Presentation to joint meeting of
Senate Committee on Revenue and Taxation
House Committee on Revenue and Taxation
by

Philip D. Oliver
Byron M. Eiseman Distinguished Professor of Tax Law, UALR Bowen School of Law

September 20, 2016

I. How the State should raise a given amount of revenue

- A. Model of (federal) Tax Reform Act of 1986
  - 1. Tax almost all economic income, restricting special rule.
  - 2. Lower rates on a higher base
    - a. Business
    - b. Personal
    - c. Investment income
  - 3. Advantages
    - a. Rate reduction
    - b. Economic efficiency
  - 4. The last thirty years — continual lures to pick-and-choose

II. Possible routes for broadening the tax base in Arkansas (lower rates — or more room to spend)

- A. Many deductions and exemptions — seemingly ad hoc
  - 1. Example of business credits
  - 2. Advantages of partial exemption or phase-in as opposed to complete exemption
  - 3. Virtue of viewing tax expenditures as equivalent to direct expenditures
  - 4. Virtue of sunsetting
- B. Some special provisions

Ideal Tax Theory

Arkansas Senate and House Committees on Revenue and Taxation
September 20, 2016

Dr. Jeremy Horpedahl
Assistant Professor of Economics, University of Central Arkansas
ACRE Scholar, Arkansas Center for Research in Economics

Mr. Chairman and members of the committee, thank you for the opportunity to speak with you today. My name is Jeremy Horpedahl and I am an assistant professor of economics at the University of Central Arkansas.

As a professor, I have the luxury of occasionally thinking about important questions in ideal terms, and to temporarily detach myself from the current political status quo. My goal here today is for us to spend a little time with our heads in the clouds, discussing tax policy from an ideal perspective rather than a practical one. For a brief moment, let's be impractical. But I hope to quickly bring the discussion back to reality and apply those ideal principles to Arkansas' current tax system.

I want you to remember three things from my comments today:

1. Good tax policy is about **collecting a set amount of revenue**. It is not about maximizing revenue nor steering the economy. It's about collecting the revenue needed to fund essential services.
2. Taxes should be collected in a way that **minimizes harm**. Harm is minimizing by keeping rates low, and relying on less harmful taxes such as **property and sales taxes**, rather than income taxes.
3. Arkansas would benefit from **reducing income tax rates** and relying more on sales or property taxes.

Ideal Tax and Budget Policy in Two (or Three) Easy Steps

From an ideal perspective, tax and budget policy would have two major steps, and possibly a third step:

1. **Set the size of the budget:** Through our chosen democratic processes, the citizens of a state choose the categories and sizes of spending we would like to accomplish through government.
2. **Design the tax system to minimize harm:** The types of tax and rates should be chosen to approximate the size of the budget in Step 1, but always with a goal of minimizing economic harm.
3. **(Optional) Address equity concerns:** If the taxes from Step 2 seem to fall disproportionately on certain groups of citizens, tweak the system around the edges to smooth out these inequities.

And ideally, that's all folks.

From a tax perspective, which is my area of expertise, the most interesting and challenging is Step 2. Which taxes will minimize harm to the economy? Economists recognize that all taxes hurt, but some hurt more than others. Certain tax types are worse because they decrease the rate of growth in the economy. And for any particular tax, the higher the rate is set, the more harmful it is.

Principles of Ideal Tax Theory

I would like to suggest to you four principles when designing tax policy. These are principles that can be applied in the real world, here in Arkansas – not just in an imaginary ideal world.

A. **Tax rates should be as low as possible to generate the required revenue:** Higher rates always cause more harm by discouraging economic activity and encouraging lobbying to get special exemptions (more on this later). This is true of all tax instruments: income, sales, and property.
B. **Taxes should be broad-based:** In order to keep rates as low as possible (Principle A), tax instruments should be as broad-based as possible. Exemptions should be exceptions, and those exceptions should have extremely strong justifications based on other economic principles. Failure to justify exemptions leads to political favoritism, the enemy of sound tax policy.
C. **Don't tax business inputs under sales tax (Define your tax base appropriately):** Not everything that looks like an exemption is bad tax policy. A common error is to call business-to-business transactions "exemptions." Examples of business inputs are seed purchased for agricultural use and machinery purchased for industrial production. We exclude these transactions from the sales tax base for good reason: we only want to tax final consumer purchases. Doing otherwise unfairly taxes industries more heavily if they have many stages of production, and may encourage vertical integration merely to avoid taxes (we call this "tax pyramiding").
D. **Choose tax instruments that minimize harm:** Economic theory and empirical research has given us some fairly strong evidence about the types of taxes which minimize harm. This does not mean that only the least harmful taxes should be used, but rather that those taxes should be used first until rates get too high. From least harmful to most harmful:
    a. Property Taxes (least harmful)
    b. Consumption Taxes (such as Sales Taxes)
    c. Income Taxes
        i. Individual Income Tax
        ii. Corporate Income Tax (most harmful)

The ordering of taxes comes from a long line of research by economists attempting to quantify the impact of various taxes on the economy. For a recent publication on this topic, the widely respected Organization for Economic Cooperation and Development (OECD) published a paper in the *Economic Journal* in 2011 called "Tax Policy for Economic Recovery and Growth." Their research suggests that lowering income taxes by increasing property and consumption taxes will increase economic growth (and the opposite change will lower economic growth).

There is also an intuition to this evidence on tax types. A general principle of taxation is that if you tax something, you discourage that activity. Taxing income will discourage people from working and starting businesses. That's the worst outcome. Taxing consumption discourages consumption, which is not so bad because then people will save, which also helps the economy (maybe even more so in the long run). Taxing property actually has very little effect, because the amount of property in the world is essentially fixed, thus no economic activity is discouraged. True, the burden of the tax does fall on property owners, but all property will still likely be owned by someone.

One final note on the ideal use of taxes. Sometimes taxes are placed on specific goods or services, which are referred to as selective taxes or excise taxes. Generally these excise taxes exist for one of two reasons: to discourage an activity we consider "bad" (what economists call "negative externalities); or to act as a kind of user fee (when direct user fees are difficult to impose). A third reason, which we hope in theory is used sparingly, is that a good is singled out for taxation merely because it is an easy target for revenue raising.

An example of a social "bad," or negative externality, is tobacco. All states tax cigarettes because cigarettes smoking cigarettes harms not only the smoker, but can also harm innocent bystanders (that's why economists call it a "social" or "external" cost). And nearly all states tax cigarettes on a per-pack basis, because whatever social harms come from cigarettes, it is based on the number of cigarettes smoked, not the price of the cigarettes.

On the other hand, smokeless tobacco is a very different case. First, while it may well be harmful to the user, the social or external costs from smokeless tobacco are less clear. To the extent that they exist, we see them through the healthcare system if the user has higher lifetime health costs, not from innocent bystanders being directly harmed. Second, smokeless tobacco is taxed often taxed based on price, not quantity (weight in this case). In Arkansas, it is taxed at 68% of the manufacturer's price. There is no good economic reason to tax smokeless tobacco this way. A premium brand causes no more social harm than a discount brand. The federal government and about a dozen states tax this product on a per unit basis (by weight or per can), which is the proper tax policy for social costs.

Finally, taxes may also be used as a more convenient way to charge users for particular government services. For example, ideally the government would directly charge the users of roads, such as with a toll. Historically setting up tolls has been inconvenient and expensive, so most states placed a tax on gasoline instead (since the users of gasoline are also the users of the road). Arkansas' current tax of 21.8 cents per gallon of gasoline is our version of this user fee. If setting up tolls is still inconvenient and costly (or maybe just politically unpopular), the fuel tax is a second-best way to raise the revenue to fund the roads. With that being said, this does not further mean that Arkansas should exempt motor fuels from the sales tax (as we and many other states do). While this would seem like gasoline is being taxed twice, it is better to think of it as two different taxes with very different purposes: one to fund a specific government service, the other to contribute equally with all other goods to the general fund.

Does Arkansas Live Up to These Principles?

Now let's come back to the real world and apply our four ideal theory principles to Arkansas. How do we rate of having low tax rates, broad based taxes, correct tax bases, and less harmful taxes?

A. **Tax rates:**
   a. Property Taxes: 0.64% effective rate as percent of home value in Arkansas, median for all states is 0.96% (Arkansas is 10th lowest), median for 12 "competitor states" is 0.825%
   b. General Sales: 9.3% average combined rate for Arkansas; median for other states is 7% (four states have none, Arkansas is 3rd highest), median for competitors is 7.55%
   c. Income Taxes
      i. Individual Income Tax (top rate): 6.9% in Arkansas; median for other states: 6% (seven states have none); median for competitors: 5.375%

ii. Corporate Income Tax (top rate): 6.5% in Arkansas; median for other states: 6.875% (six states have none, though four have worse gross receipts taxes), median for competitors: 6.0%

d. As can be seen in the data, other than for property taxes, Arkansas has consistently higher taxes rates than its competitor states and all other states

i. Competitor states are Alabama, Florida, Georgia, Louisiana, Mississippi, Missouri, North Carolina, Oklahoma, South Carolina, Tennessee, and Texas

B. Broad tax base:

a. Arkansas exempts a large number of goods from its sales tax base. An April 2012 report from DFA has 14 pages of exemptions, totaling almost $1.5 billion (for context, the general sales tax only collected about $3.6 billion in the same fiscal year, so exemptions were around 40% of total collections!). While some of those exemptions are economically justified, such as for business-to-business transactions, many are not justified such as newspapers, groceries, and motor fuel.

b. Arkansas also very broadly exempts services from the sales tax base, despite the fact that services comprise around 62% of consumer spending in Arkansas. Even if we exclude health services and nonprofits, the remaining services are around 43% of consumer spending. By broadly exempting services Arkansas is missing out on roughly half of its potential sales tax base. And by bringing more services into the tax base, we can lower taxes rates for the sales tax or other taxes.

C. Correct tax base: Arkansas also gets things wrong in the other direction, taxing some activities, such as business-to-business transactions, that should not be included in the tax base. Examples include some manufacturing machinery, repair of manufacturing equipment (in some cases; it is complicated), cleaning services, some custom computer software (again, complicated), and leasing of motor vehicles, tangible personal property, and lodgings. Removing these business purchases would shrink the tax base, but would also align policy better with sound tax principles by only taxing final consumption.

D. Tax types (percent of total state and local tax revenue derived from each tax):

a. Property Taxes: 18.1% of total tax revenue in Arkansas, 31.3% for all states, 32.2% for competitor states

b. Consumption Taxes (such as Sales Taxes)

i. General Sales Tax: 35.8% in Arkansas, 22.5% for all states, 29.4% for competitor states

ii. Selective Sales Taxes: 12.8% in Arkansas, 11.6% for all states, 13.9% for competitor states

c. Income Taxes

i. Individual Income Tax: 24.6% in Arkansas, 23.3% for all states,

ii. Corporate Income Tax: 3.7% in Arkansas, 3.6% for all states

[Data note: Source is the Census Bureau's Census of State and Local Government Finances for 2012-2013, and the percentages are for combined state and local revenue as percent of total taxes collected. There is also an "other taxes" category, so numbers will not add to 100%]

For tax types as a percent of all tax revenue, I've presented the figures for all 50 states as well as a dozen competitor states alongside Arkansas. I've done this mostly for context, as there is no reason Arkansas should copy the average for all other states. But one thing that is notable is that Arkansas relies more heavily on the sales tax, and less on the property tax, than most states do. Many states have the property tax as the largest single source of revenue; in Arkansas the sales and personal income taxes collect much more than the property tax.

Does this mean Arkansas should adjust its instruments to more closely conform to the state average? Should we lower sales taxes and raise property taxes? I don't mean to suggest that this is the preferred and ideal path. The average among states is just that, an average, and no single state perfectly conforms to that average. But when it comes to tax rates, we really want to be better than average in order to be competitive.

There may well be good reasons why keeping property taxes low in Arkansas is a good idea. And from the perspective of this committee, you have little say over property taxes anyway because it is a local tax or would require a constitutional amendment. While the property tax is the least harmful of the major tax types, Arkansas still derives much of its revenue from the second least harmful tax, consumption taxes (for even broader context, among all OECD countries, the rich countries of the world, consumption taxes average about 33% of total revenue with property taxes under 6%).

My primary recommendation is to keep the tax burden off of income taxes because that tax discourages economic activity. As the data shows, Arkansas receives about 30% of its revenue from income taxes, whereas our competitor states only receive about 18% from income taxes. If we need more revenue or want to lower the income tax rate one economically sound way to do it is to broaden the sales tax base. While ideally more of total tax revenue would come from the property tax, it is actually better to worry more about reducing the amount from income tax rather than the mix of sales vs. property taxes.

Tax Expenditures: An Obstacle to Tax Reform

Jacob Bundrick, M.S.

Policy Analyst, Arkansas Center for Research in Economics

Mr. Chairmen and members of the committee, I appreciate the opportunity to discuss tax expenditures with you today. My name is Jacob Bundrick and I am a policy analyst with the Arkansas Center for Research in Economics (ACRE) at the University of Central Arkansas.

Tax expenditures have become commonplace in tax codes at both the federal and state level. Tax expenditures are special tax provisions that depart from the legally defined tax base to lower a taxpayer's burden. Examples include exemptions, deductions, refunds, and credits. But classifying these provisions as tax expenditures depends on what the state generally considers to be the normal tax code.

Tax expenditures are, in essence, government spending through the tax code. These special provisions are structured to provide the same assistance to individuals and businesses that direct government spending would.[1] For example, Arkansas's child care tax credit achieves the same functional result as a direct subsidy to parents who paid for child care. Unlike direct subsidies, though, tax expenditures "spend" by forgoing tax revenue and are less transparent, often being "hidden" in the tax code.[2]

Tax Expenditures Give Preferential Treatment to Certain Economic Activities

Tax expenditures are frequently used to encourage certain types of economic activity. Exemptions, deductions, and other special tax provisions directly lower the tax burden for specific actions, making them relatively more attractive to taxpayers. Because tax expenditures favor certain types of activities, they inherently carry biases for select subsets of taxpayers.

Arkansas encourages several economic activities through tax provisions in the state's individual income tax code, corporate income tax code, and sales and use tax code. Consider the following examples:

- **Home Mortgage Interest Paid Deduction –** Individual income taxpayers are allowed to deduct the interest paid on their home mortgage. This tax expenditure is an effort to encourage home ownership among Arkansans. Providing preferential tax treatment to those who own homes clearly favors home owners over renters. It also favors wealthier citizens who are both more likely to own homes and more likely to itemize.[3] This tax expenditure simply mirrors the federal code, but there is no clear reason that Arkansas should.
- **In-House Research and Development Credit –** Corporate income taxpayers may receive an income tax credit worth 20 percent of qualified "in-house" research expenditures if the business engages in research that qualifies for federal research and development tax

---

[1] Stanley Surrey. *Federal Income Tax Reform,* Harvard Law Review, Vol. 84, No. 2, pg. 354, Dec. 1970, https://www.jstor.org/stable/1339715?seq=3#page_scan_tab_contents

[2] Alan Cole. *Corporate and Individual Tax Expenditures,* Tax Foundation, Fiscal Fact No. 476, Aug. 2015, http://taxfoundation.org/sites/taxfoundation.org/files/docs/TaxFoundation_FF476_0.pdf

[3] Dean Stansel and Anthony Randazzo. "Unmasking the Mortgage Interest Deduction: Who Benefits and by How Much?," *Reason Foundation Policy Study* 394, July 2011, http://reason.org/files /mortgage_interest_deduction.pdf

credits. This tax expenditure is an attempt to encourage Arkansas firms to increase R&D efforts within the state's borders. However, it favors firms belonging to R&D intensive industries and biases against those who outsource R&D.

- **Services Exempt from Sales Tax –** Services are generally exempt from Arkansas's sales and use tax. This broad exemption means that approximately 62 percent of Arkansas's consumer spending is tax exempt. This preferential tax treatment quite clearly favors taxpayers who spend more of their money on services. And any sales tax rate hike only increases the bias against taxpayers who spend more on goods.

Provisions in the tax code are also used to discourage certain economic activities. Instituting higher tax rates, additional excise taxes, or differential rates for certain economic activities directly raises the tax burden faced by the taxpayers engaged in those activities. This higher tax burden is essentially a punishment for participating in select activities and, naturally, is a bias against certain taxpayers. Consider the following examples in Arkansas's tax code:

- **Tobacco Tax –** Arkansas institutes an excise tax of $11.50 per carton of cigarettes or $1.15 per pack of cigarettes; a tax on all tobacco products, excluding cigarettes, of 68 percent of the manufacturer's invoiced selling price; and an excise tax on cigarette rolling papers of $0.25 per package. Clearly, this tax biases against taxpayers who use, produce, and sell tobacco products. It is an effort to steer taxpayers away from tobacco.
- **Soft Drink Tax –** Arkansas charges an excise tax of $2.00 per gallon on soft drink or simple syrup but a tax of just $0.21 per gallon on bottle or canned soft drink products and each gallon produced by powders or base products. This differential tax biases against taxpayers using and consuming soft drink or simple syrup.

It is sometimes the case that increased tax burdens are placed on specific activities because those activities carry negative externalities, or social costs. For example, a person smoking a cigarette is not only harming his or her self, but is also harming others who breathe in second-hand smoke. Higher taxes on cigarettes can reduce cigarette consumption, thus lowering the social cost of cigarettes.

In a general sense, though, encouraging or discouraging select economic activities through tax expenditures and other tax provisions, especially when there are no externalities at stake, shifts government away from the ideal task of implementing and enforcing a simple, transparent, and fair tax system that does as little economic harm as possible.

Tax Expenditures Encourage Special Interest Lobbying

A tax code riddled with tax expenditures is an open invitation for special interest lobbying. Taxpayers that already benefit from existing tax expenditures have a keen interest in maintaining their preferential tax treatment. At the same time, taxpayers that do not currently benefit from tax expenditures have an interest in obtaining their own preferential treatment. Tax policy that includes special provisions for some signals to others that they, too, can obtain credits and exemptions. And what taxpayer does not believe they should face a lower tax burden?

Regardless of whether some tax expenditures appear to be justifiable, their mere existence is opening the door for other, less justifiable tax provisions. Trying to steer taxpayers away from tobacco products (particularly cigarettes) may be defensible, but providing sales tax exemptions on the sale of newspapers is harder to validate. Using the tax code to provide favors to select subsets of taxpayers, regardless of how justifiable some may be, creates a culture of lobbying for special interest favors.

Tax Expenditures at Tension with Ideal Tax Structure

Tax expenditures are at odds with ideal tax structure in part because they hurt economic growth. Instead of making the best economic decisions, taxpayers become focused on qualifying for credits, exemptions and other tax provisions. By altering taxpayer behavior, tax expenditures are distorting the entire economy. Spending patterns are changed, the allocation of capital is distorted, and the distribution of income is altered.[4] This has a negative impact on the entire economy.

When taxpayers use their resources to lobby for special tax provisions, they are using their time, money, human capital, and other resources for activities that add no value to the economy. Instead of innovating or creating the next best product or service, firms are spending their resources trying to obtain political favors. If a company spends $100 million lobbying for in-house research and development tax credits instead of spending $100 million on research, we are all worse off for the loss of innovation.[5]

Tax expenditures also hurt government budgets. By providing special tax provisions to select taxpayers, the state is, in most cases, forgoing tax revenue that it would have otherwise collected. Consequently, Arkansas must raise tax rates for other activities to make up for the lost revenue. In effect, Arkansas is punishing some taxpayers to reward others.

Quality expenditure data are hard to find for most taxes in Arkansas, such as the income tax. But we can turn to data at the federal level to see the negative impact that expenditures have on government budgets. For example, total tax expenditures for the federal income tax are approximately $1 trillion, which is also how much the tax collects. In other words, roughly half of federal income tax collections are lost to tax expenditures.

Comprehensive Tax Reform

Rather than providing special tax provisions for certain economic activities, Arkansas would be better off if it created a simple, transparent, and fair tax system that interferes as little as possible with economic-based decision making. Arkansas should eliminate all tax expenditures, as there is little economic justification for their use. At the same time, Arkansas should also lower tax rates.

Eliminating tax expenditures without reducing tax rates means that there will be a significant increase in taxes. A rise in the state's overall tax burden will likely offset some of the economic gains achieved by eliminating tax expenditures because higher taxes lead to slower economic growth.[6] As such, it is not enough to only rid the tax code of loopholes – Arkansas must also lower tax rates.

While all taxes hurt economic activity to some degree, some taxes are more harmful than others. When lowering rates, it is important to consider which taxes do the most harm. Empirical evidence has shown that corporate income taxes are the most harmful, followed by individual income taxes, consumption taxes, and property taxes. Because both corporate income taxes and individual income taxes discourage productivity, Arkansas should cut these rates first.

Furthermore, Arkansas should eliminate other distortionary tax provisions. Consider the economic development incentive InvestArk. InvestArk provides select businesses that have been established in

---

[4] Jeremy Horpedahl and Brandon Pizzola, *A Trillion Little Subsidies: The Economic Impact of Tax Expenditures in the Federal Income Tax Code* (Arlington, VA: Mercatus Center at George Mason University, October 25, 2012). http://mercatus.org/sites/default/files/TaxExpenditures_Horpedahl_v1-0.pdf

[5] Ibid

[6] Jed Kolko & David Neumark & Marisol Cuellar Mejia, 2013. "What Do Business Climate Indexes Teach Us About State Policy And Economic Growth?," Journal of Regional Science, Wiley Blackwell, vol. 53(2), pages 220-255, 05. https://ideas.repec.org/a/bla/jregsc/v53y2013i2p220-255.html

Arkansas for at least two years and invest at least $5 million at a single location in plant or equipment with sales and use tax credits worth 7 percent of the eligible project expenditures. While generally not considered a tax expenditure (business-to-business transactions are not included in a properly defined tax base), InvestArk creates a bias for select firms. Not every firm wishing to invest in Arkansas has been established for at least two years or is looking to make a $5 million investment. InvestArk is preferential tax treatment for large, established firms over new, smaller firms. Tax provisions such as these are distortionary and conducive to lobbying, both of which hurt the economy.

Finally, comprehensive tax reform is much more likely to succeed if it is done all at once rather than in piecemeal fashion. Eliminating tax expenditures one by one means fighting each individual lobby along the way because only one subset of taxpayers is having their preferential treatment revoked. This runs the risk of establishing a tax code where those with a strong lobby continue to enjoy special tax treatment while those with a weak lobby lose their tax provisions. By lowering tax rates and eliminating all tax expenditures at once, the incentive for taxpayers to lobby is reduced because no one group receives special treatment.

Arkansas Tax Policy

Interstate Competition

Presentation to the Arkansas Legislature
September 20, 2016

Nicole Kaeding
Economist, Center for State Tax Policy
kaeding@taxfoundation.org
www.taxfoundation.org

TOPICS OF DISCUSSION

- Overview of Arkansas Tax Policy
- State-Local Tax Burden
- State Business Tax Climate Index

ABOUT THE TAX FOUNDATION

we've worked for
79 years

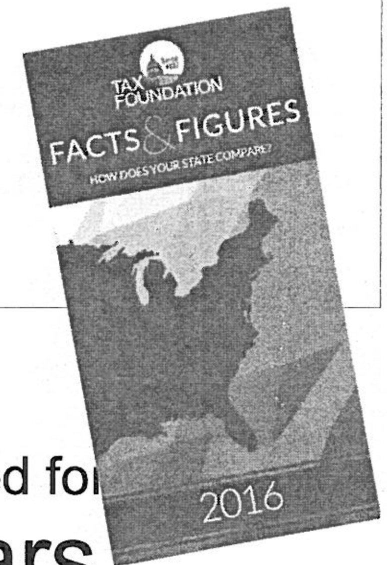
ABOUT THE TAX FOUNDATION

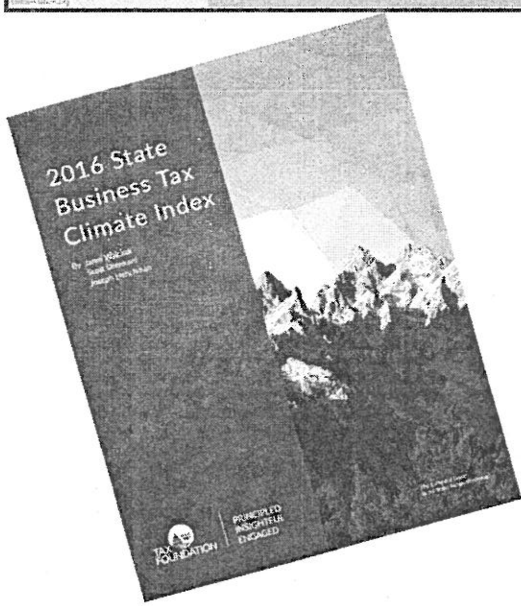
we've worked for
79 years
on objective
research,
data,
& analysis

ABOUT THE TAX FOUNDATION

we've worked for
79 years
on objective
research,
data,
& analysis
at the
federal,
state,
& local levels

ABOUT THE
TAX FOUNDATION



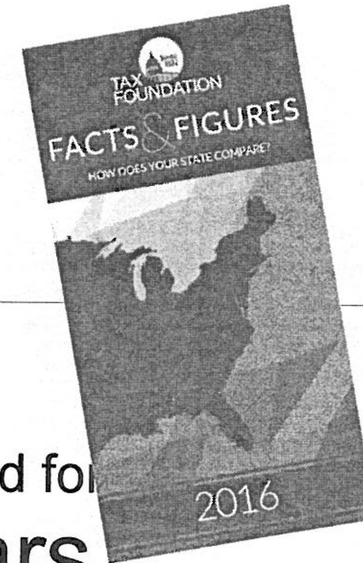


we've worked for

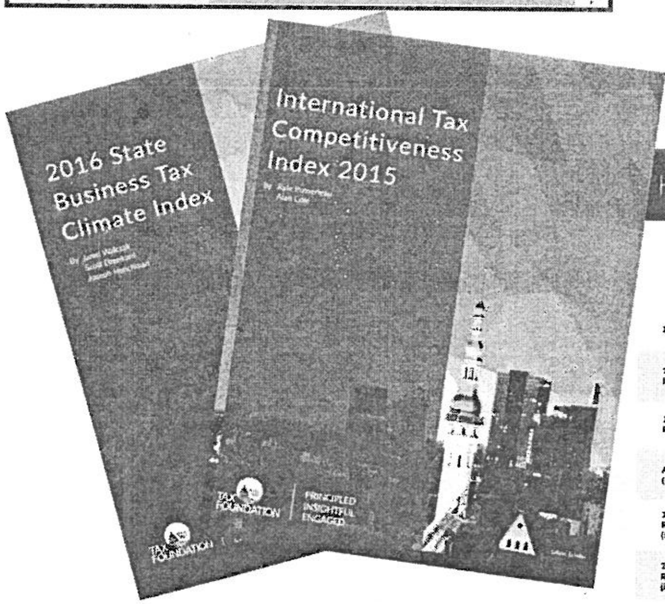
79 years

on objective
research,
data,
& analysis
at the
federal,
state,
& local levels

ABOUT THE TAX FOUNDATION



we've worked for
79 years
on objective
research,
data,
& analysis
at the
federal,
state,
& local levels

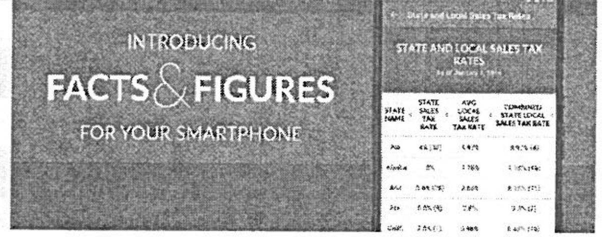


TAX FOUNDATION

How do the 2016 Presidential Tax Plans Compare So Far?

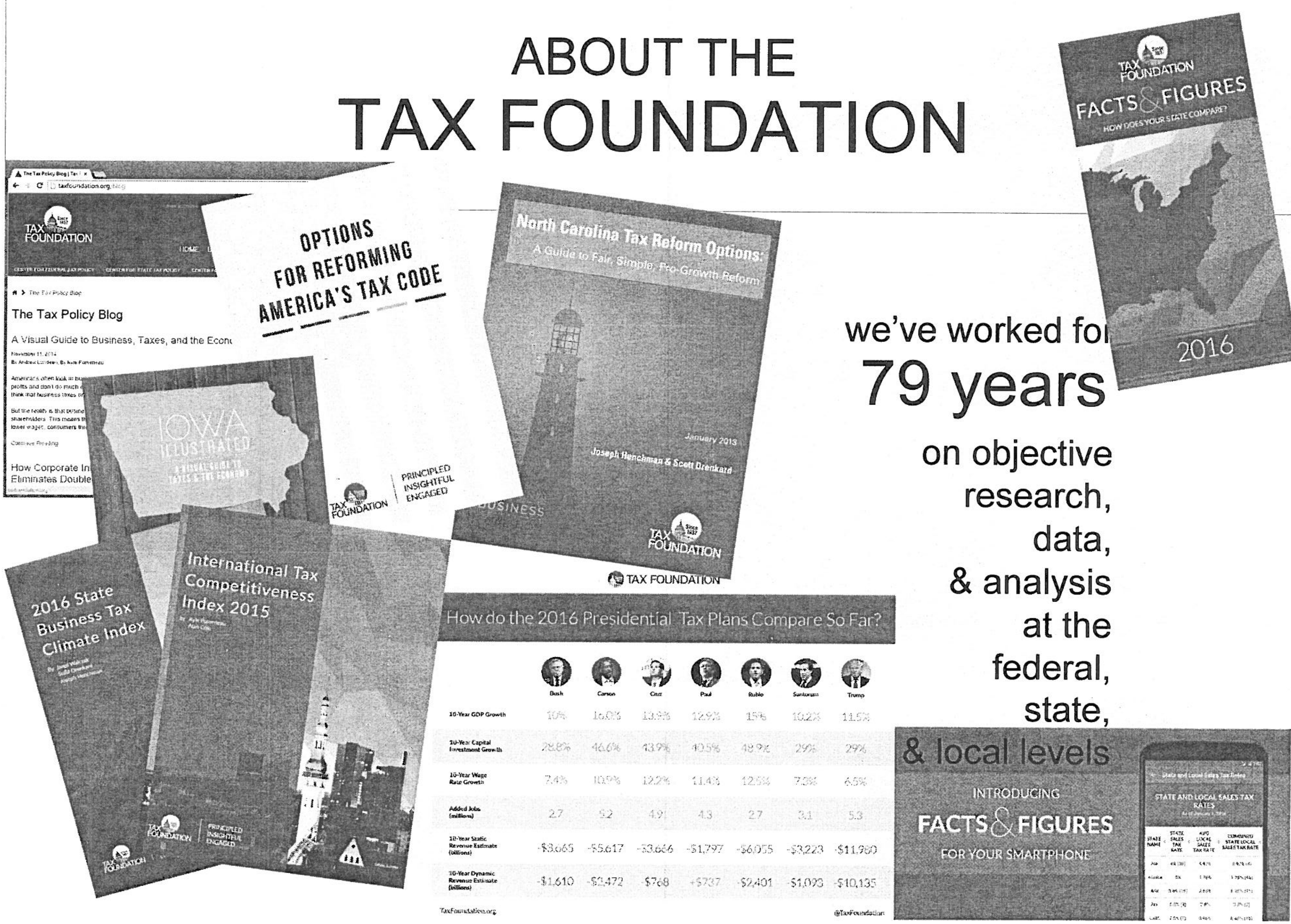
	Bush	Carson	Cruz	Paul	Rubio	Santorum	Trump
10-Year GDP Growth	10%	16.0%	13.9%	12.9%	15%	10.2%	11.5%
10-Year Capital Investment Growth	28.8%	46.6%	43.9%	40.5%	48.9%	29%	29%
10-Year Wage Rate Growth	7.4%	10.9%	12.2%	11.4%	12.6%	7.3%	6.5%
Added Jobs (millions)	2.7	5.2	4.9	4.3	2.7	3.1	5.3
10-Year Static Revenue Estimate (billions)	-$3,665	-$5,617	-$3,666	-$1,797	-$6,055	-$3,223	-$11,980
10-Year Dynamic Revenue Estimate (billions)	-$1,610	-$2,472	$768	+$737	-$2,401	-$1,093	-$10,135

TaxFoundation.org @TaxFoundation



ABOUT THE TAX FOUNDATION

we've worked for
79 years
on objective
research,
data,
& analysis
at the
federal,
state,
& local levels



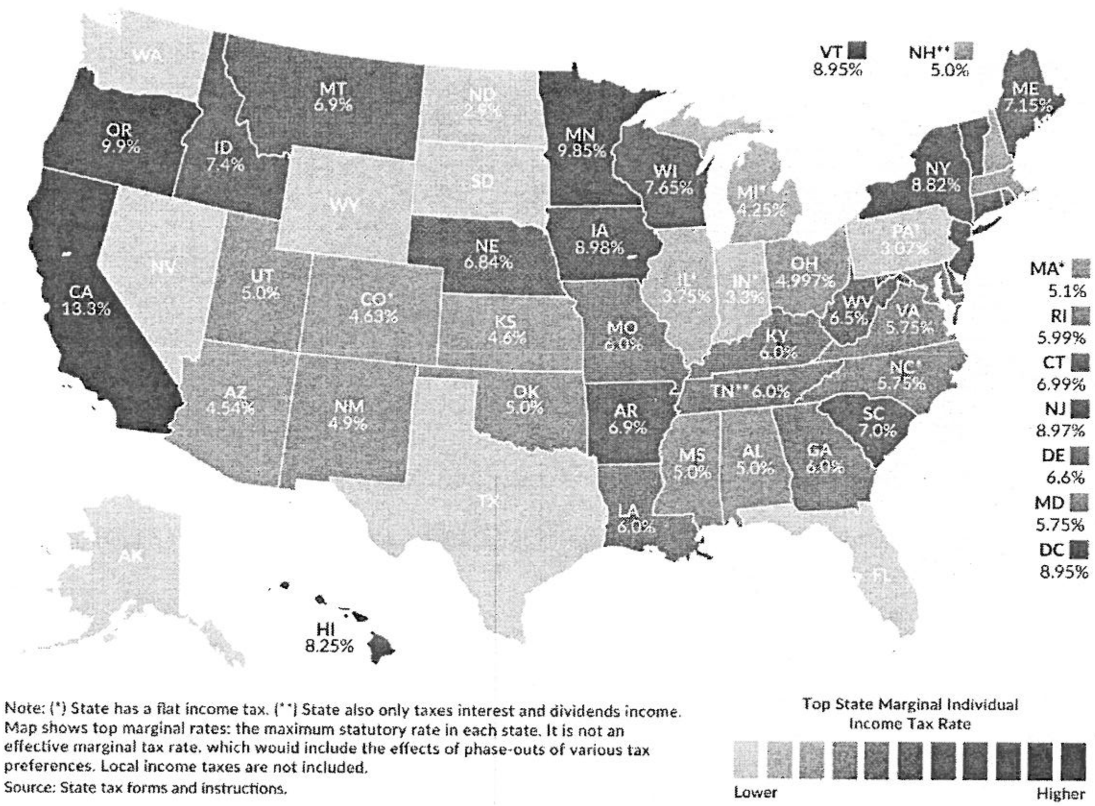
	Bush	Carson	Cruz	Paul	Rubio	Santorum	Trump
10-Year GDP Growth	10%	16.0%	13.9%	12.9%	15%	10.2%	11.5%
10-Year Capital Investment Growth	28.8%	46.6%	43.9%	40.5%	48.9%	29%	29%
10-Year Wage Rate Growth	7.4%	10.9%	12.2%	11.4%	12.6%	7.3%	6.5%
Added Jobs (millions)	2.7	5.2	4.9	4.3	2.7	3.1	5.3
10-Year Static Revenue Estimate (billions)	-$3,665	-$5,617	-$3,666	-$1,797	-$6,055	-$3,223	-$11,980
10-Year Dynamic Revenue Estimate (billions)	-$1,610	-$3,472	$768	+$737	-$2,401	-$1,093	-$10,135

COMPARATIVE STATE TAX POLICY

- We think of state tax policy in four large categories.
  - Tax Rates
  - Tax Collections
  - Tax Burdens
  - Tax Structure

TAX RATES
INDIVIDUAL INCOME TAX

How High Are Income Tax Rates in Your State?
Top State Marginal Individual Income Tax Rates, 2016



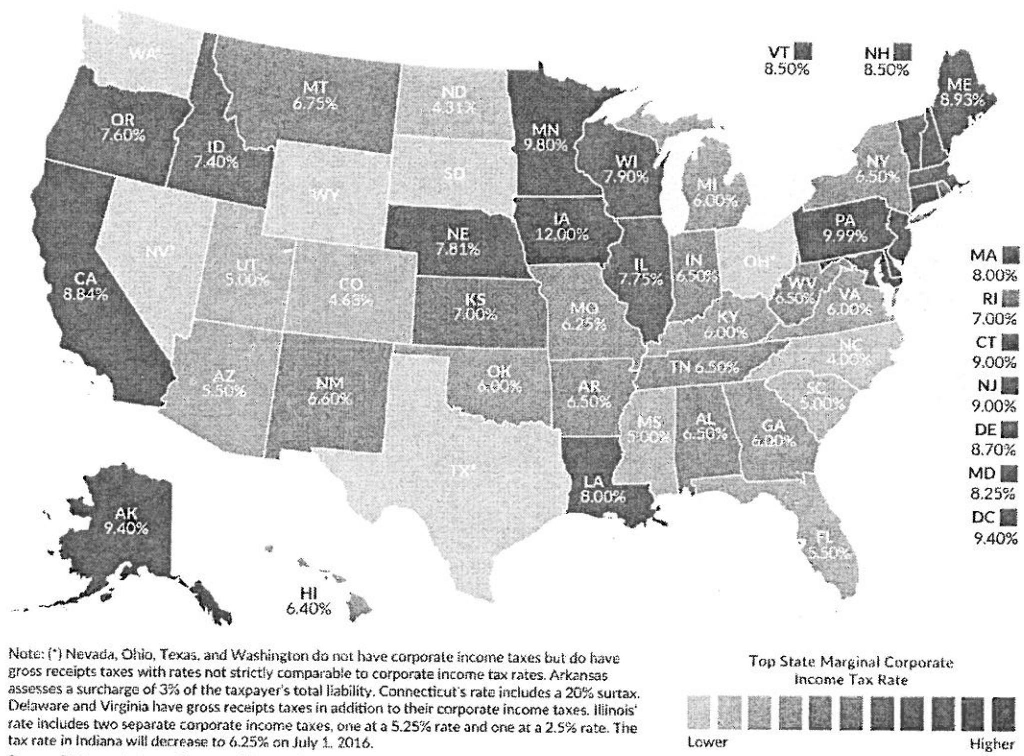
Note: (*) State has a flat income tax. (**) State also only taxes interest and dividends income. Map shows top marginal rates: the maximum statutory rate in each state. It is not an effective marginal tax rate, which would include the effects of phase-outs of various tax preferences. Local income taxes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

TAX FOUNDATION @TaxFoundation

TAX RATES
CORPORATE INCOME TAX

How High Are Corporate Income Tax Rates in Your State?

Top State Marginal Corporate Income Tax Rates in 2016



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 3% 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.

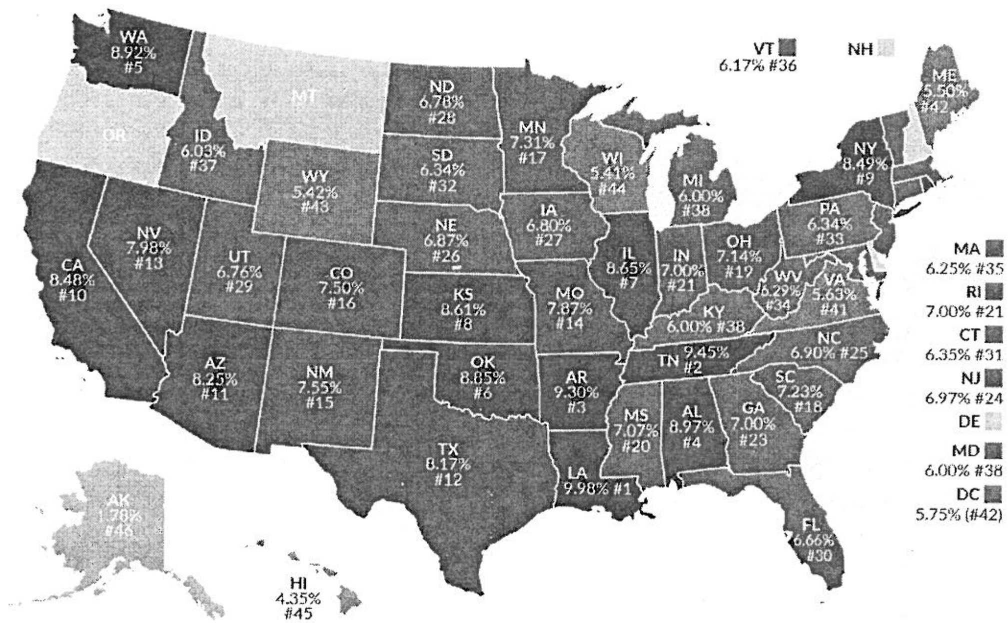
Source: State tax statutes, forms, and instructions; Commerce Clearinghouse.

TAX FOUNDATION @TaxFoundation

TAX RATES
SALES TAX

How High Are Sales Taxes in Your State?

Combined State & Average Local Sales Tax Rates (July 1, 2016)



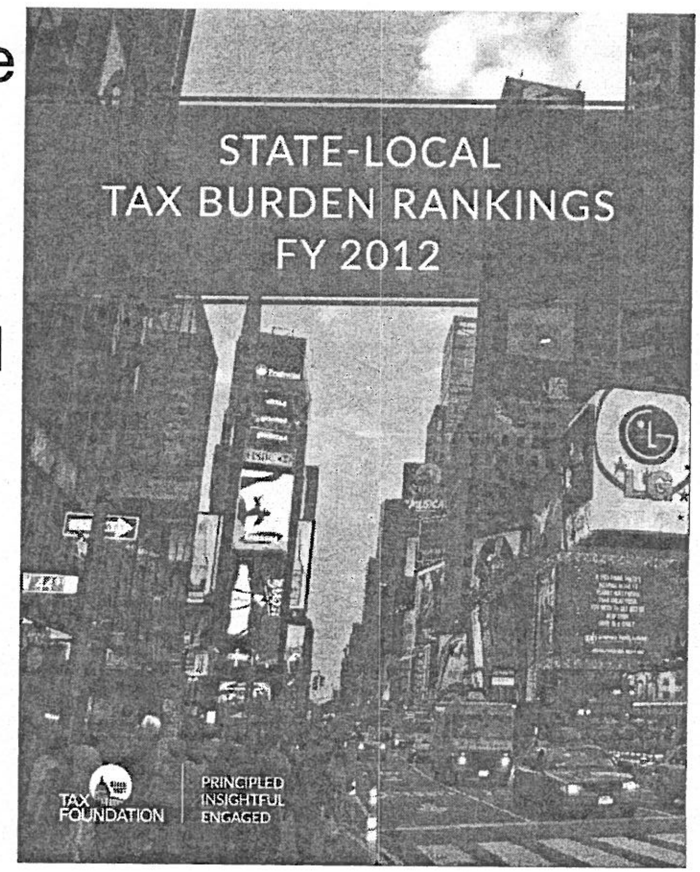
Note: City, county, and municipal rates vary. These rates are weighted by population to compute an average local tax rate. Three states levy mandatory, statewide local add-on sales taxes at the state level: California (1%), Utah (1.25%), and Virginia (1%). We include these in their state sales tax rates. The sales taxes in Hawaii, New Mexico, and South Dakota have broad bases that include many business-to-business services. Due to data limitations, the table does not include sales taxes in local resort areas in Montana. Some counties in New Jersey are not subject to statewide sales tax rates and collect a local rate of 3.5%. Their average local score is represented as a negative.

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

TAX FOUNDATION @TaxFoundation

STATE-LOCAL TAX BURDEN

- Tax burden is the portion of income that goes to taxes
- Tax collections is amount received by state; tax burden is amount paid by residents
- Incidence: Gasoline taxes
- Incidence: Corporate income tax



STATE-LOCAL TAX BURDEN

TAX INCIDENCE

Legal Incidence is Different from Economic Incidence

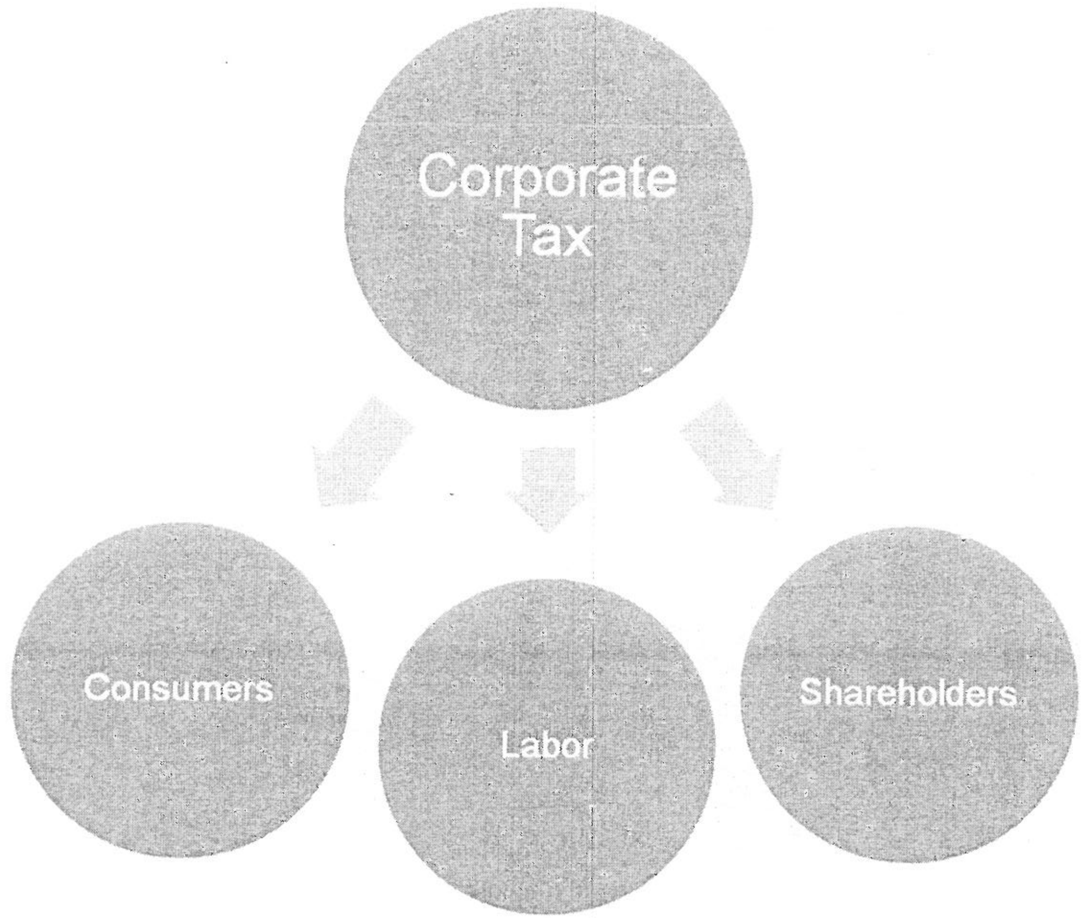
Example: Gas Taxes

State government dictates that service station businesses must collect taxes on the puchase of gasoline.
Service stations bear the legal incidence of the tax.

Customers buy at service stations, which have shifted the tax forward to customers by increasing the price.
Customers bear the economic incidence of the tax.

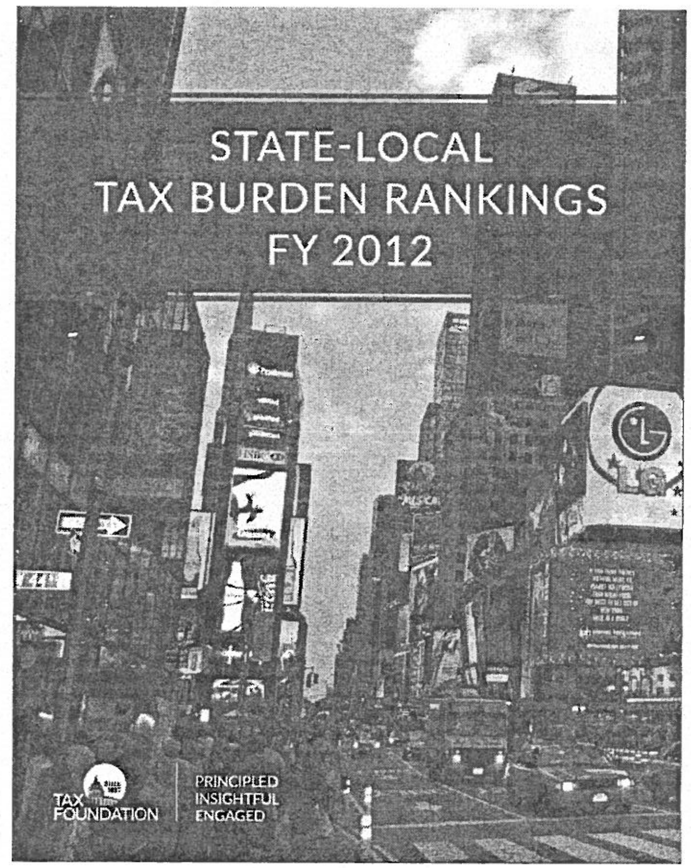
Businesses send tax collections to the state government. Even though the business has physically sent the money to the government, it did not bear the economic burden of the tax.

STATE-LOCAL TAX BURDEN
TAX INCIDENCE



STATE-LOCAL TAX BURDEN
ARKANSAS, FY 2012

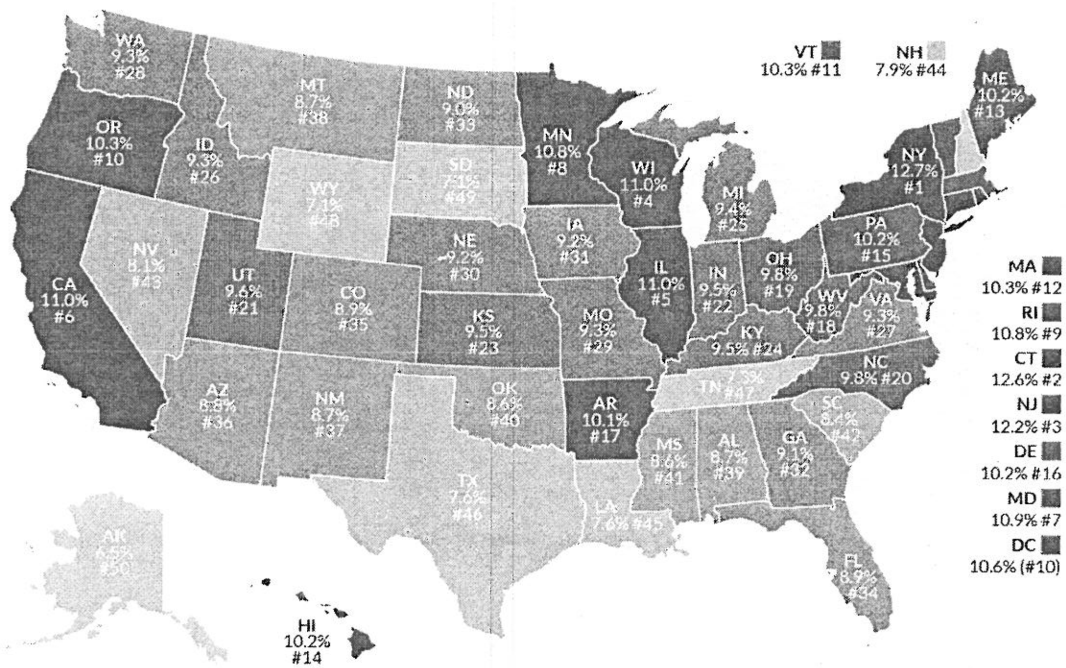
- 10.1 percent
- 17st highest
- $2,552.18 to in-state governments and $966.83 to out-of-state governments



STATE-LOCAL TAX BURDENS

State-Local Tax Burdens by State

State-Local Tax Burdens as a Percentage of State Income, FY 2012



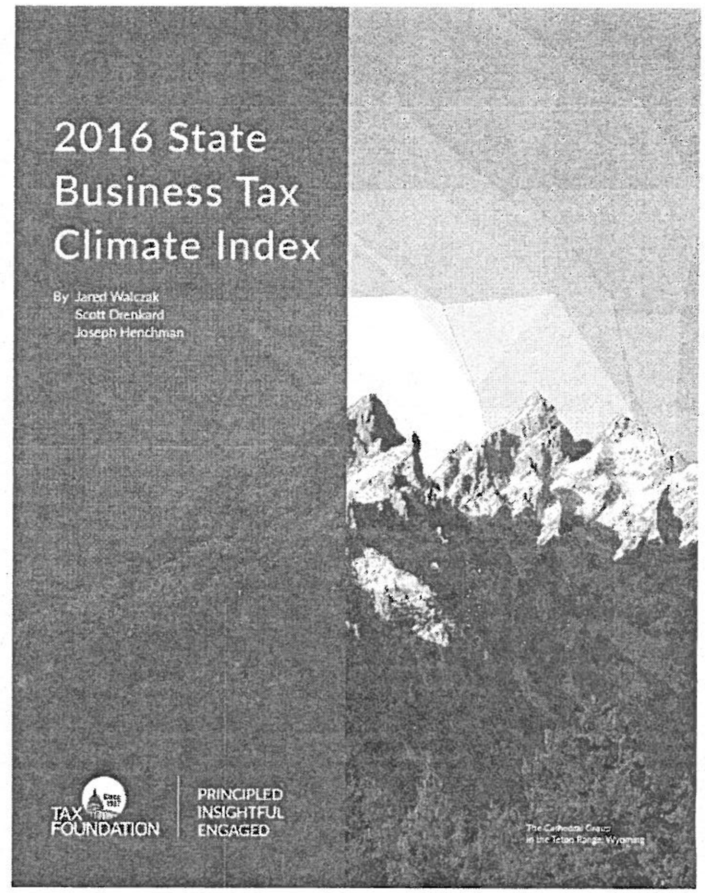
Note: As a unique state-local entity, Washington, DC is not included in rankings, but the figure in parentheses shows where it would rank.

Source: Tax Foundation calculations, U.S. Census Bureau, Rockefeller Institute, Bureau of Economic Analysis, Council on State Taxation, and Travel Industry Association.

TAX FOUNDATION @TaxFoundation

STATE BUSINESS TAX CLIMATE INDEX
MAJOR STUDIES

- Comprehensive look at state tax structures
- The **how** rather than the **how much**
- Five areas of tax:
  - Individual income taxes
  - Corporate income taxes
  - Sales and excise taxes
  - Property taxes
  - Unemployment insurance taxes



STATE BUSINESS TAX CLIMATE INDEX

Overall: 38th

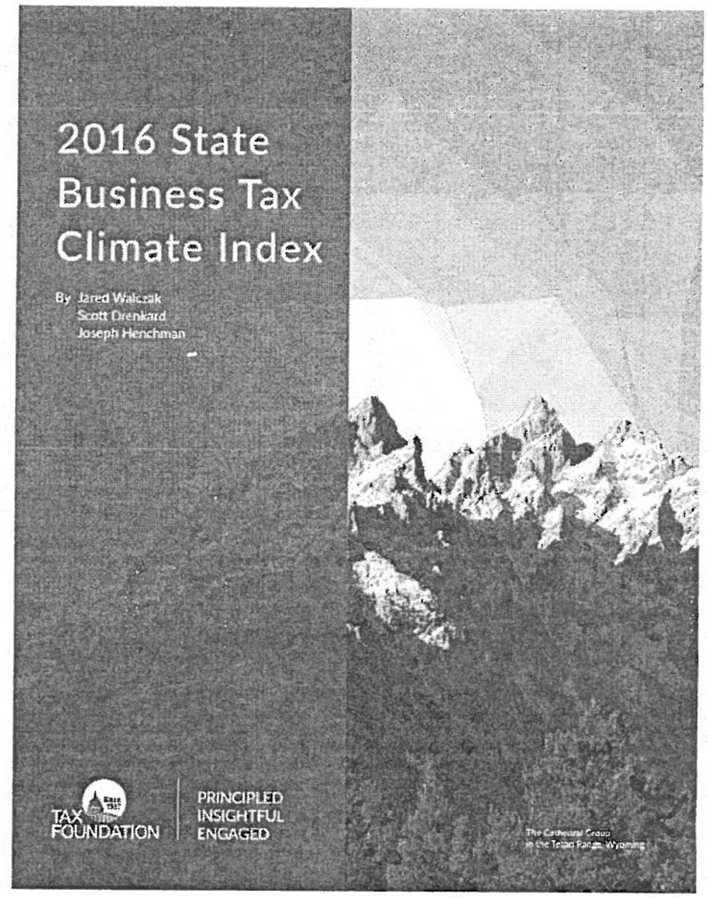
Corporate: 42nd

Individual: 29th

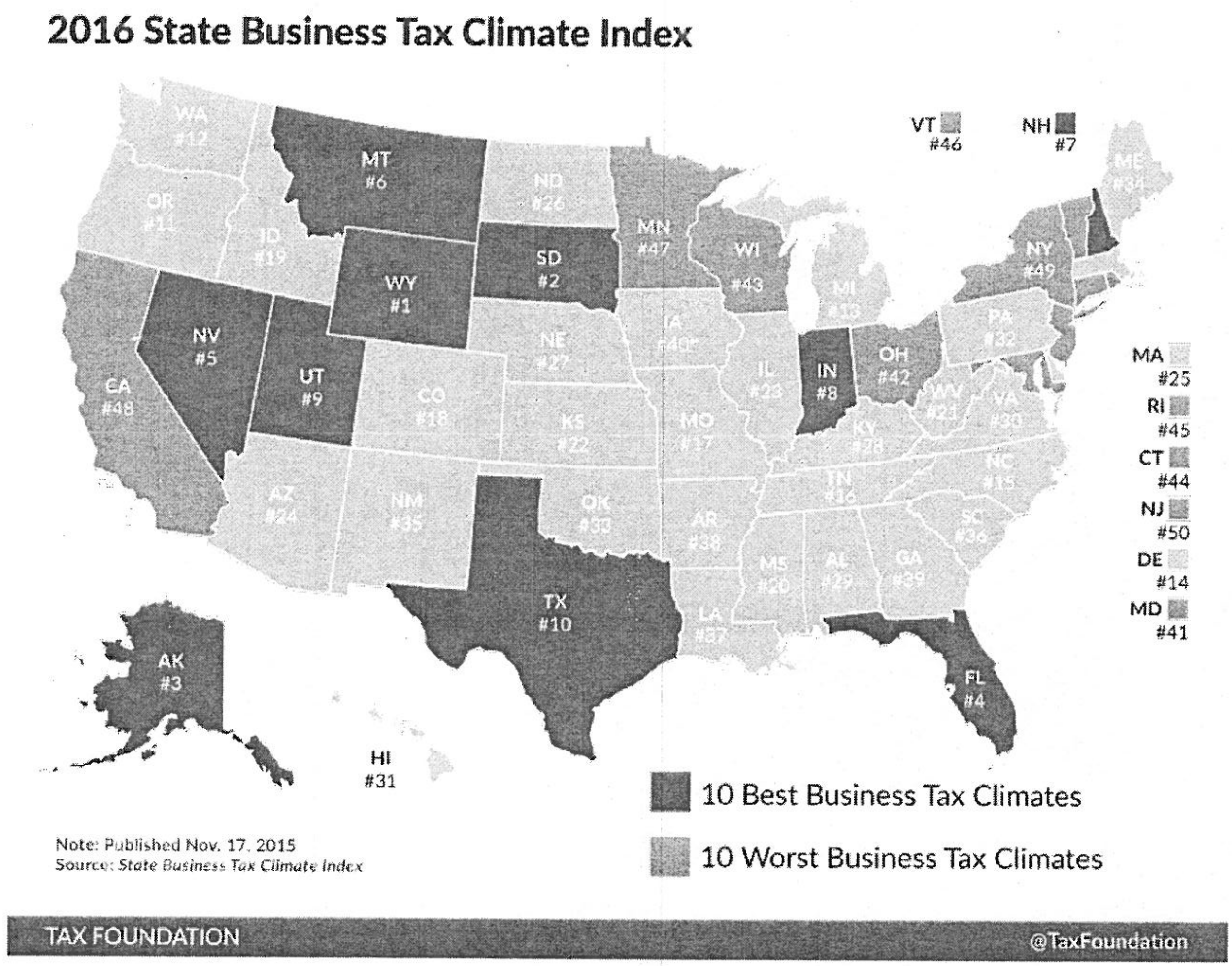
Sales: 43rd

Unemployment Insurance: 43rd

Property: 27th

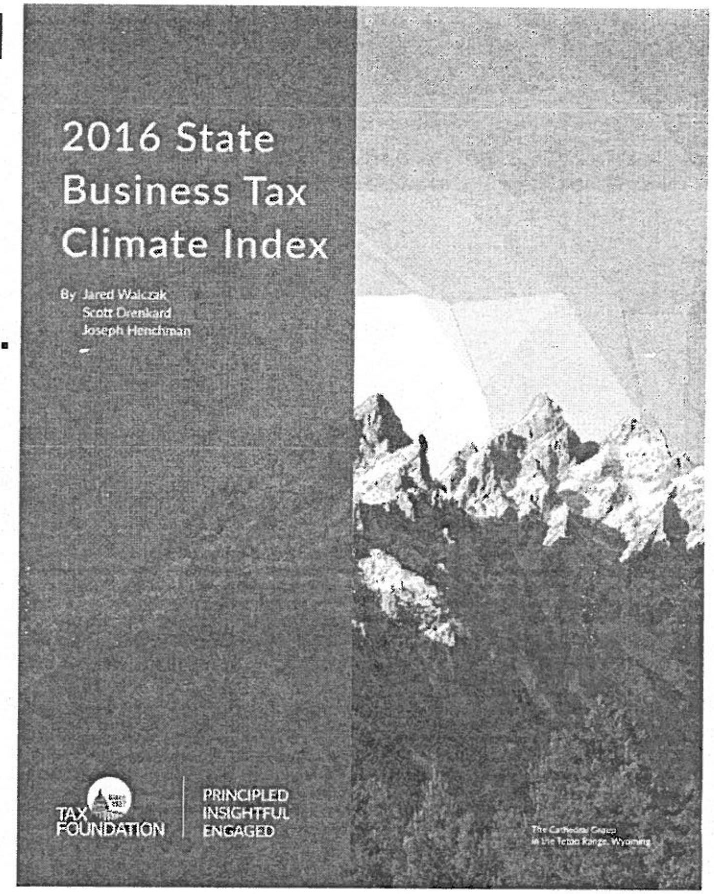


STATE BUSINESS TAX CLIMATE INDEX



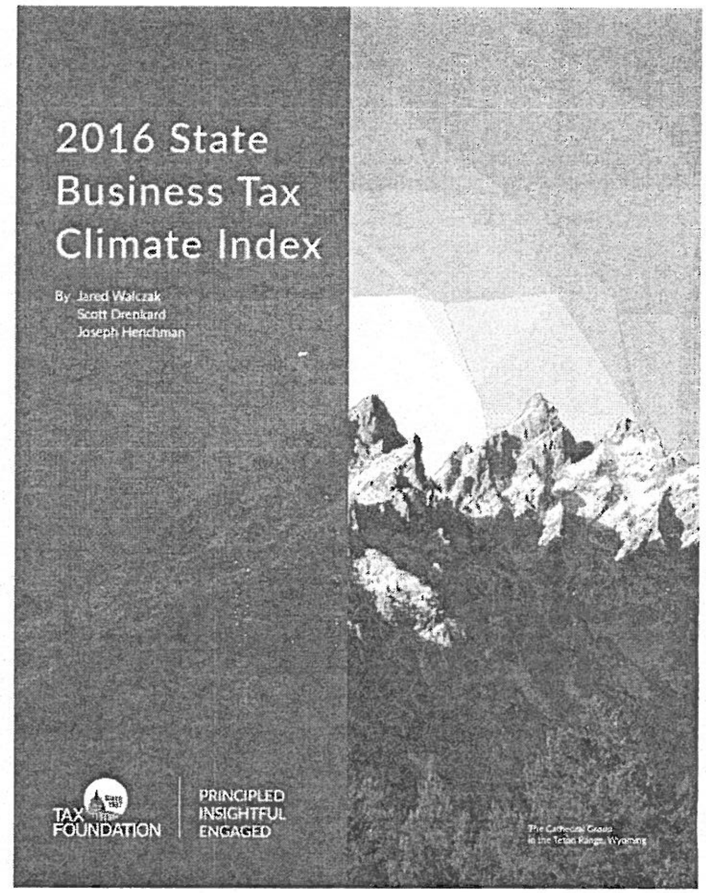
STATE BUSINESS TAX CLIMATE INDEX
CORPORATE INCOME TAX

- Arkansas's rate is 24th highest and higher than many neighboring states, and it has more brackets.
- NOLs lag other states at 0/5 years.
- Arkansas still uses a throwback rule.
- Arkansas has a number of distortionary credits.



STATE BUSINESS TAX CLIMATE INDEX
CORPORATE INCOME TAX

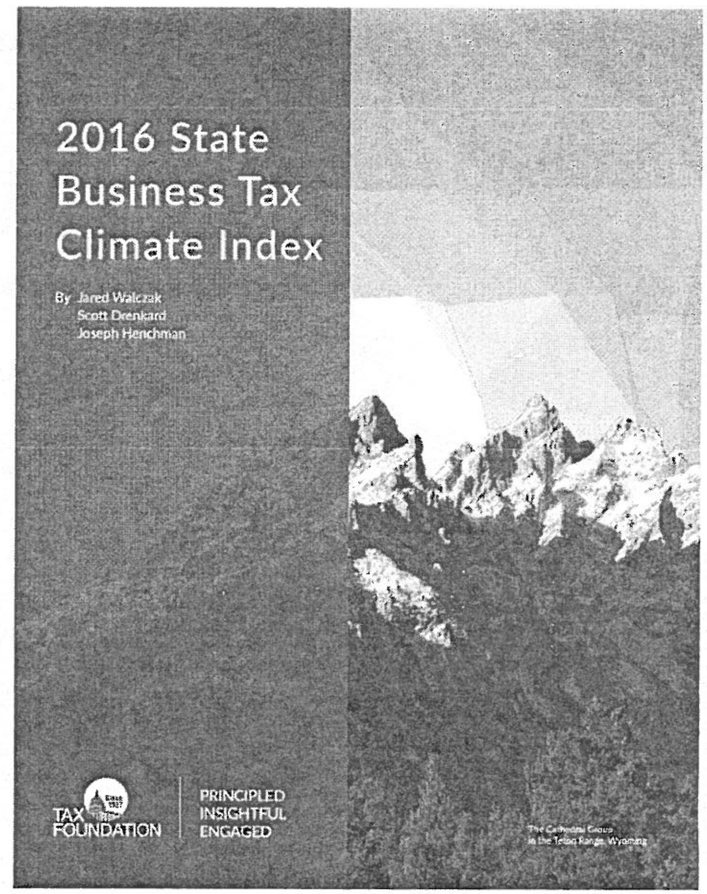
- Arkansas's 6.9 percent top rate is 14th highest and higher than many neighbors.
- Three rate schedules with four to six brackets each creates complexity.
- Arkansas has a marriage penalty.



STATE BUSINESS TAX CLIMATE INDEX
SALES TAX

- Arkansas's combined state-local sales tax rate (9.3 percent) is the third highest in the country, behind only Tennessee and Louisiana.

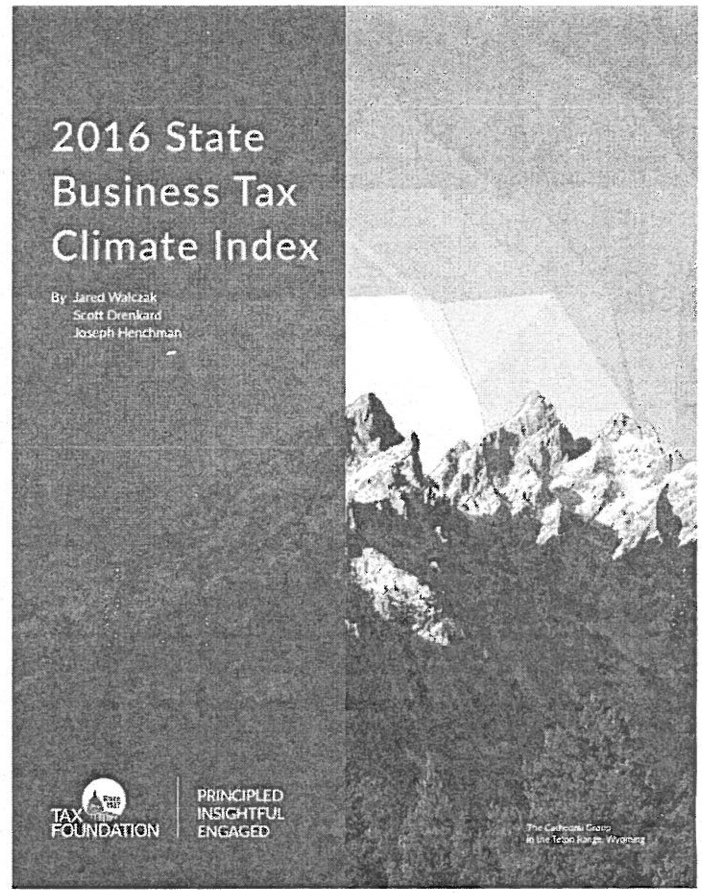
- Arkansas includes a number of business inputs in the sales tax base, such as machinery and equipment and some business services.



STATE BUSINESS TAX CLIMATE INDEX
PROPERTY TAX

- Arkansas still has a franchise tax, one of only 17 states with such a tax.

- Arkansas also taxes inventory, one of only 14 states to include it in the property tax base.



CONCLUDING THOUGHTS

- A package of reforms can tremendously help Arkansas's competitiveness.
- Cutting revenue does not have to be the only criterion. Many of these reforms can combined to offset revenue losses.
- Tax triggers can mitigate concerns about revenue availability.

QUESTIONS AND FEEDBACK

Nicole Kaeding
Economist

kaeding@taxfoundation.org
www.taxfoundation.org

A Practical Plan to Lower Arkansas's Income Tax Rates

By Dan Greenberg and Robert Steinbuch
3/3/15

The best way to help Arkansas's economy grow is through tax reform: policymakers who want to foster economic growth and attract job-creating capital investment should work to lower our income tax rates. Our nation's experience with the tax reform that President Reagan and a bipartisan Congress produced in 1986 – perhaps the greatest domestic policy achievement of modern times – provides a critical lesson for Arkansas: namely, our state can lower tax rates without decreasing government revenue. The 1986 reforms generally receive bipartisan acclaim because they accomplished more than just lower rates – they led to more jobs, greater prosperity, and increased tax revenue nationally.[1]

The income tax rate reduction that the General Assembly recently passed, prompted by Governor Hutchinson, is an admirable first step towards large-scale tax reform. As the legislative session begins to wind down, lawmakers will doubtless be presented with many opportunities to create small-scale, special-interest tax privileges. We have a better idea: **Arkansas policymakers should pursue further income tax reform based on three features of the 1986 federal model: this reform could *reduce or eliminate* tax giveaways, *swap* those giveaways for lower rates, and stay *revenue-neutral.* In the long run, such a reform would likely increase both economic growth and state revenue.**[2] And from a more political perspective, voters like lower tax rates.

1. Tax giveaways: Arkansas state law regularly discriminates among various forms of economic activity. Our tax code contains dozens of deductions, credits, and exemptions which benefit a small number of businesses and individuals, but do not seem to benefit the public generally.[3] (The technical term for what we informally call tax giveaways is "tax expenditures.") These giveaways actually harm and distort the economy, in that they encourage economic activity that is based on pursuing tax benefits rather than income creation. If the state tax code were free of these tax giveaways, policymakers would have the freedom to benefit Arkansas by writing a lower tax rate into law.

2. Lower rates: Stripping tax giveaways out of the state tax code would, by itself, be a tax increase (on a relatively small number of people or businesses). Arkansas policymakers could compensate for any such tax increase by reducing rates on the public at large. Lower tax rates (as compared to tax giveaways)

(continued on other side)

encourage economic activity that is based on income creation, rather than on pursuing tax benefits.

3. Revenue-neutrality: One argument that is regularly made against tax reductions of any kind is (to put it casually) "How are you going to pay for it?" More technically, how can policymakers compensate for the missing government revenue that tax cuts cause? One answer to this question lies in balancing the *missing* revenue from rate relief against *new* revenue that comes from eliminating tax giveaways. When these two revenue figures balance, this creates neither a tax increase nor a tax decrease. Rather, such a tax swap would be revenue-neutral.

CALCULATING REVENUE IMPACT

An ancient Danish proverb instructs us that it is difficult to make predictions, especially about the future. Nonetheless, the state's Department of Finance and Administration (DF&A) regularly makes reliable predictions about the future revenue impact of various changes to the tax code. Such predictions are inherently inexact, but they can be relied on to a reasonable extent.

Recent research from DF&A contains a reasonable estimate, for each bracket, of reducing rates by one-tenth of one percent.[4] This, of course, was one element of Arkansas's modest income tax rate reductions in 2013. It is possible to estimate the approximate cost of rate reductions for the coming year by using the table below: for instance, the top number in the right column immediately below shows that another one-tenth of 1% rate reduction in the lowest bracket (from 0.9% to 0.8%) would set back the state treasury approximately $4.712 million. Similarly, another across-the-board one-tenth of 1% rate reduction would reduce state revenues approximately $47.732 million.

Income Tax Revenue Loss, 1/10th of 1% Relief, By Bracket

$0 to $4,299	$4.712 m
$4,300 to $8,399	$4.349 m
$8,400 to $12,599	$4.158 m
$12,600 to $20,999	$7.006 m
$21,000 to $35,099	$8.122 m
$35,100 and up	$19.384 m
(total revenue loss, all brackets)	$47.732 m

In 2013, DF&A produced a report, "Business Incentives and Tax Credits Program Costs through December 31, 2012," which is an invaluable aid to those who are interested in the burden of tax expenditures on Arkansas's general revenue.[5] One can use this report, with the aid of certain assumptions,[6] to draw reasonable conclusions about the cost of some tax expenditures in future years.

Tax Expenditure / Revenue Loss	
Employee tuition reimbursement tax credit	$131,989.00
Capital development corporation	$1,618,704.00
Delta Geotourism Incentive Act	$11,789.00
Digital product and motion picture industry rebate	$585,798.00
Equity investment tax credit	$1,631,198.00
Historic rehabilitation income tax credit	$459,642.00
Investment tax incentives	$1,759,156.00
Job creation tax credit	$1,945,521.00
Low income housing tax credit	$1,189,656.00
New market tax credits	$14,900,000.00
Private wetland and riparian zone tax credit	$117,391.00
Research and development tax credits	$2,200,042.00
Research park authority tax credit	$6,890.00
Rice straw tax credit	$1,524,224.00
Targeted business special incentives	$216,497.00
Waste reduction/reuse/recycling eqpmt credit	$6,011,213.00
Tourism attraction project income tax credit	$12,190.00
Water resources conservation tax credit	$892,458.00
Workforce training tax credit	$11,590.00
Youth apprenticeship tax credit	$13,749.00
Total	$34,321,900.00

Note, however, that this is an *incomplete list* of tax expenditures – many are not listed in DF&A's report, and their cost to the state treasury is difficult to estimate. Nonetheless, we can conclude that just the income tax expenditures that are listed above cost the state treasury roughly $34 million every year. If we extend our examination of tax expenditures beyond *income* tax expenditures, so as to include *sales* tax expenditures, it is reasonable to conclude that total yearly *easily identifiable* tax expenditures with usable estimates are in the neighborhood of $95 to $105 million every year.[7] To repeat, the cost of total tax expenditures to the state treasury is likely significantly higher, because the table above is only an incomplete list of tax expenditures – it is composed of only those tax expenditures which DF&A has provided a reasonably reliable cost estimate. All of these tax expenditures could be eliminated in exchange for lower rates.

PRACTICAL POSSIBILITIES OF REVENUE-NEUTRAL RATE RELIEF

Arkansas currently competes with regional neighbors like Texas, Tennessee, and Florida which have no income tax at all. It is a fair point to make in response that our competitors have other relatively higher taxes (Texas, for instance, has a relatively onerous property tax); nonetheless, our neighbors' comparatively superior economic performance raises the possibility that their policymakers may be making better decisions about their state's tax structure. Arkansas should reform its income tax structure so as to pursue a simpler, flatter tax code with lower rates so as to, ideally, achieve the kind of productivity, job creation, and economic growth that the tax reform of 1986 created for our nation in the late 1980s and 1990s.

Assuming that policymakers are willing to eliminate tax expenditures from the state tax code, those who want to create even more rate relief into law than the General Assembly has already accomplished have many options. For instance, if policymakers decided that they wanted to significantly reduce Arkansas's top income tax bracket in the future – from 6.9% to 6.25% – this would eliminate roughly $103.35 million in tax revenue; a less aggressive reform would consist of dropping the top tax rate from 6.9% to 6.7%, which would eliminate roughly $31.8 million in tax revenue.[8] Alternately, policymakers might decide instead that all rates should be reduced by two-tenths of a percentage point; this would eliminate roughly $95.5 million in income tax revenue.[9] Even larger income tax rate reductions would be possible if lawmakers were willing to consider revenue-neutral swaps that would achieve lower income taxes in exchange for higher property taxes. (We hope it is not too forward to suggest that Texas's tax structure might have something to do with its superior record on economic growth.)

Relatedly, lawmakers who believe that lower income tax rates are important for Arkansas's future economic development should avoid creating new tax expenditures which only benefit small groups of people but crowd out the prospect of broad-based rate relief. (And if lawmakers must create additional tax expenditures, then at a minimum such expenditures should ideally have a finite life and contain a sunset clause.) If the goal is to use tax policy to help as many people as possible, then by definition broad-based rate relief is superior to tax expenditures that only benefit a relatively small number of Arkansans.

A TAX AGENDA THAT SPURS ECONOMIC GROWTH

Lawmakers should focus on tax policy changes which would encourage a fairer, flatter, less burdensome, and more efficient income tax system:

- Lawmakers should require regular yearly reporting of the estimated cost of each tax expenditure in the state's tax code, ideally accompanied by corresponding figures for past and future years;
- Lawmakers should remember that any large tax expenditure will necessarily crowd out the prospect of lower rates;
- Lawmakers should mandate that any new tax expenditures that are created must have a finite life and a sunset clause (and, in concert with the recommendation below, they should impose sunset clauses on existing tax expenditures); and, finally,
- Lawmakers should consider implementing an automatic approach that reduces rates when tax expenditures expire, which would eliminate those tax expenditures and substitute a rate reduction.

CONCLUSION

Only a few days are left before this session's looming bill-filing deadline, and fiscally conservative legislators should seize that opportunity to pursue further income tax rate relief. If America's experience with the 1986 tax reforms is any guide, such rate relief would not only lighten the tax burden on the Arkansas families and businesses which pay taxes, but also create capital investment and new jobs in a state which sorely needs them.

Dan Greenberg, a lawyer and former state legislator, is president of the Advance Arkansas Institute. Professor Robert Steinbuch, who teaches at UALR's Bowen School of Law, was deputy senior counselor to the Commissioner of the Internal Revenue Service during the George W. Bush Administration.

---

[1] See generally "How the Tax Reform of 1986 Supercharged the American Economy," Marc Kilmer, Advance Arkansas Institute.

[2] Discussed more thoroughly in "How Arkansas Can Cut Tax Rates without Revenue Loss: The Lessons of 1986," Marc Kilmer, Advance Arkansas Institute.
[3] "How Tax Breaks Harm the People of Arkansas," Marc Kilmer, Advance Arkansas Institute.
[4] This research was given to the authors by DF&A staff in January of this year.
[5] This report, published in September 2013, gives a detailed, multi-year breakdown of the cost to the state treasury of many of the state's incentives and tax credits. The report was prepared by the state Office of Excise Tax Administration, Tax Credits/Special Refunds Section.
[6] For most of the tax expenditures listed below, the DF&A report typically lists 5 figures: namely, the cost of the tax expenditures listed below for FY2008-2012 inclusive. We calculated a yearly average based on DF&A's FY2008-2012 figures, then adjusted for inflation by using the Bureau of Labor Statistics consumer price indices to calculate 2015 and 2016 figures for each tax credit, and then averaged those two figures together. The report does not list the cost of Arkansas's new market tax credits (which spring from Act 1474 of 2013); that figure of $14.9 million yearly is derived from the authors' conversations with DF&A staff, who expect it to rise over time.
[7] See DF&A's "Business Incentives" report, page 1, which shows a steady growth in total tax expenditures from FY2008's $62.2m to FY2012's $84.7m.
[8] These figures assume that cutting the new top rate (which kicks in at $75,000 annual earnings) by 1/10th of 1% would cost the state treasury $15.9 million in FY17. That estimate has been used informally by Governor Hutchinson's staff in conversations with the authors.
[9] The total revenue loss that would be triggered, were policymakers to reduce each income tax bracket's rate by one-tenth of 1%, is $47.732 million. See "Income Tax Revenue Loss" table above. Therefore, an across-the-board reduction twice that size would result in twice that amount of revenue loss.

Tax Reform in Arkansas:
Legislative, Procedural, and Constitutional Alternatives

Dan Greenberg, Advance Arkansas Institute

I. The moral and economic superiority of tax reform

II. The political failure of tax reform
   a. Is bad education the culprit?
   b. The pervasiveness of special interests
      i. Concentrated costs, dispersed benefits
      ii. The persuasiveness of the actual person in the room vs. the abstract interest of the unrepresented person.

III. Change is difficult; laws acquire their own beneficiaries.

IV. Three kinds of changes in law that could enhance tax reform.
   a. Legislative change.
      i. Straightforward tax reform/paper on tax shifts
      ii. Delayed, but automatic, tax reform.
         1. Automatic removal of tax privileges
         2. Passed today, takes effect in future.
   b. Procedural change.
      i. Sunrise/sunset rules
         1. Sunrise: cannot take effect w/o sunset
         2. Sunset: must sunset in X years.
         3. Noncompliance vulnerable to point of order objection.
         4. Either requires majority/supermajority to overturn
   c. Constitutional change
      i. Constitution prevents some "tax shifts"
         1. Forces Arkansas into relatively heavy use of income taxes
         2. With constitutional change, Arkansas could rely more on diverse types of tax revenue for tax reform.