ARKANSAS
THE ROAD MAP FOR TAX REFORM
# TABLE OF CONTENTS

## Executive Summary
A Menu of Tax Reform Solutions 1

## Chapter 1: Arkansas's Economy
Introduction 8
Arkansas's Economy 9
Personal Income 12

## Chapter 2: An Overview of Arkansas's Tax and Budget System
Introduction 22
Arkansas's Tax and Budget Structure 23
Arkansas's Budget Makeup Today 25
Measures of State Tax Competitiveness 29

## Chapter 3: Individual Income Tax
Introduction 34
A Brief History of Arkansas's Individual Income Tax 35
Structural Elements 39
Tax Expenditures: Deductions, Exemptions, and Credits 41
Individual Income Tax Reform Solutions 43

## Chapter 4: Corporate Income Tax
Introduction 48
Overview of Arkansas Corporate Income Taxation 49
Corporate Income Tax Expenditures 53
Structural Elements 55
Corporate Income Tax Reform Solutions 57

## Chapter 5: State and Local Sales Taxes
Introduction 62
Sales Tax Collections and History: General Sales Tax 63
Sales Tax Base 67
Sales Tax Exemptions 72
Taxation of E-Commerce 74
Selective Sales Taxes 77
Sales Tax Reform Solutions 79
Chapter 6: Property Taxes

Introduction .................................................................................................................. 83
General Overview of Property Taxes in Arkansas ......................................................... 84
Property Tax Structure .................................................................................................. 87
Property Tax Solutions .................................................................................................... 90

Chapter 7: Additional Important Considerations ......................................................... 91

Introduction .................................................................................................................. 92
Transportation ................................................................................................................. 93
Soft Drink Tax .................................................................................................................. 95
Tax Triggers ...................................................................................................................... 97
Executive Summary

Arkansas’s tax system is at a crossroads. After years without meaningful reform, the state seems poised to finally tackle the long-running issues within its tax code. The last several years have seen several ad hoc reforms, but the last comprehensive tax reform was in 1971; the one before that was in 1929.

Over the course of six months, our team of economists met with stakeholders from all walks of Arkansas life, including small business owners, local government officials, tax practitioners, in-state academics, trade associations, industry representatives, state officials across the political spectrum, and ordinary taxpayers. We reviewed the history of the state’s fiscal system, previous tax reform studies, and historical revenue and economic trends.

The result is this book, which is meant to help Arkansas achieve the goal of true tax reform—reform that benefits all taxpayers by addressing the many long-term hurdles the state faces. It’s meant to start the conversation about what Arkansas does well, but also what it could do better—by recognizing strengths, diagnosing challenges, and prescribing real, workable solutions. Our book seeks to be *The Road Map to Tax Reform*.

We undertook this project as an independent national organization familiar with tax developments in many states, with the view that tax systems should adhere to sound economic principles. To the greatest extent possible, taxes should be simple, transparent, neutral, and stable, and the best tax structures are those with low rates and broad bases. We formulated these recommendations in the spirit of providing useful information and observations for Arkansas policymakers, journalists, and citizens as they evaluate and reform Arkansas’s tax structure. We also had the assistance of local tax experts at the Arkansas Center for Research in Economics at the University of Central Arkansas in both the research and writing of this book.

During our travels across Arkansas, several key themes emerged:

- Arkansans take pride in their state’s relative conservative budgeting approach. Many individuals discussed Arkansas’s unique approach to budgeting through the Revenue Stabilization Act (RSA), and how the RSA ensures that adequate services are provided by the state by prioritizing where state funds are spent.

- At the same time, Arkansans were quick to point out the challenges to tax reform, largely due to Amendment 19 to the Arkansas Constitution, which requires that a tax rate increase for most taxes requires a three-fourths vote in both legislative chambers. Amendment 19 is an important check on tax increases, but does stymie efforts to embark on comprehensive tax reform.
Equity is a concern present among all interested parties in tax reform. Individuals expressed concerns regarding the prevalence of tax credits that benefit large, established businesses or firms relocating to Arkansas. They commented frequently on the special tax exemption given to residents of Texarkana. Others were concerned about the tax penalties assessed on high-income individuals and corporations through the state’s benefit recapture provisions for both individual income and corporate income.

Residents are concerned about competition. Arkansas trails many of its neighbors on tax competitiveness. Tax rates are higher in Arkansas for both individuals and corporations than in most neighboring states. Two neighboring states, Texas and Tennessee, have no income tax, which presents a direct challenge to Arkansas’s tax competitiveness. Above all else, Arkansas’s tax system should retain, and enhance, elements that allow Arkansas to improve its regional, national, and global advantages.

In the following pages, we provide background on Arkansas’s economy and Arkansas’s budget (Chapters 1 and 2). We then review each major tax—individual income, corporate income, sales, and property taxes—outlining concerns and proposing options for reform (Chapters 3, 4, 5, and 6). Chapter 7 examines additional tax considerations that fall outside of the four major tax types but still deserve attention.

A Menu of Tax Reform Solutions

Individual Income Tax

The individual income tax in Arkansas needs reform, as tax rates are high, the highest in its region. A complicated, “middle-class” tax cut was passed in 2015, but instead of making the system easier to understand, it moved the state in the wrong direction. The state now uses three different rate structures, plus one for low-income individuals—an uncommon approach. In meeting after meeting, Arkansans expressed confusion about recent tax changes, and noted the headaches associated with the state’s code.

Our individual income tax solutions improve the tax code by broadening the tax base and reducing tax rates, making the state more competitive with its neighbors and rendering the system more neutral and fair, and eliminating the complicated three rate structures created in 2015. Arkansas’s present system is inefficient and complex, making tax compliance difficult for Arkansas residents and families. Our proposals address these concerns.

Lowering tax rates and consolidating rate schedules. We offer a menu of options for broad-based reform, all of which include, at a minimum, lowering tax rates and consolidating the three rate schedules into one straightforward rate schedule:

- Repeal the current three rate schedules and transition to a flat tax of 4.95 percent, a revenue-neutral change (Option A).
· Repeal the current three rate schedules and transition to one rate schedule with rates of 0, 2, 4, and 5 percent. This option would reduce taxes for every Arkansan (Option B).

· Repeal the current three rate schedules and transition into one rate schedule with rates of 0, 2, 3, 4, 5, and 6 percent (Option C).

**Enhancing tax neutrality.** Arkansas’s individual income tax consistently fails to treat taxpayers evenhandedly. Our solutions for improving neutrality would:

· Eliminate the Texarkana border city exemption.

· Inflation-adjust Arkansas’s standard deduction to match the adjustments on its individual income tax brackets and its personal exemption credit.

**Corporate Income Tax**

**Lowering tax rates and consolidating brackets.** Arkansas’s top marginal income tax rate of 6.5 percent is the highest in the region, save for Louisiana, limiting Arkansas’s competitiveness for attracting and retaining firms into the Natural State. Our solutions would:

· Repeal the current rate schedule and transition to a flat tax of 4.95 percent (Option A).

· Repeal the current rate schedule and transition to a two-bracket system with a top rate of 5 percent (Option B).

· Repeal the current rate schedule and transition to a three-bracket system with a top rate of 6 percent (Option C).

**Rolling back credits.** Arkansas provides a number of tax credits for corporations, both through the corporate income tax and the sales tax. Evidence suggests that these tax credits provide minimal return to the state, and that a policy of picking winners and losers is ultimately counterproductive as well as inequitable. We propose that Arkansas:

· Repeal all corporate credits and use the new revenue to reduce corporate income tax rates.

**Improving tax structure.** Other provisions within Arkansas’s corporate income tax structure diverge from best practices in a number of ways which yield relatively little revenue while substantially increasing compliance costs and taxpayer uncertainty. We recommend that Arkansas:

· Eliminate the state’s throwback rule.

· Extend the state’s net operating loss carryforwards from five to ten years.
**Sales Tax**

Arkansas's sales tax is a critical source of both state and local revenue. Currently, many goods and services are unnecessarily exempted, while some business inputs are subject to tax, which can lead to multiple layers of taxation being imposed on the same final product at different points along the production process. Similarly, tax structure and administration is complex and introduces needless compliance costs. Our solutions strive to simplify the sales tax and include a range of base-broadening options.

**Right-sizing the sales tax base.** A well-structured sales tax applies to all final consumer transactions, both goods and services, while exempting business-to-business transactions. Arkansas's sales tax exempts many services, making the base overly narrow. In other ways, the base is too broad, by taxing business-to-business transactions. Accordingly, we offer a range of options for both service expansion and the exemption of business inputs. Our options include:

- Exempt business inputs, such as the sales tax on machinery and repair parts.
- Repeal sales and use credits, such as InvestArk and TaxBack.
- Modest base expansion to exempted goods such as newspapers, coin-operated car washes, and the sale of durable medical equipment.
- Intermediate base expansion to also include personal transportation services, gasoline, self-storage, among other items.
- Broad-base expansion to also include prescription drugs, membership fees for private clubs, and the trade-in deduction for motor vehicles, along with a number of personal services.

**Options to address local sales tax base expansion.** Because Arkansas’s state and local sales tax bases are the same (which is the proper tax structure), any expansion of the sales tax base at the state level would result in increased revenue for localities. We provide a number of recommendations for policymakers to address this additional revenue windfall. Our options include:

- Eliminate the state’s inventory tax.
- Reduce the sales tax rates charged by cities and counties through some sort of temporary moratorium on local option sales tax elections.
- Dedicate new funding to functions currently subsidized by the state.

**Property Tax**

Property taxes account for a large portion of local revenue in Arkansas. Property taxes are among the least economically harmful taxes, and Arkansas has relatively low effective property tax rates. For this reason, we do not suggest any major reform to residential or commercial property tax systems. However, Arkansas does use both a capital stock tax (franchise tax), and an inventory tax, both of which are destructive to economic growth.
Our recommendations would eliminate these duplicative, economically harmful taxes:

- Repeal the state’s franchise tax.
- Consider repealing the inventory tax.

**Additional Important Considerations**

Below, we provide recommendations that do not fit into the four major tax categories above, but warrant their own separate discussion. We provide solutions that would address lackluster transportation infrastructure and address Arkansas’s soda tax. Our recommendations include:

- Consider repealing the state’s soft drink tax.
- Consider changes to the state’s gasoline tax and transportation funding structure.
- Consider the use of properly-constructed tax triggers.

**Our Objective**

We hope these solutions continue the tax conversation in Arkansas by providing a framework upon which legislators and citizens can make important decisions. The menu of choices we present all ensure that the state builds a tax system for a diversified economy and positions itself as a destination for investment, entrepreneurs, and talented individuals in the years ahead. If the most robust of these reform recommendations were implemented, Arkansas’s ranking on the Tax Foundation’s *State Business Tax Climate Index* would move from 38th to 15th best in the nation.
CHAPTER 1:
ARKANSAS’S ECONOMY
Introduction

Arkansas's economy has grown consistently in recent years, but remains poorer than most neighboring states, and is among the poorest states in the nation. Statewide levels of gross domestic product and personal income trail national averages, but the state's results are not monolithic. The metropolitan areas of Little Rock and Fayetteville-Springfield-Rogers, for example, outperform the national economy in these measures, while areas like Pine Bluff have experienced economic decline.

Manufacturing, real estate, and health care comprise the largest share of Arkansas's economy. Though manufacturing has historically contributed large shares to both state gross domestic product (GDP) and employment, its share of the economy has declined over the past two decades. Today, employment in professional and business services, education and health services, and leisure and hospitality industries are growing at the fastest rate.

While Arkansas has changed in many positive ways to address the evolving 21st century economy, some disconcerting trends persist. For example, Arkansas only recently recovered to its prerecession employment level in late 2015. Additionally, for at least some Arkansans, other states have offered better opportunities worth moving for. Net inbound migration that occurred in the state from 2001-2011 has recently reversed, and more people are now leaving the state than moving in.

The illustrations in the following pages are meant to provide an overview of the Arkansas economy and context for future chapters, giving readers a broad background on where the state has been economically and where it might head in the future.
Arkansas’s Economy

State Gross Domestic Product

Arkansas had the 34th largest state economy in the U.S. in 2015 based on total production.\(^1\) When compared to the economy of its regional competitors, Arkansas is larger than Mississippi (36th), but substantially smaller than Texas (2nd), and smaller than Tennessee (19th), Missouri (21st), Louisiana (24th), and Oklahoma (29th).\(^2\) The comparative sizes of these economies are mainly driven by population; for example, both Missouri and Tennessee have populations more than twice that of Arkansas.\(^3\)

Arkansas’s gross domestic product (GDP) per capita also ranks among the lowest compared to its peers. In 2015, Arkansas’s per capita GDP of $41,299 trailed the per capita GDP of Texas, Louisiana, Missouri, Tennessee, Oklahoma, and Florida, but exceeded the per capita GDP of Mississippi (Figure 1a). Each state in the region except Texas is below the national average.

Figure 1a.

Per Capita GDP by State

Arkansas, Select Regional Competitors and the U.S. Average (2015)

<table>
<thead>
<tr>
<th>State</th>
<th>Per Capita GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Texas</td>
<td>$57,350</td>
</tr>
<tr>
<td>United States</td>
<td>$55,295</td>
</tr>
<tr>
<td>Louisiana</td>
<td>$51,989</td>
</tr>
<tr>
<td>Missouri</td>
<td>$48,152</td>
</tr>
<tr>
<td>Tennessee</td>
<td>$47,448</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>$45,975</td>
</tr>
<tr>
<td>Florida</td>
<td>$43,236</td>
</tr>
<tr>
<td>Arkansas</td>
<td>$41,299</td>
</tr>
<tr>
<td>Mississippi</td>
<td>$35,787</td>
</tr>
</tbody>
</table>

Source: Bureau of Economic Analysis, Regional Economic Accounts, Gross Domestic Product (GDP) by State.

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1 Bureau of Economic Analysis, Regional Economic Accounts, Gross Domestic Product (GDP) by State, “Gross domestic product (GDP) by state (millions of current dollars).”
2 Ibid.
The Arkansas Economy Varies by Region

It is especially valuable to go beyond state-to-state comparisons to understand regional differences in Arkansas. Economic activity is not evenly split among Arkansas’s regions. Per capita GDP is highest in the Little Rock-North Little Rock-Conway Metropolitan Statistical Area (MSA) and Fayetteville-Rogers-Springdale MSA and comparable with the national average of $49,164 (Figure 1b). This is a reflection of the higher concentration of financial, professional, and governmental services in those regions.\(^4\)

Figure 1b.

Gross Domestic Product Per Capita GDP by MSA

<table>
<thead>
<tr>
<th>MSA</th>
<th>Per Capita GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Little Rock MSA</td>
<td>$52,930</td>
</tr>
<tr>
<td>Fayetteville-Springdale-Rogers MSA</td>
<td>$50,004</td>
</tr>
<tr>
<td>United States (Metropolitan Portion)</td>
<td>$49,164</td>
</tr>
<tr>
<td>Jonesboro MSA</td>
<td>$37,194</td>
</tr>
<tr>
<td>Hot Springs MSA</td>
<td>$35,191</td>
</tr>
<tr>
<td>Pine Bluff MSA</td>
<td>$32,485</td>
</tr>
</tbody>
</table>

Source: Bureau of Economic Analysis, Regional Economic Accounts, Gross domestic product (GDP) by metropolitan area.

The Jonesboro, Hot Springs, and Pine Bluff regions are significantly poorer than Little Rock and Fayetteville-Rogers-Springdale, with per capita GDP varying by nearly $20,000 between Pine Bluff and Fayetteville-Rogers-Springdale.\(^5\)

Figure 1c shows real GDP per person over time for Arkansas and its neighboring states, along with the U.S. average.\(^6\) Arkansas has consistently lagged its regional competitors in per capita GDP in recent history, with the exception of Mississippi, but the state has also maintained steady growth in the measure over the same period.

\(^4\) Bureau of Economic Analysis, Regional Economic Accounts, Gross domestic product (GDP) by metropolitan area (millions of current dollars).

\(^5\) Bureau of Economic Analysis, Regional Economic Accounts, Gross domestic product (GDP) by metropolitan area (millions of current dollars) and Census Bureau.

\(^6\) Bureau of Economic Analysis, Regional Economic Accounts, Gross Domestic Product (GDP) by State, “Gross domestic product (GDP) by state (millions of current dollars).”
**Figure 1c.**

**Gross State Product Per Capita over Time**

Arkansas and Regional Competitors (1997-2014, chained 2009 dollars)

Source: Bureau of Economic Analysis, Regional Economic Accounts, Gross Domestic Product (GDP) by State.

**Figure 1d.**

**Per Capita Real Gross Domestic Product by MSA over Time**

Arkansas (2001-2014, chained 2009 dollars)

Source: Bureau of Economic Analysis, Regional Economic Accounts, Gross domestic product (GDP) by metropolitan area.
As Figure 1d demonstrates, the gap in per capita GDP amongst Arkansas’s MSAs is not a new phenomenon. Hot Springs, Pine Bluff, and Jonesboro have not been able to converge with Fayetteville-Springdale-Rogers and Little Rock over the last decade.

**Personal Income**

In 1929, the average inflation-adjusted personal income of an Arkansas resident was $4,180, significantly below the U.S. average of $9,674. Despite the gap, the two tend to follow the same pattern over time (Figure 1e).

In Arkansas, non-metro-area per capita income has historically been lower than metro-area per capita income, and the disparity is increasing. During the Great Recession, non-metro-area income growth remained stable and the gap temporarily shrunk (Figure 1f).

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7 Bureau of Economic Analysis, Regional Economic Accounts, Personal Income Summary: Personal Income, Population, Per Capita Personal Income.

8 Bureau of Economic Analysis, Regional Economic Accounts, Local Area Personal Income and Employment, Personal Income Summary: Personal Income, Population, and Personal Income per capita (Table CA1).
Figure 1f.

**Personal Income Per Capita, Metro vs. Non-Metro Areas**


Source: Bureau of Economic Analysis, Regional Economic Accounts, Local Area Personal Income and Employment.

**Major Industries**

Ranked in order of magnitude, the largest industrial sectors of the state in 2015 were manufacturing (14.6 percent), government (12.7 percent), real estate (10.1 percent), health care and social assistance (7.6 percent), wholesale trade (7.0 percent), and retail trade (6.8 percent) (Figure 1g).

Arkansas’s industry mix differs from the rest of the U.S. in a few notable ways. Manufacturing, agriculture, and transportation are more prominent in Arkansas than in the U.S. overall, while finance and insurance, real estate and related, and service-related sectors trail national averages.9

Though manufacturing is the largest sector in Arkansas, its share of the economy has markedly declined over the past two decades, after comprising 22.2 percent of the state output in 1997. Figure 1h shows how selected Arkansas industries have changed as percentages of the state GDP since 1997. The most notable shift has been in manufacturing, which accounted for 22 percent of the economy in 1997, and accounts for 15 percent of the economy in 2015.

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9 Bureau of Economic Analysis, Regional Economic Accounts, GDP by state (millions of current dollars).
Employment

Employment in Arkansas has risen by 34 percent since 1990, but has remained relatively flat since the early 2000s, as shown in Figure 1.10 Arkansas lost approximately 59,600 jobs during the Great Recession, and total employment remained below its prerecession high until August 2015.

In February 2016, Arkansas reached a record employment level of 1,227,800. As of August 2016, Arkansas’s unemployment rate was the 10th lowest in the country at 3.9 percent.11 All neighboring states had higher rates of unemployment for May 2016.
Figure 1h.
Percent of Total State Gross Domestic Product by Industry over Time

Percent of Arkansas GDP by Industry, 1997

- Manufacturing: 22%
- Government: 12%
- Real Estate: 9%
- Professional and Business Services: 6%
- Health care and Social Assistance: 6%
- Retail trade: 7%
- Wholesale trade: 6%
- Information: 3%
- Transportation and Warehousing: 5%
- Construction: 4%
- Finance and Insurance: 4%
- Agriculture, forestry, fishing, and hunting: 5%
- Arts, Entertainment, Accommodation, and Food Services: 3%
- Utilities: 3%
- Other services, Except Government: 3%
- Mining: 1%
- Educational Services: 0%

Percent of Arkansas GDP by Industry, 2015

- Manufacturing: 15%
- Government: 13%
- Real Estate: 10%
- Professional and Business Services: 10%
- Wholesale trade: 7%
- Retail trade: 7%
- Health care and Social Assistance: 8%
- Information: 5%
- Construction: 4%
- Transportation and Warehousing: 4%
- Finance and Insurance: 4%
- Agriculture, forestry, fishing, and hunting: 3%
- Arts, Entertainment, Accommodation, and Food Services: 3%
- Utilities: 2%
- Other services, Except Government: 2%
- Mining: 2%
- Educational Services: 1%

Source: Bureau of Economic Analysis, Regional Economic Accounts, “Gross Domestic Product (GDP) by State—GDP in current dollars.”
Arkansas’s private sector employment is spread across a number of industries, with the largest concentration in education and health services (14 percent). Manufacturing (13 percent) and retail (12 percent) are the next largest employment sectors of the private economy, while government comprises 18 percent of employment. Figure 1j shows the breakdown of nonfarm employment within the state, organized by industries, provided by the Bureau of Labor Statistics.

Among the 13 industries featured in Figure 1j, some are growing in employment, while others are flat or declining. Professional and business services, education and health services, and leisure and hospitality are growing the most in employment. Retail employment is also gaining slightly. Employment growth is generally flat for construction, wholesale trade, government, transportation and utilities, financial activities, and other services. Employment is declining in mining and logging, manufacturing, and information.

The advent of new fracking technologies led to rapid growth in mining employment during the late 2000s as Arkansas explored natural gas in the Fayetteville Shale Formation. However, energy market volatility has nearly erased mining and logging employment gains since 2012 (Figure 1k).

Just as GDP growth varies by region, there are noticeable differences in employment growth amongst Arkansas’s MSAs. Figure 1l shows MSA employment growth since 1990, and Figure 1m shows growth trends since January 2010, which is around the lowest employment level of the recession for both the nation as a whole and Arkansas individually. Over the long run, Fayetteville-Springdale-Rogers is the only MSA showing consistent growth, while Pine Bluff has been in steady decline. Fayetteville-Springdale-Rogers and Jonesboro have grown strongest since the recession, however.

Figure 1j.
Percent of Total Nonfarm Employment by Industry Seasonally Adjusted, 2015 Annual Average


Figure 1k.
Mining and Logging Employment
Arkansas, Seasonally Adjusted, (January 1990-May 2016)

Figure 1l.
**Growth in Nonfarm Employment by MSA**
*Arkansas (January 1990-April 2016)*

![Graph showing the growth in nonfarm employment by MSA in Arkansas from January 1990 to April 2016.](image)


Figure 1m.
**Growth in Nonfarm Employment by MSA since the Great Recession**
*Arkansas (January 2010-April 2016)*

![Graph showing the growth in nonfarm employment by MSA in Arkansas from January 2010 to April 2016.](image)

Migration Patterns

Migration among states can be measured by tracking the movement of federal tax returns (and exemptions claimed on those tax returns) among states over time. Since the early 1990s, Arkansas has seen a net gain of 51,009 people move into the state.

From 1990 until 2010, in-migration exceeded out-migration all years except 2000. This trend has reversed since 2011, however, with out-migration exceeding in-migration.

Although migration occurs for many reasons, not all tax-related, it is notable that since 1990 more than half of Arkansas’s in-migration was from states with high tax burdens, while most out-migration went to states with lower tax burdens. 13

Since 1990, more than 19,000 taxpayers from California and more than 9,000 taxpayers from Illinois migrated to Arkansas. Arkansas also gained more than 7,000 taxpayers from foreign locations. Over the same period, Arkansas lost the most taxpayers to Tennessee (4,273), Texas (2,271), Georgia (1,896), and Florida (789).

Figure 1n.

Migration in and out of Arkansas
Based on Number of Federal Tax Exemptions Claimed (1990-2014)


Low Educational Attainment

Educational attainment of Arkansans is among the lowest in the nation. Just 27.6 percent of Arkansas residents age 25 and older had an associate degree or higher, the second lowest in the nation, based on 2014 estimates. Nationally, 38.3 percent have an associate degree or higher, and even among bordering states the average is 31.8 percent, with Arkansas the lowest in the region. Only 7.5 percent of adults have a graduate or professional degree, again the second lowest in the nation, lowest in the region, and just two-thirds of the national average of 11.4 percent.

Low educational attainment is common among states in the region due to the large presence of manufacturing and other low-skill industrial work that does not traditionally require a college degree for employment. These trends appear to be worsening in Arkansas’s rural areas, which creates complications for sustained long-term economic development.14

CHAPTER 2: AN OVERVIEW OF ARKANSAS’S TAX AND BUDGET SYSTEM
Introduction

Arkansas’s state finances remained in relatively good health over a tumultuous last decade that included a deep recession. This is primarily due to the state’s unique budget process, the Revenue Stabilization Act, and its ability to prevent deficits and control spending.

Many elements of the state’s tax system, however, stand in the way of economic and tax competitiveness. Arkansas has a complicated individual and corporate income tax structure, high unemployment insurance taxes, and other unattractive taxes like the franchise tax.
Arkansas’s Tax and Budget Structure

An Overview of the Revenue Stabilization Act

Arkansas’s budget program, the Revenue Stabilization Act (RSA), is unique to the state and functions as a priority-based system that responds to changes in revenue flow. The RSA has been in place since 1945 and is an effective way to prevent budget deficits while controlling spending.

Expenditures are categorized into levels of descending priority, named for letters of the alphabet (A, B, and C). In some years, sub-categories such as A1 or B1 are also included. Level A includes all programs and functions of government considered most essential, while level C is a “wish list” that is funded less often.

Lawmakers rely on preliminary annual revenue forecasts to craft the upcoming fiscal year budget. In an effort to prevent severe downward swings in revenue, the forecast employs conservative assumptions. During the budget-making process, all A-level appropriations must match these preliminary revenue forecasts until the new fiscal year starts on July 1.

Subsequent revenue forecasts are made in July and in February of the next calendar year. If those forecasts predict higher revenue than the preliminary forecast, that revenue begins to fund B, B1, and C, subject to legislative approval. If the forecast predicts less revenue than is initially estimated, C and B-level appropriations receive cuts, while A-level appropriations are only cut if absolutely necessary.

The RSA process applies to state-sourced general revenue only, which consists of the tax types displayed in Figure 2b (state tax revenue sources).

Level A has been fully funded 30 out of the last 36 years. During the same period, Level B was fully funded 16 years, and level C was fully funded eight years.

Table 2a shows the actual funding outcomes for RSA categories from FY1980 to FY2015.
Surplus revenues were realized in 17 of 36 years since 1980, but 10 of those have been realized since 2004. Arkansas also adopted a rainy day fund in 2010 and gave the legislature full control of its yearly contributions.16

A less desirable feature of Arkansas's budget system is known as the General Improvement Fund (GIF). Distributions to the GIF come from surplus revenue and are split by each member of the General Assembly among “set aside," or “off-the-top” priority projects, executive projects, and legislative projects.17

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17 The constitutionality of the General Improvement Fund has been challenged on multiple occasions.
Some have criticized this system of allocating funds without oversight; for example, a 2014 report from Arkansas Advocates for Children and Families contends that GIF funds can sometimes benefit “pet projects” at the expense of major programs:

Amendment 14 to the Arkansas Constitution and subsequent Arkansas Supreme Court cases generally prohibit the General Assembly from enacting “local” legislation that designates GIF funds for a specific local project. In practice, however, the state agencies charged with distributing GIF funds “work with” the legislative sponsor of a general improvement bill to make decisions about which projects are funded. The most influential legislators usually have the greatest say over which projects get funds. The General Assembly usually uses GIF money for one-time expenses like a local capital improvement project or funding for a local program.18

A 2016 entry in the blog of the Advance Arkansas Institute described the GIF in the following way:

… a set amount of state general funds is appropriated to Planning and Development Districts (bureaucratic organizations which are allegedly supposed to encourage economic development) throughout the state. Once these monies ($70,000 per Representative and $285,000 per Senator) are received by the Planning and Development District, legislators control them by proxy. Local organizations apply for funding to their own Planning and Development District, but that funding will only be approved if a legislator in the district approves the organization’s application.19

In FY2014 and FY2015, a total of $382.2 million was set aside for GIF projects. The legislature and the executive branch were each granted $184 million of that total. Only $16.2 million was set aside for the rainy day fund.

Arkansas’s Budget Makeup Today

Arkansas derives around 65 percent of its total revenue from state sources. Arkansas’s reliance on federal assistance is second lowest amongst its six border states, behind Texas, but closer to average amongst all states.20

Over the next decade, Arkansas will have to transition into paying a portion of its Medicaid expansion program. Medicaid expansion passed in 2013, and the federal government has paid all costs associated with the expansion to date. Starting in 2017, Arkansas must pay for 5 percent of expansion costs, rising to 10 percent by 2021. The total state-sourced cost estimate over the 2017-2021 time period is $730 million out of a $9.35 billion total.21

**Figure 2a.**
Total State Revenue by Source (FY 2015)

Income and Sales Taxes are Major Levies

Within Arkansas’s state tax system, the individual income tax and sales tax are the two largest levies, comprising 49 percent and 34 percent of total state tax collections, respectively. The next largest components are the corporate income tax and tobacco tax, which make up 7.6 percent and 3.4 percent of state government tax collections, respectively (Figure 2b).

**Figure 2b.**
State Tax Revenue by Source (FY 2015)
One of the most obscure features of Arkansas’s tax system is its multi-schedule bracket system comprised of three graduated individual income tax rate schedules that depend on income level, with up to six brackets in each schedule (Table 2b). This mechanism is atypical amongst state individual income taxes, and is discussed in more detail in Chapter 3.

### Table 2b. Arkansas Individual Income Tax Brackets

<table>
<thead>
<tr>
<th>Income Level Under $21,000</th>
<th>Income Level Between $21,000 and $75,000</th>
<th>Income Level Above $75,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Bracket</td>
<td>Tax Rate</td>
<td>Income Bracket</td>
</tr>
<tr>
<td>$0-$4,299</td>
<td>0.90%</td>
<td>$0-$4,299</td>
</tr>
<tr>
<td>$4,300-$8,399</td>
<td>2.40%</td>
<td>$4,300-$8,399</td>
</tr>
<tr>
<td>$8,400-$12,599</td>
<td>3.40%</td>
<td>$8,400-$12,599</td>
</tr>
<tr>
<td>$12,600-$20,999</td>
<td>4.40%</td>
<td>$12,600-$20,999</td>
</tr>
<tr>
<td>$21,000-$35,099</td>
<td>5.00%</td>
<td>$21,000-$35,099</td>
</tr>
<tr>
<td>$35,100-$75,000</td>
<td>6.00%</td>
<td>$35,100-$75,000</td>
</tr>
</tbody>
</table>


The corporate income tax system consists of six brackets with a top marginal rate of 6.5 percent.

The state's sales tax is imposed at 6.5 percent, and cities and counties are permitted to collect a local option sales taxes that ranges from 0.5 percent to 3 percent and averages an additional 2.8 percent. Arkansas taxes food at a reduced rate of 1.5 percent, and taxes a limited number of services.

On the whole, Arkansas’s tax revenues have been stable over the past two decades, and notably, did not experience a large drop during the Great Recession. Local tax collections have remained mostly flat after adjusting for inflation (Figure 2c). This is mostly because of property tax restrictions placed on local jurisdictions in Arkansas.

### Total State Expenditures

State spending saw a modest decrease between 2010-2013, but by 2015 had rebounded to $1.45 billion above its 2010 peak (Figure 2d). However, over a slightly larger time frame, government has grown in relative terms. Arkansas state spending increased 46.25 percent between 2002 and 2015, faster than inflation (31.77 percent) and population growth (9.89 percent) over the same time period.

---

Figure 2c.  
**State and Local Tax Collections**  
*Arkansas, 1992-2013 (in 2013 dollars)*

Note: The Census Bureau reclassified Arkansas’s mandatory education-funding property tax (explained in Chapter 6) from a local tax to a state tax from 1997 to 1999. This explains the sudden drop in local tax collections.  
Source: Census Bureau, State and Local Tax Collections.

Figure 2d.  
**Total State Expenditures (FY 2002-2015)**  

Source: Department of Finance and Administration, Agency Actual Expenditures.
Conservation Expenditures

In 1996, Arkansas voters approved Amendment 75, a 1/8 cent conservation sales tax to fund the state’s Game and Fish Commission, State Parks, Heritage Commission, and Keep Arkansas Beautiful Commission. This source of dedicated revenue generated $66 million in fiscal year 2014.26 Similarly, the State of Missouri has a 1/8 cent conservation sales tax and a 1/10 cent soil and parks tax.27 As Figure 2e illustrates, both Missouri and Arkansas have higher levels of conservation-related per capita expenditure than their neighboring states.

Figure 2e.

State Parks and Wildlife Expenditures Per Capita
Arkansas and Regional Competitors (2011-2015, in 2015 dollars)

Measures of State Tax Competitiveness

Tax reform can accomplish many things; for example, it can make the budgeting process easier and more consistent as well as reduce compliance costs for individuals and businesses. Most importantly, though, tax reform can improve state competitiveness.

Two annual Tax Foundation publications, State-Local Tax Burden Rankings and State Business Tax Climate Index, provide measures of tax competitiveness that matter for taxpayers. Both of these measures have a different story to tell. The State-Local Tax Burden Rankings report answers the very first question that most taxpayers ask: “How much do residents in my state pay in taxes?” By contrast, the State Business Tax Climate Index answers the question: “How well is my state tax system structured?”

27 Missouri Department of Revenue, “Sales/Use Tax.”
State and Local Tax Burdens

Many people are familiar with tax collections measures, which tally the amount of taxes collected by state and local governments and reflect the legal incidence of taxation. Tax burdens, however, measure the economic incidence of taxation.

Figure 2f.
State-Local Tax Burdens by State
State-Local Tax Burdens as a Percentage of State Income, FY 2012

In the Tax Foundation’s annual State-Local Tax Burden Rankings, collections data are adjusted for tax importation and tax exportation, resulting in a full picture of the taxes Americans pay, in their home states and across the country. In fiscal year 2012 (the most recent year in which data is available), New Yorkers paid the most in state and local taxes (12.7 percent of total state income); Alaskans paid the least (6.5 percent).

Arkansans experience above-average state and local tax burdens, ranking 17th highest nationally. In fiscal year 2012, residents of the state paid $3,519 per capita in state and local taxes, including $966 in taxes to other states, amounting to an effective rate of 10.1 percent of total state income. Figure 2f shows the total state and local tax burden of each state in the 2012 fiscal year. Arkansas has a higher burden than all of its neighboring states.
Business Tax Climate

While how much is paid in taxes each year is an important consideration for competitiveness, equally important is how those taxes are paid. Taxes vary significantly, with certain levies being more harmful to growth, and others creating additional compliance costs.

Figure 2g.  
2017 State Business Tax Climate Index

Each year, the Tax Foundation produces the State Business Tax Climate Index to enable business leaders, state policymakers, and taxpayers to gauge how these structural elements compare. The Index examines more than 100 variables in individual income tax, corporate income tax, sales tax, unemployment insurance tax, and property tax categories to reduce these many complex considerations into a ranking.

In the most recent 2017 edition, which gauges states as of July 1, 2016, the states with the best tax systems are Wyoming, South Dakota, Alaska, Florida, Nevada, Montana, New Hampshire, Indiana, Utah, and Oregon. The states with the worst tax systems are New Jersey, New York, California, Vermont, Minnesota, Ohio, Rhode Island, Connecticut, Maryland, and Louisiana.
Arkansas's tax structure leaves much to be desired. The state's tax system is near the bottom 10 with an overall ranking of 38th (Figure 2g). Three of the state's tax component taxes rank in the bottom half of states: corporate taxes (40th), sales taxes (44th), and unemployment insurance taxes (30th). Individual income taxes rank 29th and taxes on property rank 24th, not far from the national average.

Arkansas's multi-schedule, multi-bracket individual income tax system, its failure to inflation-index tax brackets, its nonconformity to the federal definitions of corporate income and individual income, its capital stock (franchise) tax, its high maximum unemployment insurance tax rates, and its “marriage penalty” contribute to the state's poor Index rankings.

Fundamental tax reform is about improving these shortcomings so that Arkansas can collect the revenue necessary for government services while maintaining a competitive position that allows Arkansas to attract new businesses and individuals and grow opportunity in the state. By broadening tax bases and lowering tax rates, the state can have a meaningful impact on the quality of life for Arkansans.

Throughout this book, we will use State Tax Business Climate Index as a way to compare Arkansas's taxes to regional competitor states and the country as a whole. The states we have chosen for comparison are the bordering states of Louisiana, Mississippi, Missouri, Oklahoma, Tennessee, and Texas.
CHAPTER 3: INDIVIDUAL INCOME TAX
Introduction

The Arkansas individual income tax has changed little since its original passage in 1929. The state has only modified its tax rate structure on a handful of occasions over the last 80 years. In 1971, the state raised its top marginal rate from 6 percent to 7 percent, where it stayed until 2015. The state made a few minor changes in 2013 and 2015—mostly complex changes involving more rates—but has not tackled full-scale reform of its code since the 1970s.

The individual income tax is uncompetitive compared to Arkansas’s neighbors, with the highest marginal rate in the region. The state also faces a direct challenge from Texas and Tennessee, two no-income tax states that share a border with Arkansas.

It is important to bear in mind that individual income taxes are not exclusively of interest to individual taxpayers, as many businesses (S-corporations, LLCs, partnerships, and sole proprietorships) pay individual income taxes as well. Since these taxes impact Arkansas employers, it is important to consider impacts on business as well as individual payers when contemplating changes to the individual tax code.

In this chapter we provide a broad overview of the state’s individual income tax, outline issues with the current system, and discuss potential reform options. We conclude with State Business Tax Climate Index rankings for each proposed solution.
A Brief History of Arkansas's Individual Income Tax

First passed in 1929, Arkansas became the 15th state to create an individual income tax. The first tax had a top marginal rate of 5 percent on incomes above $25,000. It was unchanged until 1971, when the top marginal rate increased to 7 percent with the same $25,000 threshold. The state made changes to the standard deduction and personal exemption, both prior to 1971 and after, but the rates continued to hold constant until 2013. In 2013 and 2015, the state made a number of minor changes to lower rates for specific groups of taxpayers, such as low-income or middle-income filers, but in doing so added immense complexity to the code.

The 2015 tax changes took effect in tax year 2016, resulting in three different rate schedules with up to six brackets per rate schedule. The three rate schedules are displayed below.

Table 3a. Individual Income Tax Rates (2016)

<table>
<thead>
<tr>
<th>Income Level Under $21,000</th>
<th>Income Level Between $21,000 and $75,000</th>
<th>Income Level Above $75,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Bracket</td>
<td>Tax Rate</td>
<td>Income Bracket</td>
</tr>
<tr>
<td>$0-$4,299</td>
<td>0.9%</td>
<td>$0-$4,299</td>
</tr>
<tr>
<td>$4,300-$8,399</td>
<td>2.4%</td>
<td>$4,300-$8,399</td>
</tr>
<tr>
<td>$8,400-$12,599</td>
<td>3.4%</td>
<td>$8,400-$12,599</td>
</tr>
<tr>
<td>$12,600-$20,999</td>
<td>4.4%</td>
<td>$12,600-$20,999</td>
</tr>
<tr>
<td>$21,000-$35,099</td>
<td>5.0%</td>
<td>$21,000-$35,099</td>
</tr>
<tr>
<td>$35,100-$75,000</td>
<td>6.0%</td>
<td>$35,100+</td>
</tr>
</tbody>
</table>

This rate schedule is incredibly cumbersome. Individuals must first determine their taxable income, and then use a rate schedule depending on that level of income. The differing rates create inequities across taxpayers. Taxpayer income between $21,000 and $35,099 is taxed at 5 percent for those whose household income is between $21,000 and $75,000, but it is taxed at 6 percent for those with incomes in excess of $75,000. A similar disparity exists for income between $4,300 and $8,399 for those on the low-income or middle-income schedule. Low-income filers pay 2.4 percent, while middle-income filers pay 2.5 percent.

The rate schedule also creates large tax “cliffs,” instances where a small increase in income results in a dramatic increase in tax liability. For example, an individual earning $21,000 in income pays $666.15 in taxes in 2016, compared to $644.40 in taxes for an individual making $20,999. The additional $1 in income resulted in an additional tax liability of $21.75. An individual earning $75,000 pays $3,765.05 in taxes, while an individual earning $75,001 pays $4,265.21, a difference of $500.16.

30 A.C.A. §26-51-201.
The tax code includes a bracket adjustment for filers with incomes between $75,000 and $80,000, to offset part of the tax cliff. This is an explicit acknowledgment of the large tax cliffs present within the code. Those individuals get to reduce their total tax liability based on the following adjustment schedule in an attempt to offset the difference in rates for individuals on the middle- and high-income rate schedules, where the top marginal rate jumps from 6 percent to 6.9 percent.

<table>
<thead>
<tr>
<th>Income Range</th>
<th>Bracket Adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>$75,001-$76,000</td>
<td>$440</td>
</tr>
<tr>
<td>$76,001-$77,000</td>
<td>$340</td>
</tr>
<tr>
<td>$77,001-$78,000</td>
<td>$240</td>
</tr>
<tr>
<td>$78,001-$79,000</td>
<td>$140</td>
</tr>
<tr>
<td>$79,001-$80,000</td>
<td>$40</td>
</tr>
<tr>
<td>$80,001 and above</td>
<td>$0</td>
</tr>
</tbody>
</table>

Tax cliffs will always exist within a progressive income tax, but Arkansas’s is unique because of the three different rate schedules. This is not a standard approach across states, as many states use a progressive structure, but not multiple rate schedules. California is generally considered to have the largest number of brackets at 10, with the median number of state individual income tax brackets being four.\(^3^2\) Arkansas functionally has 16. This sort of complexity creates administrative headaches and makes the code difficult for individuals to understand. In our numerous interviews across the state, few individuals understood the recent tax changes from 2013 and 2015.

Comparing Arkansas’s Individual Income TaxesRegionally and Nationally

Compared to other state individual income tax systems, Arkansas’s is somewhat below average on the State Business Tax Climate Index, ranking 29th. Table 3c shows Arkansas’s individual income tax component ranking on the Index, in addition to select regional competitor states’ rankings.

Arkansas’s top marginal individual income tax rate is uncompetitive among its regional peers. The highest marginal rate in Arkansas is 6.9 percent, higher than all of its neighbors, and the 14th highest top marginal rate in the nation. Louisiana\(^3^3\) and Missouri have top rates of 6 percent, while Mississippi’s and Oklahoma’s top rate is at 5 percent. Presenting a unique challenge to

31 A.C.A. §26-51-201(10).
33 Louisiana’s tax rate is not directly comparable. The rate is driven in part by the state’s deduction for federal individual income taxes paid, which reduces liabilities for many but not all residents and subjects state revenue collections to the volatility of the federal tax code.
Arkansas policymakers is that the state borders both Texas and Tennessee\(^ {34} \), neither of which have an individual income tax. In conversation after conversation across the state, individual taxpayers mentioned how Arkansas’s high tax rate made it uncompetitive; many individuals told stories of friends or family members who made the choice to relocate to neighboring states in part for tax reasons.

<table>
<thead>
<tr>
<th>Table 3c.</th>
<th>State Business Tax Climate Index Individual Income Tax Component Rankings</th>
<th>Arkansas and Regional Competitors (2017)</th>
</tr>
</thead>
<tbody>
<tr>
<td>State</td>
<td>Component Ranking</td>
<td></td>
</tr>
<tr>
<td>Arkansas</td>
<td>29</td>
<td></td>
</tr>
<tr>
<td>Louisiana</td>
<td>27</td>
<td></td>
</tr>
<tr>
<td>Mississippi</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>Missouri</td>
<td>28</td>
<td></td>
</tr>
<tr>
<td>Oklahoma</td>
<td>38</td>
<td></td>
</tr>
<tr>
<td>Tennessee</td>
<td>8</td>
<td></td>
</tr>
<tr>
<td>Texas</td>
<td>6</td>
<td></td>
</tr>
</tbody>
</table>


Figure 3a.
Top State Marginal Individual Income Tax Rates, 2016

Note: (*) State has a flat income tax. (**) State also only taxes interest and dividends income. Map shows top marginal rates: the maximum statutory rate in each state. It is not an effective marginal tax rate, which would include the effects of phaseouts of various tax preferences. Local income taxes are not included. Source: State tax forms and instructions.

34 Tennessee does not tax wage income, but does have a tax on dividends and interest, known as the Hall Tax. In 2016, the state of Tennessee passed a six-year phaseout of the Hall Tax. It will be completely phased out in tax year 2022. Scott Drenkard, “Success! Tennessee to Phase Out the Hall Tax,” Tax Foundation Blog, April 22, 2016.
Excessive taxes on income are generally less desirable than taxes on consumption because they discourage wealth creation. In a comprehensive review of international econometric tax studies, Arnold et al. (2011) found that individual income taxes are among the most detrimental to economic growth, outstripped only by corporate income taxes. The authors found that consumption and property taxes are the least harmful.\(^\text{35}\)

The economic literature on graduated-rate income taxes is particularly unfavorable.\(^\text{36}\) The Arnold et al. study concluded that reductions in top marginal rates would be beneficial to long-term growth, and Mullen and Williams (1994) found that higher marginal tax rates reduce gross state product growth. This finding even adjusts for the overall tax burden of the state, lending credence to the precept of broad bases and low rates.\(^\text{37}\)

### Individual Income Tax Collections

Individual income tax collections have grown significantly through the years, but have seen sizable swings, dipping notably during recessionary periods.

![Arkansas Individual Income Tax Collections (1950–2014, 2014 Dollars)](image)

**Figure 3b.**


Note: Dollar amounts are inflation adjusted based on the annual average Consumer Price Index for All Urban Consumers (CPI-U) with a 2014 base year.


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Structural Elements

The individual income tax code includes a number of provisions other than income tax rates. The state currently offers a standard deduction of $2,200 ($4,400 for married filers), with personal exemption credits of $26 per person. In conversations we had with Arkansas taxpayers, the complexity of the individual income tax emerged as a frequent concern. Arkansas residents are often uncertain of what their tax liability will be, given the complex bracket structure, married filing separately on a combined return, and a plethora of additions and subtractions to taxable income.

Inflation Adjustments

Inflation indexing is an important facet of a well-structured individual income tax code. When an income tax system does not adjust tax brackets for inflation, a phenomenon known as bracket creep can occur. Higher incomes can bump a taxpayer into the next tax bracket, even if that higher income is merely keeping pace with inflation. A lack of inflation adjustment can also push more of a taxpayer’s income into the highest bracket for which they qualify. This combined with bracket creep can lead to a higher average tax rate. This is problematic because increased incomes haven’t risen in real terms—only nominally. In other words, taxpayers’ tax bills would increase even though their purchasing power has not. Indexing addresses this by altering each bracket level each year by the level of annual inflation.

Inflation adjustments should apply to more than just tax brackets. The standard deduction and personal exemption credits should be adjusted as well. Currently, the state indexes its personal exemption credit for inflation, but does not adjust its standard deduction.

Marriage Penalty

Because the individual income tax bracket widths are identical for single and joint filers, Arkansas’s income tax contains a “marriage penalty,” meaning married couples pay more in taxes when filing jointly than they would if they filed separately. This can have serious business ramifications. The top 20 percent of income earners is dominated (85 percent) by married couples, and this same 20 percent also has the highest concentration of business owners of all income groups. Therefore, marriage penalties have the potential to affect a significant share of pass-through businesses. Arkansas is one of 24 states and the District of Columbia to impose a marriage penalty.

Married couples can limit the adverse impact of this penalty by choosing to file separately on the same return. Typically, filers must select the same filing status at the federal and state level, but Arkansas permits married couples to file separately on the same return even if they filed jointly at the federal level. The majority of married filers take advantage of this option, which frequently reduces, but does not altogether eliminate, the marriage penalty.

Arkansas’s marriage penalty does not extend to its standard deduction or personal exemption. The state doubles its standard deduction (from $2,200 to $4,400) and its personal exemption (from $26 to $52) for married couples.

**Internal Revenue Code Conformity**

For reasons of administrative simplicity, states frequently seek to conform many, though rarely all, elements of their state tax codes to the federal tax code. This harmonization of definitions and policies reduces compliance costs for individuals and businesses with liability in multiple states and limits the potential for double taxation of income. No state conforms to the federal code in all respects, and not all provisions of the federal code make for good tax policy, but greater conformity substantially reduces tax complexity and has significant value.

Arkansas is unique among its peers, as it does not use the federal tax code as the basis of its income calculations. In 28 other states, the income tax base begins with federal adjusted gross income, though some adjustments (e.g., pension and retirement income, Social Security benefits, and most significantly, federal deductibility) diverge from the federal treatment of income.

**Individual Income Taxes Affect Arkansas Businesses, Too**

Individual income taxes are of considerable importance to pass-through entities, businesses that pay the individual income tax in lieu of the corporate income tax because their earnings “pass through” to the income tax form of the owners or shareholders rather than being remitted by the business entity itself. Because S corporations, partnerships, sole proprietorships, and limited liability corporations (LLCs) remit their income tax payments through the individual income tax, the individual code is a significant policy issue for the majority of Arkansas businesses. Figure 3c shows the share of employer firms in each sector that pay individual income taxes in Arkansas (separated by type). In total, 64 percent of Arkansas businesses are pass-through businesses.

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45 A.C.A. § 26-51-403
48 “County Business Patterns, Geographic Area Series: County Business Patterns by Legal Form of Organization,” Census Bureau, 2014.
Figure 3c.

Arkansas Employer Businesses Subject to Individual Income Tax
Arkansas Sole Proprietorships, Partnerships, and S Corporations by Industry (2014)

Traditional C corporations care about individual income tax rates as well, since high rates can impede their ability to attract and retain talented employees. In conversations with corporate leaders in Arkansas, individual income taxes were a recurring theme, with many expressing the belief that Arkansas’s high statutory individual income tax rates often keep potential employees from even considering Arkansas. Attracting and retaining employees is difficult, partly due to Arkansas’s tax code.

Tax Expenditures: Deductions, Exemptions, and Credits

Low Income Tax Exemption

Arkansas uses several other provisions than its different rate schedules to lower taxable income for low-income filers. 49 First, individuals with income at or below a specific level, $11,643 in 2015, 50 are completely exempt from individual income taxation. 51 The amount exempt from taxation is adjusted every year according to the Consumer Price Index, and is similar to the federal poverty level. 52 Additionally, the state has a low-income tax credit available for individuals with incomes between $11,644 and $15,100 as of 2015. 53 The tax credit is 80 percent of the

49 A.C.A. §26-51-301.
51 The low-income tax exemption is increased for married couples and head of households. The amount varies based on the number of dependents. In 2015, married couples with one dependent or none were exempt if income was below $19,635, and $23,631 for those with two or more dependents. Head of households with one dependent or none were exempt below $16,553 in income, or $19,733 for those with two or more dependents.
52 In 2015, individuals with less than $11,643 were exempt from taxation. The federal poverty level was $11,770. https://aspe.hhs.gov/2015-poverty-guidelines
amount of income taxes due, but reduces by $4.00 for every $100 in additional income.\textsuperscript{54} To simplify the administration, the Arkansas Department of Finance and Administration publishes a tax table that includes the effects of this tax credit.\textsuperscript{55}

The state also includes several limitations on claiming the tax credit. Filers’ total income—not just the income taxable in Arkansas—must be below the thresholds.\textsuperscript{56} Individuals also may not itemize deductions, cannot file married filing separately, and cannot use the exclusions for military or retirement pay.\textsuperscript{57}

### Border City Exemption

One of the most notable challenges to the state’s tax competitiveness is that Arkansas borders two no-income tax states, Texas and Tennessee. In an attempt to adjust for that, the state passed Act 28 of 1977, which allowed residents of a border community to lower their income tax rate. Residents of a town with a "street state line" that borders a state without an individual income tax may hold an election to lower their income tax to equal those of the border state.\textsuperscript{58} In exchange, the state sales tax rate would be 1 percent higher.\textsuperscript{59} Texarkana, Arkansas, took advantage of the provision and voted to eliminate the state income tax within the city’s border.

In 2016, the absence of an income tax in Texarkana cost the state $21.2 million in foregone income tax revenue, but raised an additional $4.6 million in sales tax revenue, for a net loss of $16.6 million in revenue.\textsuperscript{60}

Because the law requires that localities must have a state street line border to qualify for the exemption, the use of the exemption is limited to Texarkana. Other localities that border no-income tax states, like West Memphis, do not qualify, as the Mississippi River divides Arkansas and Tennessee, not a street.

In our numerous interviews in the state, individuals expressed concern about the fairness of this provision. Arkansans suggested that lowering the tax rate for all residents would be a much better solution than selectively exempting residents.

There is little economic argument for the exemption either. While it benefits the residents of Texarkana, it does not actually limit cross-border competition. The tax disparity still exists; it is just moved several miles to the east, on the Texarkana city border, not the Texas state border.

\textsuperscript{54} A.C.A. §26-51-301(f).
\textsuperscript{56} A.C.A. §26-51-301(g).
\textsuperscript{57} A.C.A. §26-51-301(h).
\textsuperscript{58} A.C.A. §26-52-602.
\textsuperscript{59} A.C.A. §26-52-607.
\textsuperscript{60} Arkansas Department of Finance and Administration, E-mail to Matthew Crumb, August 1, 2016.
Capital Gains

Arkansas provides a lower tax rate for capital gains income. The first piece of legislation dealing with the preferential treatment of capital gains was passed in 1985. According to Act 848 of 1985, a portion of an individual’s capital gains would be excluded from taxation: 10 percent in 1987, 30 percent in 1988, and 60 percent in 1989. However, legislation in 1987 delayed the changes until 1989, with subsequent legislation delaying it until 1991. In 1991, a different change was passed before the exclusion could go into effect. Starting with the 1991 tax year, the capital gains tax rate could not exceed 6 percent, even though the top marginal income tax rate was 7 percent.

In 1999, the taxation of capital gains was revisited. The 6 percent tax rate cap was removed, and instead the state allowed taxpayers to exclude 30 percent of the capital gain starting in 2000. The idea behind this type of tax change is to make the capital gains tax more neutral across time. The cost basis of capital gains does not increase with inflation, so the tax hits both nominal and real gains. Part of an investor’s gains are nominal gains, gains that keep pace with inflation, meaning the real gains are lower. Additionally, capital gains taxes are a double tax on corporate profits, as individuals are taxed on their wages, then on the corporate income of any firms they might invest in, then once more if those investments pay off in the form of dividends or capital gains.

The 30 percent exclusion continued until Act 1488 of 2013. The Act increased the capital gains exclusion from 30 percent to 50 percent, and it exempted capital gains in excess of $10 million from taxation. Initially, the Arkansas legislature repealed these provisions in 2015, then quickly reinstated the provisions during the same legislative session. Any capital gain in excess of $10 million was exempted with a retroactive date of January 1, 2014. Starting July 1, 2016, the capital gains tax exclusion is 50 percent.

Individual Income Tax Reform Solutions

Our individual income tax solutions improve the tax code by broadening the tax base and reducing tax rates, making the state more competitive with its neighbors and the system more neutral and fair. We have included three options for policymakers to consider.
During our interviews, individuals repeatedly stated a desire to get Arkansas at or below a 5 percent individual income tax rate to better compete with regional peers. Two of our options achieve this goal, one in a revenue-neutral way and one with large revenue losses. However, the revenue loss could be favorably offset with other tax changes described later in the book. Finally, our third option does not reach the desired 5 percent rate. Instead, it lowers the rate to 6 percent but consolidates the state’s three rate schedules.

All three options leave the low-income tax exemption and the low-income tax credit in effect. All three options would remove the Border City Exemption and would adjust for inflation the individual income tax brackets, the standard deduction, and the personal exemption credit.

**Individual Income Tax Option A**

Option A would transition the current complex rate schedule to a flat tax of 4.95 percent. This flat tax would be approximately revenue neutral, though the rate could be increased or decreased to achieve a tax cut or a tax increase. This rate would exceed the stated goal of 5 percent and be lower than most neighboring states. However, because this would raise tax rates for some filers, Amendment 19 would require a three-fourths vote in the legislature for passage.

The new rate schedule is below.

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0</td>
<td>4.95%</td>
</tr>
</tbody>
</table>

**Individual Income Tax Option B**

Option B would do two things: consolidate the state’s three rate schedules into one rate schedule, then lower the rate in such a way to get the top marginal rate to 5 percent. This tax change would not raise tax rates on any tax filers, exempting it from the Amendment 19 vote threshold. Instead, all filers would receive a tax cut. Option B would result in a large loss of revenue for the state, but that revenue loss could be offset with changes to the state’s sales tax base detailed in Chapter 5.

The new rate schedule is below.

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0-4,299</td>
<td>0%</td>
</tr>
<tr>
<td>$4,300-12,599</td>
<td>2%</td>
</tr>
<tr>
<td>$12,600-$35,099</td>
<td>4%</td>
</tr>
<tr>
<td>$35,100+</td>
<td>5%</td>
</tr>
</tbody>
</table>
Individual Income Tax Option C

Option C is similar to Option B, but with more income tax brackets and a higher top marginal rate. This tax change would not raise tax rates on any tax filers, exempting it from the Amendment 19 vote threshold. Most filers would receive a tax cut under this plan; only those between $35,100 and $75,000 in income on the middle rate schedule would not. Their tax rate would stay constant, but they were the main beneficiary of the new rate schedule that went into effect for tax year 2016. Option C would result in a large loss of revenue for the state, but that revenue loss should be offset with changes to the state’s sales tax base detailed in Chapter 5.

The new rate schedule is below.

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0-4,299</td>
<td>0%</td>
</tr>
<tr>
<td>$4,300-8,399</td>
<td>2%</td>
</tr>
<tr>
<td>$8,400-12,599</td>
<td>3%</td>
</tr>
<tr>
<td>$12,600-21,099</td>
<td>4%</td>
</tr>
<tr>
<td>$21,000-35,000</td>
<td>5%</td>
</tr>
<tr>
<td>$35,100+</td>
<td>6%</td>
</tr>
</tbody>
</table>

All Individual Income Tax Reforms

All of these proposals would increase Arkansas’s ranking on the State Business Tax Climate Index and improve its competitiveness among its regional and national peers. Below are the resulting rank changes from the various proposals to Options A, B, and C described above. These are all improvements over Arkansas’s current rankings on the State Business Tax Climate Index. The state ranks 38th overall and 29th on the individual income tax subcomponent.

<table>
<thead>
<tr>
<th>Reform Option</th>
<th>Overall Rank</th>
<th>Component</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>15</td>
<td>17</td>
</tr>
<tr>
<td>B</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>C</td>
<td>29</td>
<td>27</td>
</tr>
</tbody>
</table>
Introduction

With a top rate of 6.5 percent, Arkansas imposes one of the highest corporate income tax rates in its region. The state’s corporate code is progressive for incomes below $100,000 with five brackets, but becomes a flat 6.5 percent if taxable income exceeds $100,000. The state relies heavily on credits to reduce tax liabilities for targeted industries to ameliorate the impact of its high statutory rate.

In this chapter, we provide a broad overview of Arkansas’s corporate income tax, outline issues to consider regarding the current system, and provide options for reform. Accompanying these solutions are projected State Business Tax Climate Index rankings for the recommended reforms.
Overview of Arkansas Corporate Income Taxation

Arkansas’s corporate income tax was first passed in 1929, making it the 15th state to adopt a corporate income tax. The first corporate income tax was a flat 2 percent of all corporate net income. In 1941, a graduated corporate income tax was instituted with rates ranging from 1 to 5 percent.

The state’s current corporate income tax rate schedule was created in 1991. Arkansas’s corporate income tax is a progressive income tax with five brackets below $100,000 in net income, but it converts to a flat tax of 6.5 percent for those corporations with net income greater than $100,000. This type of benefit recapture—subjecting all of a corporation’s income to the highest rate—is unusual among states. The top marginal rate of 6.5 percent is the second highest in its region—only Louisiana’s code has a higher rate (8 percent)—and the 24th highest nationally. Arkansas relies heavily on tax credits to offset the high tax rate, allowing targeted industries and firms a better chance at competing.

Arkansas’s corporate income tax rates and brackets are shown in Table 4a.

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0</td>
<td>&gt; 1%</td>
</tr>
<tr>
<td>$3,001</td>
<td>&gt; 2%</td>
</tr>
<tr>
<td>$6,001</td>
<td>&gt; 3%</td>
</tr>
<tr>
<td>$11,001</td>
<td>&gt; 5%</td>
</tr>
<tr>
<td>$25,001</td>
<td>&gt; 6%</td>
</tr>
<tr>
<td>$100,001</td>
<td>&gt; 6.5%</td>
</tr>
</tbody>
</table>

Among bordering states, Louisiana imposes an 8.0 percent top rate, Missouri imposes a 6.25 percent top rate, Mississippi imposes a 5 percent top rate, Oklahoma imposes a 6 percent top rate, Tennessee imposes a 6.5 percent rate, and Texas forgoes a corporate income tax in favor of a gross receipts tax, the Texas Margins tax. Arkansas’s top rate of 6.5 percent is tied for the second highest in the entire southeast (Figure 4a).

70 Ibid.
71 Ark. Code §26-51-205(a)(2)
72 Louisiana’s tax rate is not directly comparable. The rate is driven in part by the state’s deduction for federal corporate income taxes paid, which reduces liabilities for many but not all businesses and subjects state revenue collections to the volatility of the federal tax code.
Forty-four states levy a corporate income tax, and of those, Arkansas is one of just 17 that have a graduated rate system. Public finance experts generally find single-rate corporate tax systems are more consistent with the principles of simplicity and neutrality. In contrast to the individual income tax, there is no meaningful "ability to pay" concept in corporate taxation. Jeffery Kwall, a professor at Loyola University Chicago School of Law, notes that graduated corporate rates are inequitable—that is, the size of a corporation bears no necessary relation to the income levels of the owners. Indeed, low-income corporations may be owned by individuals with high incomes, and high-income corporations may be owned by individuals with low incomes. 74

A single-rate system minimizes the incentive for firms to engage in expensive, counterproductive tax planning to mitigate the damage of higher marginal tax rates that some states levy as taxable income rises. Arkansas’s graduated rate structure, by contrast, encourages businesses to engage in tax arbitrage, which is economically unproductive and introduces additional compliance costs.

Note: (*) Nevada, Ohio, Texas, and Washington do not have corporate income taxes but do have gross receipts taxes with rates not strictly comparable to corporate income tax rates. Arkansas assesses a surcharge of 2% of the taxpayer’s total liability. Connecticut’s rate includes a 20% surtax. Delaware and Virginia have gross receipts taxes in addition to their corporate income taxes. Illinois’ rate includes two separate corporate income taxes, one at a 5.25% rate and one at a 2.5% rate. The tax rate in Indiana will decrease to 6.25% on July 1, 2016.

Source: State tax statutes, forms, and instructions; Commerce Clearinghouse.

Since 2008, 15 states and the District of Columbia have cut corporate income tax rates, and Michigan shifted from a gross receipts tax to a traditional corporate income tax. In Arkansas, by contrast, corporate income taxes have never been cut in the history of the tax, and the current rates and brackets have remained unchanged since 1991, when the top marginal rate was raised from 6 percent to 6.5 percent.

Reductions in corporate rates elsewhere reflect a trend toward decreased reliance on a highly volatile tax imposed on a declining amount of taxable income, and, in some instances, an effort to simplify the tax structure by broadening the base and lowering the rate. Corporate income tax revenue is in decline across the country as more businesses choose to structure as S corporations and limited liability corporations (LLCs), single sales factor apportionment schemes become more common, and states give away more of their tax base in special credits and deductions.

Corporate income taxes also tend to be complex and impose substantial administrative burdens for both payers and the government, and this complexity has not abated as the tax base has eroded. Finally, revenue volatility necessarily follows from the nature of the tax, since in periods of economic distress, many companies may post losses and thus lack exposure to a corporate income tax (as evidenced below in Figure 4b).

Comparing Arkansas’s Corporate Taxes Regionally and Nationally

When compared to other states’ corporate income tax systems, Arkansas ranks below its peers, both regionally and nationally, with the 40th best corporate income tax system in the country. On our State Business Tax Climate Index, Louisiana, Mississippi, Missouri, Oklahoma, and Tennessee all rank higher than Arkansas on the corporate income tax component ranking. Table 4b shows Arkansas’s State Business Tax Climate Index corporate income tax component ranking, in addition to select competitor states’ rankings.

<table>
<thead>
<tr>
<th>Table 4b.</th>
<th>State Business Tax Climate Index Corporate Income Tax Component Rankings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arkansas and Select Regional Competitors (2017)</td>
<td></td>
</tr>
<tr>
<td>State</td>
<td>Component Ranking</td>
</tr>
<tr>
<td>Arkansas</td>
<td>40</td>
</tr>
<tr>
<td>Louisiana</td>
<td>36</td>
</tr>
<tr>
<td>Mississippi</td>
<td>12</td>
</tr>
<tr>
<td>Missouri</td>
<td>5</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>9</td>
</tr>
<tr>
<td>Tennessee</td>
<td>22</td>
</tr>
<tr>
<td>Texas</td>
<td>49</td>
</tr>
</tbody>
</table>

Source: Tax Foundation, 2017 State Business Tax Climate Index


76 Arkansas Bureau of Legislative Research, Arkansas Legislative Tax Handbook, October 2014, 29.
Corporate Income Tax Collections

Corporate income taxes are among the most volatile sources of state revenue, since many companies may generate little or no net income during economic downturns. While practically all revenue streams are cyclical, with collections lower during periods of economic distress, corporate income taxes experience particularly deep troughs. Property values may decline during a recession, but they are rarely wiped out, limiting how low property tax collections can go. Similarly, consumption patterns may decline, leading to lower sales tax revenues than when the economy is slowing, but sales can only drop so far. Many companies' net income, by contrast, can bottom out or even go into negative territory. As such, corporate tax collections tend to be highly volatile, spiking sharply in good years and collapsing in bad ones.

As demonstrated in Figure 4b, corporate income tax collections took a significant hit during the Great Recession, just at the time when Arkansas most needed revenue stability. In fiscal year 2016, the corporate income tax brought in $486.7 million, accounting for 9.1 percent of state net general revenue and 7.5 percent of state gross general revenue. Arkansas's corporate income tax collections per capita were decidedly middle-of-the-pack at the 23rd highest collections in the nation in fiscal year 2014.

Figure 4b.


Note: Dollar amounts are inflation adjusted based on the annual average Consumer Price Index for All Urban Consumers (CPI-U) with a 2014 base year.

77 Arkansas Department of Finance and Administration, "General Revenue Report for June and FY16 Summary," July 5, 2016, 2.
78 Arkansas's general fund includes a number of statutory diversions, for such items as public school desegregation and education adequacy. Gross general revenue figures are before such diversions, while net figures are the available general revenues after such diversions occur.
Corporate Income Tax Expenditures

Arkansas offers a range of deductions, exemptions, and credits against corporate income tax liability. By far the most significant of these are the Create Rebate and the Waste Reduction and Recycling Equipment Credit. The Create Rebate provides an income tax credit for payroll expenses of expanding firms, while the Waste Reduction and Recycling Equipment Credit is an income tax credit for investments in new recycling machinery. Table 4c lists the corporate income tax credits in excess of $1 million in fiscal year 2014.

Table 4c. Corporate Income Tax Credits in Excess of $1 Million

<table>
<thead>
<tr>
<th>Credit</th>
<th>Amount in FY14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Waste Reduction and Recycling Equipment</td>
<td>$12,114,222</td>
</tr>
<tr>
<td>Create Rebate</td>
<td>$10,060,963</td>
</tr>
<tr>
<td>Equity Investment Incentive Act</td>
<td>$3,229,753</td>
</tr>
<tr>
<td>Research and Development</td>
<td>$2,165,229</td>
</tr>
<tr>
<td>ArkPlus</td>
<td>$1,658,525</td>
</tr>
<tr>
<td>Advantage Arkansas</td>
<td>$1,486,542</td>
</tr>
<tr>
<td>Historic Rehabilitation Tax Credit</td>
<td>$1,423,007</td>
</tr>
<tr>
<td>Water Resource Conservation</td>
<td>$1,016,390</td>
</tr>
</tbody>
</table>

Source: Arkansas Department of Finance and Administration, Business Incentives and Tax Credits Program Costs Through December 31, 2014

Deductions, exemptions, and credits all serve to reduce tax liability, but they do so in distinct ways that are important to bear in mind while attempting any comparison. Deductions reduce taxable income by a given amount, whereas credits are a subtraction against tax liability. Imagine, for instance, a corporate taxpayer with $50,000 in Arkansas corporate income tax liability. A $5,000 credit will reduce tax liability to $45,000, whereas a $5,000 deduction will reduce tax liability by less than $500, as the reduction in liability will be equal to the tax on that $5,000. An exemption, meanwhile, excludes certain revenue from the tax rolls altogether.

The Waste Reduction and Recycling Equipment Credit provides an income tax credit of 30 percent of the cost of “waste reduction, reuse, or recycling equipment, including the cost of installation.” The tax credit, created in 1991, can be carried forward for a total of three years and must be approved by the Arkansas Department of Environmental Quality.

The Consolidated Incentive Act of 2003 authorized many of the other tax credits listed above. The Act created Advantage Arkansas, ArkPlus, the Create Rebate, Targeted Business Payroll, and Research and Development (InvestArk and TaxBack, which are described in Chapter 5, were also created by this Act), and eliminated a number of previous programs. These credits work in tandem to attempt to induce economic development and reward a number of specified behaviors. To qualify for these credits, corporations must apply to one of several government agencies (the overseeing agency varies by the credit program).

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80 Arkansas’s largest business incentive is InvestArk, which provides a credit against a firm’s sales and use tax liability if it invests more than $5 million in a single location of project. Since it offsets sales tax liability, this credit will be discussed later in Chapter 5. However, the estimated $40 million in revenue increase from InvestArk’s repeal is used to offset other corporate income tax changes discussed in this chapter.

81 A.C.A §26-51-506(e)(1).

82 A.C.A §15-4-27.
The first group of these credits are credits for businesses that hire new workers. The Create Rebate is the largest and provides a tax credit of 3.9 to 5 percent of payroll for new full-time employees, assuming a minimum payroll increase of $2 million within 24 months. Corporations are able to claim the credit for up to ten years.\(^83\) Advantage Arkansas is a similar program that provides an income tax credit ranging from 1 to 4 percent after the corporation enters into a financial agreement with the Arkansas Economic Development Commission. The credit may offset up to 50 percent of a firm’s liability in one year and can be carried forward for up to nine years.\(^84\) The Targeted Business Payroll Income Tax Credit provides a 10 percent credit for start-up businesses in a targeted business sector.\(^85\)

In addition to providing credits for expanded payroll, the Act authorized new credit programs for new investment and research located in Arkansas. ArkPlus is a 10 percent credit against total new investment in the state between $2 million and $5 million.\(^86\) The credit can be carried forward for up to nine years, while Research and Development credits are available to firms that work with Arkansas-based colleges to conduct research.\(^87\)

Incentives can be effective, but they are not efficient. By lowering tax costs for targeted industries or rewarding particular business activities, they can yield higher employment or greater investment in those sectors. Unfortunately, the cost of these incentives must be borne by other, non-favored businesses which bear a correspondingly higher tax burden. Ultimately, incentives involve picking winners and losers, and seek to guide the economy in keeping with policymakers’ (often competing) visions. A well-structured tax code with a broader base—eliminating many of the incentives—and a lower rate would do far more to encourage job creation and economic growth.

Arkansas Legislative Audit conducted a cost-benefit analysis of 50 projects from 2003 to 2014. It found that 33 projects had a negative cost-benefit analysis, largely because 24 of the projects involved InvestArk credits which do not require job creation.\(^88\) But the analysis made a dubious assumption that dramatically influences its direct results: the analysis assumed that projects would have not occurred without the tax credit. It is quite possible that business expansions, either through payroll or investment, would have occurred even without the tax incentives. In fact, a 2016 analysis by the Arkansas Democrat-Gazette found multiple instances where business officials acknowledged that “workers would have been hired without state involvement.”\(^89\)

All states rely on incentives to some degree, but Arkansas relies on targeted incentives to help offset the state’s high tax rates. Credits can create confusion: in many cases, companies must navigate an application process to be approved for such credits, and of course, some companies fail to qualify.

\(^{83}\) A.C.A. §15-4-2707.  
\(^{84}\) A.C.A. §15-4-2705.  
\(^{85}\) A.C.A. §15-4-2709.  
\(^{86}\) A.C.A. §15-4-2706.  
\(^{87}\) A.C.A. §15-4-2708.  
This uncertainty can make Arkansas less attractive than a state with a lower overall rate but fewer incentives, even though firms that do decide to locate in Arkansas may obtain approval for a number of credits and other incentives which reduce their overall tax burden.

**Structural Elements**

**Net Operating Loss Carrybacks and Carryforwards**

The corporate income tax is designed to tax only the profits of a corporation. However, a yearly profit snapshot may not fully capture a corporation's true profitability. For example, a corporation in a highly cyclical industry may look very profitable during boom years but post substantial losses during bust years. When examined over the entire business cycle, the corporation may actually have only a moderate profit margin.

Although corporate income tax liability is determined on an annualized basis, business cycles do not follow the calendar. To mitigate this reality, states (along with the federal government) allow corporations to deduct losses from previous years and future years to offset current taxes owed. These net operating loss (NOL) “carrybacks” and “carryforwards” smooth out tax obligations over time, ensuring that industries with cyclical income are not at a competitive disadvantage against industries with more consistent and stable revenue streams.

The deduction for net operating losses helps ensure that, over time, the corporate income tax is a tax on average profitability. Without the NOL deduction, corporations in cyclical industries pay much higher taxes than those in stable industries, even assuming identical average profits over time.

There are two important variables of a state's NOL provisions: the number of years allowed for carrybacks and carryforwards, and caps on the amount of carrybacks and carryforwards. The maximum that any state allows for carrybacks is three years, with no cap (that is, an unlimited dollar amount allowed). Among the states that allow carrybacks, the most common timespan is two years with no cap. The maximum carryforward given in any state is 20 years, again with no cap (most states allow either 15 or 20 years, though 20 is more desirable). The longer the overall time span, the higher the probability that the corporate income tax is being levied on the corporation’s average profitability.

Arkansas, however, lags other states on its NOL provisions. Arkansas does not allow for any carrybacks, and only allows for carryforwards for five years. Its regional peers all provide better NOL treatment.
Table 4d.
Net Operating Loss Carryforwards and Carrybacks
Arkansas and Selected Regional Competitors (2016)

<table>
<thead>
<tr>
<th></th>
<th>Carryback (Years)</th>
<th>Carryback Cap</th>
<th>Carryforward (Years)</th>
<th>Carryforward Cap</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arkansas</td>
<td>0</td>
<td>$0</td>
<td>5</td>
<td>Unlimited</td>
</tr>
<tr>
<td>Louisiana</td>
<td>0</td>
<td>Unlimited</td>
<td>20</td>
<td>Unlimited</td>
</tr>
<tr>
<td>Mississippi</td>
<td>2</td>
<td>Unlimited</td>
<td>20</td>
<td>Unlimited</td>
</tr>
<tr>
<td>Missouri</td>
<td>2</td>
<td>Unlimited</td>
<td>20</td>
<td>Unlimited</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>2</td>
<td>Unlimited</td>
<td>20</td>
<td>Unlimited</td>
</tr>
<tr>
<td>Tennessee</td>
<td>0</td>
<td>$0</td>
<td>15</td>
<td>Unlimited</td>
</tr>
<tr>
<td>Texas</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
</tbody>
</table>


Apportionment and Sourcing

When businesses operate in more than one state, income must be apportioned among those states for tax purposes. The legal term for whether a state has the power to tax is nexus—which typically requires a business to have some physical presence, either property or employees, in a state—and the determination of the amount of that business's income subject to a given state's corporate income tax is known as apportionment. States apportion business profits based on some combination of the percentage of company property, payroll, and sales located within their borders.

Traditionally, states adopted an evenly weighted three-factor apportionment formula of property, payroll, and sales, meaning that property, payroll, and sales are taken into account equally determining income apportionment. Today, states have moved increasingly toward weighting their sales factor more heavily, with 19 states even employing single sales factor apportionment, meaning the only determinant of the percent of firm profits subject to tax within the state is the percent of sales into that state.

Arkansas currently uses a double-weight sales formula, meaning that Arkansas functionally uses a four-factor approach: sales, sales, property, and payroll. If, hypothetically, a business owned all of its property and employed all its personnel in Arkansas, but only sold ten percent of its sales in the state, then twenty percent of its net income would be subject to Arkansas's corporate income tax.

This treatment is beneficial for firms that export to other states, as in-state sales weigh more heavily into the apportionment ratio. Having labor-intensive or capital-intensive operations matters less under a double-weighted sales approach.

However, the efforts that Arkansas makes to minimize the harm for exporters are undone by its throwback rule. Because each state has a different apportionment method, sometimes certain income goes untaxed. Throwback rules, which exist in 25 states and the District of Columbia, throw back this so-called "nowhere income" into the state's taxable base. In many cases, multiple states claim the right to tax the same income, introducing added complexity to the tax code and
introducing double taxation. Arkansas requires firms with nowhere income to include it in the state’s taxable base.

The state uses separate reporting, as opposed to combined (or consolidated) reporting, meaning that out-of-state subsidiaries of Arkansas-based corporations do not have their profits or losses combined with those of the parent company in determining taxable income. Combined reporting can produce an increased likelihood that corporations will have more than 100 percent of their income considered part of the tax base across multiple states. Should Arkansas move to mandatory combined reporting, it would increase collections somewhat inasmuch as these subsidiaries are profitable, though subsidiaries posting a net loss in other states would decrease the parent company’s Arkansas tax liability.

**Corporate Income Tax Reform Solutions**

Our corporate income tax solutions would make Arkansas more competitive by bringing its corporate income tax rate from one of the highest in its region to rates more typical with its competitors while broadening the tax base by limiting or eliminating state tax policies which pick winners and losers. These policies help mitigate tax uncertainty for business, eliminate the “sticker shock” associated with Arkansas’s high statutory income tax rates, and begin changing the state from a system of taxation which is only competitive for favored industries, positioning the state for future growth.

**Rein in Tax Credits**

Tax credits reduced tax liabilities by approximately $35 million in fiscal year 2014. Sold as a way to improve Arkansas’s competitiveness regionally, these credits only mitigate Arkansas’s uncompetitive tax structure. The credits are beneficial for the targeted firms and industries that receive the credits, but they punish non-favored industries with higher rates than otherwise necessary.

An ideal policy, of course, would involve the immediate reduction or elimination of existing tax credits. Eliminating these credits would fully offset the revenue losses associated with Option C discussed later in the chapter.

**Improve Treatment of Net Operating Losses**

Arkansas’s strict net operating loss treatment penalizes struggling businesses, denying them the ability to deduct losses at the time of their greatest financial need. Arkansas can improve business cycle neutrality by extending its carryforwards from five years to 10 years. By phasing in this change over a few years, the effect on the state’s budget will be minimal.

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90 Arkansas filers do have the option of filing a consolidated return per A.C.A §26-51-805(a)(1).
92 Representative Neal, “HB1430 Fiscal Note,” February 26, 2015, 1.
Eliminate the Throwback Rule

Arkansas taxes the “nowhere income” of corporations through its throwback rule, which added unneeded complexity to the state's corporate income tax code. Arkansas should eliminate its throwback rule.

Consolidate Brackets and Lower Rates

Finally, we propose to lower Arkansas's corporate income tax rate and consolidate the number of brackets. All three of these proposals are revenue negative, but are not designed to stand alone. They should be combined with reforms from other sections of this book, particularly the sales tax reforms in Chapter 5.

Option A

Our first proposal, Option A, would change Arkansas's current structure to a 4.95 percent flat tax on all corporate income; however, this proposal would require a three-fourths legislative majority due to the restrictions placed on tax changes by Amendment 19 of the Arkansas Constitution. This rate would match the tax rate under Option A for the individual income tax as well.

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0</td>
<td>4.95%</td>
</tr>
</tbody>
</table>

Table 4e. Option A
Corporate Income Tax Rate Schedule

Option B

Our second proposal, Option B, would change Arkansas's current structure to a two-bracket system with the top marginal rate at 5 percent. To eliminate the need for a higher vote threshold, Option B creates a zero bracket for corporations with less than $11,000 in corporate income. Ideally, a corporate tax code would not have a zero bracket, but Arkansas's unique constitutional requirement presents a challenge to passing a tax reform package.

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0-11,000</td>
<td>0%</td>
</tr>
<tr>
<td>$11,001+</td>
<td>5%</td>
</tr>
</tbody>
</table>

Table 4f. Option B
Corporate Income Tax Rate Schedule
Option C

Our final proposal, Option C, would change Arkansas’s current structure to a three-bracket system with the top marginal rate at 6 percent. It is a more incremental approach than options A or B. To eliminate the need for a higher vote threshold, Option C creates a zero bracket for corporations with less than $11,000 in corporate income.

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0-11,000</td>
<td>0%</td>
</tr>
<tr>
<td>$11,001-25,000</td>
<td>5%</td>
</tr>
<tr>
<td>$25,001+</td>
<td>6%</td>
</tr>
</tbody>
</table>

All three options would result in less revenue for the state of Arkansas, but these changes could be offset with elimination of tax credits—discussed in the next section—and changes to the state’s sales tax base.

All Corporate Income Tax Reforms

Combining all of these proposals would increase Arkansas’s ranking on the State Business Tax Climate Index and improve its competitiveness among its regional and national peers. Below are the resulting rank changes from combining the various proposals above with rate structures in Options A, B, and C.

<table>
<thead>
<tr>
<th>Reform Option</th>
<th>Resulting Index Ranking</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Overall Rank</td>
</tr>
<tr>
<td>A</td>
<td>15</td>
</tr>
<tr>
<td>B</td>
<td>20</td>
</tr>
<tr>
<td>C</td>
<td>29</td>
</tr>
</tbody>
</table>
CHAPTER 5: STATE AND LOCAL SALES TAXES
Introduction

Sales taxes are a crucial component of Arkansas's overall tax system. Almost half of the tax revenue generated at the state level comes from general and selective sales taxes: about 47 percent in fiscal year 2013, close to the national average. Counties and cities in Arkansas also have the option to impose a local sales tax and most exercise that option, generating slightly more than half of tax revenue at the local level in Arkansas: about 56 percent in fiscal year 2013, much more than the 17 percent national average. Only two of Arkansas’s seventy-five counties don't levy a local option sales tax, and more than 300 cities have elected to do so after being given the option in 1981.

Given this dominance in Arkansas's mix of tax instruments, it is not surprising that Arkansas has one of the highest sales tax rates in the country. Combining the statewide 6.5 percent rate and a weighted average of local taxes puts Arkansas at the third highest rate in the country of 9.3 percent (only neighboring Louisiana and Tennessee are higher). Arkansas also imposes selective sales taxes on a variety of goods, including short-term vehicle rentals, residential moving truck rentals, tourism, motor fuels, vending machines, cigarettes, other tobacco products, beer, liquor, and mixed drinks (two separate state taxes and an optional local tax on mixed drinks). Most of these goods are also subject to the general sales tax rate, with notable exceptions such as motor fuels.

In this chapter we provide an overview of Arkansas’s sales tax, how it has changed over time, how it compares regionally and nationally, and suggest ways Arkansas can improve the tax.

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93 Census Bureau, 2013 Annual Surveys of State and Local Finances.
94 Ibid.
Sales Tax Collections and History: General Sales Tax

The general sales and use tax generates a significant amount of revenue for state and local governments in Arkansas. Of all taxes collected in Arkansas in fiscal year 2013, the general sales tax was the single largest component, at $3.85 billion or almost 36 percent of the total taxes collected. For local governments, the general sales tax is even more dominant, collecting just over $1 billion in fiscal year 2013, or almost 47 percent of local taxes in Arkansas (Figure 5a).

Figure 5a.
Arkansas State and Local Tax Collections
(1977–2013, in 2013 Dollars)

Of the $3.8 billion raised in fiscal year 2013 for state and local governments, approximately three-fourths of this total went to the state, with the remaining $1 billion going to cities and counties. Collections have grown in real terms over time, even when adjusted for changes in population. Sales tax collections per capita are over two-and-half times higher than in 1977, though essentially unchanged in the last decade (Figure 5b).
Part of the reason for the increase in collections per capita is due to changes in the sales tax rate. At the state level, the rate was only increased once from its inception up until 1984. Since then, the statewide sales tax rate has been increased six times and is now more than double the 3 percent rate that existed prior to 1984. Four of these six recent sales tax increases have been earmarked to fund specific spending programs (Table 5a).

Table 5a.
Arkansas State Sales Tax Rates
1935–2016

<table>
<thead>
<tr>
<th>Year</th>
<th>Rate</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1935</td>
<td>2.000%</td>
<td>First Temporary Sales Tax</td>
</tr>
<tr>
<td>1941</td>
<td>2.000%</td>
<td>First Permanent Sales Tax</td>
</tr>
<tr>
<td>1958</td>
<td>3.000%</td>
<td></td>
</tr>
<tr>
<td>1984</td>
<td>4.000%</td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td>4.500%</td>
<td></td>
</tr>
<tr>
<td>1997</td>
<td>4.625%</td>
<td>0.125% for Game Protection, Parks &amp; Tourism, and Heritage</td>
</tr>
<tr>
<td>2001</td>
<td>5.125%</td>
<td>0.5% for Property Tax Relief</td>
</tr>
<tr>
<td>2004</td>
<td>6.000%</td>
<td>0.875% for Educational Adequacy</td>
</tr>
<tr>
<td>2013</td>
<td>6.500%</td>
<td>0.5% for Four Lane Highways (temporary)</td>
</tr>
</tbody>
</table>

Note: Sales tax increases enacted as Constitutional Amendments are indicated in italics (Amendments 75, 79, and 91 to the Arkansas Constitution).
Comparing Arkansas’s Sales Tax Structure to Regional and National Competitors

Arkansas has one of the most poorly structured sales taxes in the nation according to our State Business Tax Climate Index, putting the state at a disadvantage with its regional competitors. Arkansas’s poor score is driven by two factors: the state’s high combined state and local sales tax rate of 9.3 percent, and an improperly structured sales tax base. Arkansas taxes a number of business inputs within its sales tax (discussed at length later in the chapter). Table 5b shows Arkansas’s State Business Tax Climate Index sales tax component ranking, in addition to the rankings of select regional competitor states.

<table>
<thead>
<tr>
<th>State</th>
<th>Component Ranking</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arkansas</td>
<td>44</td>
</tr>
<tr>
<td>Louisiana</td>
<td>50</td>
</tr>
<tr>
<td>Mississippi</td>
<td>38</td>
</tr>
<tr>
<td>Missouri</td>
<td>24</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>36</td>
</tr>
<tr>
<td>Tennessee</td>
<td>46</td>
</tr>
<tr>
<td>Texas</td>
<td>37</td>
</tr>
</tbody>
</table>

Source: Tax Foundation, 2017 State Business Tax Climate Index

Sales Tax Rate Composition

Arkansas has a very high combined state and local sales tax rate of 9.3 percent using a weighted average of local sales tax rates. Arkansas’s rate places it third highest in the country. But as Figure 5c demonstrates, Arkansas is in a high sales tax region of the country.

The first and second highest rates are in bordering states, and all bordering states are in the top half of sales tax rates. Arkansas’s high sales tax rate is notable not only because it is the third highest, but also because it has increased in recent years. In 2009, Arkansas had only the tenth highest rate at 7.79 percent. Since 2009, the state rate has increased a half percentage point and the local rate has increased a full point.97 Table 5c compares Arkansas to select regional peers.

Figure 5c.
How High Are Sales Taxes in Your State?
Combined State & Average Local Sales Tax Rates (July 1, 2016)

Arkansas and Bordering States (2016, midyear)

<table>
<thead>
<tr>
<th>State</th>
<th>State Rate</th>
<th>Avg. Local Rate</th>
<th>Total Rate</th>
<th>National Rank</th>
<th>Max Local Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arkansas</td>
<td>6.50%</td>
<td>2.80%</td>
<td>9.30%</td>
<td>3</td>
<td>5.13%</td>
</tr>
<tr>
<td>Louisiana</td>
<td>5.00%</td>
<td>4.98%</td>
<td>9.98%</td>
<td>1</td>
<td>7.00%</td>
</tr>
<tr>
<td>Mississippi</td>
<td>7.00%</td>
<td>0.07%</td>
<td>7.07%</td>
<td>20</td>
<td>1.00%</td>
</tr>
<tr>
<td>Missouri</td>
<td>4.23%</td>
<td>3.64%</td>
<td>7.87%</td>
<td>14</td>
<td>5.00%</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>4.50%</td>
<td>4.35%</td>
<td>8.85%</td>
<td>6</td>
<td>6.50%</td>
</tr>
<tr>
<td>Tennessee</td>
<td>7.00%</td>
<td>2.45%</td>
<td>9.45%</td>
<td>2</td>
<td>2.75%</td>
</tr>
<tr>
<td>Texas</td>
<td>6.25%</td>
<td>1.92%</td>
<td>8.17%</td>
<td>12</td>
<td>2.00%</td>
</tr>
</tbody>
</table>

Source: Sales Tax Clearinghouse, Tax Foundation calculations, State Revenue Department Websites
Local Option Sales Tax

In 1981, cities and counties in Arkansas were given the option to include local sales taxes on top of the base sales tax rate. In order to initiate or raise the local sales tax rate, voters in the jurisdiction must approve the change. Since 1981, there have been roughly 900 local sales tax elections held in Arkansas. Overall, about 70 percent of the elections succeeded in raising the local sales tax rate, though in general elections, when turnout is highest, the pass rate is only around 42 percent.98

As a result of the local sales tax elections, local option sales taxes now are in place in 73 of the 75 counties in Arkansas, as well as in 314 cities, as of July 2016. County rates range from 0.5 to 3.25 percent (Cleveland County is the highest), and city rates range from 0.5 to 3.5 percent (DeWitt is the highest). When the state, county, and city rates are combined, fourteen cities in Arkansas have rates of 11 percent or greater.99

Sales Tax Base

Like most states, Arkansas imposes its sales tax on a base that consists of most goods—with economically significant policy carve-outs—and relatively few services. Although service taxation in Arkansas is somewhat broader than in the average state, it falls short of what most public finance scholars would define as optimal.

Arkansas does not tax prescription drugs or gasoline under its state sales tax and taxes groceries at a lower rate (1.5 percent), exempting a sizable and stable portion of consumer spending. In Arkansas, 13.2 percent of personal consumption expenditures in 2014 were spent on off-premise food and beverage consumption and gasoline and other energy goods.100 The state also exempts many, though not all, services, and select other goods. By law, tangible personal property is included in the sales tax base unless expressly exempted, whereas services are only subject to tax if specifically enumerated.

Services comprise an ever larger share of consumer transactions. Combined with pressure to exempt certain other goods from time to time, base erosion is inevitable. As the tax base shrinks, lawmakers tend to look to rate increases for additional revenue. A better option is to broaden the tax base, which can permit rate reductions even in revenue positive scenarios.
Taxation of Business Inputs

When contemplating broadening the sales tax base, it is important to maintain proper treatment of business inputs. A well-structured sales tax is imposed on all final consumer goods and services while exempting all purchases made by businesses that will be used as inputs in the production process. This is not because businesses deserve special treatment under the tax code, but because applying the sales tax to business inputs results in multiple layers of taxation embedded in the price of goods once they reach final consumers, known as “tax pyramiding.” The result is higher and inequitable effective tax rates for different industries and products, which is both non-neutral and non-transparent.

While most states make some effort to exclude business inputs from taxation, few do so consistently or uniformly. It has been estimated that 34.3 percent of total business taxes paid in Arkansas are general sales taxes, above the national average of 19.8 percent. In a perfectly structured tax code, that share would be zero. The state has taken steps to address the taxation of business inputs in recent years, moving to partially exempt repair of machinery and equipment from the sales tax. But the rules are still often unclear to businesses in advance of making decisions, creating confusion in decision making while violating good principles of tax neutrality and allowing tax costs to be embedded in the final price of goods several times over.

Taxation of Services

Another major contributing factor to the shrinking sales tax base over time—in Arkansas and elsewhere—is that American consumption habits have shifted over the years. Whereas the U.S. economy was heavily weighted toward goods when sales taxes were first imposed, today the economy is increasingly service-oriented. Figure 5d shows national goods and services consumption shares since 1929.

Since 1977, Arkansas’s sales tax breadth—a measure of the broadness of the tax base—has fallen from an implicit sales tax base equal to 77 percent of personal income to roughly 44 percent of personal income in 2013 (Figure 5e). This does place Arkansas in the top tier of states with a broad sales tax base, but it still means that Arkansas is exempting more than half of the potential sales tax base. In other words, the same amount of revenue could be raised with less than half the current rate if the sales tax base covered all goods and services.

The Federation of Tax Administrators (FTA) periodically publishes a survey of services taxable under each state’s sales tax, with the most recent data compiled in 2010. The survey includes both business-to-business services (which should be exempted under a well-structured sales tax, as discussed earlier) and final consumer services. Seventy-one of the transactions could be either, depending on the identity of the purchaser.

Figure 5d.

**Percent of Total Personal Consumption Expenditures**
*Goods vs. Services, U.S. (1929–2013)*


Figure 5e.

**Arkansas’s Sales Tax Breadth**
*(1977–2013)*

Source: Sales tax revenue from Census of State and Local Finances, Personal Income from BEA, method is modified version from John Mikesell, “The Disappearing Retail Sales Tax,” State Tax Notes 63, 777-791.
The following tables enumerate these service categories and note whether the Arkansas sales tax applies to each service type. As of 2010, Arkansas taxed 83 of the 181 services enumerated in the FTA survey under the general sales tax. Of those, at least 24 should be exempted because they are business inputs. In addition to the services generally surveyed by the FTA, Arkansas also taxes the following services: alarm monitoring, body piercing, electrolysis, pet kennel services, industrial laundry services, locksmith services, pager services, cleaning parking lots and gutters, and tattooing.

Table 5d.
Arkansas’s Tax Treatment of Business Input Services

<table>
<thead>
<tr>
<th>Business Input Service</th>
<th>Taxed in Arkansas?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advertising, Billboards</td>
<td></td>
</tr>
<tr>
<td>Advertising, Magazine</td>
<td></td>
</tr>
<tr>
<td>Advertising, Newspaper</td>
<td></td>
</tr>
<tr>
<td>Advertising, Radio &amp; Television (Local)</td>
<td></td>
</tr>
<tr>
<td>Advertising, Radio &amp; Television (National)</td>
<td></td>
</tr>
<tr>
<td>Advertising Agency Fees (Excluding Ad Placement)</td>
<td></td>
</tr>
<tr>
<td>Armored Car Services</td>
<td>✔</td>
</tr>
<tr>
<td>Bulldozers, Draglines, &amp; Construction Machinery Rentals (Long-Term)</td>
<td>✔</td>
</tr>
<tr>
<td>Bulldozers, Draglines, &amp; Construction Machinery Rentals (Short-Term)</td>
<td>✔</td>
</tr>
<tr>
<td>Check &amp; Debt Collection</td>
<td></td>
</tr>
<tr>
<td>Commercial Art &amp; Graphic Design</td>
<td></td>
</tr>
<tr>
<td>Commercial Linen Supply</td>
<td>✔</td>
</tr>
<tr>
<td>Credit Information &amp; Credit Bureaus</td>
<td></td>
</tr>
<tr>
<td>Custom Fabrication Labor</td>
<td></td>
</tr>
<tr>
<td>Data Processing Services</td>
<td></td>
</tr>
<tr>
<td>Employment Agencies</td>
<td></td>
</tr>
<tr>
<td>Financial &amp; Tickertape Reporting</td>
<td></td>
</tr>
<tr>
<td>Food Storage</td>
<td>✔</td>
</tr>
<tr>
<td>Industrial Sewer &amp; Refuse Services</td>
<td>✔</td>
</tr>
<tr>
<td>Information Services</td>
<td></td>
</tr>
<tr>
<td>Interstate Telephone &amp; Telegraph</td>
<td>✔</td>
</tr>
<tr>
<td>Intra-Telephone &amp; Telegraph</td>
<td>✔</td>
</tr>
<tr>
<td>Labor Charges, Repairs to Commercial Fishing Vessels</td>
<td>✔</td>
</tr>
<tr>
<td>Labor Charges, Repairs to Interstate Vessels</td>
<td>✔</td>
</tr>
<tr>
<td>Labor Charges, Repairs to Intrastate Vessels</td>
<td>✔</td>
</tr>
<tr>
<td>Labor Charges, Repairs to Railroad Rolling Stock</td>
<td>✔</td>
</tr>
<tr>
<td>Lobbying &amp; Consulting Services</td>
<td></td>
</tr>
<tr>
<td>Mainframe Computer Access &amp; Processing Services</td>
<td></td>
</tr>
<tr>
<td>Maintenance &amp; Janitorial Services</td>
<td>✔</td>
</tr>
<tr>
<td>Marketing</td>
<td></td>
</tr>
<tr>
<td>Metal, Non-Metal, &amp; Coal Mining Services</td>
<td></td>
</tr>
<tr>
<td>Mini-Storage</td>
<td>✔</td>
</tr>
<tr>
<td>Oil Field Services</td>
<td></td>
</tr>
<tr>
<td>Online Data Processing Services</td>
<td></td>
</tr>
<tr>
<td>Packing &amp; Crating</td>
<td></td>
</tr>
<tr>
<td>Process Server Fees</td>
<td></td>
</tr>
<tr>
<td>Public Relations &amp; Management Consulting</td>
<td></td>
</tr>
<tr>
<td>Rental of Films &amp; Tapes by Theaters</td>
<td></td>
</tr>
<tr>
<td>Rental of Hand Tools to Licensed Contractors</td>
<td>✔</td>
</tr>
<tr>
<td>Secretarial &amp; Court Reporting Services</td>
<td></td>
</tr>
<tr>
<td>Security Services</td>
<td>✔</td>
</tr>
<tr>
<td>Seismograph &amp; Geophysical Services</td>
<td></td>
</tr>
<tr>
<td>Sign Construction &amp; Installation</td>
<td></td>
</tr>
<tr>
<td>Software, Material Custom Programs</td>
<td>✔</td>
</tr>
<tr>
<td>Software, Modifications to Canned Programs</td>
<td></td>
</tr>
<tr>
<td>Software, Professional Services Custom Programs</td>
<td>✔</td>
</tr>
<tr>
<td>Soil Preparation, Custom Bailing, &amp; Other Agricultural Services</td>
<td></td>
</tr>
<tr>
<td>Swimming Pool Cleaning &amp; Maintenance</td>
<td>✔</td>
</tr>
<tr>
<td>Telemarketing Services (Contract)</td>
<td></td>
</tr>
</tbody>
</table>
### Table 5d. Continued.

#### Arkansas’s Tax Treatment of Business Input Services

<table>
<thead>
<tr>
<th>Service Type</th>
<th>Taxed in Arkansas?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Telephone Answering Services</td>
<td>✓</td>
</tr>
<tr>
<td>Temporary Help Agencies</td>
<td>✓</td>
</tr>
<tr>
<td>Test Laboratories (Excluding Medical)</td>
<td>✓</td>
</tr>
<tr>
<td>Test Laboratories (Medical)</td>
<td>✓</td>
</tr>
<tr>
<td>Typesetting &amp; Platemaking for Print Trades</td>
<td>✓</td>
</tr>
<tr>
<td>Utilities, Electricity (Nonresidential)</td>
<td>✓</td>
</tr>
<tr>
<td>Utilities, Natural Gas (Nonresidential)</td>
<td>✓</td>
</tr>
<tr>
<td>Utilities, Other Fuel (Including Heating Oil, Nonresidential)</td>
<td>✓</td>
</tr>
<tr>
<td>Utilities, Water (Nonresidential)</td>
<td>✓</td>
</tr>
<tr>
<td>Welding Labor (Fabrication &amp; Repair)</td>
<td>✓</td>
</tr>
</tbody>
</table>

Source: Federation of Tax Administrators (2010).

### Table 5e.

#### Arkansas’s Tax Treatment of Other Service Types

<table>
<thead>
<tr>
<th>Consumer Service Type</th>
<th>Taxed in Arkansas?</th>
</tr>
</thead>
<tbody>
<tr>
<td>900 Number Services</td>
<td>✓</td>
</tr>
<tr>
<td>Aircraft Rental to Individual Pilots (Long-Term)</td>
<td>✓</td>
</tr>
<tr>
<td>Aircraft Rental to Individual Pilots (Short-Term)</td>
<td>✓</td>
</tr>
<tr>
<td>Amusement Parks (Admission &amp; Rides)</td>
<td>✓</td>
</tr>
<tr>
<td>Bail Bond Fees</td>
<td>✓</td>
</tr>
<tr>
<td>Barber Shops &amp; Beauty Parlors</td>
<td>✓</td>
</tr>
<tr>
<td>Billiard Parlors</td>
<td>✓</td>
</tr>
<tr>
<td>Bowling Alleys</td>
<td>✓</td>
</tr>
<tr>
<td>Circus &amp; Fairs (Admission &amp; Games)</td>
<td>✓</td>
</tr>
<tr>
<td>Coin-Operated Video Games</td>
<td>✓</td>
</tr>
<tr>
<td>Cultural Events (Admission)</td>
<td>✓</td>
</tr>
<tr>
<td>Dating Services</td>
<td>✓</td>
</tr>
<tr>
<td>Debt Counseling</td>
<td>✓</td>
</tr>
<tr>
<td>Dentists</td>
<td>✓</td>
</tr>
<tr>
<td>Diaper Service</td>
<td>✓</td>
</tr>
<tr>
<td>Downloading, Movies &amp; Digital Video</td>
<td>✓</td>
</tr>
<tr>
<td>Downloading, Music</td>
<td>✓</td>
</tr>
<tr>
<td>Downloading, Other Electronic Goods</td>
<td>✓</td>
</tr>
<tr>
<td>Electricity (Residential)</td>
<td>✓</td>
</tr>
<tr>
<td>Fishing &amp; Hunting Guide Services</td>
<td>✓</td>
</tr>
<tr>
<td>Funeral Services</td>
<td>✓</td>
</tr>
<tr>
<td>Fur Storage</td>
<td>✓</td>
</tr>
<tr>
<td>Garment Services (Altering &amp; Repairing)</td>
<td>✓</td>
</tr>
<tr>
<td>Gift &amp; Package Wrapping Services</td>
<td>✓</td>
</tr>
<tr>
<td>Health Clubs &amp; Gyms</td>
<td>✓</td>
</tr>
<tr>
<td>Horse Boarding &amp; Training (Excluding Race Horses)</td>
<td>✓</td>
</tr>
<tr>
<td>Household Goods Storage</td>
<td>✓</td>
</tr>
<tr>
<td>Laundry &amp; Dry Cleaning Services (Coin-Operated)</td>
<td>✓</td>
</tr>
<tr>
<td>Laundry &amp; Dry Cleaning Services (Non-Coin-Operated)</td>
<td>✓</td>
</tr>
<tr>
<td>Local Transit (Intra-City) Buses</td>
<td>✓</td>
</tr>
<tr>
<td>Massage Services</td>
<td>✓</td>
</tr>
<tr>
<td>Natural gas (Residential)</td>
<td>✓</td>
</tr>
<tr>
<td>Nursing Services (Out of Hospital)</td>
<td>✓</td>
</tr>
<tr>
<td>Other Fuel (Including Heating Oil, Residential)</td>
<td>✓</td>
</tr>
<tr>
<td>Pari-Mutuel Racing Events</td>
<td>✓</td>
</tr>
<tr>
<td>Personal Instruction (Dance, Golf, Tennis, Etc.)</td>
<td>✓</td>
</tr>
<tr>
<td>Pet Grooming</td>
<td>✓</td>
</tr>
<tr>
<td>Physicians</td>
<td>✓</td>
</tr>
<tr>
<td>Pinball &amp; Other Mechanical Amusements</td>
<td>✓</td>
</tr>
<tr>
<td>Private Clubs (Membership Fees)</td>
<td>✓</td>
</tr>
<tr>
<td>Professional Sports Events (Admission)</td>
<td>✓</td>
</tr>
<tr>
<td>Rental of Video Tapes for Home Viewing</td>
<td>✓</td>
</tr>
<tr>
<td>Residential Sewer &amp; Refuse Services</td>
<td>✓</td>
</tr>
<tr>
<td>School &amp; College Sports Events (Admission)</td>
<td>✓</td>
</tr>
</tbody>
</table>
Sales Tax Exemptions

The Arkansas Department of Finance and Administration releases periodic sales tax expenditure reports, the most recent (issued in 2012) covering fiscal year 2011. This most recent report is not an "official" list of sales tax exemptions, and is several years old, but there is much to be gleaned from the report.

A tax expenditure is something that would have been taxed but was specifically exempted or abated, or a subtraction, credit, deduction, or exclusion that was implemented to reduce or completely eliminate an entity’s or individual's tax liability. The report details 103 sales tax exclusions which carve more than a billion dollars from the sales tax base. Not all of these expenditures are created equally, however, and different starting definitions of the sales tax base make comparison across states difficult.

For instance, many of the listed expenditures are business inputs. The state lists the sale of “machinery and equipment used directly in manufacturing or processing” as an expenditure, but this is a clear business input. There are many other ways that sales taxes can pyramid, hence the efforts to exclude other inputs, such as chemicals and catalysts and agricultural fertilizers for commercial production.

Other provisions are largely administrative, such as exempting governmental transactions. Others reflect policy choices made by the legislature. Arkansas exempts prescription drugs from the sales tax base, and taxes groceries at a lower rate, 1.5 percent.

It is worth noting that the tax expenditure report does not quantify the loss associated with not taxing services more broadly, since services are not part of the sales tax base unless expressly included by statute. Goods, by contrast, are excluded unless expressly exempted. If the exclusion of most services were treated as a sales tax exemption, it would dwarf most of those presently quantified.

Table 5e, Continued.
Arkansas’s Tax Treatment of Other Service Types

<table>
<thead>
<tr>
<th>Service Type</th>
<th>Exempted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shoe Repair</td>
<td>✔</td>
</tr>
<tr>
<td>Tanning Parlors &amp; Salons</td>
<td>✔</td>
</tr>
<tr>
<td>Tax Return Preparation</td>
<td></td>
</tr>
<tr>
<td>Taxidermy</td>
<td>✔</td>
</tr>
<tr>
<td>RV Parks (Overnight)</td>
<td>✔</td>
</tr>
<tr>
<td>Tuxedo Rental</td>
<td>✔</td>
</tr>
<tr>
<td>Water (Residential)</td>
<td>✔</td>
</tr>
</tbody>
</table>

Source: Federation of Tax Administrators (2010).
In addition to the exemptions listed on the Department of Finance and Administration report released in 2012, Arkansas has two sales tax credits for businesses, InvestArk and TaxBack. InvestArk is the largest business incentive in Arkansas, representing half ($40 million) of all incentives given in 2014. TaxBack is much smaller, totaling only $589,028 in 2014, down from $8 million in 2011.

InvestArk provides a credit against an established business’s sales tax liability as the firm invests $5 million in a “project, including land, buildings, and equipment used in the construction, expansion, or modernization.” The credit equals 0.5 percent above the state’s current sales tax rate, and is used to offset a corporation’s direct sales tax liability. The credit cannot exceed 50 percent of a firm’s sales tax liability in one year, and it can be carried forward for up to five years.

InvestArk was a topic of frequent conversations during our travels across Arkansas. Many businesses viewed it as an essential portion of the Arkansas tax code, largely to offset the improper tax treatment of machinery repair parts discussed earlier in this chapter. However, other taxpayers, largely smaller firms and individuals, remarked often on the unfair advantage large, established firms received from this tax credit. Fixing the state’s sales tax base to exclude business inputs would be a better long-term strategy than relying on tax credits that seek to ameliorate the damage.

TaxBack provides a sales tax credit for “the purchase of building materials and machinery and equipment” to businesses that “create new jobs as a result of construction, expansion, or facility modernization projects in Arkansas.” Expanding firms must invest more than $100,000 into the project to receive the credit, which cannot offset the sales taxes paid into the Education Adequacy Fund or Conservation Trust Fund.

The policy rationales for many of these exemptions are understandable. They do, however, carve away the sales tax base, forcing the rate to be higher in order to raise the same revenue on a smaller base of transactions.

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103 The majority of Arkansas’s business incentives are credits against corporate income tax liability and are therefore discussed in Chapter 4.
105 Ibid.
106 A.C.A. §15-4-2706(i)(2)(B).
107 A.C.A. §15-4-2706(i)(3).
109 A.C.A. §15-4-2706(d).
Taxation of E-Commerce

Another factor contributing to dwindling sales tax bases over time is the lack of taxation of remote purchases, such as those made over the Internet. Currently, retailers are only required to collect sales taxes in states in which they have a physical presence of property or employees. This geographic limitation on the scope of state taxing power, while not new, has come under pressure due to the growing size of Internet retail and the resultant disparity in tax treatment between goods purchased online and goods purchased at brick-and-mortar stores.

Keeping the sales tax aligned with the modern economy is important for the state and brick-and-mortar retailers, just as making multistate sales tax collection as seamless and simple as possible is important for Internet retailers and the national economy as a whole.

The Limits of Use Taxes

Use taxes were enacted as complements to sales taxes not long after their introduction. While the sales tax is owed for purchasing an item, the use tax is owed for using an item when sales tax has not been paid. States introduced use taxes out of concern that taxpayers would avoid sales taxes by purchasing goods in states with lower or no sales tax instead of purchasing them in-state and paying the sales tax. The use tax thus creates a tax obligation for consumers who do this, and all states with a sales tax also have a use tax with the same rate as the sales tax.

However, because the use tax requires self-reporting and payment by the consumer instead of collection at the point-of-sale by the retailer, use tax compliance is very low except for large purchases or business purchases susceptible to a state audit. Thus, consumers do not tend to report many of their Internet purchases in order to avoid paying use tax on them.

An Increased Push to Tax Internet Purchases

Americans spent about $263 billion in Internet retail purchases in 2013, a growth of 15 percent over the previous year and comprising about 6 percent of the $4.5 trillion in total retail sales. The growth rate has been fairly steady, and it is likely that Internet commerce will continue to grow as a share of national retail.

While the largest driver of continued discussion of e-commerce taxation is the desire for more revenue, there is also a neutrality argument at play. There is no economically justifiable reason why the same good should be untaxed if it is purchased online versus purchased in a brick-and-mortar store. Such discrepancies are non-neutral and favor online purchases at the expense of purchases made at traditional retail establishments.

110 About half the states also include a use tax payment line on their income tax form, but the collections from this method are minimal. Features of this sometimes include an exemption for purchases under a certain threshold and a lookup table where taxpayers can pay a certain amount based on their income rather than tracking all purchases throughout the year. See, e.g., Nina Manzi, “Use Tax Collection on Income Tax Returns in Other States,” Minnesota House of Representatives Research Department Policy Brief, April 2012, http://www.house.leg.state.mn.us/hrd/pubs/usetax.pdf

However, state taxing power is generally limited to individuals and businesses within the state's borders (to prevent harm to the national economy from tax exporting). To get around this issue, some states have passed "click-through nexus" or "affiliate nexus" statutes requiring out-of-state retailers to collect sales tax under certain circumstances, leading to extended litigation and uncertainty. Examples include New York's "Amazon" Tax Law (and subsequent similar laws in other states). Arkansas passed a similar law in 2011. If affiliates exceed $10,000 in referrals to the out-of-state retailer within a calendar year, the retailer is considered to have physical presence within the state.

These types of laws are problematic because they are non-neutral, only applying to certain online retailers. Further, they can discourage companies from locating distribution facilities or other operations in-state and can be triggered by de minimis contact with a state (e.g., an Amazon affiliate being located in-state).

The Streamlined Sales Tax Project (SSTP) was launched in 2000 as a way to harmonize state sales tax structures in light of the U.S. Supreme Court's Quill decision. The SSTP is a joint effort by states and the business community to reduce administrative and sales tax compliance burdens with an eye toward convincing Congress to authorize states to obligate the remittance of use tax by remote sellers, and to encourage voluntary remittances by select remote vendors. Twenty-four states, including Arkansas, representing 33 percent of the U.S. population, have ratified the Streamlined Sales and Use Tax Agreement.

However, this effort to balance states' reserved powers with the need for simpler rules and remittance procedures has been severely hamstrung by the refusal of many large states to participate, including California, Illinois, New York, and Texas. While no state should be compelled to participate in SSTP, the Project suffers because many states believe they can assert expanded tax authority without the hard work required by SSTP, such as centralizing tax collection and auditing, reducing local sales tax complexity, adopting uniform definitions of items, and compensating vendors for administrative costs.

In an attempt to attract more member states, the SSTP Governing Board has focused increasingly on uniformity and not simplification. In many cases, the Project has enabled state sales tax complexity by permitting separate tax rates for certain goods, not addressing growing local tax jurisdiction complexity, and permitting states to retain parochial sales tax rules.

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113 ACA, §26-52-172(d)-(e)
114 Arkansas, Georgia, Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Vermont, Washington, West Virginia, Wisconsin, and Wyoming.
Federal Solutions

Presently, there are three options for the taxation of remote sellers being weighed federally—the Marketplace Fairness Act (MFA),\(^{116}\) the Online Sales Simplification Act (OSSA),\(^{117}\) and the Remote Transactions Parity Act (RTPA)\(^ {118}\)—all of which would authorize states to require collection of their sales taxes by out-of-state retailers.\(^ {119}\)

Each bill approaches the issue differently. The MFA and the RTPA are similar in that they depend on destination sourcing in exchange for states making their sales tax administration simpler, with the RTPA adding the requirement that states integrate freely-provided tax lookup software into retailer systems and sharply limiting the ability of states to audit businesses without physical presence. The OSSA uses hybrid-origin sourcing and would transform the sales tax from a tax on consumers to a tax on businesses.\(^ {120}\)

States are understandably interested in knowing how much revenue could be collected if they could require sales tax collection on Internet commerce. Revenue estimates, however, are difficult to make with certainty because one must guess both how much Internet commerce could be taxed and how much is currently untaxed (some percentage of Internet sales taxes is actually presently collected because of retail physical presence, voluntary reporting of business purchases, or voluntary vendor collection by Streamlined Sales Tax Project vendors).

In 2009, Bruce, Fox, and Luna estimated that states would lose $11 billion in 2012 if they could not collect sales tax on Internet purchases, and this became the leading source of revenue estimates by virtue of being the only one.\(^ {121}\) Subsequent experience casts doubt on the accuracy of this estimate. For instance, New York, with its law collecting tax on online sales in effect during the pendency of a legal appeal, collected $360 million through February 2012, well short of the $2.5 billion estimated by the Bruce, Fox, and Luna study.\(^ {122}\) Economic consultant Jeff Eisenach produced scaled-down estimates of states’ sales tax collection potential in 2013, pegging it at $3.9 billion nationwide.\(^ {123}\)

While it is true that state tax collections will increase if federal legislation is enacted, states relying on the previous study’s numbers risk writing excessive revenue expectations into their budget plans. States should therefore act cautiously with respect to spending anticipated new revenue when a federal bill is enacted.


\(^{117}\) A discussion draft of the Online Sales Simplification Act of 2015 was circulated by House Judiciary Committee Chairman Bob Goodlatte, January 2015, http://www.subnet.nga.org/downloads/1501HybridOriginDiscussionDraft.pdf


\(^{119}\) Joseph Henchman, ‘The Marketplace Fairness Act: A Primer.’

\(^{120}\) Ibid.


\(^{122}\) Ibid.

Arkansas's Ability to Require Remote Sellers to Collect Sales Taxes

If legislation such as the Marketplace Fairness Act were to be enacted, Arkansas’s active participation in SSTP would go a long way toward ensuring the state’s compliance, though there remain opportunities to enhance neutrality and uniformity in the sales tax code. Nevertheless, the state must exercise great caution in considering any changes which introduce new complexity in sales tax administration, or which allow nonuniform bases or disparate treatment in local or add-on sales taxes.

Sales Tax Holidays

Arkansas is one of 17 states that currently holds an annual “sales tax holiday” where certain items are exempt from the sales tax for one or more days. Arkansas’s sales tax holiday is usually held over one weekend in early August before the start of the school year. School supplies are exempt for the sales tax in any amount, and clothing purchases of up to $100 per item and clothing accessories up to $50 per item are exempt. While these may be a nice, short break from taxes for back-to-school consumers, there is no sound economic reason to hold these tax holidays. If anything, they distract citizens’ attention away from real problems with state tax systems. Academic research has consistently found that these holidays provide no boost to economic growth, they increase tax complexity and compliance costs, and some of the savings may even be illusory as retailers partially offset the tax savings by raising prices.124

As part of comprehensive tax reform, Arkansans would be better served by eliminating the sales tax holiday and lowering overall tax burdens. While this does not provide as much of a visible, political boost to taxpayers, they would ultimately be better off with slightly lower tax rates year-round. North Carolina recently eliminated its sales tax holiday as part of a major tax overhaul in 2013, and most states do not even offer these holidays anyway.

Selective Sales Taxes

In addition to the general sales tax, Arkansas also levies a number of selective sales taxes on specific goods. In many cases these taxes are in addition to the general sales tax, though some are exempted. While selective sales tax collections are not as large as the general sales tax, they do represent a major source of state and local revenue, about 13 percent of the total in fiscal year 2013 (most of this at the state level).

The largest single selective sales tax revenue generator are motor fuels taxes, which have consistently generated around $450 million per year for the past 15 years. Motor fuels are also notable because they are currently exempted from the general sales tax. While most states do not include gasoline in the general sales tax base, seven states do. The current tax rates are 21.5 cents per gallon for gasoline, 22.5 cents per gallon for diesel, and 6 cents per gallon for diesel intended for off-road use (fuel taxes are discussed in more detail in Chapter 7).

Arkansas also levies selective sales taxes on a variety of tobacco and alcohol products. Cigarettes are taxed at $1.15 per pack, while most other tobacco products are taxed at a rate of 68 percent of the manufacturer’s selling price (premium cigars are treated slightly differently). In total, taxes on tobacco products generate more than $200 million per year.

Taxes on alcohol beverages in Arkansas generate roughly $50 million per year. Beer, wine, and liquor all have excise taxes but the rates are different, and the rate varies based on the type of alcohol, the proof of the beverage, and other factors. Drinks served at restaurants and bars have an additional tax placed on them, but only for beer (1 percent) and mixed drinks.

The tax on mixed drinks is especially notable because it consists of two or three different tax rates stacked on top of the general sales tax rate. There are two statewide mixed drink taxes of 4 and 10 percent, and where alcohol can be legally served, local governments have the option of levying an additional 10 percent tax (5 percent for establishments with a “private club” designation). When general state, county, and city sales taxes, plus state and local mixed drink taxes, are combined, the tax can be well over 30 percent at the retail level in some cities. For example, the total mixed drink tax rate is 33 percent in Little Rock and 32.5 percent in North Little Rock. These retail sales taxes are in addition to the excise taxes that are already included in the price of a bottle of liquor. While there is no comprehensive list of selective retail sales tax rates across the country, the Arkansas mixed drink tax is likely one of the highest.

127 See these documents provided by the two cities: http://www.littlerock.org/citydepartments/finance/divisions/treasury.aspx and http://nlr.ar.gov/government/a_z_department_list/city_clerk_and_treasurer/business_licenses_and_taxes/
Sales Tax Reform Solutions

Given Arkansas’s fairly wide sales tax base relative to other states, there is already some acceptance of a broad sales tax base. There are notable exceptions, such as groceries and gasoline, but Arkansas can broaden its sales tax base to make it more in line with generally accepted economic principles of taxation. Broadening the sales tax base to more goods and services also allows Arkansas to lower its tax rates, further improving the tax system without significantly altering revenue available for state spending. While the sales tax rate could be lowered, a better option is to lower income tax rates as discussed in the corporate and individual income tax chapters of this book. Our sales tax solutions focus on broadening the state’s sales tax base, while holding the rate constant.

Base Broadening Options

A well-structured sales tax applies to all final consumer purchases, both goods and services, while exempting business inputs. Currently, Arkansas exempts a significant number of consumer transactions which, if included in the base, would permit substantial rate reductions to either the sales tax or other tax instruments.

Among the existing exemptions of consumer goods, the grocery and gasoline exemptions are the largest. If food for home consumption or gasoline were included in the sales tax base, the rate could be lowered or dedicated to lower other tax instruments.

Lawmakers should also consider expanding the sales tax base to include additional services, while exempting business inputs. Table 5f provides a list of goods and services that could be included in the sales tax base in Arkansas. The items are grouped into three options for different sizes of base expansions, though the three options should not be seen as rigid categories. Broadening the sales tax to any additional items is a movement in the right direction, though for political expediency reasons, it is often easier to expand the base to many new goods and services rather than just a few.
Table 5f.
Sales Tax Base Broadening Options

<table>
<thead>
<tr>
<th>Service Type</th>
<th>Expanded Base Options</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales to Nonprofit Hospitals                                         ✔</td>
<td>✔</td>
</tr>
<tr>
<td>Candy and Soft Drinks                                                    ✔</td>
<td>✔</td>
</tr>
<tr>
<td>ATVs and Off-Road Vehicles                                              ✔</td>
<td>✔</td>
</tr>
<tr>
<td>Manufactured Housing                                                     ✔</td>
<td>✔</td>
</tr>
<tr>
<td>Newspapers                                                               ✔</td>
<td>✔</td>
</tr>
<tr>
<td>Coin-Operated Car Washes                                                ✔</td>
<td>✔</td>
</tr>
<tr>
<td>Sales, Rentals, or Repair of Durable Medical Equipment                  ✔</td>
<td>✔</td>
</tr>
<tr>
<td>Subscription Publications                                               ✔</td>
<td>✔</td>
</tr>
<tr>
<td>Gasoline and Motor Fuel                                                 ✔</td>
<td>✔</td>
</tr>
<tr>
<td>Self Storage                                                             ✔</td>
<td>✔</td>
</tr>
<tr>
<td>Ground Transportation Services                                          ✔</td>
<td>✔</td>
</tr>
<tr>
<td>Air Transportation Services                                             ✔</td>
<td>✔</td>
</tr>
<tr>
<td>Water Transportation Services                                           ✔</td>
<td>✔</td>
</tr>
<tr>
<td>Prescription Drugs and Other Medical Products                           ✔</td>
<td></td>
</tr>
<tr>
<td>Trade-in Deduction for Motor Vehicles                                   ✔</td>
<td></td>
</tr>
<tr>
<td>New or Used Motor Vehicles or Trailers of Less Than $4,000              ✔</td>
<td></td>
</tr>
<tr>
<td>First 500 KWH of Electric to LIH                                        ✔</td>
<td></td>
</tr>
<tr>
<td>Membership Fees to Private Clubs                                       ✔</td>
<td></td>
</tr>
<tr>
<td>Sales of Raw Products to Consumer (e.g., Farmers' Markets)              ✔</td>
<td></td>
</tr>
<tr>
<td>Groceries                                                                ✔</td>
<td></td>
</tr>
<tr>
<td>Veterinary Services                                                     ✔</td>
<td></td>
</tr>
<tr>
<td>Travel Agent Services                                                   ✔</td>
<td></td>
</tr>
<tr>
<td>Barber Shops/Beauty Parlors                                             ✔</td>
<td></td>
</tr>
<tr>
<td>Dating Services                                                         ✔</td>
<td></td>
</tr>
<tr>
<td>Diaper Services                                                         ✔</td>
<td></td>
</tr>
<tr>
<td>Garment Services (Altering &amp; Repairing)                                 ✔</td>
<td></td>
</tr>
<tr>
<td>Massages                                                                ✔</td>
<td></td>
</tr>
<tr>
<td>Personal Instruction (Dance, Golf, etc.)                                ✔</td>
<td></td>
</tr>
</tbody>
</table>

Business Input Exclusion

As part of improving the sales tax, Arkansas should also look to exempt purchases by businesses where possible. As discussed above, Arkansas taxes a number of services that are purchased primarily by businesses and others that are purchased by both consumers and businesses. Exempting business purchases from the sales tax is not a handout to business, but rather is part of sound tax policy which should have the goal of taxing final consumer purchases only. Either specific exemptions should be written for goods and services likely to constitute business inputs, or businesses should be granted the ability to claim an exemption from the sales tax for all business purchases. Many states allow nonprofit organizations to make sales-tax-exempt purchases. Similar provisions could be made for business purchases to avoid taxation of business inputs without attempting to ascertain which goods or services are likely to constitute business-to-business transactions.
Options for Windfall to Local Governments from Sales Tax Base Expansion

In Arkansas the local sales tax base is generally the same as the statewide sales tax base. Thus, any change to the statewide base will also expand the local base. If Arkansas were to expand its statewide sales tax base with the goal of lower statewide tax rates, one immediate consequence would be a revenue windfall for local governments that currently impose a sales tax. While local governments would no doubt appreciate the additional revenue, without some additional consideration this would mean Arkansans may actually have a large tax increase as part of comprehensive tax reform. To address this issue, here are several options for how the state could handle the revenue windfall generated for cities and counties:

- Eliminate the inventory tax – Arkansas is one of about a dozen states that currently taxes business inventory. It is part of the local property tax in Arkansas, and it is discussed further in the property tax chapter (Chapter 6) of this book.

- Reduce sales tax rates – Local governments could be required to lower sales tax rates by some amount to offset the additional size of the base. Alternatively or in addition, a temporary moratorium on local option sales tax elections could be used.

- Dedicate new funding to functions currently subsidized by state – Local governments receive a large amount of their revenue in the form of transfers from the state (about $4.6 billion in FY 2013). Some of the new revenue could be used to fund the services currently being funded by these transfers.

128 Census Bureau, 2013 Annual Surveys of State and Local Finances.
CHAPTER 6: PROPERTY TAXES
Introduction

Property taxes are an important part of government finance in Arkansas, especially at the local level, though not as important as sales taxes. Effective property tax rates in Arkansas are among the lowest in the nation. In speaking to Arkansans across the state, the low relative property tax burden is something many of them are aware and proud of. About 43 percent of the tax revenue generated at the local level came from property taxes in fiscal year 2013, much less than the national average of 73 percent.129

Arkansas also has a unique feature of its property tax with regards to education. In Arkansas there is a constitutionally mandated minimum 25 mills property tax levied by school districts to fund schools statewide. While still ultimately used at the local level, the U.S. Census Bureau considers this a state property tax. In effect, this means Arkansas generates about 12 percent of its statewide tax revenue from property taxes, the fourth highest in the nation behind Vermont, New Hampshire, and Wyoming. Arkansas caps property tax rates for counties and cities, and limits annual increases in appraisals. There is also a homestead credit of $350, which is funded by a dedicated sales tax.

While property taxes come primarily from real estate, Arkansas also levies property taxes on cars, boats, livestock, motorcycles, and recreational vehicles. Business inventory is also taxed at the local level, and a capital stock tax (known in Arkansas as a franchise tax) is levied by the state.

In this chapter we overview Arkansas’s property tax and how it compares regionally and nationally, as well as suggest some small areas for reform and improvement.

General Overview of Property Taxes in Arkansas

According to the Tax Foundation’s 2017 State Business Tax Climate Index, Arkansas is ranked 24th on property taxes, the only component of the Index where Arkansas is better than 25th place. Compared to border states, Arkansas does relatively well, trailing only Missouri and Oklahoma. Arkansas’s low collections per capita and as a percent of personal income are the primary factors giving Arkansas a favorable score on this component. However, Arkansas also imposes both a capital stock (franchise) tax at the state level and an inventory tax at the local level. Missouri and Oklahoma each only impose one of these two harmful taxes, giving them higher rankings than Arkansas.

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129 As discussed below, most of the statewide property taxes as reported by the U.S. Census Bureau are in some sense local taxes. If all property taxes were instead to be classified as local taxes, they would comprise about 61 percent of local tax revenue, still below the national average.
Table 6a.

**State Business Tax Climate Index**

**Property Tax Component Rankings**

**Arkansas and Bordering States (2017)**

<table>
<thead>
<tr>
<th>State</th>
<th>Property Tax Component Rank</th>
<th>Overall Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arkansas</td>
<td>24th</td>
<td>38th</td>
</tr>
<tr>
<td>Louisiana</td>
<td>30th</td>
<td>41st</td>
</tr>
<tr>
<td>Mississippi</td>
<td>35th</td>
<td>28th</td>
</tr>
<tr>
<td>Missouri</td>
<td>7th</td>
<td>15th</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>12th</td>
<td>31st</td>
</tr>
<tr>
<td>Tennessee</td>
<td>29th</td>
<td>13th</td>
</tr>
<tr>
<td>Texas</td>
<td>37th</td>
<td>14th</td>
</tr>
</tbody>
</table>

Source: Tax Foundation, 2017 *State Business Tax Climate Index*.

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**Property Tax Collections and Effective Rates**

Property taxes in Arkansas have gone through two distinct periods in recent history. The first is the period up until 1996, when voters approved Amendment 74 to the Arkansas Constitution. Prior to 1996 property tax had been generally flat. In fact, on a per capita, inflation-adjusted basis, collections were lower in 1995 than they had been in 1977, the first year of reliable data from the U.S. Census Bureau. Amendment 74 mandated that school districts impose a minimum 25 mills property tax, which is to be used for improving education across the state and, to some extent, equalizing educational spending (though school districts are free to levy a higher millage). After 1996, property tax collections began to increase sharply and are roughly double the 1995 inflation-adjusted level (more than 60 percent greater on a per capita basis) at about $2 billion per year.

**Figure 6a.**

**State and Local Property Tax Collections**

(1977–2013, in 2013 Dollars)

Note: Dollars amounts are adjusted for inflation based on the annual average Consumer Price Index for All Urban Consumers (CPI-U) with a 2013 base year.

While Arkansas has very low property taxes compared to the rest of the nation, Arkansas’s regional peers also generally have very low property tax rates. As seen in Table 6b below, Arkansas’s effective property tax rate of 0.64 percent is essentially equal to Missouri’s and Mississippi’s, and higher than Louisiana’s. Only Texas stands out as having a very high property tax in this region, with all of the other states below the median.

Table 6b.
Property Taxes Paid as a Percentage of Owner-Occupied Housing Value
Arkansas and Bordering States (2014)

<table>
<thead>
<tr>
<th>State</th>
<th>Effective Rate</th>
<th>National Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arkansas</td>
<td>0.64%</td>
<td>41</td>
</tr>
<tr>
<td>Louisiana</td>
<td>0.50%</td>
<td>48</td>
</tr>
<tr>
<td>Mississippi</td>
<td>0.65%</td>
<td>40</td>
</tr>
<tr>
<td>Missouri</td>
<td>0.65%</td>
<td>40</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>0.85%</td>
<td>29</td>
</tr>
<tr>
<td>Tennessee</td>
<td>0.75%</td>
<td>33</td>
</tr>
<tr>
<td>Texas</td>
<td>1.67%</td>
<td>6</td>
</tr>
</tbody>
</table>

Source: Tax Foundation, Facts & Figures 2016: How Does Your State Compare?
Property Tax Structure

Arkansas’s property tax applies to all forms of property, unless specifically exempted. Exempted property includes public property, churches and cemeteries, schools and libraries, intangible personal property, and household furniture and furnishings. All other property is subject to the property tax, which is based on 20 percent of the property’s assessed value, which approximates the market value of the property. This 20 percent assessment may seem like a big discount for taxpayers, but since all taxable property is treated this way, the discount is illusory. The same property tax collections could be achieved with local millage rates that are one-fifth of current rates if property were taxed at 100 percent of assessed value.

Agricultural land is assessed based on the productivity of the land, rather than its market value. Determining the productivity of agricultural land is a complicated assessment process, but factors considered include the soil, use of land (crop, pasture, or timber), and valuation (based on crop prices or other outputs and the income they provide). Once the assessed value has been determined, though, the same 20 percent of value formula is used.

Minimum and Maximum Millage Rates

Millage rates are then applied to 20 percent of the assessed value of the land. The millage is set at the local level, but as mentioned above school districts must set a minimum 25 mills, which is remitted to the state for redistribution to school districts based on a preestablished matrix which includes characteristics of the students. School districts may levy higher millage rates if they choose above the minimum 25 mills, which they would then be free to use exclusively on their district.

Counties may levy millage rates up to 21 mills, though there are also limits for specific governmental functions within this overall limit of 21 mills: 5 mills for general government, 5 mills for bond indebtedness, 5 mills for library operations, 3 mills for library capital improvements, and 3 mills for roads. Similarly, cities may levy millage rates up to 20 mills, but with similar limits within the overall limit. The limits for cities are the same as counties, except there is no road millage, and up to 1 mill each can be applied to police and firefighter pensions.

Assessment Limitations and Homestead Credit

Arkansas’s Constitutional Amendment 79 sets limits on the annual increases in property valuation. For homestead property, which is an owner-occupied primary residence, the annual increase in valuation cannot exceed 5 percent. For all other real property, the annual increase cannot exceed 10 percent. These limits only apply to regular annual assessments if there is no change in ownership nor improvements to the property. If property is sold or substantially improved, the property can be reassessed based on the current market value of the property. There is also a complete freeze on homestead property owned by individuals 65 years or older, or individuals who are classified as disabled.
In addition to setting assessment limitations, Amendment 79 established a homestead credit of up to $350 per year (the Amendment sets the minimum credit at $300, but it can be increased by law). The homestead tax credit is funded by a one-half percent sales tax. In essence, Arkansas has traded off a slightly higher sales tax for a slightly lower property tax for homeowners.

**Other Property Taxes**

**Capital Stock Tax**

Arkansas levies a capital stock tax (known as the franchise tax) on the net worth of a business. The tax is 0.3 percent of the outstanding capital stock of corporations, and there is no maximum amount. Only 16 states currently levy a capital stock tax. Several of Arkansas’s regional competitor states, such as Alabama, Oklahoma, and Tennessee, have capital stock taxes; Mississippi passed legislation to phase out its tax over the next twelve years. Arkansas’s tax rate is the second highest in the country, trailing only Connecticut. Capital stock taxes create sizable disincentives to capital formation and corporate wealth accumulation, yet they raise very little revenue. The last three fiscal years, Arkansas’s franchise tax has only raised about $26 million, or roughly 0.2% of all taxes collected in the state.

States are increasingly shifting from capital stock taxes because of their detrimental economic effects. Kansas eliminated its capital stock tax in 2011, and Rhode Island and West Virginia completed phaseouts in 2015. Missouri and Pennsylvania eliminated their tax as of the 2016 tax year. New York’s tax continues to phase out, and Mississippi, as mentioned above, passed a phaseout in 2016 to end in 2028.

**Inventory Tax**

In addition to taxing real property and personal property, Arkansas also levies its property tax on business inventories. Only 12 states fully tax business inventory as personal property. In Arkansas the inventory tax is not a separate tax, but rather is included as a part of local property taxes. Estimating revenue impacts is therefore challenging, as local governments typically do not report a separate line for inventory tax revenue specifically.

Arkansas does have a “Freeport exemption” for inventory in transit that is not intended for sale in Arkansas, though this is not widely advertised and may only be known to businesses that are highly dependent on goods in transit. But even with this exemption, taxing business inventory imposes a significant burden on a select group of businesses and industries, while most businesses do not have to worry about the tax very much.

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States With and Without Capital Stock Taxes in 2016

Notes: (*) indicates that taxpayers pay the greater of corporate income tax or capital stock tax liability. Missouri, Pennsylvania, Rhode Island, West Virginia just finished phasing out their capital stock taxes. Mississippi will begin phasing out its capital stock tax in 2018, with the phase-out completed in 2028. Source: Tax Foundation, Facts & Figures 2016: How Does Your State Compare?

Property Taxes on Business Inventory, as of July 1, 2016

Property Tax Solutions

Most major reforms to the property tax would require constitutional changes or changes in millage rates at the local level. For these reasons, we do not suggest any major reforms to the residential or commercial property tax system. It is worth emphasizing again that Arkansas has very low property taxes, despite much academic research showing that property taxes are among the least economically harmful taxes.

Two aspects of the property tax system that could be reformed are the capital stock tax and the inventory tax. The capital stock tax raises little revenue, it is harmful for highly capitalized businesses, and Arkansas has one of the highest rates in the country. Lowering the rate or phasing out this tax completely is worth considering as part of an overhaul of Arkansas’s entire tax system.

The inventory tax is also worth considering for reform or elimination. This tax discourages businesses that carry large inventories from locating in Arkansas, and goes against principles of sound taxation. Since the tax is assessed locally, statewide reforms would have to come in the form of redefining what property is covered by the property tax by law or constitutional amendment (for example, as Arkansas already does for household furnishings and other items in Amendment 71). As mentioned in the sales tax chapter, this change could be made as part of a swap with the expanded sales tax base, which would provide a revenue windfall to counties.

Table 6c. Property Tax Reform Options

<table>
<thead>
<tr>
<th>Reform Option</th>
<th>Resulting Index Rankings</th>
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<tbody>
<tr>
<td></td>
<td>Overall Rank</td>
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<tr>
<td>Eliminating Franchise Tax</td>
<td>36</td>
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CHAPTER 7: ADDITIONAL IMPORTANT CONSIDERATIONS
Introduction

Arkansas’s budget and tax system includes some additional considerations which are outside of those topics already discussed, but merit attention in reform conversations. The most formidable of these is the state’s transportation system, which has incurred costs in recent years due to bonding to make improvements as opposed to paying as costs are incurred.

The state is also one of just four with an excise tax on soft drinks, joining Tennessee, West Virginia, and Virginia in taxing nonalcoholic beverages with specific taxes. Academic evidence shows that these taxes do little to impact obesity, and are disproportionately borne by low-income families.

Finally, we discuss the tax reform practice of using revenue triggers to phase in tax reforms so that revenue stability is maintained while moving the state toward a more competitive tax system. Several states have implemented revenue triggers and provide ample examples to craft a trigger tailored for Arkansas.
Transportation

In 1933, Arkansas defaulted after borrowing nearly $160 million in the 1920s to construct roads (the equivalent of nearly $3 billion today).\textsuperscript{136} Half the state’s annual revenue was dedicated to debt payments, and restructuring those obligations left a lasting memory of not spending more than the state has.

The Arkansas gasoline tax today stands at 21.5 cents per gallon, the 38th highest of the 50 states. Because state motor fuel taxes are usually imposed as an excise of a given amount per gallon, and tend not to be indexed for inflation, tax collections tend to decline in real terms over time. Arkansas is no different in this regard, as the figure below shows.

Figure 7a. 
Arkansas Gasoline Tax Rate

![Graph showing the history of the Arkansas gasoline tax rate from 1921 to 2011. The graph includes a blue line representing the tax rate in 2016 cents and a red line representing the tax rate in nominal cents. The graph indicates a decline in the tax rate over time.]

Note: Includes the motor fuel excise tax (currently 21.5 cpg) and the petroleum environmental assurance fee (currently 0.3 cents).
Source: Arkansas Statutes.

The Arkansas gasoline tax was last increased when Governor Huckabee (R) approved a bill in 1999 to raise it by three cents over three years, with the funds from that and a diesel tax increase supporting a $575 million Interstate Rehabilitation Program (IRP) bond issue approved by voters that year.\textsuperscript{137} Voters renewed the program in 2011 with another series of 12-year bonds.\textsuperscript{138} The program is again focused on repairs and maintenance of interstates rather than new construction or other state highways. In 2012, voters approved a temporary half-cent sales tax increase to fund $1.3 billion in 10-year bonds for state highway construction and maintenance.\textsuperscript{139}

\textsuperscript{139} Ballotpedia, Arkansas Sales Tax Increase Amendment, 2012, https://ballotpedia.org/Arkansas_Sales_Tax_Increase_Amendment,_Issue_1_(2012)
Bonding improvements, rather than funding them on a pay-as-you-go basis, has benefits and costs. The 1999 IRP concentrated construction in what turned out to be years of low construction cost inflation, bringing Arkansas’s interstates to 72 percent in good condition. However, the program incurred $208 million in interest expense by the time the bonds were paid off in 2014, three years after voters borrowed more to repair interstate highways. Critics of the 2011 increase contended that the state was spending $74 million per year ($58 million in federal highway funds and $16 million in state fuel tax) on debt service and repayment rather than maintenance and construction.\(^{140}\)

In 2016, Governor Hutchinson (R) approved legislation transferring surplus state funds to the Highway Transfer Fund.\(^{141}\) Had this not occurred, the state would have been unable to provide a 20 percent match to federal funds and forfeited approximately $200 million per year in federal highway aid.\(^ {142}\)

The state highway system stands at 16,398 miles, carrying 80 percent of the traffic and 95 percent of the heavy truck traffic in the state. The Arkansas State Highway and Transportation Department estimated the state needs to spend an additional $200 million per year to maintain pavement and bridge conditions and mitigate highway congestion. Similarly, of Arkansas’s 12,523 bridges, 32 percent are 50 years old or older. The American Society of Civil Engineers estimates that repairing or replacing all structurally deficient bridges in Arkansas would cost $1.14 billion.\(^ {143}\) The 2015 Governor’s Working Group on Highway Funding further identified $16.8 billion of unmet ultimate highway needs, including funds to complete I-49 and I-69.\(^ {144}\) State highway officials have outlined $5 billion worth of projects to be completed in the next few years.\(^ {145}\)

The 2015 working group made a variety of funding recommendations, drawing on the 2010 Blue Ribbon Committee Final Report:

- **Index the motor fuel taxes to inflation**, while capping any increase to 2 cents per gallon per year. They estimated a 2-cent increase in the gasoline and diesel taxes would generate $41.1 million per year.
- **Increase the diesel tax by 5 cents per gallon.** They estimated this would generate $31.5 million per year.
- **Dedicate revenue from the sales tax on new and used vehicles to the highway fund.** They estimated this would transfer $242.4 million per year, when fully phased in, from the general fund to the highway fund.


• Make permanent 3/8-cent of the temporary 1/2-cent sales tax approved in 2012. This would make $170 million in revenue permanent after the existing tax expires in 2023.

• Increase the motor fuel taxes by larger amounts. Options included an 8-cent increase to recoup amounts lost to inflation in recent years ($160 million) or a phased-in 15-cent increase over three years ($308 million by the third year).

• Change in Reportable Miles Traveled. Drivers would report their annual mileage at their annual car tags renewal and pay a fee.

• Apply the sales tax to motor fuel purchases. This would raise approximately $200 million per year.

Those who use the roads should primarily pay directly for them through tolls, fuel taxes, and related fees. Funding by users is most equitable, connects wear-and-tear to user payments, and reduces pressure on the state budget as a whole.

**Soft Drink Tax**

Arkansas is one of four states to impose a special tax on soft drinks. The tax was enacted in 1992 to partly fund the state’s share of matching funds for Medicaid. It is currently imposed at the following rates:

- $2 per gallon of syrup used in soft drinks.
- 21 cents per gallon of bottled or canned soft drink product.
- 21 cents per gallon produced by powders or base products.

Items exempted from the tax include exports, powders that produce coffee or tea, drinks or concentrate to produce a drink of at least 10 percent fruit or vegetable juice, wholesaler-to-retailer sales, infant formula, dietary supplements, bottled water, and any product containing milk.

The tax raises $45 million a year, which is then leveraged for Medicaid funds from the federal government at about a 3 to 1 ratio. Excess collections beyond that required for Medicaid matching funds are deposited in a Medicaid Trust Fund; in 2013, the fund had $267 million in it, from soft drink tax collections as well as from taxes on ambulance licenses, insurance premiums, and hospitals. Arkansas voters chose to retain the tax in a 1994 referendum, 55 percent to 45 percent.

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146 Jim Guy Tucker, *For Two Decades, the Soda Tax Has Served Arkansas Well*, Talk Business & Politics, July 10, 2013, http://talkbusiness.net/2013/07/jim-guy-tucker-for-two-decades-the-soda-tax-has-served-arkansas-well/ The bill was passed alongside a chocolate tax, but the chocolate tax was repealed almost immediately in early 1993.

147 Ark. Code § 26-57-901 et seq.


For a standard 12-ounce soft drink can, the tax is approximately 2 cents; for a 2-liter container of soda, the tax is approximately 11 cents. One inconsistency in the tax is that syrup used to make soft drinks (about 1 gallon of syrup produces 6 gallons of soft drinks) is taxed at $2 per gallon, or about 33 cents per gallon of finished product, while bottled or canned soft drinks are taxed at 21 cents per gallon. This higher rate is primarily borne by restaurants that serve soft drinks; a 2015 proposal to equalize the tax at the lower rate found it would have cost the state $5.2 million per year in soft drink tax revenue.\(^{150}\)

Nationally, a federal tax on soft drink syrup was enacted in 1917 along with other excise taxes on luxuries as part of the effort to fund World War I.\(^ {151}\) Additional 10 percent taxes on bottled soft drinks and soft drink fountain sales followed in 1919. These taxes were repealed in 1922, but reenacted in 1932 with other taxes as the federal government sought to balance its budget in the face of collapsing revenue during the Great Depression. The taxes were in turn repealed two years later, due to low revenue collection and unpopularity. In the states, Tennessee, Virginia, and West Virginia have long-standing soft drink taxes, along with Arkansas. Berkeley, California, and Philadelphia, Pennsylvania, have recently enacted soft drink taxes both for revenue collection and anti-obesity purposes; these taxes have per gallon rates between $1.28 and $1.92, or six to nine times the size of the Arkansas tax.

Taxes on soft drinks have several drawbacks:

- **Soda taxes are regressive; they disproportionately harm low-income people.** In fact, poor people don’t just spend more on the tax as a percentage of their income, they actually pay more in real dollars as well. A 10 percent soda tax could burden high-income families by $24.29, while poor families would be harmed nearly twice that amount at $47.38. The World Health Organization has proposed a tax twice that size, and some U.S. cities have proposed or enacted rates several orders of magnitude larger. In 2016, the city of Philadelphia, for example, enacted a tax of 1.5 cents per ounce of liquid, which could increase the price of a 2-liter bottle of soda by a stratospheric 102 percent and intensify this regressive effect.

- **Consumers might purchase less soda, but do so in favor of other high-calorie drinks.** A 2010 study found that a percentage point increase in taxes on soda would lead people to switch to milk, consuming an average of eight additional calories per day, leaving them worse off. Another 2012 study from Cornell University indicates that many soda drinkers will even switch to beer in the face of a soda tax hike, meaning consumers are simply swapping one public health no-no for another. Even if the goal is to simply reduce soda consumption regardless of what gets substituted, the public health outcomes aren’t likely to pan out. Researchers found that even if you impose a soda tax at the rate of 58 percent, roughly equal to the combined rate of state and federal cigarette taxes, it would only decrease average United States Body Mass Index by a mere 0.16 points. For a


6-foot-tall person, this is the equivalent of less than a pound. This limited effect actually makes sense, as soda comprises a very small percentage of calories consumed -- only 7 percent of calories total. Trying to tax just this small share of calories is not enough to put a dent in the obesity epidemic in this country.

- These types of taxes complicate the tax code. Businesses would have to spend time and money on updating their point of sale software and obtaining legal advice. When states have chosen to tax or not tax particular foods and beverages, inevitably a number of difficult legal questions arise. Tax administrators and retailers would be forced to analyze which beverages fall into which category based on potentially vague guidelines. Policymakers should consider whether it’s worth imposing these administrative costs for a tax that places a higher burden on lower-income households and provides potentially limited public health benefits.

Because of these drawbacks, Arkansas legislators might consider ways to eliminate or phase out this tax.

**Tax Triggers**

Tax triggers are a new take on an old concept: contingent enactment of a legislative provision. States have long relied upon bills with contingent enactment clauses, providing that certain features of new legislation shall only be operative if certain conditions are met. Tax triggers build on this model, making tax reform measures contingent on state revenues meeting or exceeding established targets.

Tax triggers can help ensure revenue stability and limit the uncertainty associated with changes to the tax code while providing an efficient way for states to dedicate some portion of revenue growth to tax relief. States are increasingly turning to tax triggers as a component of tax reform measures.152

- **Massachusetts** voters in 2000 ratified a phase-in of tax cuts designed to reduce the state’s individual income tax rate from 5.95 to 5.0 percent over three years, but the reductions were frozen by the legislature in 2002 at a rate of 5.3 percent. As a compromise, the legislature agreed to allow further reductions to a 5.0 percent rate to proceed, but only after a series of increases to the personal exemption had been implemented, and at a pace of 0.05 percent per year, contingent upon state tax revenues having grown at least 2.5 percent faster than the rate of inflation.

- **Michigan**, as part of a larger tax reform package enacted in 2015, is set to begin implementing income tax reductions beginning in fiscal year 2023. Although several states have delayed implementation until several years after enactment, Michigan's eight-year deferral is unusual in its length. Following any year in which there is inflation-adjusted general fund/general purpose revenue growth, the individual income tax rate is to be reduced by an amount calculated by an equation which captures a portion of cumulative inflation-adjusted revenue growth over fiscal year 2021 collections. The income tax rate would be reduced proportionately by the amount which the prior year's general fund revenue exceeded inflation-adjusted fiscal year 2021 revenue, multiplied by a statutorily-set adjustment factor of 1.425 and divided by total income tax revenue. Competing legislation would have utilized year-over-year revenue growth rather than a cumulative measure of inflation to trigger tax cuts.

- **Missouri** legislators, as part of a modest package of tax reductions, enacted a schedule of incremental individual income tax reductions, designed to reduce the top marginal rate from 6.0 percent to 5.5 percent over five or more years. The legislation establishes rate reductions of 0.1 percent per year, contingent on the previous year's net general revenue collections exceeding the highest amount of net general revenue collected in any of the three prior fiscal years by at least $150 million, beginning on or after 2017. The first reduction will be delayed at least one year, since the state's budget director has certified that revenue targets were not met.

- **New Hampshire**'s business profits tax (a corporate income tax) was cut from 8.5 to 8.2 percent in 2016, while the business enterprise tax (a value-added tax) rate declined from 0.75 percent to 0.72 percent. Subsequent reductions in 2018, however, will only proceed if the combined fiscal years 2016-2017 biennial unrestricted general and education trust fund revenues exceed $4.64 billion.

- **North Carolina** adopted comprehensive tax reform in 2013. That year's legislation saw substantial individual income, corporate income, and sales tax reform, along with the repeal of the estate tax, relying on triggers for some of the corporate income tax reductions. The 2013 legislation cut the corporate income tax rate from 6.9 percent to 6.0 percent while broadening the tax base by reducing certain tax credits and exemptions, and scheduled a further reduction to 5.0 percent in 2014. Subsequent reductions, however, were made contingent on achieving statutorily-set revenue targets. Initially, the law established that if net general fund tax collections for the 2015 fiscal year exceeded $20.2 billion, the tax rate would be reduced by one percentage point, with a similar provision in place should revenue exceed $20.975 billion in fiscal year 2016. In 2015, after the first triggered reduction had been implemented, the General Assembly adopted further reforms, including an additional individual income tax rate reduction. Believing that these tax changes would delay reaching $20.975 billion in revenue, the legislature removed the timeline, stipulating that the second triggered reduction would be implemented whenever net general fund revenues exceeded the benchmark figure, whether in fiscal year 2016 or thereafter. The adjustment notwithstanding, robust revenue growth has North Carolina on track to certify the 3.0 percent rate for the 2017 tax year.
- **Oklahoma** is in the process of individual income tax reductions culminating in a 4.85 percent rate, down from an initial rate of 5.25 percent. Reductions were designed to proceed in two stages, with an intermediate reduction to 5.0 percent in 2016 or the first year thereafter in which projected general revenues at a 5.0 percent rate exceeded projected general revenues for 2014.

- **West Virginia** in 2008 embarked on a project of tax reform in an effort to reduce the state’s high and regionally uncompetitive business tax rates. At the time, the corporate income tax stood at 8.75 percent and a corporate franchise tax was imposed at a rate of 0.55 percent. Beginning with an immediate rate reduction from 8.75 percent to 8.5 percent for the 2009 tax year, the state committed to further reductions to 7.75 percent in 2012, 7.0 percent in 2013, and 6.5 percent in 2014, with each reduction contingent on the combined balance in the state’s two rainy day funds equaling or exceeding 10 percent of the budgeted general fund revenue for the subsequent fiscal year. Had rainy day fund balances fallen short of this benchmark in any given year, the entire schedule would have been pushed back one year. Ultimately, however, the state reached all of its targets, and the corporate income tax cuts went into effect on schedule.

- **The District of Columbia** in 2014 approved a tax reform package which reduced corporate and individual income tax rates, adopted more generous standard deductions and personal exemptions, and expanded the Earned Income Tax Credit, among other changes. Additional tax reform priorities were made contingent upon midyear annual revenue estimates exceeding preliminary annual revenue estimates, with any additional monies in fiscal years 2015 and 2016 funneled into implementation of at least seventeen tax reform provisions, addressed in order of priority.

Well-designed triggers ensure that benchmarks reflect meaningful revenue growth, rather than capturing a rebound from a year of weak revenues or the effects of inflation. They also avoid undue time constraints which can derail, rather than delay, the implementation of a program of contingent reforms. When properly constructed, tax triggers serve as a valuable mechanism for implementing responsible tax reform.
ABOUT THE TAX FOUNDATION

The Tax Foundation is the nation’s leading independent tax policy research organization. Since 1937, our research, analysis, and experts have informed smarter tax policy at the federal, state, and local levels. Our Center for State Tax Policy uses research to foster competition among the states and advises policymakers on how to improve their tax systems.

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ABOUT THE ARKANSAS CENTER FOR RESEARCH IN ECONOMICS

The Arkansas Center for Research in Economics (ACRE) is an Arkansas-focused research center housed in the College of Business at the University of Central Arkansas. ACRE scholars and policy analysts use research and analysis to find solutions for Arkansas’s problems. Our research focuses on barriers to employment, taxes and subsidies, public education, and good governance. We educate and provide resources for students, teachers, voters, activists, legislators, and business leaders.

ACRE promotes solutions that respect the personal and economic freedoms of individuals because protecting and expanding these freedoms has a proven record of improving the lives of people around the world and here at home.
Arkansas’s tax system is at a crossroads. After years without meaningful reform, the state seems poised to finally tackle the long-running issues within its tax code. The last several years have seen several ad hoc reforms, but the last comprehensive tax reform was in 1971; the one before that was in 1929.

This book is meant to help Arkansas achieve the goal of true tax reform—reform that benefits all taxpayers by addressing the many long-term hurdles the state faces. It’s meant to start the conversation about what Arkansas does well, but also what it could do better—by recognizing strengths, diagnosing challenges, and prescribing real, workable solutions. Our book seeks to be *The Road Map to Tax Reform.*