

# There's Nothing Natural about the State of Government Spending in Arkansas

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## ABSTRACT

Arkansas is one of the poorest states in the United States, but it has a relatively high level of state government spending compared to similar states. This study examines the drivers of state spending and of spending increases in Arkansas. We investigate both the largest spending categories in absolute terms and categories that have grown significantly in recent decades. We also investigate formal and informal institutional changes that affect state and local government spending. Arkansas has seen significant growth in spending in recent decades. Between 1991 and 2013, state spending has almost doubled, increasing by almost 97 percent even after adjusting for inflation and population. The growth since 1951 has been ever more dramatic, increasing ninefold in real, per capita terms. We investigate what state- and local-level changes have brought about this growth and what institutional changes may have driven the growth, and we suggest institutional reforms.

*JEL* codes: H72, H20, H71, H75, H765

Keywords: public expenditure, state budget, state revenue, state tax, Arkansas, budget constraint, Revenue Stabilization Law, public finance, education expenditure, public pensions

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**I**n recent decades, government spending in Arkansas has increased dramatically. Between 1991 and 2013, state government spending in Arkansas grew by 97 percent, even after adjusting for inflation and population growth. And although the growth in government spending has been particularly noticeable in the past few decades, the trend began long before then. In 1951, the state spent just \$770 per capita, whereas in 2013, spending had grown to \$6,791 per capita (both figures are in 2013 dollars), a more than ninefold increase in spending in real dollars.

What factors have contributed to this dramatic growth in the size of Arkansas's government? Our goal in this paper is to answer that question in two separate ways. First, we identify the specific forms the spending has taken. What new programs have been added? How much did established programs grow? And second, we dig deeper into the legal changes and informal institutions that contributed to this growth in spending.

Many of the trends we observe in Arkansas are similar to those in other states. When appropriate, we draw comparisons with the other 49 states, as well as with relevant comparison groups (such as states in the same region or states with similar income levels), to see if Arkansas is merely following the trend of other states or if something different is happening. However, some of the laws and institutions of Arkansas are unique and deserve extra attention.

One unique feature of Arkansas's budgeting process is the Revenue Stabilization Law, first passed in 1945, which limits the ability of the state to run budget deficits. This law was initially established to simplify the budgeting process in Arkansas, but it has become one of the process's defining features. The Revenue Stabilization Law provides a ranking of spending programs in the state, and in the case of lower-than-expected tax revenue, programs at the bottom of the ranking list are defunded first or partially defunded to maintain a balanced budget. This process eliminates Arkansas's need for a robust rainy day fund, which many other states maintain. This budget feature has the beneficial effect of ensuring that Arkansas will never run a budget deficit. However, it also implies that, in

“Changes in the tax code, as well as in the growth rate of the economy, are . . . crucial factors in determining the total spending and thus spending growth in Arkansas.”

a large sense, the total amount of spending in Arkansas is actually driven by the tax code rather than by annual budget appropriations. Changes in the tax code, as well as in the growth rate of the economy, are therefore crucial factors in determining the total spending and thus spending growth in Arkansas.

Additionally, this study will investigate the effect of *Lake View School District No. 25 v. Huckabee* and subsequent court cases, in which a variety of legislative measures were taken to correct the Arkansas Supreme Court’s ruling that the system of public school financing was inequitable and unconstitutional. As a result, legislation now requires a minimum level of state expenditure per student, part of which comes from the state general fund if local districts cannot raise enough revenue. Local governments must tax at a minimum rate of 25 mills to fund their K–12 education system (although they are free to tax at a higher rate). The state then uses a formula to determine the minimum spending a school must have. That amount depends not only on the number of students but also on the characteristics of the students.

## OVERVIEW OF STATE GOVERNMENT SPENDING IN ARKANSAS

To better understand the extent of government spending in Arkansas, it is useful to make two comparisons. The first is to compare Arkansas to a group of relevant competitor states. The second is to compare Arkansas today with Arkansas in past years (with appropriate adjustments for changes in population and inflation).

To compare Arkansas with competitor states, we must first select a group of states. By *competitor states*, we mean states that have a similar history and culture to Arkansas’s and that compete most directly with Arkansas for individuals and businesses. None of the existing Census, Office of Management and Budget, or Bureau of Economic Analysis regions fits our definition precisely, so we have created two

TABLE 1. PER CAPITA STATE SPENDING BY ARKANSAS'S COMPETITOR STATES, FISCAL YEAR 2014

State (bold = border state)	Per capita state spending (\$)
Arkansas	7,674
<b>Mississippi</b>	6,198
<b>Louisiana</b>	5,867
<b>Oklahoma</b>	5,771
Virginia	5,508
Alabama	5,148
<b>Tennessee</b>	4,688
South Carolina	4,561
North Carolina	4,404
Georgia	4,303
<b>Texas</b>	4,086
<b>Missouri</b>	3,822
Florida	3,420
Average (all except Arkansas)	4,815
<b>Average (border states)</b>	5,072

Sources: State spending data from the National Association of State Budget Officers, "State Expenditure Report: Examining Fiscal 2013–2015 State Spending," table 1; and population data for 2014 from the US Census Bureau, "Annual Estimates of the Resident Population for the United States, Regions, States, and Puerto Rico: April 1, 2010 to July 1, 2015."

sets of comparison states that are relevant to our analysis: The first set, called *border states*, is made up of the states that share a border with Arkansas. The second set, called *competitor states*, consists of the border states plus the rest of the states that were part of the Confederate States of America. (In other words, the competitor states include the states of the old Confederacy plus Missouri and Oklahoma.) The other former Confederate states were chosen for this comparison because of the culture and history they share with Arkansas.

Table 1 provides the most important comparison for our study, showing that government spending in Arkansas is especially high. The data include all spending by the state governments in each state from all sources (including transfers from the federal government).

Table 1 clearly shows that Arkansas has the highest spending among the states listed—and not just by a little. Arkansas spends almost 24 percent more per capita than the state with the next-highest spending, Mississippi. On average, Arkansas spends over 59 percent more than its competitor states, which spend an average of \$4,815 per capita. Compared to its border states, Arkansas still spends 51 percent more than their average of \$5,072.

**TABLE 2. PER CAPITA STATE SPENDING, NET OF FEDERAL FUNDS, BY ARKANSAS'S COMPETITOR STATES, FISCAL YEAR 2014**

State (bold = border state)	Per capita state spending, net of federal funds (\$)
Arkansas	5,481
Virginia	4,358
<b>Louisiana</b>	3,933
<b>Oklahoma</b>	3,860
<b>Mississippi</b>	3,683
Alabama	3,219
North Carolina	3,046
South Carolina	3,002
Georgia	2,997
<b>Tennessee</b>	2,826
<b>Missouri</b>	2,634
<b>Texas</b>	2,550
Florida	2,194
Average (all except Arkansas)	3,192
<b>Average (border states)</b>	3,248

Sources: State spending data from the National Association of State Budget Officers, "State Expenditure Report: Examining Fiscal 2013–2015 State Spending," table 1; and population data for 2014 from the US Census Bureau, "Annual Estimates of the Resident Population for the United States, Regions, States, and Puerto Rico: April 1, 2010 to July 1, 2015."

It is possible that Arkansas stands out in table 1 because, being a relatively poor state, it receives a significant amount of transfers from the federal government. The expenditure data from the National Association of State Budget Officers (used in table 1) also allow us to compare state spending without federal funds. The data in table 2 show per capita state government spending after subtracting for spending funded by the federal government.

As the data in table 2 demonstrate, Arkansas still has by far the highest state government spending compared with the competitor states. The amounts for other very poor states, such as Mississippi, do drop significantly between table 1 and table 2, but Arkansas remains at the top. The full group of competitor states spends on average \$3,192 per capita, and Arkansas spends almost 72 percent more, at \$5,481. Limiting the analysis to just the border states gives a very similar average result of \$3,248 per capita.

The high level of spending in Arkansas is especially concerning because Arkansas is a very-low-income state. Using most measures of income, Arkansas is regularly ranked as one of the three poorest states. Using the most recent data

**TABLE 3. PER CAPITA STATE SPENDING AS A PERCENTAGE OF PER CAPITA INCOME, 2014**

State (bold = border state)	Total state spending per capita as % of per capita income	Per capita state spending, net of federal funds (\$)
Arkansas	33.5	24.0
<b>Mississippi</b>	29.5	17.5
<b>Louisiana</b>	23.7	15.9
<b>Oklahoma</b>	22.9	15.3
Alabama	21.8	13.6
<b>Tennessee</b>	18.8	11.3
South Carolina	18.5	12.2
North Carolina	17.1	11.8
Georgia	16.8	11.7
Virginia	16.2	12.8
<b>Texas</b>	15.1	9.4
<b>Missouri</b>	14.6	10.1
Florida	12.9	8.3
Average (all except Arkansas)	19.0	12.5
<b>Average (border states)</b>	20.7	13.2

Note: Own-source state spending is net of federal transfers received.

Sources: See tables 1 and 2 for spending data and US Census Bureau, “Selected Economic Characteristics, 2014 American Community Survey 1-Year Estimates” for per capita income.

from the US Census Bureau, Arkansas ranked 48th in both median household income and per capita income and 49th in median family income.<sup>1</sup> Arkansas also has the seventh highest poverty rate, at 19 percent, and the fifth highest black poverty rate, at 36 percent. Some state spending discussed later in this paper, such as that for welfare and education, does have a goal of addressing poverty.<sup>2</sup> However, the high overall state spending is still notable for such a poor state.

Table 3 shows state government spending per capita as a percentage of per capita income in the same group of states. The percentage is calculated in two ways: (1) for total state spending (from table 1), and (2) for only “own source” spending (net of federal transfers, from table 2). For both calculations, we observe that Arkansas spends far more at the state level as a share of its income

1. US Census Bureau, “Selected Economic Characteristics, 2014 American Community Survey 1-Year Estimates,” accessed July 11, 2017. Mississippi and West Virginia are the other two of the three poorest states.

2. Kaiser Family Foundation, “Poverty Rate by Race/Ethnicity,” accessed July 11, 2017. The data come from the Census Bureau’s March 2015 Current Population Survey.

**TABLE 4. ARKANSAS STATE GOVERNMENT EXPENDITURES PER CAPITA (SELECTED CATEGORIES) FOR 1951, 1991, AND 2013**

Category	1951 (\$)	1991 (\$)	2013 (\$)	Real spending growth (%)	
				1951–2013	1991–2013
Total	732.17	3,354.72	6,599.91	801.4	96.7
Welfare (mostly Medicaid)	150.79	688.09	1,737.66	1052.4	152.5
K–12 education transfers to school districts	144.39	713.82	1,431.85	891.6	100.6
Higher education	71.88	481.37	881.41	1126.3	83.1
Insurance trust benefits (mostly state pensions)	4.44	126.17	482.88	10,775.4	282.7
Health and hospitals	47.76	212.12	416.72	772.6	96.5
Highways	165.96	331.49	351.77	112.0	6.1
Government administration	15.32	83.52	204.87	1,237.0	145.3
Public safety	8.12	98.56	199.05	2,350.8	102.0
Interest on debt	20.24	93.95	46.57	130.1	-50.4

Note: Dollar amounts are in 2013 dollars. Categories were selected for importance either in size or politically. The categories will not add to the total spending since not all categories are listed, but they do make up more than 80 percent of spending in all three years.

Source: US Census Bureau, Annual Surveys of State and Local Government Finances, various years.

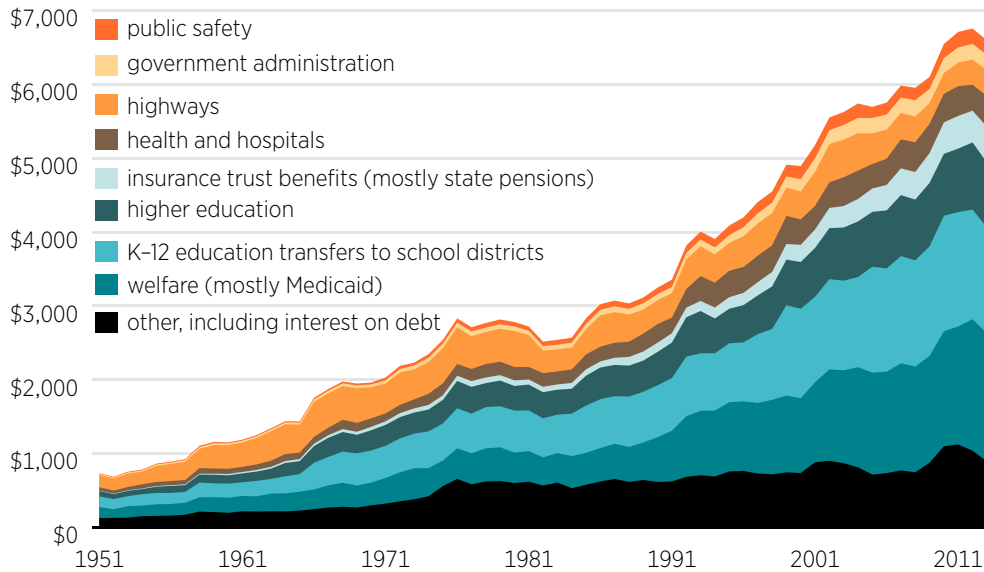
than any of the competitor states. Using just own-source revenue, we can see that Arkansas is spending almost double what the competitor states are on average (24.0 percent vs. 12.5 percent).

The data in tables 1–3 show that Arkansas is spending a very large number of taxpayer dollars. But where is the money being spent? And how has it changed over time? Using historical data from the Census Bureau’s Census of State Finances, we can begin to answer these questions.

Table 4 provides three selected years of data from the Census Bureau’s *Annual Surveys of State and Local Government Finances*, and figure 1 shows the same data for all years from 1951 through 2013. We selected fiscal year (FY) 1951 because it was the earliest year with mostly complete data for Arkansas, and we selected FY 2013 because it is the most recent year available from the Census Bureau for making cross-state comparisons and keeping consistent categories. We selected FY 1991 as an intermediate date to show more recent growth in state spending in Arkansas. As will be seen in the section on public education spending, 1991 was the year before an important court decision that altered how public schools are financed in Arkansas. For the other spending categories, there is no particular reason that 1991 is significant, but it does give us a picture of government growth in more modern times.



FIGURE 1. ARKANSAS STATE GOVERNMENT EXPENDITURES PER CAPITA, 1951-2013



Note: Amounts are in 2013 dollars.

Source: US Census Bureau, Annual Surveys of State and Local Government Finances, various years.

As mentioned before, spending in Arkansas has increased dramatically since 1951, by around 800 percent or ninefold in per capita, inflation-adjusted terms. Spending has continued to increase dramatically in recent decades, as shown by the increase of nearly 97 percent since 1991. State governments have not taken on many new roles since 1991, other than an expanded role in health-care, so for most categories the increase is just more state spending than was needed to fund the same services in the past. Health and hospital spending have only increased at the average rate of overall state spending, but, as discussed later, Medicaid spending has increased dramatically.

Four categories stand out as the primary drivers of increased state spending in Arkansas:

- K-12 education transfers to school districts
- Insurance trust benefits (mostly state pensions, but also unemployment insurance, retirement healthcare benefits, and workers' compensation)
- Public safety (mostly for corrections at the state level)
- Welfare (mostly for Medicaid)

All four of these categories have increased by about 100 percent or more in real, per capita terms in just the past two decades. General government administration spending has also increased by more than 100 percent; however, the total spending for that category is very small.

Because education transfers have increased dramatically and make up a relatively large portion of the budget, we examine that category in detail later. For public safety, Medicaid, and pensions, we offer some brief comments here.

## Public Safety Spending

The doubling in public safety spending in Arkansas from 1991 to 2013 was much greater than the average increase across all 50 states. In real, per capita terms, public safety spending at the state level grew by about 31.5 percent across the United States, but it grew by 102 percent in Arkansas. Most spending in the state-level public safety category is for corrections, both in Arkansas and in the United States, at 68.5 percent and 65.5 percent of total corrections spending, respectively. But state-level corrections spending only increased by 10.8 percent across all states, whereas it was up 89.8 percent in Arkansas since 1991.<sup>3</sup>

The reasons for the increase in state-level corrections spending in Arkansas are complicated, but it is notable that 1991 was the peak year in Arkansas for the murder rate (11.1 per 100,000) and near the peak for violent crime (593.3 per 100,000, with only 1994 being higher). From 1991 to 2013, the murder rate in Arkansas fell 52 percent and the violent crime rate fell 22 percent.<sup>4</sup> Disentangling causation is challenging, as perhaps the boom in corrections spending helped push crime rates down. However, it is important to recognize that the drop in crime was part of a national trend, while state-level spending on corrections increased more quickly than the national rate.

## Medicaid Spending

The issue of welfare spending—and specifically Medicaid—in Arkansas is an even more challenging area to analyze. And stopping the data in 2013, the latest information available from the Census Bureau, is also problematic for Arkansas and all states. The Affordable Care Act made major changes to Medicaid, many of which are still being implemented. From the end of 2013 to July 2016, the number of

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3. US Census Bureau, Annual Surveys of State and Local Government Finances, various years.

4. Federal Bureau of Investigation, Uniform Crime Reporting, annual crime reports, various years.

Arkansans enrolled in Medicaid and the Children’s Health Insurance Program (CHIP) increased by 60 percent—from around 557,000 to 889,000, much more than the national increase of 27 percent, and the eighth largest state increase.<sup>5</sup> That change was under Arkansas’s private-option waiver to the Affordable Care Act (now a more permanent program called Arkansas Works), which was signed by the governor in April 2016.<sup>6</sup> At least for the near future, nearly all the funding for the expansion of Medicaid in Arkansas will be federal, as much of Medicaid funding already is.

Because so much of the funding for Medicaid currently and historically has come from the federal government, it is quite challenging to analyze the issue within the context of the state budget. Although Medicaid funding is a crucial budget issue for state and federal spending over the coming decades, our analysis in this paper is on the historical changes in the components of Arkansas’s state-level government spending. Although Medicaid represents a large and growing portion of the state budget, most of the burden is and has been on US taxpayers in general, rather than on Arkansas taxpayers. Thus, a detailed analysis of Medicaid funding mostly falls outside the scope of this paper.

### Public Pensions in Arkansas

The primary and dominant subcategory of insurance trust benefits is employee retirement spending, better known as public pensions. Employee retirement spending constitutes almost 99 percent of this category for 2013. Arkansas, like most other states, has seen dramatic growth in the public pension payments as decades’ worth of state employees retire and continue to live longer lives. But the issue with public pensions is much greater than simply increased expenditures.

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5. Kaiser Family Foundation, “Total Monthly Medicaid and CHIP Enrollment,” July 2016.

6. “Governor Asa Hutchinson Releases Statement on House and Senate Passage of Arkansas Works,” news release, April 7, 2016.

“Arkansas, like most other states, has seen dramatic growth in the public pension payments as decades’ worth of state employees retire and continue to live longer lives.”

Most state pension systems are also underfunded. In December 2008, the public pensions of all 50 US states were underfunded by a combined \$3.23 trillion.<sup>7</sup> These unfunded pension liabilities equated to off-balance-sheet government debt that was more than three times greater than publicly traded state debt (\$0.94 trillion).

Arkansas is no exception to underfunded pensions. However, Arkansas has done a better job than some states of making sure the pension system is funded. Thus, Morningstar places Arkansas in the middle “fair” category at 72.5 percent funded in 2011, better than the 21 “poor” states in funded liability (defined as less than 70 percent funded).<sup>8</sup> Analysis from the Pew Charitable Trusts up to 2013 also shows that Arkansas is in a fair position at 74 percent funded, better than many states that are funded at less than 70 percent but still far below the ideal of 100 percent funded.<sup>9</sup>

However, when fair-value discount rates are used instead of Government Accounting Standards Board actuarial methods (which tend to understate liabilities), Arkansas’s 2015 funding ratio drops to 51 percent.<sup>10</sup> This figure equates to unfunded liabilities, or off-balance-sheet government debt, of more than \$20 billion for the state. Yet Arkansas’s somewhat alarming market funding ratio still ranks as the 21st highest among all US states. And Arkansas finds itself in a better position than most states for the manageability of pension liabilities. A 2016 report from the Hoover Institution finds that Arkansas’s unfunded market value liabilities as a share of total state revenue ( $1.61 \times$  total revenue) is more favorable than that of 34 other states.<sup>11</sup>

But without fundamental reform—namely, shifting from defined benefit plans to defined contribution plans—Arkansas’s unfunded liabilities will continue to grow. More than 90 percent of the economists that make up the Initiative on Global Markets (IGM) Economic Experts Panel agree or strongly agree that without significant reform (increased taxes, spending cuts, alteration of public-sector pensions, or some combination), US states “will require a combination of

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7. Robert Novy-Marx and Joshua Rauh, “The Liabilities and Risks of State-Sponsored Pension Plans,” *Journal of Economic Perspectives* 23, no. 4 (2009): 191–210.

8. Rachel Barkley, *The State of State Pension Plans: A Deep Dive into Shortfalls and Surpluses* (Chicago: Morningstar, November 2012).

9. Pew Charitable Trusts, “The State Pensions Funding Gap: Challenges Persist” (Issue brief, Pew Charitable Trusts, Washington, DC, July 2015).

10. Andrew G. Biggs, “The State of Public Pension Funding: Are Government Employee Plans Back on Track?” (AEI Economic Perspectives, American Enterprise Institute, September 2015).

11. Joshua D. Rauh, *Hidden Debt, Hidden Deficits: How Pension Promises Are Consuming State and Local Budgets* (Stanford, CA: Hoover Institution, 2016).

severe austerity budgets, a federal bailout, and/or default.”<sup>12</sup> Arkansas can avoid this fate by transitioning pensions to defined contribution plans.

## FORMAL AND INFORMAL INSTITUTIONS, LEGISLATION, AND COURT RULINGS IN ARKANSAS

In this section we look at some of important formal and informal institutions and institutional changes that have contributed to the growth of state government spending in Arkansas. Some of these changes involve spending at a broad level, such as the Revenue Stabilization Law. Others involve more narrow areas of government spending, such as education spending.

### Debt Default, Futrell Amendments, and Revenue Stabilization Law, 1933–1945 and Beyond

Several of the current budgetary processes and informal institutions in Arkansas can be traced to Great Depression–era budget issues.<sup>13</sup> The first major event was in 1933, when Arkansas became the first and only US state in the 20th century to default on its debt. More than 5,000 municipalities and districts defaulted on their debt in the 1920s and 1930s, but Arkansas was the only state to default.<sup>14</sup> Although all states suffered financially during the Depression, Arkansas was unable to make regular payments on its debt, and creditors took legal recourse.

The primary reason for the accumulation of debt by the state of Arkansas was the assumption of municipal debts that were incurred for the construction of roads in the 1920s. After the flood of 1927, the state assumed \$70.5 million in municipal debt and issued further debt to continue constructing roads and

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12. IGM Economic Experts Panel, “U.S. State Budgets,” *IGM Forum*, October 1, 2012.

13. This section relies on several published sources, including Meagan M. Jordan, “Arkansas Revenue Stabilization Act: Stabilizing Programmatic Impact through Prioritized Revenue Distribution,” *State and Local Government Review* 38, no. 2 (2006), 104–11; Kroll Bond Rating Agency (KBRA), “An Analysis of Historical Municipal Bond Defaults: Lessons Learned—The Past as Prologue” (Public finance report 11-14-2011, KBRA, New York, November 2011); and entries from the *Encyclopedia of Arkansas History and Culture*, “Amendments 19 and 20” and “Revenue Stabilization Act,” the Central Arkansas Library System, Little Rock, accessed June 20, 2017. We also rely on original unpublished archival research by Terra Votaw, summarized in her manuscript “The Tax Plan that Saved Arkansas: An In Depth Look at the Causes and Effects of the Revenue Stabilization Act from 1925–1950” (Arkansas Center for Research in Economics working paper, University of Central Arkansas, Conway), available from the authors upon request.

14. Louisiana, South Carolina, and Texas also had “technical defaults” in which they did miss payments, but ultimately there was a resolution such that no individual investors were harmed financially.

highways—about \$13 million in 1927 and further issues in subsequent years.<sup>15</sup> By 1932, Arkansas had “\$160 million in public debt, the highest in the nation on a per capita basis.”<sup>16</sup> When tax revenue plummeted in the early 1930s, Arkansas was forced to declare bankruptcy.<sup>17</sup>

One of the immediate formal institutional changes following Arkansas’s debt default was the passage in 1934 of amendments 19 and 20 to the Arkansas Constitution. These amendments, commonly known as the Futrell Amendments, were named after Governor Junius Futrell, who proposed and campaigned for them. The Futrell Amendments put strong constraints on Arkansas’s ability to raise taxes, spend revenue, or issue new debt. For example, raising most taxes required either a popular vote or, in emergencies, a three-fourths supermajority in both houses of the legislature. A popular vote was also required to issue any new debt, except for the purpose of refunding the existing debts (such as those defaulted on the previous year). These amendments are still mostly in force today, although a subsequent amendment in 1986 did allow the state and substate government units to issue revenue bonds (i.e., bonds for capital improvements that will generate revenue in the future to repay the bond).

The next major institutional change for Arkansas came in 1945, with the passage of the Revenue Stabilization Act of 1945. This act is interesting because it sets up a unique budgeting process in Arkansas that prioritizes spending categories as revenue comes into state coffers, discussed later in this paper. The act is also interesting because it has some features of a formal institution, but also some features of an informal one. Although there is no constitutional or other formal requirement to do so, the Arkansas legislature has passed a similar budget bill each budget year since 1945. The regular passage of a Revenue Stabilization Act in Arkansas as the fiscal institution for allocating Arkansas’s tax revenue is a custom that all legislators are aware of and continue to pass, but the act passes merely by custom rather than by constitutional requirement. Arkansas could at any time use a different budgeting process, but the same prioritization procedure used in 1945 is passed by each subsequent legislature.

The original Revenue Stabilization Act had a different primary function from the way the act is used today. Originally, the main goal of the act was to create a general fund for tax revenue. The fund was meant to replace the existing system, which had about 100 different taxes, each funding different state

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15. Ben Johnson, *Arkansas in Modern America: 1930–1999* (Fayetteville: University of Arkansas Press, 2000), 8–9.

16. *Ibid.*, 14.

17. Monica Davey, “The State That Went Bust,” *New York Times*, January 22, 2011.

agencies. In essence, the entirety of Arkansas's pre-1945 fiscal system worked like the funding of roads in many states today, where specific revenues (e.g., gas taxes, license fees, vehicle property taxes) are used to fund a specific function such as road construction and maintenance. Although there was some sense to this system because many taxes are essentially user fees, the system also created significant complications in long-term governmental budgeting, especially over the business cycle with unstable revenues for each of the state agencies. So the main function of the first Revenue Stabilization Act was to consolidate the government budget for most purposes, setting up a general fund in the budget in place of the roughly 100 autonomous budgets.

A second function of the Revenue Stabilization Act was to provide another hard constraint against budget deficits and the issuance of further state debt. This second function has been the primary reason for all the subsequent Revenue Stabilization Acts passed each year since 1945. The acts provide for a process whereby all of the spending bills passed in a legislative session are prioritized through a central process. The process involves the governor, the heads of the House and the Senate, and other high-ranking legislators and bureaucrats ranking all the spending bills into categories (usually A, B, and C, though today there are subcategories such as A1 as well). For example, in recent years categories A and A1 consisted mostly of education spending by the state for K–12 and higher education, while category B consists mostly of spending on correctional institutions and health and human services. Programs are funded only if there is enough revenue to pay for them, and programs ranked lower on the priority list may be only partially funded or may not be funded at all.<sup>18</sup> In the 36 fiscal years since 1980, category A spending has been fully funded 30 times, although in just 16 of the past 36 years there was enough funding for all categories.<sup>19</sup> In other words, the items further down the list—especially those in category C—may rightly be regarded as a wish list of programs.

The beneficial part of the Revenue Stabilization Act is that Arkansas is unable to run budget deficits. There is less need for a rainy day fund, which most states have, because programs are automatically cut (or not funded at all) if revenues are not available. But there is a negative side to the act as well: it also makes

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18. Meagan M. Jordan, "Arkansas Revenue Stabilization Act: Stabilizing Programmatic Impact through Prioritized Revenue Distribution," *State and Local Government Review* 38, no. 2 (2006), 104–11.

19. Data provided to the authors by the Arkansas Bureau of Legislative Research on June 23, 2016, by the assistant director of fiscal services and the assistant director of research (Kevin Anderson and Richard Wilson).

“Because there have almost always been more spending bills passed than will ever be realistically funded, Arkansas regularly spends every penny that it takes in through taxes.”

it unlikely that Arkansas will run a budget surplus. Because there have almost always been more spending bills passed than will ever be realistically funded, Arkansas regularly spends every penny that it takes in through taxes.

This dynamic of the Revenue Stabilization Act—the assurance that all funds are spent—also has an important underlying budgeting feature. It means that the tax system itself is crucially important for determining the level of government spending. While this is true in some way for every state, it is true in a very strong way for Arkansas. To state it another way, the level of government spending in Arkansas is directly determined by the tax system. Taxes are the “tail that wags the dog” in Arkansas budgeting. If taxes are raised, government spending is guaranteed to go up. If taxes are cut, spending is guaranteed to go down. The allocation of government spending is determined as it is in most states, although the priority list is determined through a behind-closed-doors process and by more than just the legislature. But the level of spending is set by the tax system itself. Understanding this fact is crucial to understanding why government spending has increased in Arkansas.

Some nuance is required regarding the statement that the level of taxation is the driver of the level of spending in Arkansas. There are other important factors, with federal aid to the state being another large and growing source of revenue. Revenue from specific sources, such as college tuition, is generally dedicated to specific spending, such as higher education. But in large part, the absolute size of Arkansas’s spending is determined by the tax system.

A complete analysis of Arkansas’s tax system and its evolution over time is beyond the scope of this paper.<sup>20</sup> But we will offer a few highlights to help readers better understand why taxes—and, consequently, spending—in Arkansas are so high today. Arkansas uses all the major tax

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20. For a complete analysis of Arkansas’s tax system, its history, and suggestions for reforming it, see Nicole Kaeding et al., *Arkansas: The Roadmap to Tax Reform* (Washington, DC: Tax Foundation and Arkansas Center for Research in Economics, 2016).



instruments available to states, including income, sales, and property taxes, while some of Arkansas's neighbors do not have certain taxes (notably, Tennessee and Texas have no personal income tax). The overall state-and-local tax burden—10.1 percent—is the highest among the competitor states defined in the previous section, and it is the 17th highest in the nation.<sup>21</sup> Arkansas has the second-highest average state-and-local sales tax rate, at 9.3 percent.<sup>22</sup> The top marginal state income tax rate is 6.9 percent, the second highest among our competitor states (South Carolina is slightly higher at 7.0 percent), and two border states have no individual income tax (Texas and Tennessee).<sup>23</sup> The corporate tax rate is also the second highest among Arkansas's competitor states, at 6.5 percent (tied with Tennessee and Alabama, and less than Louisiana).<sup>24</sup> All these data points show that taxes are high in Arkansas compared with border and competitor states, and even compared with the nation in some cases.

## Public Education Funding in Arkansas Since 1992

Arkansas's state and local expenditures on public education have grown considerably over the last several decades. From 1992 to 2013, K–12 spending grew more than 73 percent, from \$2.91 billion in 1992 to \$5.05 billion in 2013.<sup>25</sup> Even when accounting for population, expenditures on public schools grew by more than 41 percent, from \$1,206 per capita to \$1,708 per capita.<sup>26</sup> The growth in education spending in Arkansas has been driven primarily by a pivotal lawsuit commonly known as *Lake View*.

In 1992, Arkansas's Lake View School District filed a lawsuit claiming that unconstitutional disparities existed in public school funding between wealthy and low-income school districts. Two years later, Pulaski County Chancery Court Judge Annabelle Imber sided with Lake View, ruling that Arkansas's public school finance system was indeed unconstitutional. The Arkansas General Assembly was given two years to pass legislation to rectify the ruling and, in 1995,

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21. Tax Foundation, "State-Local Tax Burden Rankings FY 2012," January 2016.

22. Scott Drenkard and Nicole Kaeding, "State and Local Sales Tax Rates in 2016," Tax Foundation, March 2016.

23. Nicole Kaeding, "State Individual Income Tax Rates and Brackets for 2016," Tax Foundation, February 2016.

24. Ibid.

25. United States Census Bureau, Annual Surveys of State and Local Finances, State and Local Elementary and Secondary Education Expenditures. Values have been adjusted for inflation to reflect December 2015 dollars.

26. Author's calculations. Population data are from the American Community Survey 1-Year Estimates and the Statistical Abstract of the United States: 2012 (131st edition).

#### BOX 1. EQUITABLE SCHOOL FINANCE PLAN

This funding system worked by pooling local property tax revenue, 75 percent of the state's miscellaneous funds from the previous year, and state equalization funding to divide among the state's average daily membership. The state first calculated base local revenue per student at the state level by multiplying statewide assessment property valuations by the uniform tax rate of 25 mills and applying an assumed collection rate of 98 percent. Local districts would then calculate their own local revenue per student by a similar process. The amount of state equalization funding per student that each district received was then determined by subtracting local revenue per student from the statewide base local revenue per student. The state then provided the poorest districts with additional base funding to ensure that each district received at least 80 percent of the funding per student that the state's 95th percentile district received.

enacted a new school funding formula called the Equitable School Finance Plan. The formula guaranteed that all districts would receive at least 80 percent of the funding per student that the state's 95th percentile district received, and it provided funding for facilities for the first time. Voters also approved Amendment 74 to the Arkansas State Constitution, mandating that each school district impose a minimum property tax of 25 mills for maintenance and operations.

The Equitable School Finance Plan moved Arkansas's education funding system from a model based on expenditures to a model based on revenues.<sup>27</sup> However, revenues across districts varied because of diversity in property values and the willingness of some districts to tax above and beyond the 25 mill minimum rate.<sup>28</sup> To offset disparities in wealth across the state's districts, the state issued equalization funding up to the uniform tax rate of 25 mills.<sup>29</sup>

The Equitable School Finance Plan (box 1) had a substantial effect on Arkansas's education budget. When the *Lake View* lawsuit was filed in 1992, Arkansas was spending \$1,206 per capita on education, for total expenditures of \$2.91 billion. By 1999, Arkansas had increased its educational spending by more than \$186 per person to \$1,392 per capita, or total expenditures of \$3.69 billion. In 1998, Pulaski County Chancery Court Judge Collins Kilgore deemed that the

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27. Act 916, Act 917, and Act 1194 of the 1995 regular session.

28. Districts with higher millage rates were permitted to retain half of the additional revenue while remitting the other half to the state.

29. *Public School Finance Programs of the United States and Canada, 1998–99* (Washington, DC: US Dept. of Education, Office of Educational Research and Improvement, National Center for Education Statistics, 2001).

## BOX 2. ARKANSAS SUPREME COURT'S REASONS FOR RULING SYSTEM OF FINANCE UNCONSTITUTIONAL

1. The Arkansas Department of Education failed to conduct an adequacy study or define adequacy.
2. Arkansas had abysmal educational rankings.
3. Arkansas had low benchmark scores.
4. Arkansas students needed remediation in college.
5. Arkansas's teacher salaries were not comparable to those of surrounding states.
6. There were disparities in teacher salaries within the state.
7. There were problems with recruiting and retaining quality teachers.
8. There were special needs for poverty-level students, including English-language learners.
9. School districts in low-income areas needed improved and advanced curriculum, quality teachers, and adequate facilities, supplies, and equipment.
10. School districts facing high enrollment growth had needs such as additional buildings.

Source: Lake View Sch. Dist. No. 25 v. Huckabee (Lake View III), 351 Ark. 31, 91 S.W.3d 472 (2002); "A Chronology of Changes in the Structure and Funding of the Public Education System in Arkansas From 1819 to 2007," Arkansas Department of Education.

move toward this new funding method and the implementation of Amendment 74 were enough to dismiss the *Lake View* court case without trial.

Despite the significant increase in educational funding, the Arkansas Supreme Court reversed the lower court's decision in 2000 and required that a trial determine whether the Equitable School Finance Plan had indeed corrected the disparities in funding. In May 2001, Judge Kilgore again declared that the public school funding system was inequitable and inadequate. Upon appeal of the chancery court's decision, the Arkansas Supreme Court upheld the ruling that the system was unconstitutional.<sup>30</sup> The Arkansas Supreme Court delayed issuing its mandate until January 1, 2004, to allow the General Assembly the opportunity to remedy the concerns.<sup>31</sup>

The Arkansas Supreme Court issued 10 reasons for its ruling that the system was unconstitutional (box 2).<sup>32</sup> The court further stated that it was the state's responsibility to define adequacy; to assess, evaluate, and monitor the entire

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30. See Lake View Sch. Dist. No. 25 v. Huckabee (Lake View III), 351 Ark. 31, 91 S.W.3d 472 (2002); "A Chronology of Changes in the Structure and Funding of the Public Education System in Arkansas From 1819 to 2007," Arkansas Department of Education.

31. Ibid.

32. Ibid.

spectrum of public education; and to know how state revenues are spent and whether true equality in education is being achieved.

In the 2003 Regular Session, the state legislature passed Act 94 to create the Joint Committee on Educational Adequacy. This committee was tasked with studying the state's educational system, determining how to provide adequate education to all public school students, and conducting an adequacy study. Shortly after, the state legislature hired school funding experts Picus and Associates to perform the adequacy study. The adequacy study resulted in the suggestion of several changes to Arkansas's funding model. The most significant suggestion was for Arkansas to move to an evidence-based funding matrix. This matrix was intended to "provide a methodology for determining an adequate level of funding to allow schools to meet minimum accreditation standards and adequately educate Arkansas students."<sup>33</sup>

In the Second Extraordinary Session of 2003, the 84th General Assembly passed Act 59, commonly known as the Public School Funding Act. The act largely followed the evidence-based model provided by Picus and Associates and overhauled the previous funding system by establishing a per-student funding formula. Although the old system was a zero-sum game (i.e., an increase in funding for one school meant less funding for other schools), the new system was one of open-ended funding. Rather than funding schools on the basis of available money, the state adopted a funding method on the basis of what is needed to provide an adequate education for all students.

The matrix that was established in Act 59 of 2003 (and is in use today) assigns dollar values to the line items that construct the matrix. The line items include teachers, counselors, special educators, instructional facilitators, and librarians; secretaries; principals; continuing education pay for teachers; technology; instructional materials; extra duty funds; supervisory aides; substitutes; carry forwards; operations and maintenance; central office; transportation; retirement add-ons; and enhanced funding.<sup>34</sup> The line items are then added together to calculate a total per-student dollar amount and multiplied by each school district's average daily membership for the previous school year to determine the total amount of "foundation funding" necessary. In this system, a gain in funding for one school district does not necessarily affect the funding of another school district. The new formula allotted \$5,400 per student in the

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33. *The Resource Allocation of Foundation Funding for Arkansas School Districts (Act 57 of the Second Extraordinary Session of 2003 and Act 1204 of 2007)*, Project Number 11-180 (Little Rock: State of Arkansas Bureau of Legislative Research, 2012).

34. *Ibid.*

2004/05 school year (\$6,929 in 2015 dollars), an increase of approximately \$700 per student over the previous system.

In addition to foundation funding, the Public School Funding Act also established categorical funding. Categorical funding is additional funding allocated to districts to address the needs of students in poverty, students who are English language learners (ELL), and students who need alternative learning environments, and to provide professional development for teachers. These funds are considered restricted, meaning that the funds for these programs can be used only in a manner related to their intended use.

The largest categorical funding measure, National School Lunch Program (NSLP) funding, is used to address the needs of impoverished students. The state uses the concentration of students who are eligible for the federal NSLP to determine the poverty level of each school district and provides additional funding based on each district's concentration of poverty. The Public School Funding Act of 2003 allocated funding to provide one full-time equivalent position for every 100 students in districts with poverty concentrations below 70 percent; two full-time equivalent positions for every 100 students in districts with poverty concentrations between 70 percent and 90 percent; and three full-time equivalent positions for every 100 students in districts with poverty concentrations at 90 percent and above.<sup>35</sup> Funding for the current year is based on poverty metrics from the previous year.

For an illustration of how districts are funded, consider a hypothetical example of a 1,500-student district with 1,100 students eligible for free or reduced-cost lunch in 2015. On the basis of the district's poverty rate of 73 percent and the funding rates for FY 2016, the district would receive \$1,042 for each of the 1,100 students qualifying for free or reduced-cost lunch, totaling \$1,146,200 for the 2016 school year.

Two other NSLP funding measures exist in addition to base NSLP funding. In 2005, Act 2283 created NSLP growth funding, which ensured that districts received enough funding to supplement a growing number of impoverished students. Any district whose enrollment has grown by at least 1 percent in each of the past three years is eligible for NSLP growth funding. Act 811 of 2007 created NSLP transitional adjustments, which provide adjustments in funding over a three-year period for districts that move from a higher or lower funding rate. NSLP transitional adjustments promote a gradual change

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35. *National School Lunch State Categorical Funding and Expenditures*, vol. 1 (Little Rock: State of Arkansas Bureau of Legislative Research, 2015).

in funding rather than large, immediate swings for districts that move into new tiers of funding.

The implementation of NSLP funding in FY 2005 had an immediate effect on the budget, increasing it by more than \$183.2 million. By FY 2014, this figure had grown by more than 11 percent, to \$203.8 million.

The Public School Funding Act of 2003 also designated support for ELL as categorical funding. Arkansas Code Annotated § 6-20-2303 defines *English language learners* as “students identified by the state board as not proficient in the English language based upon approved English proficiency assessment instruments administered annually in the fall of the current school year, which assessments measure oral, reading, and writing proficiency.” To determine ELL status, the state administers home language surveys at the time of student registration and, upon identifying potential candidates, provides a screening or placement test to determine fluency.

In 2003, the state followed Picus and Associates’ recommendation and authorized funding to “support 40 percent of a full-time teacher for every 100 students who are both English language learners and eligible for free or reduced lunch” for the 2004/05 school year.<sup>36</sup> In 2006, the state increased the funding rate to support 60 percent of a full-time teacher for every 100 students who qualify for both ELL and NSLP funding. Unlike NSLP, ELL funding is issued on the basis of the number of current ELL students.

Because the state already issued money to support ELL students, the designation of ELL as a categorical funding measure had very little effect on the state’s budget at the onset. However, in the years after its designation, ELL funding has grown by more than 140 percent, from \$5.28 million in the 2004/05 school year to \$12.82 million in the 2013/14 school year.

Alternative learning environments (ALE) also received categorical funding status under the Public School Funding Act. Arkansas Code Annotated § 6-20-2303 defines alternative learning environments as “student intervention programs that seek to eliminate traditional barriers to learning for students.” ALE programs are used to assist the learning of at-risk students who fall within 12 categories, including disruptive behavior, recurring absenteeism, and family problems.

Although ALE funding existed before the passage of the Public School Funding Act of 2003, the new formula altered how funding was determined. The old system provided that a student must be in an ALE program for 20 consecutive days in one school year before he or she would be eligible for ALE funding, and it

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36. Ibid.

did not account for the total number of days a student was in ALE during the school year. The new formula changed ALE funding eligibility from 20 consecutive days to 20 total days in an ALE program in one school year and took into account the total number of days students spent in ALE. In July 2010, however, the rules were changed to again require that a student be in an ALE program for 20 consecutive days before he or she is eligible for additional funding.

Before the move to the matrix-based funding formula, alternative learning environments were required to have a student–teacher ratio of no more than 20 to 1. The new rules, however, shrank the size of ALE classrooms. Kindergarten through sixth-grade ALE programs became limited to a student–teacher ratio of 10 to 1 (or 12 to 1 with a paraprofessional), and seventh-grade through twelfth-grade ALE programs became limited to a student–teacher ratio of 15 to 1 (or 18 to 1 with a paraprofessional). The Public School Funding Act of 2003 initially set a funding rate that could support a student–teacher ratio of 15 to 1. However, on the recommendation of Picus and Associates in 2006, the funding rate was again altered to support a student–teacher ratio of 12 to 1 beginning in the 2007/08 school year.

District funding for ALE programs is based on the previous year’s full-time equivalent students in the district’s ALE program. Full-time equivalents are calculated by multiplying the ratio of total number of days spent in ALE programs to the total number of school days times the ratio of the number of hours spent in ALE programs per day to six hours. For the district to receive funding for an ALE student, the student must have been in the ALE program for at least 20 consecutive days. It is important to note that “ALE funding is not intended to cover the full cost of ALE programs,” but to supplement foundation funding to “allow districts to provide more intensive services for their additional educational needs.”<sup>37</sup>

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37. *State Categorical Funding Review: Alternative Learning Environments*, Project Number 14-001-28b (Little Rock: State of Arkansas Bureau of Legislative Research, 2014).

“The changes made to the state’s ALE programs had a tremendous effect on the budget. In the 2003/04 school year . . . the state spent \$3.85 million on ALE programs. After altering the financing formula, ALE funding jumped by more than 500 percent, to \$23.57 million.”



The changes made to the state's ALE programs had a tremendous effect on the budget. In the 2003/04 school year, before the implementation of the Public School Funding Act, the state spent \$3.85 million on ALE programs. After altering the financing formula, ALE funding jumped by more than 500 percent, to \$23.57 million. After briefly dipping to \$16.79 million in 2007, ALE funding has hovered in the \$22.5 million to \$23.7 million range, when accounting for inflation.

The fourth type of categorical funding that the Public School Funding Act established was professional development (PD) funding. PD is "a program of continuing education activities for teachers, administrators, and some classified staff aimed at improving teaching skills and increasing knowledge."<sup>38</sup> Before the Public School Funding Act of 2003, all certified staff members were required to complete 30 hours, or 5 days, of PD as mandated by the Arkansas State Board of Education. In the Public School Funding Act of 2003, however, the state legislature followed the suggestions of Picus and Associates and extended the standard teacher contract from 185 days to 190 days. Under the new contract, all certified staff members were required to complete at least 60 hours, or 10 days, of PD.

To pay for the extended teacher contracts, the level of funding allocated through the matrix to teacher salaries was increased by \$101 per student (\$125 in 2015 dollars). To pay for the additional 30 hours of professional development per certified staff member, the legislature allocated \$50 per student in categorical funding (\$62 in 2015 dollars). Initiating this categorical funding had an immediate effect on the budget of \$27.78 million. Acts 2318 and 2131 of 2005 created the Arkansas Online Professional Development Initiative and allowed the Arkansas Department of Education to use up to \$4 million of the money appropriated for PD to create an online training system. The online portal, known as ArkansasIDEAS, is primarily maintained by the Arkansas Educational Television Network. The use of \$4 million to operate ArkansasIDEAS decreased the \$50 per student funding for PD by more than \$8 per student.

Total funding for PD ranged from a high of \$27.78 million in FY 2005 to a low of \$21.66 million in FY 2012. In 2013, however, the PD funding rate was slashed by 40 percent, from \$54 per student to \$32.40 per student, to take effect in FY 2015. The move to cut funding was done in an effort to help keep the public school employee insurance plan afloat. The budget cut was done with "the expectation that the State Board of Education would reduce the required num-

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38. Ibid.



ber of professional development hours from 60 to 36.” In the 2015 regular session, the state legislature passed Act 44, which reduced the number of required days of professional development in the basic teacher contract from 10 to 6.

Although it was not specifically addressed by the courts, the *Lake View* ruling also led politicians to put a larger emphasis on pre-K. In the Second Extraordinary Session of 2003, the General Assembly passed Act 49, which expanded the previous pre-K program (Arkansas Better Chance) into the Better Chance for School Success program. As the Arkansas Division of Child Care and Early Childhood Education put it, the “Arkansas Legislature made a commitment to expand early childhood education funding by \$100 million to serve low-income three- and four-year-old children in areas at high risk for academic failure with high-quality pre-K services.”<sup>39</sup> In FY 2004, the year before the expansion, the state spent \$14.89 million on the Arkansas Better Chance program. In FY 2005, the year of the expansion, spending jumped by 285 percent, to \$57.34 million. Spending continued to climb until it reached a peak in FY 2009 of \$127.05 million, an increase of more than 750 percent over pre-expansion figures. As of the latest data (FY 2014), Arkansas was spending \$112.51 million on the Arkansas Better Chance program.

Perhaps the biggest structural change *Lake View* brought was when the legislature committed to making education the government’s first priority through Act 108 of the 2003 Second Extraordinary Session. Act 108 created the Educational Adequacy Fund, which provides additional, emergency funding for public education. In the event that the Public School Fund Account and the Department of Education Fund Account should fall short of funding an adequate education, the state can turn to the Educational Adequacy Fund to make up the difference. Furthermore, Act 108 provides a “doomsday clause.” Should the funds available for education fail to provide enough money to provide an adequate education, the state is authorized to pull money from other state agencies to fully fund education. Tom Courtway, interim director of the Department of Education, testified that under Act 108, “if there has to be a budget cut, [the state] will reduce other budgets of other agencies of the State of Arkansas to fully fund K through 12 public education.”<sup>40</sup> In the past, Arkansas funded education on the basis of what was available. After the passage of Act 108, public education became the state’s top

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39. *Arkansas Better Chance Program Manual* (Little Rock: Arkansas Division of Child Care and Early Childhood Education, revised August 2009).

40. Bradley D. Jesson and David Newbern, “In the Supreme Court of Arkansas, *Lake View School District no. 25 of Phillips County, Arkansas, et al., appellants v. No. 01-836, Governor Mike Huckabee, et al., appellees*” (special masters’ report to the Supreme Court of Arkansas, 2004).

obligation. In relation to the Revenue Stabilization Act, K–12 public education now receives category A1 funding status.

In May 2007, the Arkansas Supreme Court declared the Arkansas public school finance system constitutional. The transformation of the funding method from one based on money that was available to one based on what is necessary at the beginning of the 21st century had a significant effect on the education budget. In FY 2004, under the previous funding method, Arkansas spent \$4.39 billion on education. By the time the state’s public school finance system was declared constitutional in 2007, that figure had jumped by more than \$750 million to \$5.14 billion. In total, *Lake View* took Arkansas’s education expenditures from \$1,206 per capita in 1992 to \$1,807 per capita in 2007.

## Targeted Incentives

Targeted economic development incentives have grown to be a thorn in the side of Arkansas’s budget. In calendar year 2013 alone, tax incentives and subsidies cost the state of Arkansas more than \$218.56 million—or nearly \$74 per capita.<sup>41</sup> The state uses these incentives to attract and retain business in an effort to boost the state’s economy. Although targeted incentives are common in today’s economic development practices, they have their roots in the 1940s.

Leading up to World War II, Arkansas saw a steady decline in population because economic opportunity was sparse. The outflow of residents only worsened as the war industries enticed more agricultural labor to leave rural Arkansas in favor of urban areas. As the end of the war drew near, Hamilton Moses, chairman of Arkansas Power and Light, became concerned with the negative economic impact that the closing of the war industries would have on Arkansas. To combat this, Moses led a group of business leaders in forming the Arkansas Economic Council in 1943. To replace the war industries, the council developed a recruitment model that encouraged existing firms to create production facilities in Arkansas. The council promoted the “benefits of a surplus labor force and compliant local governments.”<sup>42</sup> In 1945, the state legislature followed suit and created the Arkansas Resources and Development Commission.<sup>43</sup>

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41. This amount includes costs of the Governor’s Quick Action Closing Fund, Amendment 82 bonds, and tax expenditures related to economic development.

42. Ben F. Johnson III, *Arkansas in Modern America, 1930–1999* (Fayetteville: University of Arkansas Press, 2014).

43. C. Calvin Smith, *War & Wartime Changes: The Transformation of Arkansas, 1940–1945* (Fayetteville: University of Arkansas Press, 1986).

Despite the recruitment efforts of the Arkansas Economic Council and the Arkansas Resources and Development Commission, the exodus of Arkansas's population continued to increase in the years following the war. After experiencing the benefits of working in the war industries, few Arkansans were interested in returning to agricultural life. Arkansas lost more than 542,000 residents between 1945 and the end of 1955.<sup>44</sup> In an effort to create more economic opportunity in Arkansas, the state legislature passed Act 404 in 1955. Act 404 established the Arkansas Industrial Development Commission, which was to be chaired by Winthrop Rockefeller. This commission was tasked with recruiting industry to Arkansas and, to the pleasure of Governor Orval Faubus and the state legislature, was credited with creating 10,431 jobs in its first year of operation.<sup>45</sup>

Arkansas's recruitment efforts continued to expand, particularly through the use of tax incentives. Tax incentives, or tax expenditures, provide subsidies to select firms through special tax benefits such as credits and refunds. Although traditional subsidies affect the state's budget through expenditures, tax expenditures affect the state's budget by decreasing the state's revenue. Arkansas's use of tax expenditures saw rampant growth throughout the 1980s and 1990s. In 1985, tax expenditures cost the state of Arkansas just \$1.37 million, or less than \$1 per capita. But by 1998, the cost of tax incentives had grown by more than 7,600 percent to \$105.55 million, or \$40 per capita, adjusted for inflation.<sup>46</sup> Since then, the cost of tax expenditures has fluctuated between a low of \$59.88 million (\$22 per capita) in 2000 and a high of \$95.68 million (\$34 per capita) in 2007.

The early years of the 21st century again saw Arkansas expand economic development incentives, this time through traditional subsidies. In the 2003 regular session, the legislature proposed Amendment 82 to the state constitution. That move opened the door for targeted incentives to dramatically affect state expenditures. Amendment 82, which was adopted at the November 2004 general election, allows the Arkansas General Assembly to "authorize the Arkansas Development Finance Authority to issue general obligation bonds to finance infrastructure or other needs to attract large economic development projects." The infrastructure needs may include land acquisition, site preparation, road and highway improvements, employee training, and environmental mitigation,

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44. Donald Holley, "Leaving the Land of Opportunity: Arkansas and the Great Migration," *Arkansas Historical Quarterly* 64, no. 23 (2005): 245–61.

45. John Kirk, "Rockefeller the Reformer," *Arkansas Times*, May 7, 2015.

46. Office of Excise Tax Administration, "Business Incentives and Tax Credits Program Costs through December 31, 2014," Arkansas Department of Finance and Administration, September 2015.

among other needs. The bonds “may be issued for an amount up to five percent of state general revenues collected during the most recent fiscal year.”

Originally, firms had to commit to an investment of more than \$500 million in capital expenditures and the hiring of more than 500 employees to qualify for Amendment 82 bonds. However, the restrictions put on Amendment 82 were deemed too strict to attract a major project. An amendment to soften the qualification requirements was proposed in 2009 and was adopted by voters in the 2010 general election to become effective January 1, 2011. The qualification statement now reads, “the General Assembly may authorize the issuance of bonds bearing the full faith and credit of the State of Arkansas if the prospective employer planning an economic development project is eligible under criteria established by law.” Randy Zook, president and CEO of the Arkansas State Chamber of Commerce/Associated Industries of Arkansas, stated that the change to Amendment 82 meant that the bonds “can actually be used in just about any size project” but that the presumption “is [Amendment 82] will be only used in major deals.”<sup>47</sup>

Amendment 82 was exercised for the first time in 2013, when the state legislature approved \$125 million worth of Amendment 82 bonds for Big River Steel in Osceola.<sup>48</sup> Of the \$125 million issue, \$75 million was treated as a grant; the other \$50 million was issued as a low-interest loan that was expected to be repaid by Big River Steel, although it was still a general obligation of the state.<sup>49</sup> In return, the state was promised 525 full-time, permanent jobs. In 2015, the General Assembly approved an \$87.1 million bond issue for Lockheed Martin in Camden, Arkansas, in return for 600 full-time jobs. However, Lockheed Martin lost the bid for the government contract the bonds were intended to finance, so the bonds were never issued. To date, Amendment 82 bonds have only been issued for Big River Steel. Nevertheless, the ability to issue 5 percent of the state’s general revenues in bonds to entice firms creates a dangerous window for expanding the state’s budget.

In 2007, the state created a smaller, more nimble fund to provide subsidies to firms. Act 510 of the 2007 regular session created the Governor’s Quick Action Closing Fund (QACF). Arkansas code annotated § 19-5-1231 states that the QACF is used to provide “investment incentives to compete with other states to attract new business and economic development to the state or to retain existing

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47. Rob Moritz, “Amendment 82 Gives State Flexibility to Seal Super Deal,” *Arkansas News*, January 21, 2013.

48. Mark Carter, “Arkansas Legislature Puts Big Issues to Rest,” *Arkansas Business*, April 19, 2013.

49. IHS, “Review of the Big River Steel Incentive Proposal: A Market Viability and Cost-Benefit Analysis” (Report, IHS, Washington, DC).

business in the state.” Use of the QACF must first be approved by the governor and then, upon the governor’s approval, reviewed by the Arkansas Legislative Council.

The QACF is funded by transferring money from the General Revenue Allotment Reserve Fund and, through FY 2015, has been allocated \$156.252 million.<sup>50</sup> The QACF received \$50 million during the 86th General Session, \$50 million during the 87th General Session, \$15.727 million during the 88th General Session, \$20.525 million during the 89th General Session, and \$20 million during the 90th General Session.<sup>51</sup>

According to Act 510 accounting, \$108,480,431 from the QACF was spent between FY 2008 and FY 2015.<sup>52</sup> As of June 30, 2015, the fund consisted of \$12,673,330 in unpaid commitments, \$22,460,000 that had been offered to projects but not yet accepted, and \$18,568,950 that remained uncommitted.<sup>53</sup>

Despite Arkansas’s widespread use of financial incentives, empirical evidence reveals that targeted incentives are largely ineffective at stimulating the economy. In fact, 25 of 26 peer-reviewed academic studies performed since 1980 found that tax incentives had no clear positive impact on the local economy.<sup>54</sup> Although firms that receive handouts may see benefits, they often cannibalize firms that do not receive incentives, washing out any net positive economic effect.

Targeted incentives often require tax hikes on those who do not receive financial incentives. Although this effect happens at all levels of government, it is very clearly seen at the county level, where sales taxes are increased to fund incentives. For example, Arkansas’s Clark and Mississippi counties have both increased sales taxes to finance economic development projects.

Targeted incentives also create fiscal costs when they are given to non-marginal firms, or businesses that are already expanding or locating in Arkansas. A 2016 report from the Arkansas Center for Research in Economics states that “Issuing tax breaks and subsidies to firms that are going to expand or locate in Arkansas regardless of aid means that the state forgoes tax revenue that it

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50. Michael Preston, executive director of the Arkansas Economic Development Commission, to Senator Sample and Representative Branscum, July 15, 2015.

51. Ibid.

52. Ibid.

53. Ibid.

54. For example, see T. W. Lester, “Does Chicago’s Tax Increment Financing (TIF) Programme Pass the ‘But-For’ Test? Job Creation and Economic Development Impacts Using Time-Series Data,” *Urban Studies* 51, no. 4 (2014); D. Neumark and J. Kolko, “Do Enterprise Zones Create Jobs? Evidence from California’s Enterprise Zone Program,” *Journal of Urban Economics* 68, no. 1 (2010).

“Arkansas officials have gambled and lost taxpayer money before.”

would have otherwise received or sacrifices other, potentially more productive uses of its tax dollars. Incentives are merely a giveaway to politically favored firms when they are not the deciding factor in where a firm chooses to locate or expand.”<sup>55</sup>

Arkansas is not immune to the fiscal costs of corporate welfare. For example, Scott Lancaster, general counsel for Bad Boy Mowers of Batesville, Arkansas, said that the company would have expanded in Arkansas even without the nearly \$4 million it received from the state from 2012 through 2014.<sup>56</sup> Peco Foods in Independence County is another example. The state gave Peco Foods \$485,000 worth of incentives, but chief operating officer Benny Bishop said, “We would have chosen Arkansas for expansion even without state incentives.”<sup>57</sup> Arkansas clearly lost revenue by issuing this unnecessary aid.

In addition to these fiscal costs, financial incentives create moral hazard. Politicians are willing to provide incentives to riskier “economic development projects” because they are using taxpayer money rather than their own. When these projects fail, taxpayers bear the financial loss.<sup>58</sup>

Arkansas officials have gambled and lost taxpayer money before. German manufacturer Beckmann Volmer in Osceola is a prime example. After receiving a \$1.5 million subsidy from the QACF, the company entered bankruptcy and has been unable to return any grant money to the state.<sup>59</sup> In other words, government bureaucrats lost taxpayer money gambling for private gain.

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55. Jacob Bundrick, *Tax Breaks and Subsidies: Challenging the Arkansas Status Quo* (Conway: Arkansas Center for Research in Economics, University of Central Arkansas, August 2016).

56. Brian Fannery, “State’s Incentive Program Built on Promise,” *Arkansas Democrat-Gazette*, January 17, 2016.

57. Ibid.

58. Jacob Bundrick, “Taking a Gamble: Firms’ Tax Breaks Too Big a Risk,” *Arkansas Democrat-Gazette*, September 3, 2016.

59. Jacob Bundrick, “Taking a Gamble: Use of Public Funds Risky Business,” *Arkansas Democrat-Gazette*, March 7, 2016.

There are many more negatives to targeted incentives, including rent-seeking, regional unrealism, and opportunity costs. The evidence condemning the use of financial incentives is quite damning. Yet, in spite of the mounting evidence, Arkansas continues to look for more ways to spend taxpayer dollars on ineffective corporate handouts.

## REFORM IDEAS

Government spending in Arkansas is high and increasing, especially when compared with other relevant states and with Arkansas’s own history. If spending is to be reduced—or, at the very least, if increases are to be slowed down—two important questions must be addressed. First, what programs should be affected? And second, how should the process take place?

We’ll start with the second question first. One major reform we suggest is for Arkansas to reexamine its use of the Revenue Stabilization Act. If the act or something like it is to be continually used, our first suggestion is to formalize its use through a constitutional amendment. But during the process of debating the constitutional amendment, we suggest that Arkansas consider a different version of the act.

The beneficial parts of the act should be maintained, such as protecting against budget deficits and providing a clear prioritization of government spending. But in its current form, the act also guarantees that Arkansas will spend all of the tax revenue earned, and it encourages lawmakers to always be looking for ways to increase taxes. In some senses, it is the opposite of laws such as Colorado’s Taxpayer Bill of Rights, which refunds surplus tax revenue to taxpayers. A new version of the Revenue Stabilization Act that included provisions for limiting tax increases and for refunding surplus tax revenue, while still providing a strong defense against budget deficits, would put Arkansas on a much more stable and prosperous path into the future.

### Public Education Spending

Given that education is the largest spending category in Arkansas and is one of the fastest growing, it must be scrutinized carefully when considering spending reforms. To start, one should consider the efficiency of Arkansas’s education spending or whether it has improved outcomes.

In a 2015 report, researchers from the Office for Education Policy at the University of Arkansas determined that “after accounting for cost-of-living,



Arkansas spends more per pupil than its neighbors.”<sup>60</sup> Yet Arkansas’s test scores in large part lag the scores of its six neighboring states. In 2015, the percentage of Arkansas’s fourth graders scoring proficient or higher on National Assessment of Educational Progress (NAEP) math and reading exams was higher than the percentages only in Louisiana and Mississippi, two states with a higher poverty rate than Arkansas. Arkansas’s eighth-grade statistics were similar, except that Arkansas students’ math scores exceeded those of Oklahoma as well.<sup>61</sup>

Oklahoma is a natural comparison for Arkansas’s education efficiency because both states have similar poverty levels (60.5 percent of students eligible for free or reduced-cost lunch) and score reasonably similarly on NAEP exams. Arkansas, however, spends roughly \$2,000 more per pupil than Oklahoma to get the same educational results. In other words, Arkansas is less efficient in education spending than Oklahoma. Experts at the Office for Education Policy state that “although Arkansas has drastically improved the amount of resources available to districts in the state, students are still not doing as well as would be hoped on standardized measures of academic achievement.”<sup>62</sup>

Given the relatively poor level of education efficiency in Arkansas, it is interesting to note that the reforms adopted under *Lake View* created a funding matrix rather than a spending matrix. Despite the specific line item funding based on Picus and Associates’ “evidence-based” model (which is to “identify research-based educational strategies, cost them out, and then aggregate them to adequate site, district, and state expenditure levels”), school districts are not required to spend foundation money in the same way that the matrix allocates the funding.<sup>63</sup> The absence of such a requirement creates discrepancies between the amounts funded for each specific purpose and the amounts actually spent on those activities. For instance, the state may allocate \$190 per student for principal pay, but districts may pay principals more or less than \$190 per student. Implementing reforms to ensure that money is being spent for the purpose for which it is allocated would minimize discrepancies, increase accountability to the public, and ensure that districts are aligning with research-based educational strategies.

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60. Elise Swanson, Gary W. Ritter, and Sarah C. McKenzie, “The State of Education in Arkansas 2015: How Much Are Arkansas Schools Spending?,” *Arkansas Education Report* 12, no. 3 (2015).

61. *Ibid.*

62. *Ibid.*

63. Allan Odden, Lawrence O. Picus, and Mark Fermanich, *An Evidence-Based Approach to School Finance Adequacy in Arkansas* (Final report submitted to the Joint Committee on Educational Adequacy of the Arkansas Legislature, September 1, 2003, Lawrence O. Picus and Associates, Los Angeles).



However, such reforms are not perfect. Tying district spending to the broad funding formula reduces the freedom of individual districts to cater to their specific needs. It is not unreasonable to assume that an urban district of 23,000 students (Little Rock) has different spending needs than a rural district with an enrollment of fewer than 400 (Dermott). In other words, curbing wasteful spending by implementing a spending matrix may also inadvertently handcuff innovation that leads to better student outcomes.

Rather than instituting spending restrictions, Arkansas could improve education efficiency by increasing school choice within the state. Increasing choice in education through open-enrollment charter schools means that competition between schools is permitted. In the education marketplace, schools compete on quality. This means that increasing competition would increase the quality of the education supplied and, as a result, improve educational outcomes.

The Arkansas Department of Education's 2015 Charter School Evaluation Report found that Arkansas's open enrollment charter schools performed better in literacy and no worse in math than traditional public schools.<sup>64</sup> And, in the 2014/15 school year, Arkansas's open enrollment charter schools received roughly \$1,000 less per pupil than traditional public schools did.<sup>65</sup> Better outcomes with fewer dollars means improved education efficiency. The improved efficiency in education is not limited to charter schools, though. In Texas, increased competition from charter schools has led to improved educational outcomes in traditional public schools as well.<sup>66</sup> This, again, means a higher level of education efficiency.

Arkansas should remove its arbitrary cap on the number of open-enrollment charter schools. As of 2017, the cap was set at 29 charter schools, but it is designed to grow over time.<sup>67</sup> Although the cap is not permanent, it still slows the growth in education competition. Consider the process for obtaining an open-

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64. Gary W. Ritter, Patrick J. Wolf, and Leesa Foreman, *2011–2012 Arkansas Charter School Academic Evaluation* (Fayetteville: University of Arkansas, rev. June 1, 2015).

65. Arkansas Department of Education Data Center, *Statewide Information System Report, 2015–2016*.

66. Kevin Booker et al., "The Effect of Charter Schools on Traditional Public School Students in Texas: Are Children Who Stay Behind Left Behind?" *Journal of Urban Economics* 64, no. 1 (2008): 123–45.

67. Arkansas Code Annotated § 6-23-304(c)(1)(B) provides that "if the cap on the number of charters available for an open-enrollment public charter school is within two (2) charters of meeting any existing limitation or cap on available open-enrollment charters, the number of available charters shall automatically increase by five (5) slots more than the most recent existing limitation or cap on open-enrollment charters."

enrollment charter.<sup>68</sup> Arkansas has a cap of 29 open-enrollment charter schools but has slots to authorize 5 more. Those wishing to open a charter school must submit a letter of intent to apply for an open enrollment charter by early March and submit the application by late April. Applications are considered over the summer, and the Charter Authorization Panel issues its authorization decision in August. In early September, the Arkansas State Board of Education decides whether to review the panel's decision. If a school receives an open-enrollment charter, it will generally open the next school year.

If 15 schools apply for a charter in the current application cycle, a maximum of 5 may be approved, even if the Charter Authorizing Panel would like to approve all 15. Those not given one of the five slots must wait until the next application cycle, when the cap will automatically increase by 5, pursuant to Arkansas law. But even then, just 5 more schools can be approved. This cap creates an artificial barrier to entry and inhibits Arkansas's ability to increase educational choice.

Arkansas could also look to universal education vouchers to increase school choice. Currently, Arkansas has a very limited voucher program called the Succeed Scholarship Program. The Succeed Scholarship Program allows parents to enroll their child in a private school if their child is disabled, currently enrolled in a public school, and attended a public school for the entire year before enrolling in the private school.<sup>69</sup> If the child is the son or daughter of an active-duty military member, the public school requirement is waived. The amount of the voucher received by the student is the lesser of the state's foundation funding amount for public schools or the amount of tuition and fees for the private school. The program is currently limited to 100 students, with an appropriation of up to \$800,000 for the 2016/17 school year.

In its current form, the Succeed Scholarship Program increases Arkansas's budget. It is an add-on to the present public education funding model. However, expanding vouchers or establishing an education savings account system to replace the current K-12 funding model could actually reduce the state's budget. For example, the Milwaukee Parental Choice Program was found to have a net fiscal benefit of approximately \$46.7 million in FY 2010 alone.<sup>70</sup>

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68. Arkansas Department of Education, "Instructions for Completing the 2016 Open-Enrollment Public Charter School Application" (Arkansas Department of Education, Little Rock).

69. "Rules Governing the Succeed Scholarship Program," Arkansas Department of Education, January 2016.

70. Robert Costrell, *The Fiscal Impact of the Milwaukee Parental Choice Program: 2010-2011 Update and Policy Options* (Fayetteville: University of Arkansas, Department of Education Reform, 2011).

Arkansas is spending a large portion of its budget on education, but outcomes continue to underwhelm. Arkansas could improve education efficiency by allowing more competition in the education marketplace.

## Targeted Incentives

Arkansas's economic development incentive programs should be eliminated. The literature demonstrating the ineffectiveness of these programs is extensive. Rather than wasting tax dollars by providing financial incentives for a select few companies, Arkansas should create a more regionally competitive tax environment. By eliminating special interest carve-outs, Arkansas would be able to begin reducing its regionally worst state-local tax burden.<sup>71</sup>

Arkansas would be better suited if it simplified its complex and opaque tax code instead of creating new targeted incentives. The state can begin by taking several simple steps. Arkansas should (a) reduce its number of corporate tax brackets (six), (b) index corporate tax brackets for inflation, (c) use the same corporate tax base as the federal income tax code, and (d) remove antiquated manufacturing taxes. These steps are by no means the only measures Arkansas should take, but they are small, achievable changes that will help improve the state's tax climate.

## CONCLUSION

Although Arkansas's nickname is "the Natural State," there is nothing natural about the current level of state spending. When compared to Arkansas's own past spending and the spending levels in similar states, government spending could be much lower at the state level. Some of this reduction could involve simply decentralizing certain spending and tax functions, such as roads and education, to local governments more than they already are. In other words, part of the issue we have highlighted in this paper is that government spending in Arkansas is more centralized than in similar states, because we focused mostly on state-level spending. But even considering overall spending (state and local), Arkansas still has some of the highest spending levels among similar states. Thus, a more fundamental rethinking of the role of government in Arkansas is necessary.

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71. Nicole Kaeding, "Map: State-Local Tax Burden Rankings for FY 2012," Tax Foundation, January 20, 2016.

Our analysis in this paper is limited to the period up to FY 2013, for the most part. We used this ending year because it was the most recent year for which comparable data was available across states for the categories we examined. Since 2013, important changes have taken place that could further increase state spending in Arkansas. The primary change is the establishment of Arkansas's Medicaid expansion, now called Arkansas Works. In this paper, we focused on the historical details of how Arkansas became a high-spending state. The state's Medicaid expansion means that Medicaid spending will continue to be the largest and one of the fastest-growing components of state spending in Arkansas.

A major change that could be made to cap spending in Arkansas is actually a function of the tax code. Because of Arkansas's unique budgeting procedure in the Revenue Stabilization Law, total spending is automatically capped by the total amount of tax revenue taken in. This law has served Arkansas well in preventing budget deficits and forgoing the need for a large rainy day fund. But the law has also meant that state spending has grown as a function of changes in the tax code. A modified version of the traditional Revenue Stabilization Law may serve Arkansas even better in the future. One improvement could be to include a feature similar to Colorado's Taxpayer Bill of Rights, in which tax revenue growth beyond inflation and population growth is refunded to taxpayers (unless explicitly approved by referendum). A less radical change would be to make the Revenue Stabilization Law a permanent feature of the budget process by amending the Arkansas Constitution. As discussed previously, the law currently persists mostly by tradition.

How big of a state government Arkansans want is, ultimately, up to Arkansans. But history has shown the wisdom of constitutional restrictions on various government activities, to limit both the momentary whims of elected legislatures and the pervasive influence of special interests. Given Arkansas's history of state spending growth, it would be wise to consider some limitations on future increases in spending.

## ABOUT THE AUTHORS

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