MERCATUS CENTER
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RESEARCH SUMMARY

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

Despite being one of the poorest states in the nation, Arkansas has a high state government spending level, even in comparison to similar states. Arkansas has higher state spending per capita than its bordering states and other regional "competitor states," specifically Alabama, Florida, Georgia, North Carolina, South Carolina, and Virginia. When federal transfers are subtracted from state government spending, Arkansas still has far higher spending than its competitor states.

In "There's Nothing Natural about the State of Government Spending in Arkansas," Jeremy Horpedahl and Jacob Bundrick undertake a comprehensive analysis of how Arkansas got to where it is today as well as the reforms necessary to put Arkansas on a more sustainable path. Arkansas's spending trends are very similar to those of other states, but the magnitude of Arkansas's spending and the institutional environment that has shaped it are unique. Given Arkansas's history of state spending growth, it would be wise to consider some limits to future increases in spending.

DRIVERS OF SPENDING GROWTH

Arkansas's spending increased by 97 percent from 1991 to 2013, even after adjusting for inflation and population growth. The state spends $7,674 per capita, 59 percent more than its competitor states, which spend an average of $4,815 per capita. Considering just own-source revenue, Arkansas is spending almost double what its competitor states are spending on average. The state government has not taken on many new roles since 1991, other than an expanded role in healthcare, so for most categories the increase is just more spending needed to fund the same services as in the past. The primary drivers of Arkansas state spending growth have all experienced cost-per-capita increases of around 100 percent or more in just the past two decades.

- *Education transfers to local governments*. Education transfers have increased dramatically and constitute a relatively large portion of the budget. A series of changes that resulted from the *Lake View* court case took Arkansas's education expenditures from $1,206 per capita in 1992 to $1,807 per capita in 2007.
- *Insurance trust benefits*. Public pensions, the most significant item in this category, have not only grown more expensive over the years—they have also developed a significant funding problem. Arkansas's pension system has been assessed as 72 percent funded using state discount rates and as only 51 percent funded using fair-value discount rates.
- *Public safety*. Public safety spending, most of which relates to corrections, has grown by more than 100 percent since 1991, much greater than the average of 31.5 percent across all 50 states.
- *Welfare spending*. Owing to the state's Medicaid expansion, welfare will continue to be the largest and one of the fastest-growing components of state spending in Arkansas.

INSTITUTIONAL ENVIRONMENT

Several of the current budgetary processes and informal institutions in Arkansas can be traced to Great Depression–era budget issues. In 1933, Arkansas became the first and only US state in the 20th century to default on its debt. As Arkansas suffered financially, the state issued a series of laws and amendments to its constitution. In addition to the Futrell Amendments of the 1930s and the *Lake View* court case and related cases since the 1990s, the following legislative acts stand out as institutional factors that have shaped Arkansas's spending.

The Revenue Stabilization Act of 1945

The Revenue Stabilization Act of 1945 established a process whereby all spending bills passed in a legislative session are prioritized by the legislature. 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 not funded at all. Although the act has successfully prevented budget deficits, it has made state spending very sensitive to changes in the tax system.

Removal of the Cap on Targeted Economic Development Incentives

Targeted economic development incentives have become a thorn in the side of Arkansas's budget. The state uses these incentives to attract and retain business in an effort to boost the state's economy, but empirical evidence reveals that targeted incentives are largely ineffective at stimulating the economy. In 2013 alone, tax incentives and subsidies cost the state of Arkansas more than $218.56 million—nearly $74 per capita. In 2016, voters approved a measure that removed the cap on issuing new state debt for large development projects.

REFORM OPTIONS

- *Instituting a new and improved Revenue Stabilization Law*. Arkansas's Revenue Stabilization Law has served the state well by preventing budget deficits and allowing the state to forgo a large "rainy day fund," but it could be improved. A modified version of the law would include a feature refunding taxpayers when tax growth outpaces inflation and population growth. Additionally, Arkansans could make the law a permanent feature of the budget process by amending the state constitution.
- *Improving the efficiency of education spending*. Education is the largest and one of the fastest-growing spending categories in Arkansas. The state spends more per pupil on education than neighboring states, yet its test scores generally lag behind those of these same neighbors. Rather than instituting spending restrictions, Arkansas could improve the efficiency of education spending by increasing school choice. Increasing the number of open-enrollment charter schools would increase competition with traditional public schools on the basis of quality, and this competition would improve educational outcomes.
- *Ending corporate welfare*. Rather than funneling tax dollars toward a select few companies, Arkansas should create a more competitive tax environment. Reducing the number of corporate tax brackets, indexing corporate tax brackets for inflation, using the same corporate tax base as the federal income tax code, and removing antiquated manufacturing taxes are all steps that the state can take to simplify its tax code.