

Arkansas:

Options for Sales Tax Reform

Presentation to the Arkansas Tax Reform
and Relief Task Force
March 19, 2018

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TOPICS OF DISCUSSION

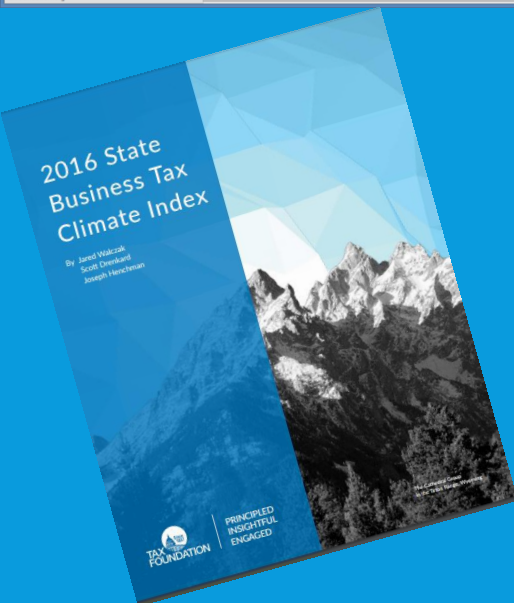
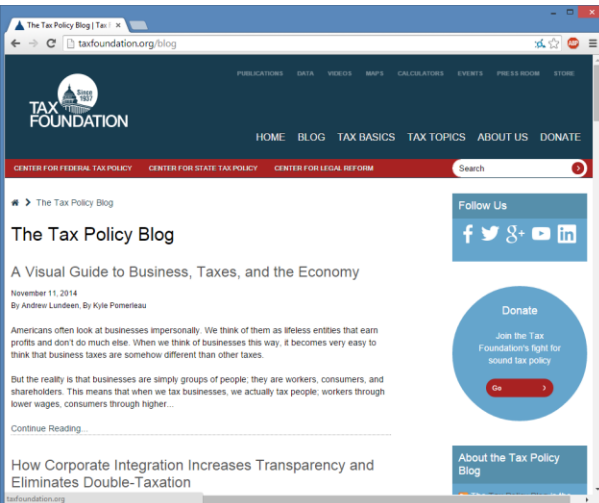
- History of Sales Taxes
- Eroding Sales Tax Bases
- Principles of Sales Taxation
- Internet Sales Tax Issues
- Arkansas Comparative Analysis
- Important Considerations for Reform
- Arkansas Tax Exemptions
- Recommendations for Reform

ABOUT THE TAX FOUNDATION

we've worked for
81 years

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research,
data,
& analysis
at the
federal,
state,
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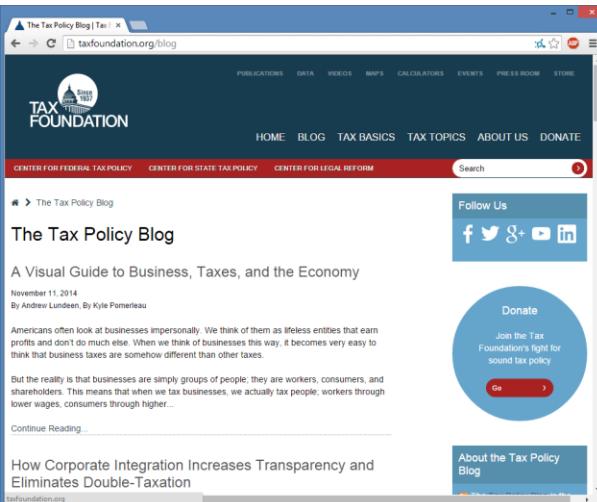
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TAX FOUNDATION

How do the 2016 Presidential Tax Plans Compare So Far?

By Kyle Pomeroy and Alan Cole

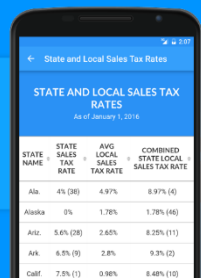
	Bush	Carson	Cruz	Paul	Rubio	Santorum	Trump
10-Year GDP Growth	10%	16.0%	13.9%	12.9%	15%	10.2%	11.5%
10-Year Capital Investment Growth	28.8%	46.6%	43.9%	40.5%	48.9%	29%	29%
10-Year Wage Rate Growth	7.4%	10.9%	12.2%	11.4%	12.5%	7.3%	6.5%
Added Jobs (millions)	2.7	5.2	4.9	4.3	2.7	3.1	5.3
10-Year Static 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

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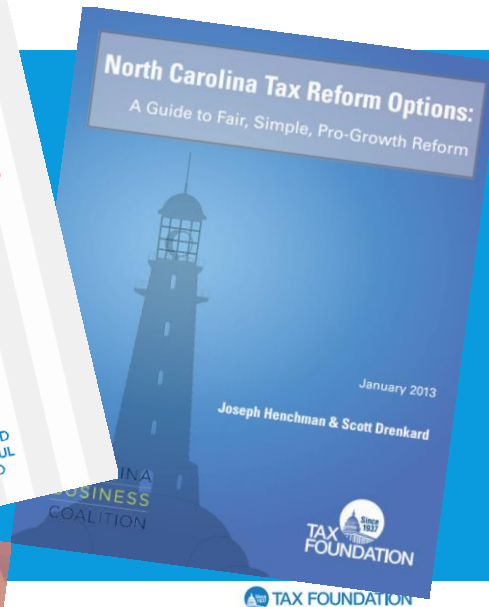
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INTRODUCING
FACTS & FIGURES
FOR YOUR SMARTPHONE



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How do the 2016 Presidential Tax Plans Compare So Far?

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INTRODUCING
FACTS & FIGURES
FOR YOUR SMARTPHONE

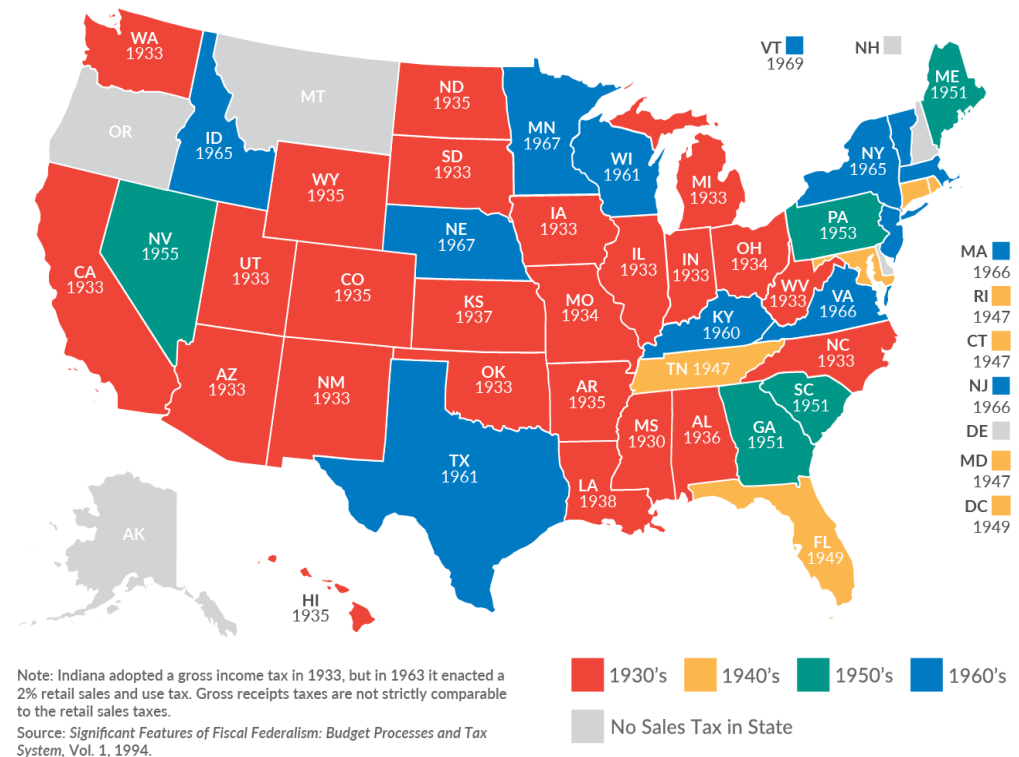


SALES TAXES

THE HISTORY

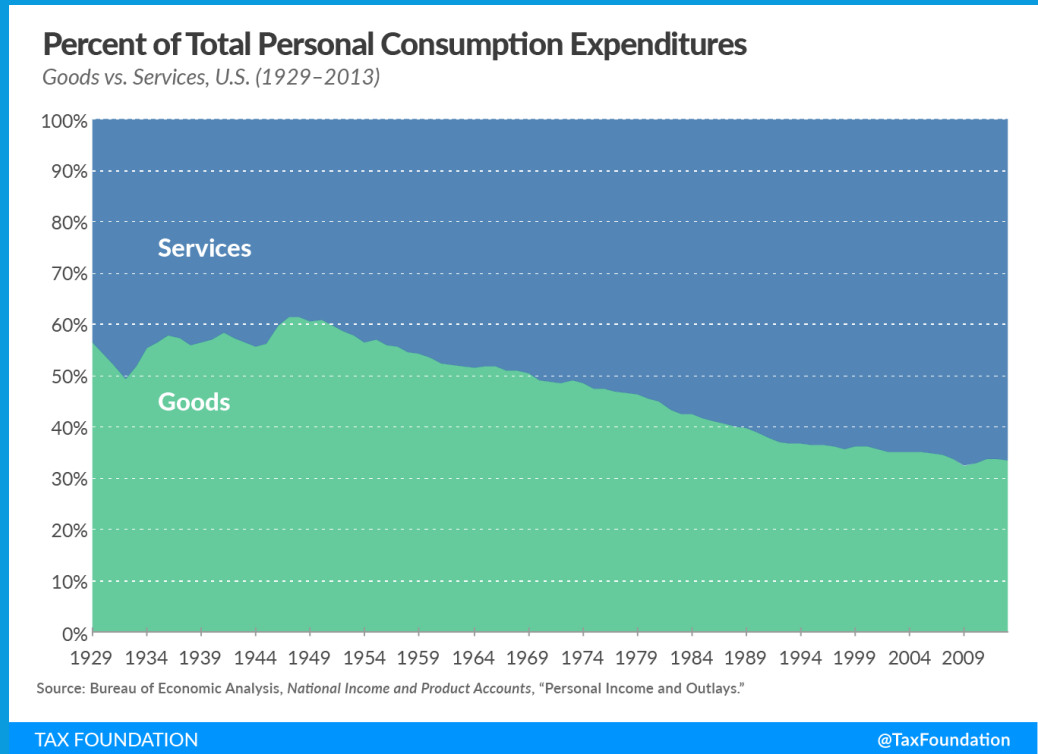
- The first broad-based, general state sales tax was in Mississippi in 1930.
- Other states quickly followed MS's lead, replacing gross receipts taxes with sales taxes.

When Was a Sales Tax Adopted in Your State?



ERODING SALES TAX BASES

- However, the sales tax bases of states quickly began to shrink.
- First, the economy changed quickly, moving from a goods-centered economy to a services-centered economy.



ERODING SALES TAX BASES

- Second, states moved to exempt goods from their sales tax base as a way to mitigate the perceived regressivity.
 - In 2018, only seven states include groceries in their sales tax base.
 - Only one state taxes prescription drugs.

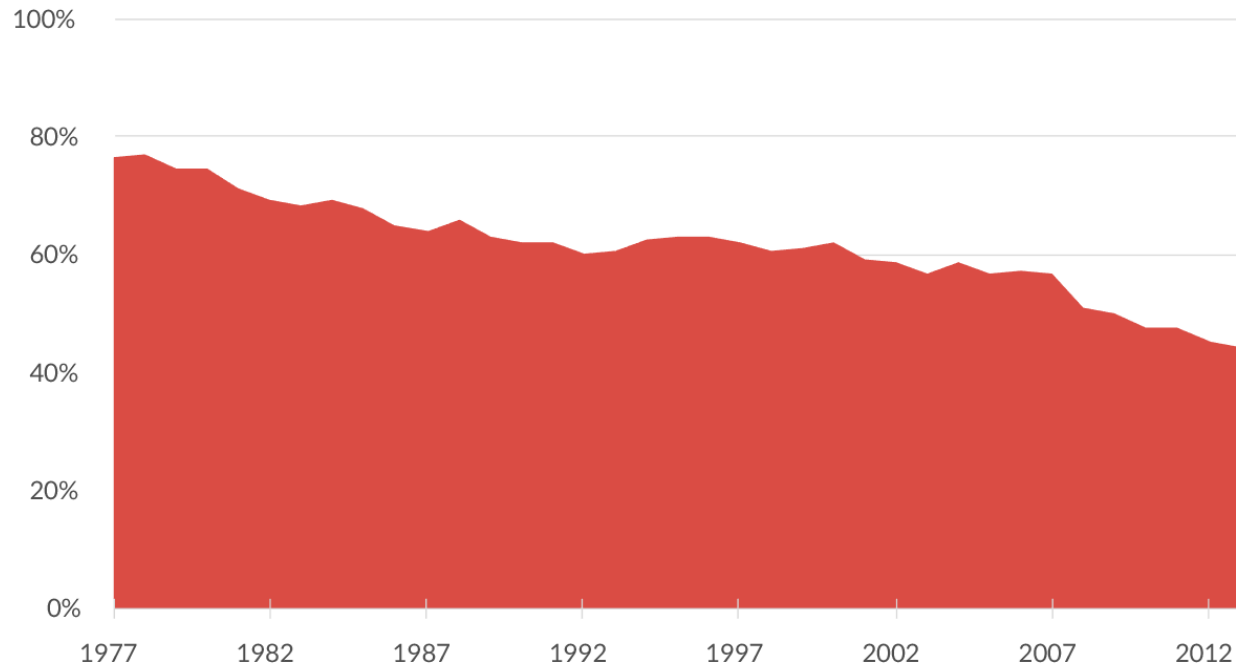
ERODING SALES TAX BASES

- The blanket exemptions for goods and wholesale exclusion of services has resulted in narrow state sales tax bases.
- Sales Tax Breadths from Selected States, 2015
 - U.S. Median: 23%
 - Arkansas: 43%, 8th
 - Alabama: 35%, 23rd
 - Iowa: 35%, 23rd
 - Louisiana: 37%, 18th
 - Oklahoma: 34%, 29th
 - Tennessee: 34th, 29th
 - Texas: 42%, 9th

ERODING SALES TAX BASES

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.

PRINCIPLES OF SALES TAXATION

- Sales taxes should tax final consumption.
- Taxing inputs leads to tax pyramiding. Pyramiding leads to higher costs for consumers, fewer job opportunities for workers, and lower returns for shareholders.
- Services should also be taxed: As John Due described, “Acquisition of services by households constitute consumption expenditure in the same fashion as the purchase of commodities; there is no basic difference between the two that warrants different tax treatment.”

PRINCIPLES OF SALES TAXATION

- The existence of an excise tax does not mean that a good should be exempt from the general sales tax. “There is no justification for such an exemption,” according to John Mikesell.
 - The PFM interim report was incorrect in its reading of the economic literature.
- Consider a tax on gasoline.
 - Gasoline is final consumption and should be taxed accordingly.
 - It’s also true that gasoline consumption is a good proxy for measuring road usage, and applying a separate excise tax to gasoline is an appropriate way to fund transportation spending.

PRINCIPLES OF SALES TAXATION

- The regressive nature of the sales tax is often overstated.
- In the short term, sales taxes are regressive, but in the long run, they are only slightly regressive.
- According to Laird Graeser, “... individuals adjust their spending patterns to approximate their long-term economic power and consume proportionately to this long-term expectation of income....Assuming that all consumption is taxed equally, lifetime consumption taxes are proportional to lifetime income.”
- We’ll discuss later what Arkansas can and should do to mitigate any concerns about regressivity.

1977

THE *COMPLETE AUTO* TEST

- **Nexus**
Sufficient connection between state and taxpayer
- **Fair Apportionment**
State cannot tax beyond its fair share of interstate commerce
- **Non-Discrimination**
State cannot tax out-of-state activity or taxpayers while exempting in-state activity or taxpayers
- **Fairly Related**
Tax must be fairly related to services provided to taxpayer

NEXUS

QUILL V. NORTH DAKOTA

- Physical presence rule “firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduces litigation concerning those taxes.”
- Justice Byron White dissented:
 - Injustice that some sales escaping taxation
 - Technological change has made compliance no longer burdensome.
- Today: 10,364 sales tax jurisdictions (as of 4/1/16) and growing by several hundred a year. States reluctant to cooperate on even basic rules and definitions.
- *Quill* decision technically applies only to sales taxes.

CONGRESSIONAL ACTION

PROPOSALS

- General idea is a *quid pro quo* whereby states can collect sales tax on online purchases **if** they adopt simplifications as set out in federal law.
- **Marketplace Fairness Act** requires single entity in state to handle all sales/use tax administration, a single audit of remote sellers, a single sales and use tax return, a uniform tax base between state and locals, free software to track tax rates and zip codes, immunity from software errors, and a small seller exception (\$1 million).
- **Remote Transactions Parity Act** (Rep. Noem), in addition, phases out small seller exception, limits audits for small sellers only to fraud, requires software to be integrated for free, and requires 180 days before state changes can take effect. Bill includes all requested additions from Tax Foundation except federal jurisdiction.

WAYFAIR CASE

SOUTH DAKOTA LAW

- South Dakota is one of 3 states that tax nearly all services under its sales tax. Internet sales are about the only thing South Dakota does not tax, because of *Quill*.
- South Dakota is one of 23 states that fully adopts SST definitions and rules, requires local base uniformity, and limits range of local tax rates.
- South Dakota includes a *de minimis* threshold (\$100,000 or 200 sales) and bans retroactive collection.
- As it is a law collecting taxes paid and borne by residents, South Dakota still bases tax liability on physical presence in the state.

WAYFAIR CASE

POSSIBLE OUTCOMES

- **Dismissal (DIG).** Always a possibility, esp. if Congress acts.
- **Affirmance.** Court reaffirms or is silent on *Quill*. Unlikely to deter state laws or motivate congressional action unless Court rules out all state nexus laws in all areas of tax. Unlikely.
- **Reversal with Little Guidance.** Court upholds South Dakota law but is unclear or narrow on why. States accelerate nexus-expansion laws without fear of court action. May prompt Congress to act. Chief Justice Roberts likes narrow rulings.
- **Reversal Removing Limits on States.** Court lets states do what they want, limited by Due Process.
- **Reversal Stating Clear Limits on States.** Court lets states collect but in a way that requires connection to state, prohibits discriminatory burdens, and requires internal consistency.

WAYFAIR CASE

TAX FOUNDATION'S ARGUMENT

- **Nexus** (Due Process & Interstate Commerce Clauses). Nexus threshold should scale with the burden and complexity of a state's sales tax compliance system.
 - To consider: if state is minimizing compliance burdens and risk differentials to extent practicable (SSTP, *de minimis* threshold, limit audit liability, retroactivity).
- **Non-Discrimination** (Commerce Clause). Taxing or otherwise burdening activity out-of-state while leaving identical activity in-state untaxed or unburdened.
- **Apportionment** (Commerce Clause). Internal consistency.
- Goal is to get Court to articulate clear limits on state tax authority, if *Quill* is overturned.

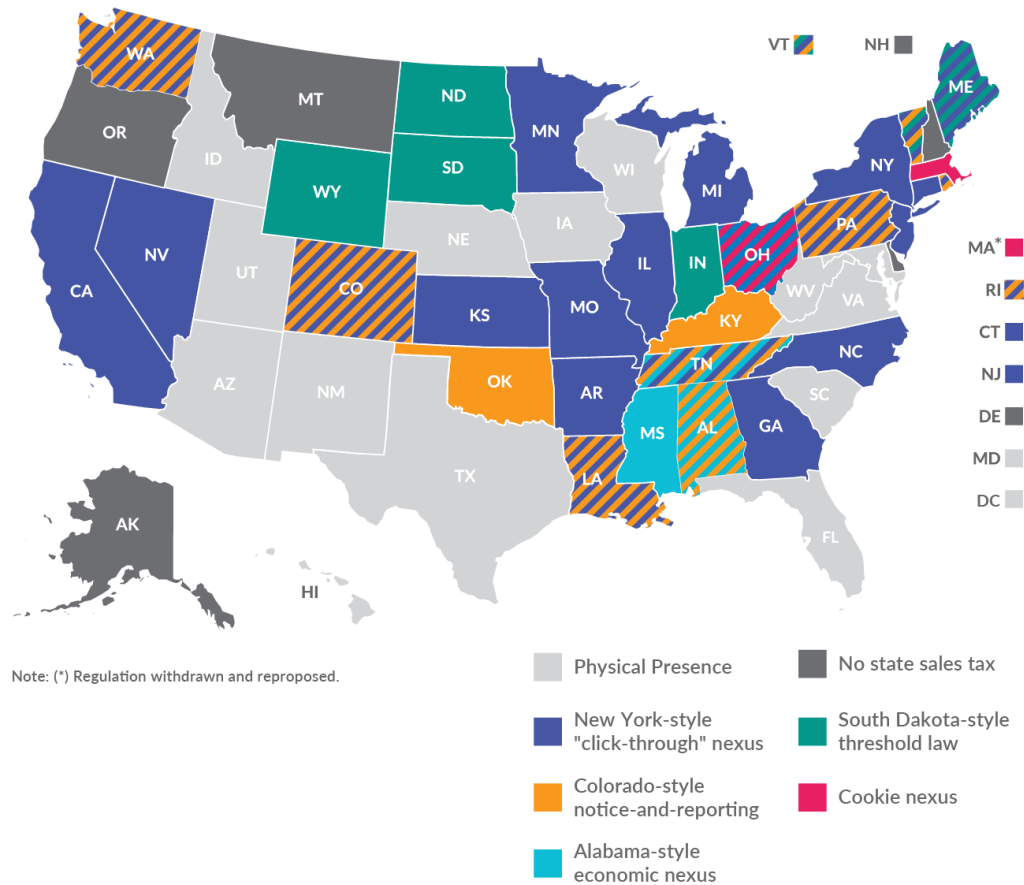
ONLINE SALES TAX

WHY THINGS WILL GET WORSE IF CONGRESS AND THE COURTS DO NOTHING

- 22 states have adopted New York-style click-through nexus laws, expanding physical presence to include out-of-state sellers who have paid referral agreements with in-state entities:
- 10 states have adopted Colorado-style notice-and-reporting laws. AL,
- 3 states ignore physical presence entirely, focusing on economic activity in the state.
- 2 states have adopted cookie nexus provisions. **Absent congressional or court action establishing a new standard, states will continue to pass laws aggressively subjecting internet commerce to compliance burdens.**

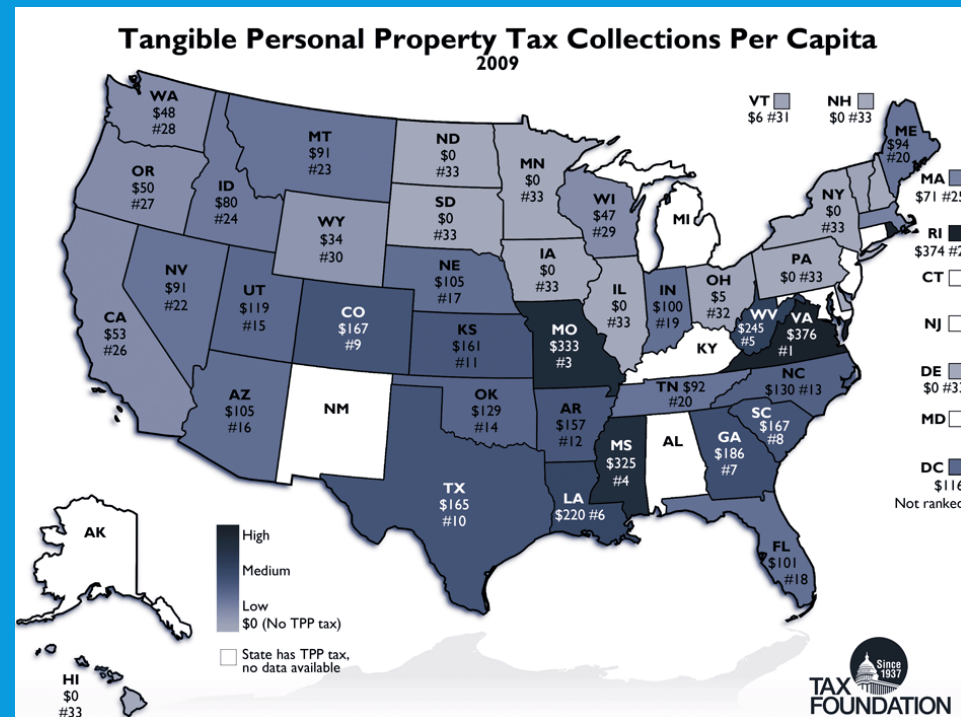
WHY THINGS WILL GET WORSE IF CONGRESS AND THE COURTS DO NOTHING

31 States Tax Internet Sellers Without Physical Presence



TANGIBLE PERSONAL PROPERTY

- PFM included this map in both its testimony and its interim report as an illustration of sales taxes on tangible property.
- PFM misrepresented this data. This map does not refer to sales taxes.



COMPARATIVE STATE TAX POLICY

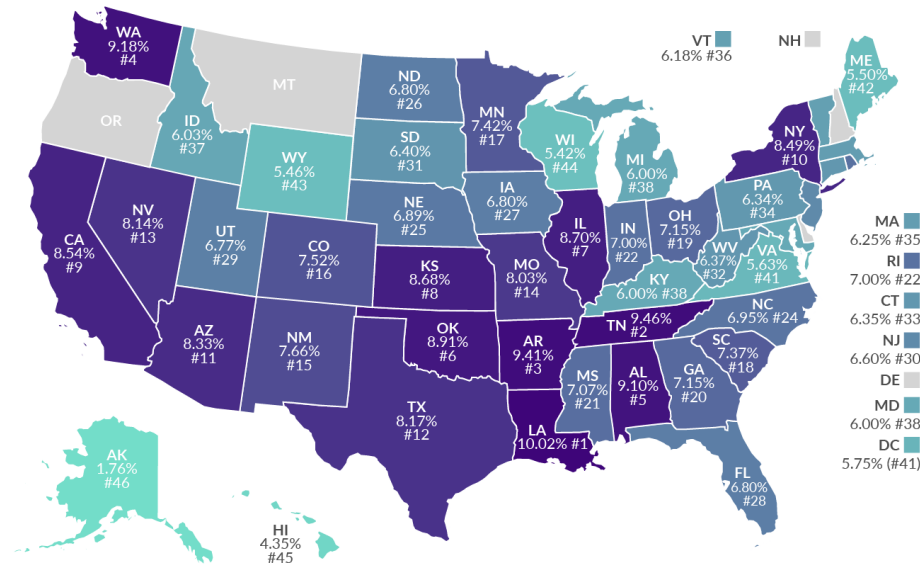
- We think of state tax policy in four large categories.
 - Tax Rates
 - Tax Collections
 - Tax Burdens
 - Tax Structure

TAX RATES

SALES TAX

How High Are Sales Taxes in Your State?

Combined State & Average Local Sales Tax Rates, Jan. 1 2018



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 (1.25%), Utah (1.25%), and Virginia (1%); we include these in their state sales tax. The sales taxes in Hawaii, New Mexico, North Dakota, and South Dakota have broad bases that include many services. This map does not include sales taxes in local resort areas in Montana. Salem County is not subject to the statewide sales tax rate and collects a local rate of 3.3125%. New Jersey's average local score is represented as a negative.

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

Combined State & Average Local
Sales Tax Rate

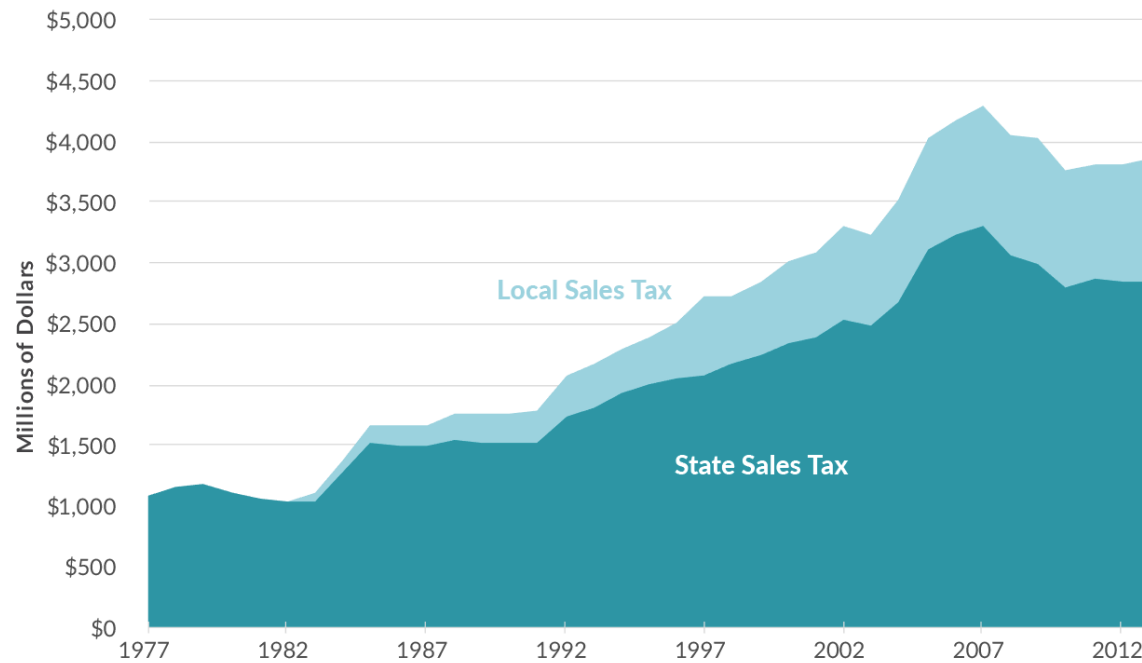


TAX COLLECTIONS

SALES TAX

Arkansas State and Local Tax Collections

(1977–2013, in 2013 Dollars)

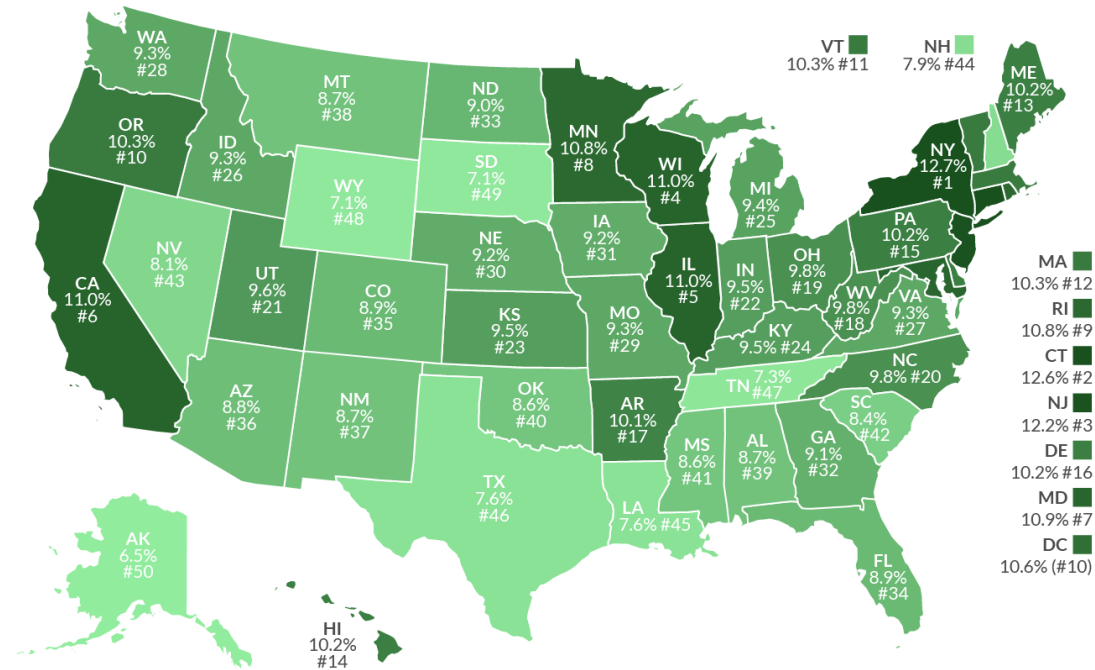


Note: Dollar amounts are adjusted for inflation based on the annual average Consumer Price Index for All Urban Consumers (CPI-U) with a 2013 base year.
Source: Census Bureau, *State and Local Government Finances*; Bureau of Labor Statistics, *Consumer Price Indexes (All Urban Consumers)*.

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.

State-Local Tax Burden as a Percentage of State Income



STATE BUSINESS TAX CLIMATE INDEX

- 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: 39th

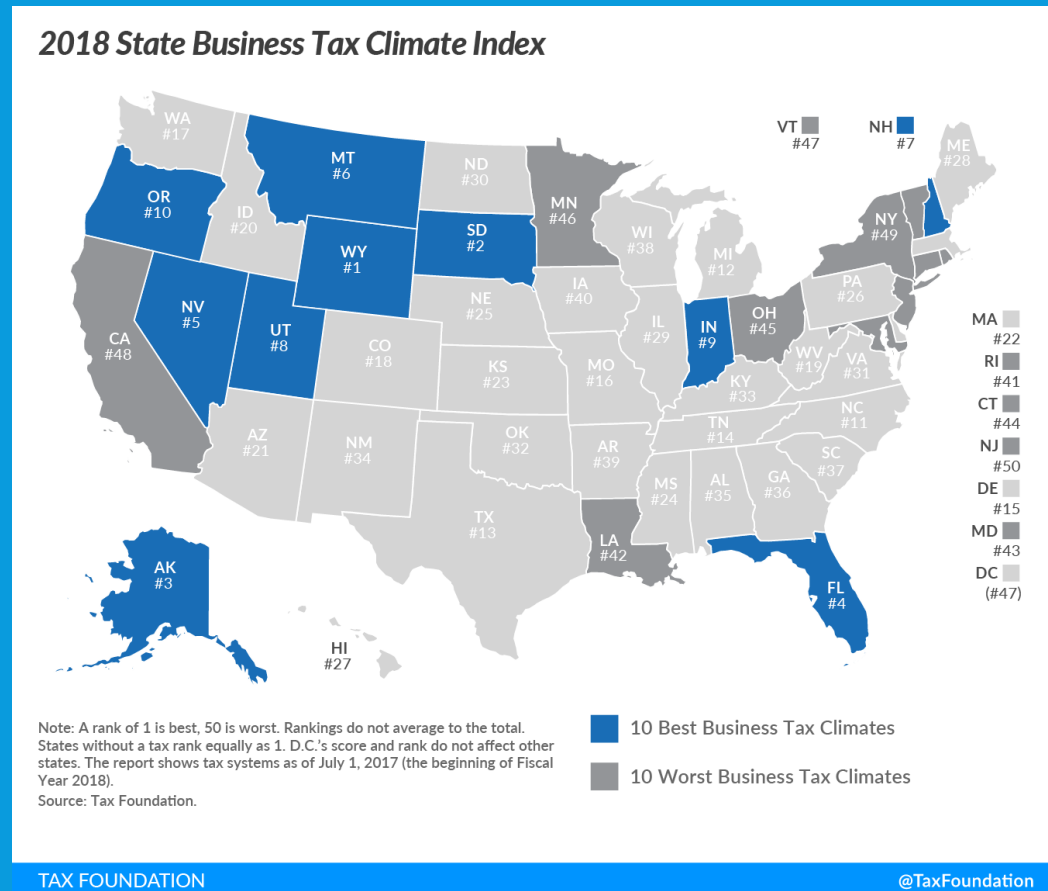
Corporate: 39th

Individual: 30th

Sales: 44th

Unemployment Insurance:
32nd

Property: 22nd



STATE BUSINESS TAX CLIMATE INDEX

SALES TAX

- Arkansas includes a number of inputs into its sales tax, leading to pyramiding.
- The state recently repealed the sales tax on machinery repair parts, which is a good step forward, but still work left to do.
- The state includes office equipment, business leases and rentals, and business fuels in the state sales tax.
 - In some cases, AR provides some relief. For instance, natural gas for manufacturers is charged at a lower rate, but it is still taxed.
- The state also doesn't include a number of services in the sales tax.
- Arkansas also loses points for its sales tax holiday.

IMPORTANT CONSIDERATIONS FOR REFORM

- Our reform book, *Arkansas: The Road Map to Tax Reform*, details a number of reforms for Arkansas to make.
- As mentioned previously, Arkansas has the third-highest combined state and local sales tax rate in the country.
 - However, the state's high individual and corporate income tax rates are more concerning.
- Instead, Arkansas should focus its attention on sales tax base issues.

SALES TAX BASE REFORMS

SALES TAX HOLIDAY

- Sales Tax Holiday:
 - Arkansas provides a back-to-school sales tax holiday in early August every year.
 - Clothing (below \$100), school supplies, and clothing accessories (below \$50) are exempted.
 - Sales tax holidays do not generate economic growth.
 - For fiscal year 2011, DF&A said the holiday reduces sales tax collections by \$2 million.
 - They impose large costs on retailers.
 - Arkansas should consider repealing its sales tax holiday and using the revenue for broader tax reform efforts.

SALES TAX BASE REFORMS

TAX EXEMPTIONS

- The task force should also consider eliminating unneeded or improperly structured sales tax exemptions.
- First, need to consider what sorts of exemptions should be eliminated.
 - As mentioned earlier, business inputs should be exempt. These exemptions should not be repealed.
- Second, there are better ways to mitigate regressivity than blanket exemptions.
 - The broad exemptions target more than low-income individuals.
 - It would be better to use an expanded standard deduction, EITC, or grocery credit to target relief.

SALES TAX BASE REFORMS

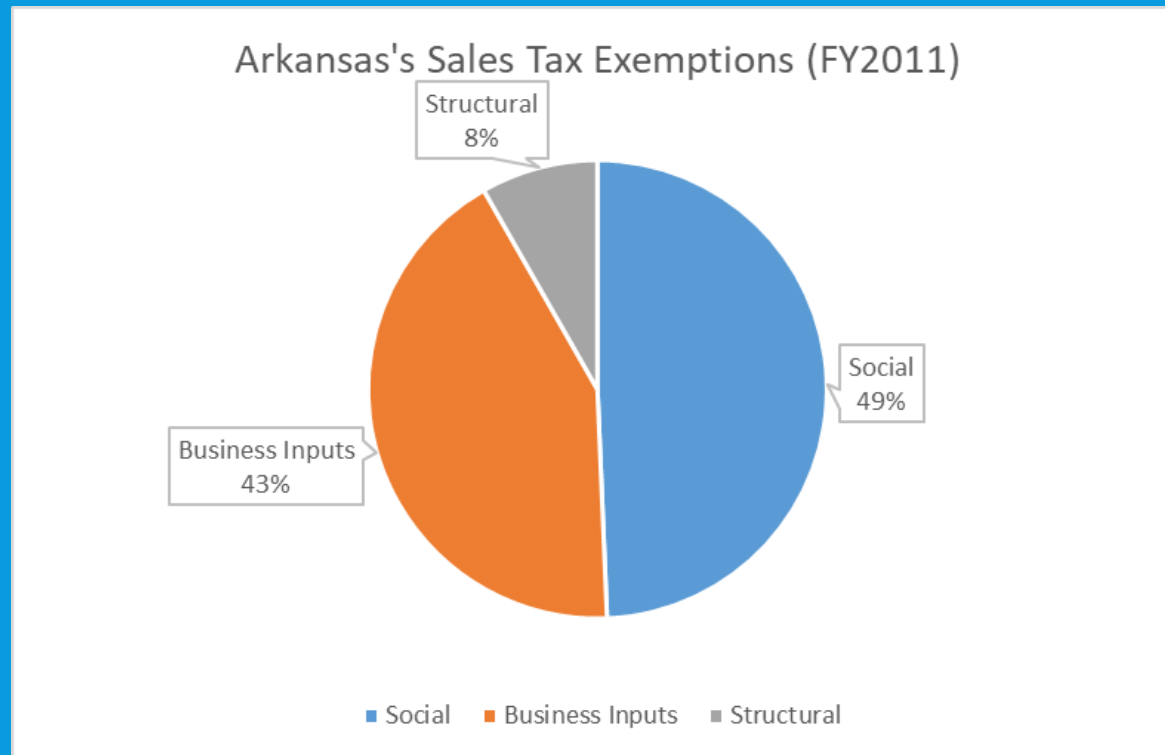
TAX EXEMPTIONS

- The Fiscal Year 2011 DF&A Report identified \$1.48 billion in sales tax exemptions in Arkansas.
 - The new report is forthcoming.
 - This does not include services.
- Motor fuel exemptions illustrate the challenge in parsing exemption reports.
- DF&A totaled \$380 million in exemptions, but \$55 million would be considered a business input.

Motor Fuel Exemptions		
Gasoline/Motor Fuels		\$325,237,468
Sales of Motor Fuel to Bus Fleets		\$94,317
Special Fuels for Shipping		\$13,602,208
Dyed Diesel		\$41,263,111
	Total	\$380,197,104

SALES TAX BASE REFORMS

TAX EXEMPTIONS



SALES TAX BASE REFORMS

TAX EXEMPTIONS

- Large Social Exemptions
 - Gasoline and Motor Fuels: \$325 million
 - Groceries: \$197 million
 - Prescription Drugs: \$143 million
- Large Business Input Exemptions
 - Sales to Hospitals: \$104 million
 - Feedstuffs: \$99 million
 - Manufacturing Machinery: \$85 million
- Large Structural Exemptions
 - WIC: \$46 million
 - Sales to the U.S. Government: \$46 million

OTHER ITEMS TO CONSIDER

- Expanding the sales tax base will increase revenue to localities. Any reform should consider that impact.

CONCLUDING THOUGHTS

- Arkansas's sales tax structure is ripe for reform.
- The state has the third-highest combined state-local sales tax rate in the country, but the bigger concern is with the state's sales tax base.
 - The state should consider eliminating a number of its social sales tax exemptions and instead use targeted approaches to mitigate concerns about regressivity.
 - The state should also carefully monitor developments in Washington, D.C., on the internet sales tax issue.
- Finally, sales tax reforms should not happen in a vacuum. Base expansions can help reduce other tax rates in AR, such as the individual and corporate income taxes.

QUESTIONS

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