxable income* is not always a good proxy for *total income*.

Arkansas' tax policies that have lowered marginal income tax rates for taxpayers with incomes $21,000-$75,000 and subsequently below $21,000 lowered the income tax rates for taxpayers with *taxable incomes* within these income ranges, not *total income*. Thus, many taxpayers with *total incomes* above $75,000 (those in the top income quintile) in the case of the middle-income tax cut and total incomes above $21,000 in the case of the low-income tax cut also benefitted from these tax cuts.

Take for example a single taxpayer with $85,000 in income, $80,000 from wages and $5,000 from capital gains, who also has $15,000 in itemized deductions. This taxpayer's taxable income would be $85,000 - $2,500 - $15,000 = $67,500. This taxpayer would benefit from the middle-income tax cut.

How many taxpayers in the top 20 percent of taxpayers are in this situation? Here's a breakdown of the relationship between total and taxable income for the top 20%:

> 5 percent of taxpayers in the top quintile (with *total* incomes more than $93,000) have taxable incomes between $21,000 and $75,000. They directly benefitted from the middle-income tax cut.
>
> 6 percent of taxpayers in the top quintile (with *total* incomes more than $93,000) have *taxable* incomes that are less than $21,000. These tax units will directly benefit from the low-income tax cut.

Because the more taxable income a filer has, the more tax savings they experience from reductions in marginal tax rates, it is not surprising that so large a share of the total dollars of the middle-income and low-income tax cuts will flow to taxpayers that fit this profile. But this distinction between total and taxable income by itself doesn't account for all of the discrepancy between intended tax cut beneficiaries—the largest explanatory piece has to do with married filing status, which we discuss next.

3) Married Filing Status

The other phenomenon at play in creating the result of high-income households benefitting from tax cuts intended to benefit low- and middle-income families is the ability of Arkansas married filers to choose the filing status that bests suits them.

89 percent of taxpayers in the top quintile (with *total* incomes more than $93,000) have taxable incomes that are greater than $75,000.[1] One might think that accordingly they would not be expected to benefit from either the low- or middle-income tax cuts enacted in recent years given their total combined incomes. However, 77 percent of these households are comprised of filers with more than one income, which means they have the opportunity to file separately and benefit from the low- or middle-income tax cuts if one (or both) of their separate taxable incomes falls under the thresholds of $21,000 or $75,000.

For example, a household with two earners who both make $50,000 would be in the top income quintile because their total income is $100,000 (>$93,000). Even if they were both able to reduce their incomes by $12,500 via exclusions, deductions, etc. their combined *taxable* income of $75,000 would make them ineligible for either the low- or middle-income tax cuts enacted in Arkansas. However, by filing separately, they each have $37,500 in taxable income, meaning they would both benefit from the middle-income tax cut.

This is also the case for much wealthier taxpayers, where one filer earns a higher income than the other. If spouse 1 makes $350,000 and spouse 2 makes $80,000, after deductions/exclusions, spouse 2 will have taxable income below $75,000, meaning the household will benefit from the middle-income tax cut, even though the household's combined resources puts them in the top 1% of Arkansas taxpayers.

In fact, when ITEP models each of the low- and middle-income tax cuts requiring married filers to file their incomes jointly, the share of the tax cut received by the top quintile drops from over 50% to under 20%.

If Arkansas lawmakers would like to better target reductions to marginal rates in its <$21k and $21-$75k tax tables, it is advisable for the state to:

- require that tax tables be selected based on *gross* instead of *taxable* income;
- require taxpayers with incomes above a certain threshold to file a joint return;
- or implement both of the above changes

[1] ITEP treats tax payers that are married and filing separately but who live in the same household as a single tax unit for the purposes of reporting tax incidence analysis.

- **Sen. Hendren, Rep. Pitsch: what portion of the population that earns greater than $89,000 received the low- and middle-income tax cuts; examples of how this functions**

Arkansas Resident Tax Units (taxpayers married but filing separately living in the same household are treated as a single tax unit)

% with total income < $89,000	79%
% with total income >$89,000	21%

Interpretive note: The majority of households (close to 80%) in Arkansas have total incomes of less than $89,000.

Tax Units Getting Middle-Income Tax Cut

		As % of all tax units
% all taxpayers get a cut	43%	
% with total income < $89,000 get a cut	37%	29%
% with total income >$89,000 get a cut	66%	14%

Interpretive note: ITEP estimates that 43% of Arkansas households benefitted from the middle-income tax cut. Of the 21% of households that have more than $89,000 of total income, 66% of them benefitted from the cut (meaning at least one spouse per tax unit had taxable income less than $75,000). These higher-income households benefitting from the middle-income tax cut represent 14% of all tax units.

Tax Units Getting Low-Income Tax Cut

		As % of all tax units
% all taxpayers get a cut	33%	
% with total income < $89,000 get a cut	27%	21%
% with total income >$89,000 get a cut	57%	12%

Interpretive note: ITEP estimates that 33% of Arkansas households benefitted from the low-income tax cut. Of the 21% of households that have more than $89,000 of total income, 57% of them benefitted from the cut (meaning at least one spouse per tax unit had taxable income less than $21,000). These higher-income households benefitting from the low-income tax cut represent 12% of all tax units.

See discussion provided in the first bullet for examples of how this functions.

- **Sen. Irvin: Tennessee language on "intent of the legislature" in regard to tax triggers**

  In 2016, Tennessee lawmakers were interested in repealing the state's tax on interest and dividends but realized that they could not implement such a drastic change in the course of a single year. They therefore enacted Public Chapter No. 1064 which included language stating that:

  > *It is the legislative intent that the tax be reduced by one percent (1%) annually through enactments of general bills beginning with the first annual session of the 110th General Assembly.*

  This legislation identified a long-run goal for the state's tax system. But the phase-out schedule was non-binding, meaning that if a future legislature reevaluated the state's fiscal outlook and decided that a 1 percentage-point rate would require untenable cuts to public services, it could forgo the cut simply by choosing not to enact another general bill.

  On the other hand, since realizing the phase-out would require new legislation, it also allowed lawmakers an opportunity to consider speeding up the phase-out, which they later did in 2017.

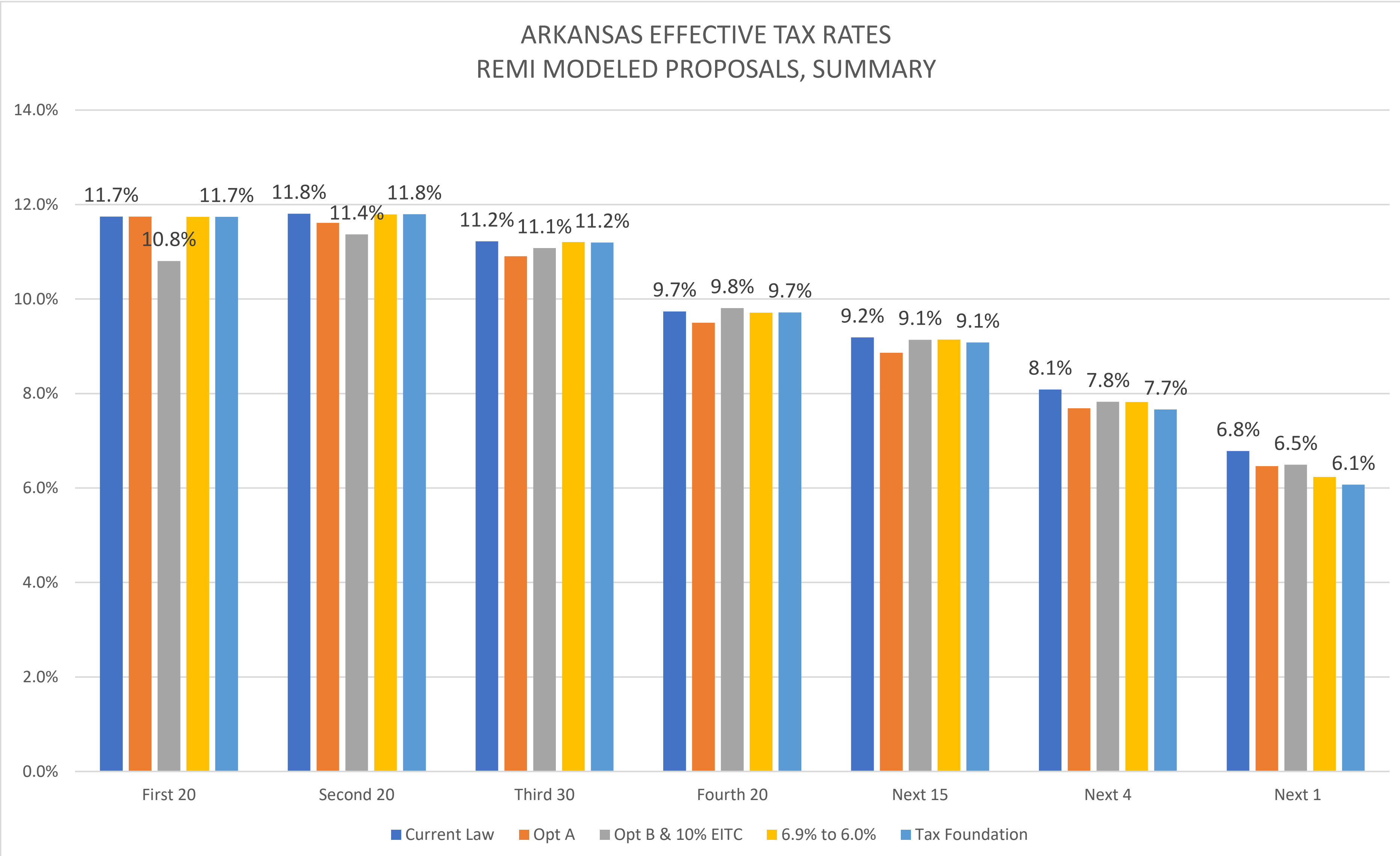
  The Tennessee language was imperfect. While phasing down the rate from 5% to 1% was contingent on additional legislation being passed, full repeal of the tax was initially scheduled to occur in 2022—far outside the current budget window—even absent legislation and without any conditions needing to be met before repeal would take place. It is fiscally irresponsible to schedule significant tax cuts to take effect more than a year in advance, with or without a trigger, as it is impossible to predict the condition of the economy and a state's budget over longer time horizons. But for lawmakers who insist on using a trigger, the least-dangerous option is to design a layered trigger wherein multiple conditions must be satisfied simultaneously before a tax cut is automatically triggered. Suggested layers include:

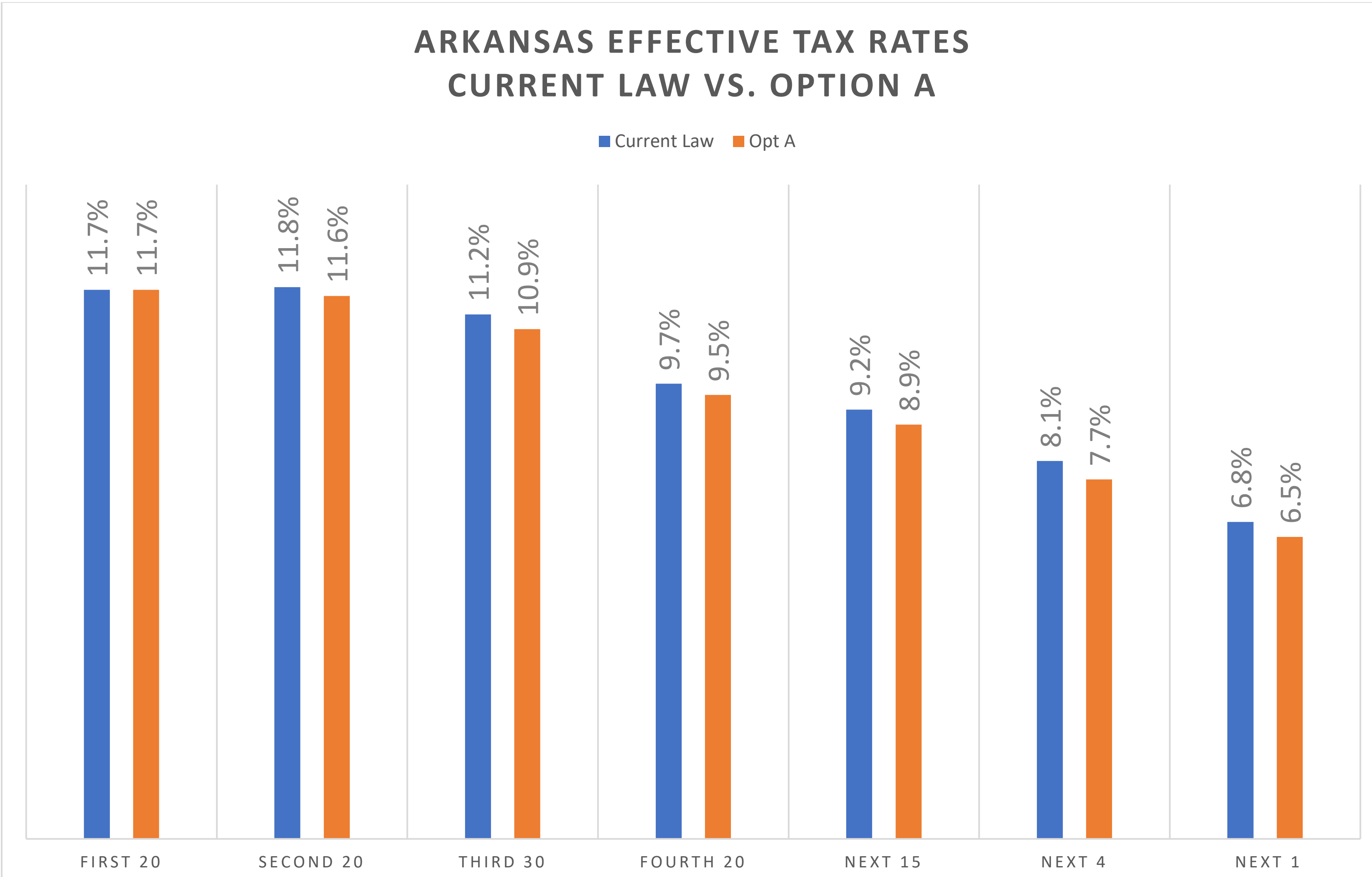
  - Rainy day fund large enough to cover two months (16.7 percent) of annual spending
  - Current revenues should exceed collections from each of the last 5 years, adjusted for population growth and inflation in the cost of government-purchased goods/services
  - A current services projection should show that, even with the tax cut, revenues will be sufficient to continue providing existing services at current levels for at least the next 3 years.

  Any triggered tax cut should also include a mechanism automatically reversing the cut if the economy significantly declines following the tax cut's enactment and/or if state revenues fall much more dramatically than expected.

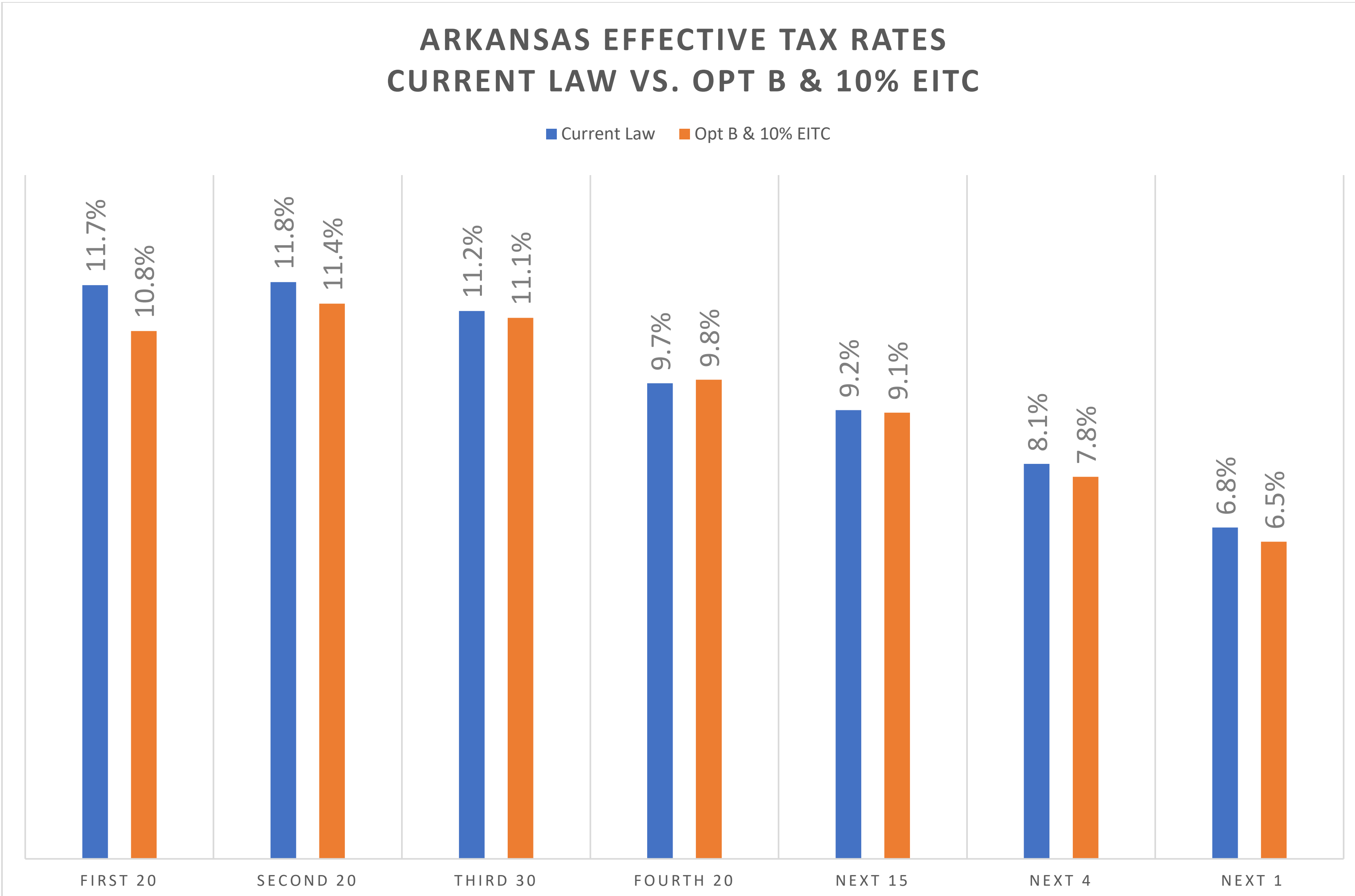
- **Sen. Teague, Sen. Hendren: with the proposals sent to REMI (and voted on during the August 7 meeting), how will that affect Arkansas's regressivity in terms of the chart on slide 1**

  See below for charts showing the change in effective tax rates for combined Arkansas state and local taxes under the different policy scenarios modeled by REMI:
  - Baseline AR 2019 law (includes low-income tax cuts)
  - REMI proposals:
    - Option A
    - Option B & 10% refundable EITC
    - Rate cut of 6.9% to 6.0% for $75,000 tax table
    - Tax Foundation package
      - Rate cut of 6.9% to 6.0% for >$75,000 tax table
      - Cut CIT rate to 6.0%
      - Single sales factor apportionment
      - Repeal of the Throwback rule
      - Repeal of the Franchise tax
      - Repeal of the Inventory tax

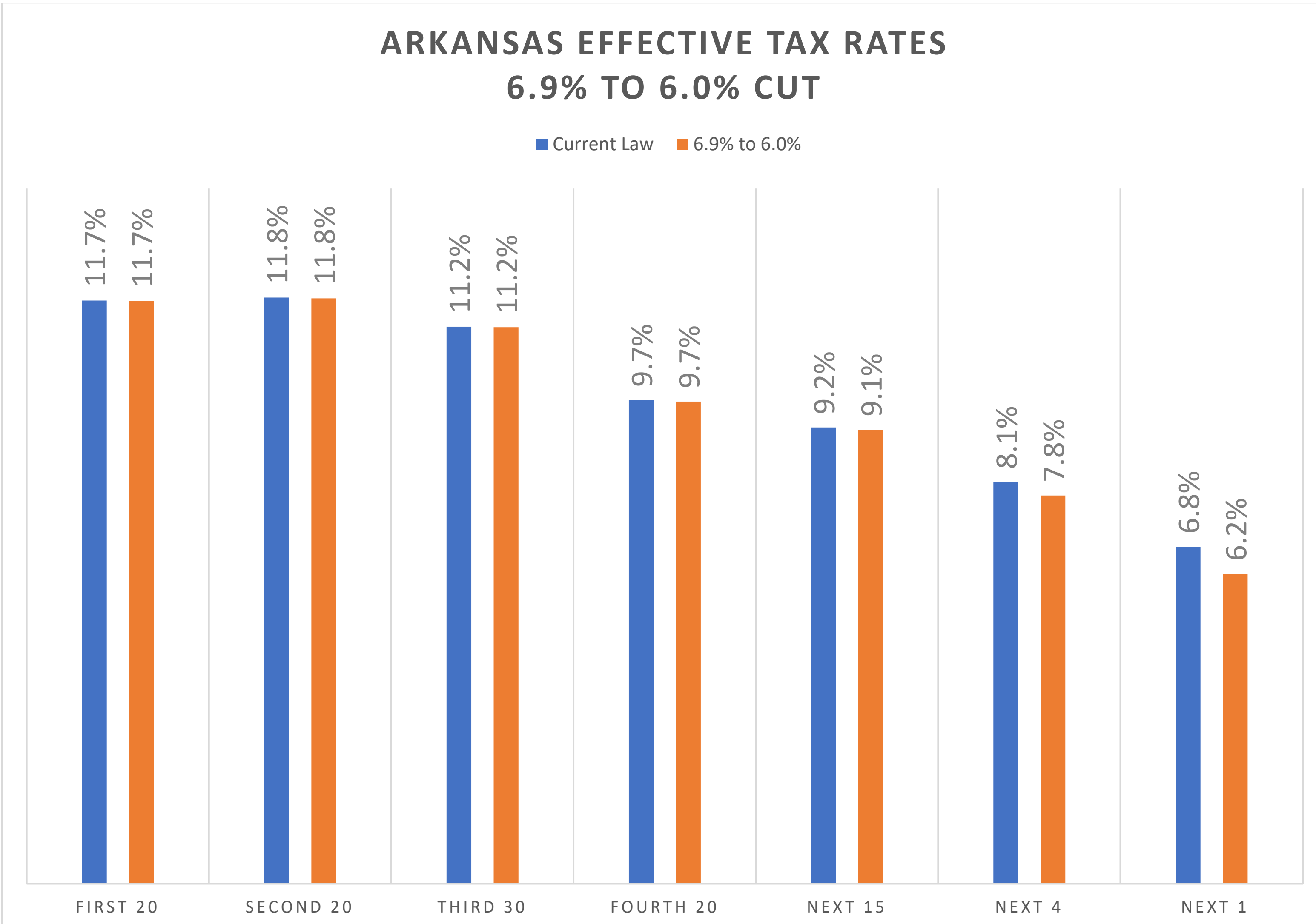

ARKANSAS EFFECTIVE TAX RATES
REMI MODELED PROPOSALS, SUMMARY
14.0%
12.0%
10.0%
8.0%
6.0%
4.0%
2.0%
0.0%
11.7%
10.8%
11.7%
11.8%
11.4%
11.8%
11.2%
11.1%
11.2%
9.7%
9.8%
9.7%
9.2%
9.1%
9.1%
8.1%
7.8%
7.7%
6.8%
6.5%
6.1%
First 20
Second 20
Third 30
Fourth 20
Next 15
Next 4
Next 1
Current Law
Opt A
Opt B & 10% EITC
6.9% to 6.0%
Tax Foundation



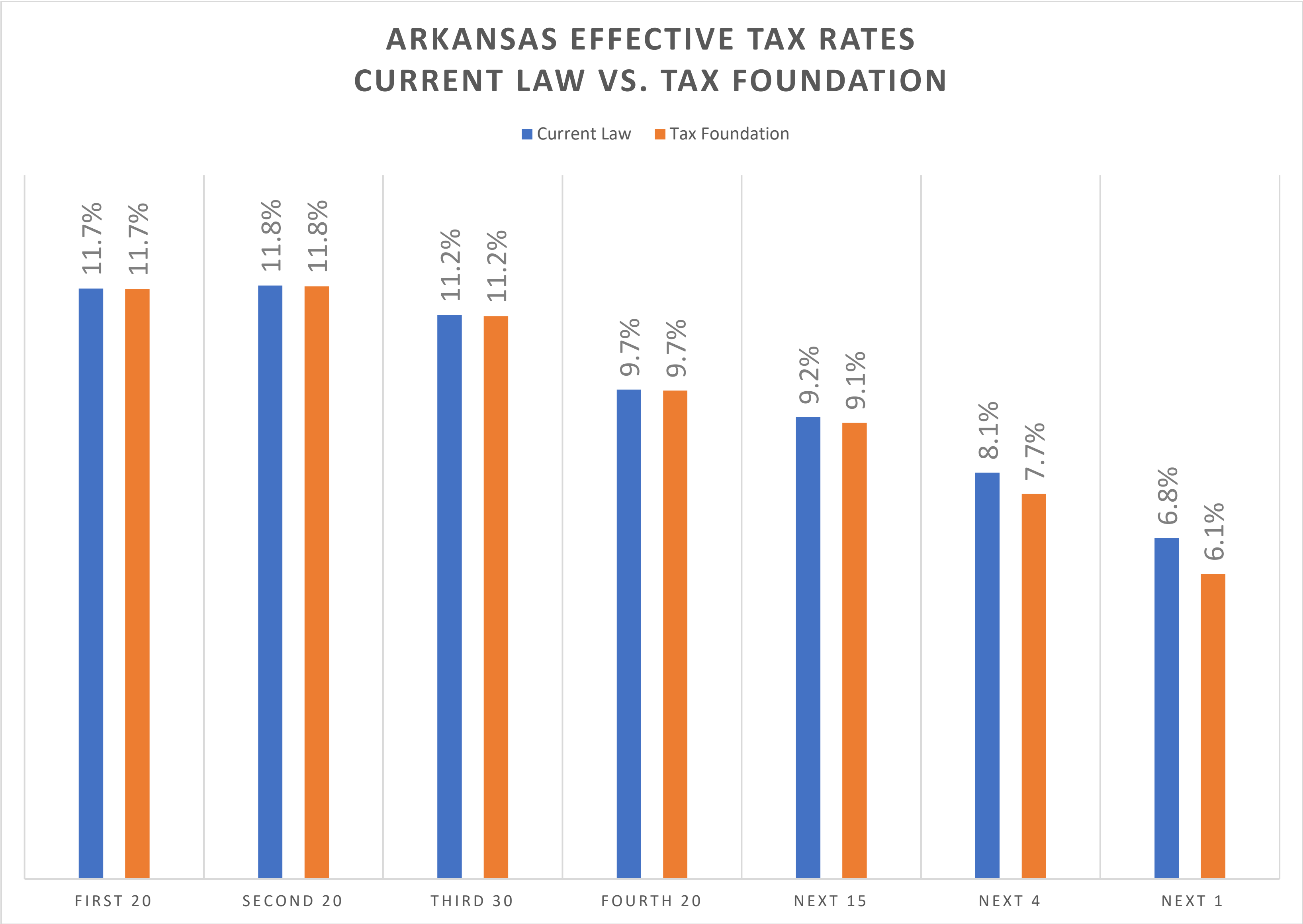
Beneficiaries: Top 80% get tax cuts; Bottom 20% sees no change



Beneficiaries: Bottom 40% and top 5% see significant cuts; middle 40% through 95% see little tax change.



Beneficiaries: Bottom 80% sees no change; top 20% gets all the cut (with top 1% primary beneficiaries).



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