

Arkansas:

Options for Income Tax Reform

Presentation to the Arkansas Tax Reform
and Relief Task Force
April 26, 2018

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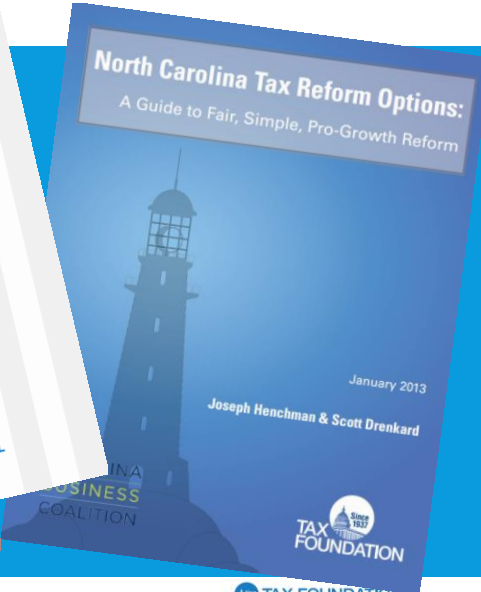
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TOPICS OF DISCUSSION

- Relationship between Taxes and Economic Growth
- Comparative Analysis
- Important Considerations for Reform
- Individual Income Tax Reforms
- Corporate Income Tax Reforms
- Other Items for Reform

ABOUT THE TAX FOUNDATION



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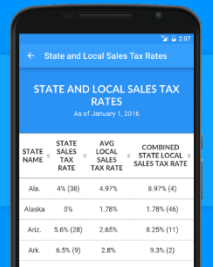


How do the 2016 Presidential Tax Plans Compare So Far?

	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%	12.5%	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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ACADEMIC LITERATURE ON TAXES & GROWTH

In 2012, we reviewed 26 major studies that examine the relationship.

- Higher taxes are associated with slower growth.
 - All studies but three agree.
 - All studies in the last fifteen years agree.
- Authors included:
 - Christina Romer
 - Jens Arnold of the OECD



Special Report

December 18, 2012
No. 207

What Is the Evidence on Taxes and Growth?

By
William McBride, PhD

Introduction

The idea that taxes affect economic growth has become politically contentious and the subject of much debate in the press and among advocacy groups. That is in part because there are competing theories about what drives economic growth. Some subscribe to Keynesian, demand-side factors, others Neo-classical, supply-side factors, while yet others subscribe to some mixture of the two or something entirely unique. The facts, historical and geographical variation in key parameters for example, should shed light on the debate. However, the economy is sufficiently complex that virtually any theory can find some support in the data.

For instance, the Congressional Research Service (CRS) has found support for the theory that taxes have no effect on economic growth by looking at the U.S. experience since World War II and the dramatic variation in the statutory top marginal rate on individual income.¹ They find the fastest economic growth occurred in the 1950s when the top rate was more than ninety percent.² However, their study ignores the most basic problems with this sort of statistical analysis, including: the variation in the tax base to which the individual income tax applies; the variation in other taxes, particularly the corporate tax; the short-term versus long-term effects of tax policy; and reverse causality, whereby economic growth affects tax rates. These problems are all well known in the academic literature and have been dealt with in various ways, making the CRS study unpublishable in any peer-reviewed academic journal.³

So what does the academic literature say about the empirical relationship between taxes and economic growth? While there are a variety of methods and data sources, the results consistently point to significant

ACADEMIC LITERATURE ON TAXES & GROWTH

- All taxes impose a burden on economic growth, known as a deadweight loss, but the amount of the burden is not uniform across taxes.
- In particular, gross receipts taxes, corporate income taxes, and individual income taxes.
- But why? Income taxes are generally considered to be taxes on capital, the most mobile factor in the economy. Taxes on capital impact decisions on location and investment for businesses and decisions on saving, labor, and leisure for individuals.

COMPARATIVE STATE TAX POLICY

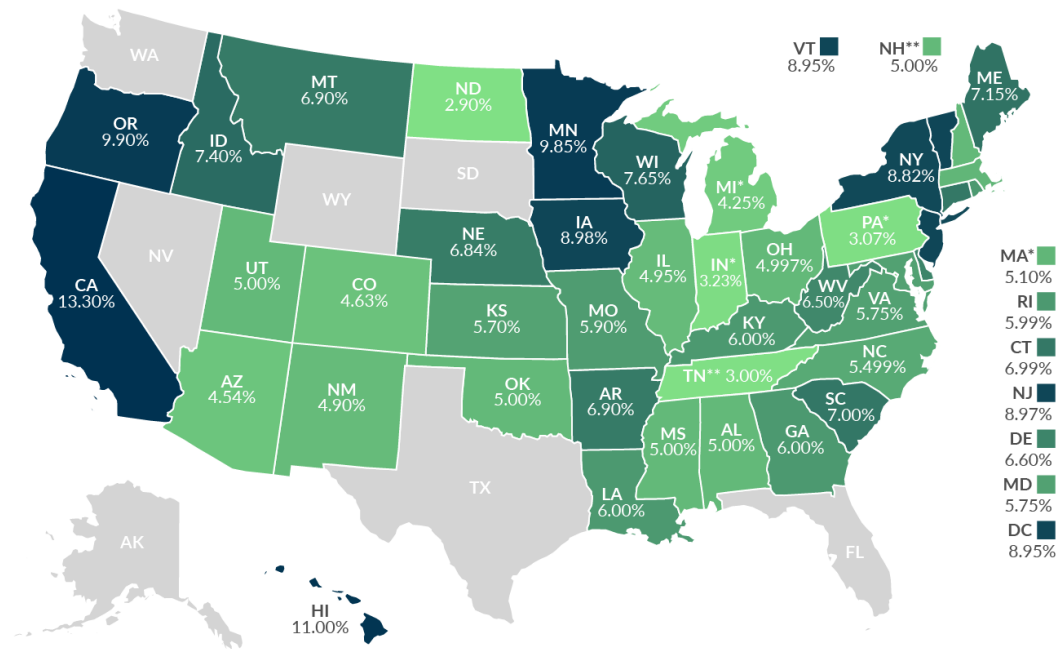
- We think of state tax policy in four large categories.
 - Tax Rates
 - Tax Collections
 - Tax Burdens
 - Tax Structure

TAX RATES

INDIVIDUAL INCOME TAX

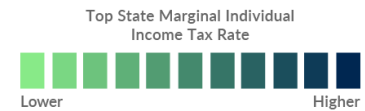
How High Are Income Tax Rates in Your State?

Top State Marginal Individual Income Tax Rates, 2018



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

Source: Tax Foundation; state tax statutes, forms, and instructions; Bloomberg BNA.



TAX RATES

INDIVIDUAL INCOME TAX

- A comparison of the top marginal rate hides much of the underlying complexity with the Arkansas individual income tax structure. Arkansas is the only state with multiple rate schedules.

Individual Income Tax Rates (2019)

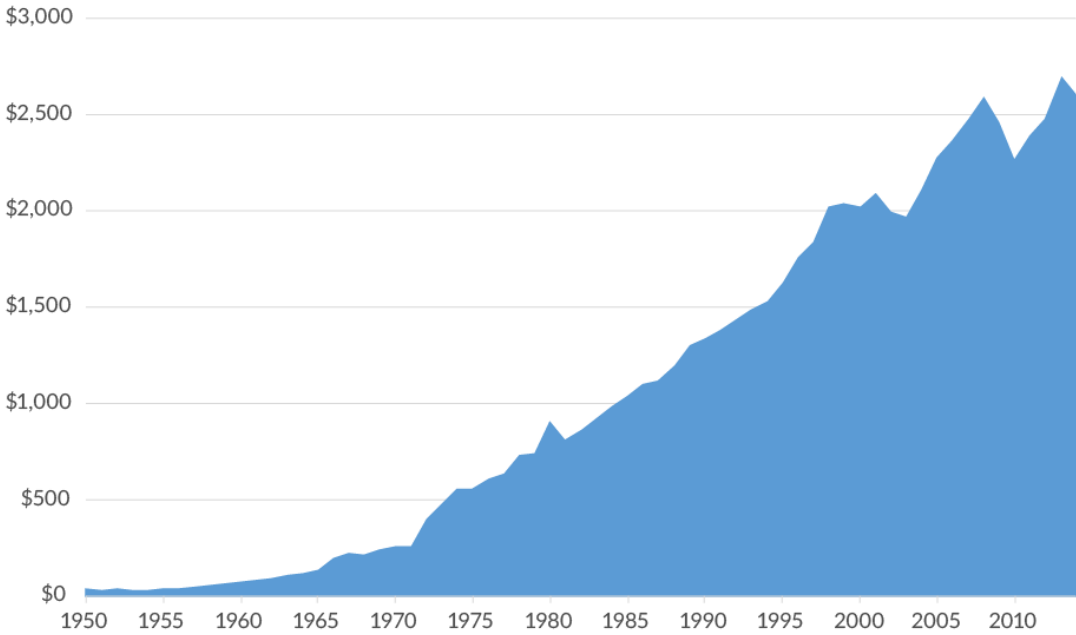
Total Income Under \$21,000		Total Income Between \$21,000 and \$75,000		Total Income Above \$75,000	
Income Bracket	Tax Rate	Income Bracket	Tax Rate	Income Bracket	Tax Rate
\$0-\$4,299	0.0%	\$0-\$4,299	0.75%	\$0-\$4,299	0.9%
\$4,300-\$8,399	2.0%	\$4,300-\$8,399	2.5%	\$4,300-\$8,399	2.5%
\$8,400-\$12,599	3.0%	\$8,400-\$12,599	3.5%	\$8,400-\$12,599	3.5%
\$12,600-\$20,999	3.4%	\$12,600-\$20,999	4.5%	\$12,600-\$20,999	4.5%
		\$21,000-\$35,099	5.0%	\$21,000-\$35,099	6.0%
		\$35,100-\$75,000	6.0%	\$35,100+	6.9%

Note: The exact brackets will change slightly due to Arkansas's policy of inflation adjusting its brackets annually.

TAX COLLECTIONS

INDIVIDUAL INCOME

Arkansas Individual Income Tax Collections (1950-2014, 2014 Dollars)

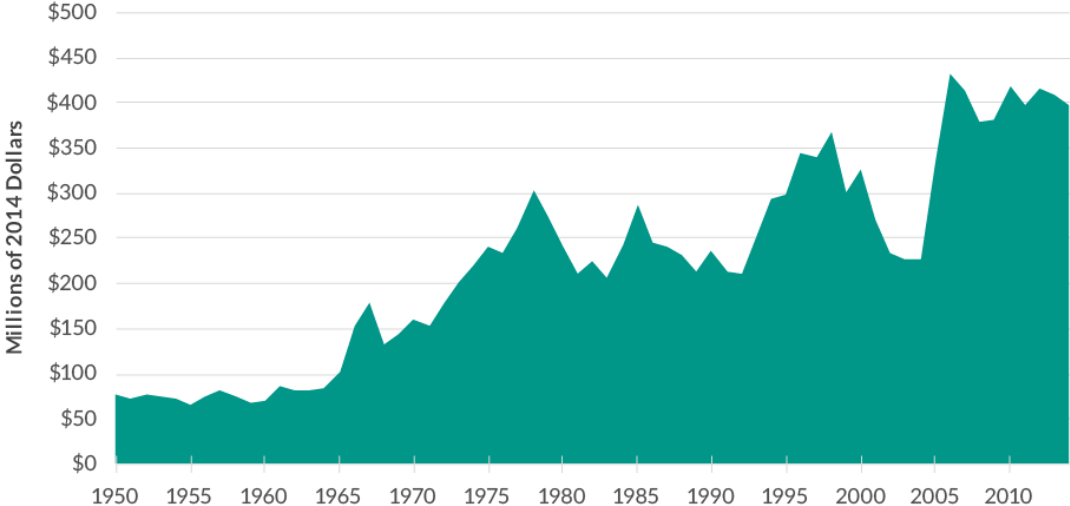


Note: Dollar amounts are inflation adjusted based on the annual average Consumer Price Index for All Urban Consumers (CPI-U) with a 2014 base year.
Source: Census Bureau, State and Local Government Finances; Bureau of Labor Statistics, Consumer Price Indexes (All Urban Consumers).

TAX COLLECTIONS

CORPORATE INCOME

Corporate Income Tax Collections (1950–2014, in 2014 Dollars)

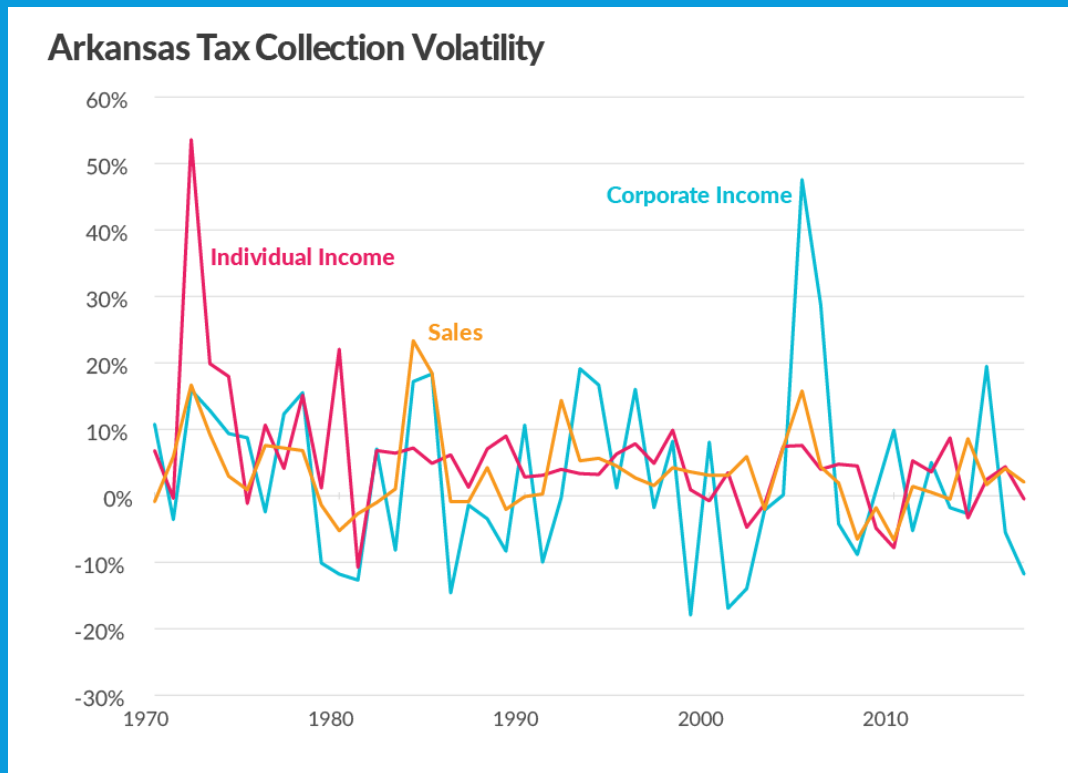


Note: Dollar amounts are inflation adjusted based on the annual average Consumer Price Index for All Urban Consumers (CPI-U) with a 2014 base year.
Source: Census Bureau, *State and Local Government Finances*; Bureau of Labor Statistics, *Consumer Price Indexes (All Urban Consumers)*.

TAX COLLECTIONS

VOLATILITY

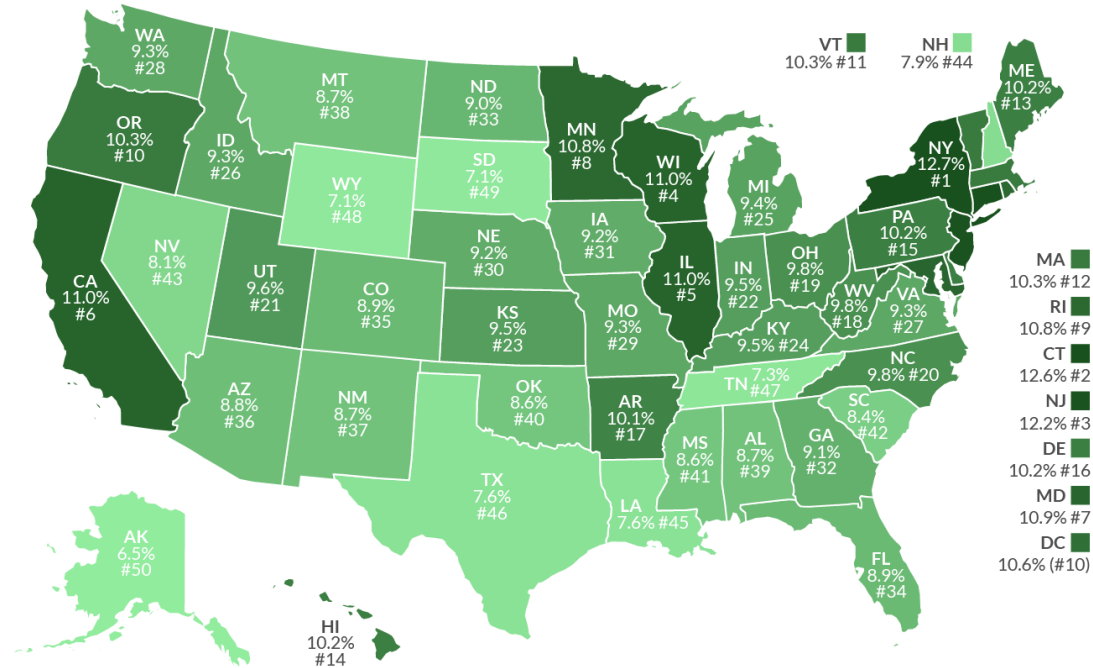
- Income taxes in Arkansas are also quite volatile, making budgeting difficult.



STATE-LOCAL TAX BURDENS

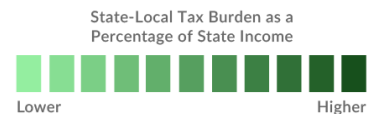
State-Local Tax Burdens by State

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 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

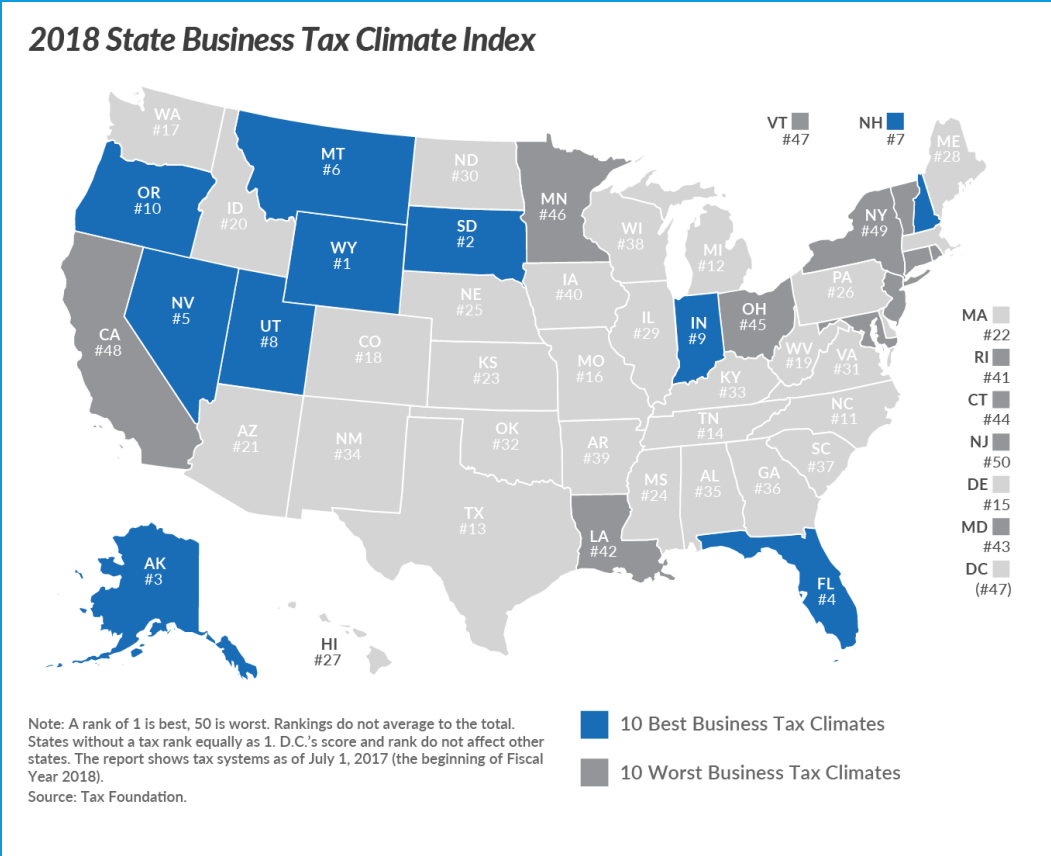
Corporate: 39th

Individual: 30th

Sales: 44th

Unemployment Insurance:
32nd

Property: 22nd



STATE BUSINESS TAX CLIMATE INDEX

INDIVIDUAL INCOME

- Arkansas loses points for its complex individual income tax.
 - The state is the only state with three sets of tax brackets.
 - High marginal income tax rate of 6.9 percent.
 - The state has a marriage penalty.

STATE BUSINESS TAX CLIMATE INDEX

CORPORATE INCOME

- Arkansas is also hindered by its corporate income tax.
 - The rate is high, especially when paired with multiple tax brackets.
 - Limited net operating losses and the state's throwback rule penalize investment in the state.

IMPORTANT CONSIDERATIONS FOR REFORM

- Our reform book, *Arkansas: The Road Map to Tax Reform*, details a number of reforms for Arkansas to make.
- Arkansas should make changes to both its individual and corporate income tax rates and bases.

INDIVIDUAL INCOME TAX REFORMS

TAX RATES

- As mentioned earlier, the 2015 and 2017 tax changes have resulted in an odd tax structure with multiple rate schedules.
- Additionally, there are large marginal rate cliffs built into the code.
 - An individual making \$20,999 in income would pay \$493.52 in taxes in 2019, while an individual making \$21,000 would pay \$659.69. An extra \$1 in income increased taxes by \$166.17.
 - An individual making \$74,999 in income would pay \$3,759 in taxes in 2019, while an individual making \$75,000 would pay \$4,265. An extra \$1 in income increased taxes by \$507.

INDIVIDUAL INCOME TAX

TAX RATES REFORMS

- The state acknowledges that this is an issue. The state gives a credit to smooth the tax cliff at \$75,000, but it doesn't completely eliminate the issue.

Income Range	Bracket Adjustment
\$75,001-\$76,000	\$440
\$76,001-\$77,000	\$340
\$77,001-\$78,000	\$240
\$78,001-\$79,000	\$140
\$79,001-\$80,000	\$40
\$80,001 and above	\$0

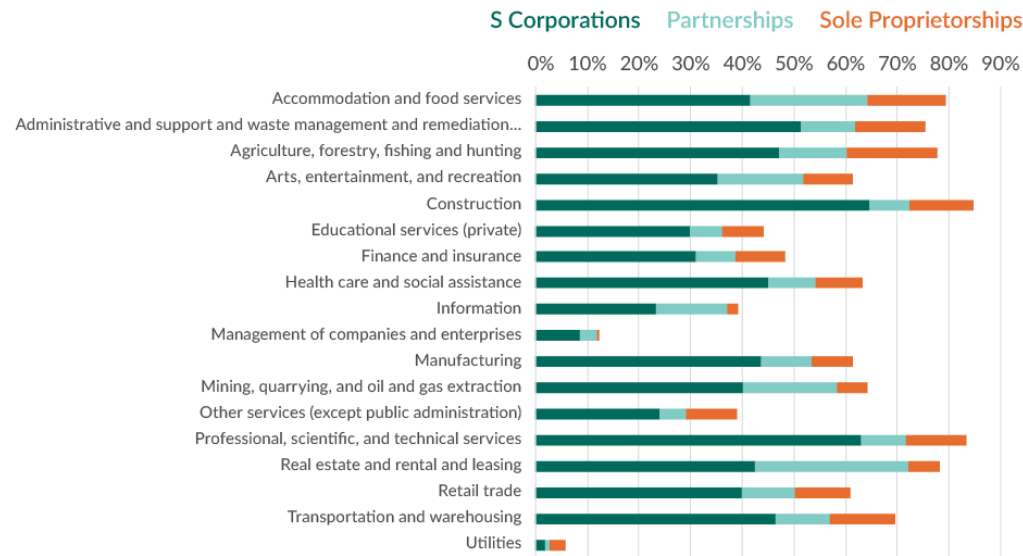
INDIVIDUAL INCOME TAX

TAX RATES REFORMS

- It is also important to note that many pass-through businesses pay under the individual income tax in Arkansas.

Arkansas Employer Businesses Subject to Individual Income Tax

Arkansas Sole Proprietorships, Partnerships, and S Corporations by Industry (2014)



Note: This does not include non-employer firms.
Source: Census Bureau, County Business Patterns.

INDIVIDUAL INCOME TAX

TAX BASE REFORMS

- Arkansas's individual income tax base also has a number of exemptions.
- Similar to our discussion last month, exemptions can be grouped into several large categories: structural and policy.
 - In Arkansas, policy exemptions total \$1.2 billion.
 - Standard deduction is the largest at \$870 million
- As Arkansas looks to lower individual income tax rates, eliminating exemptions can help finance the changes.

CORPORATE INCOME TAX

TAX RATE REFORM

- The 6.5 percent top marginal income tax rate on corporate income is high nationally and should be lowered.
- 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.

CORPORATE INCOME TAX

TAX BASE REFORMS

- One of the most important questions for a multistate business is how is income apportioned among the states.
 - Arkansas uses a double-weighted sales approach.

ALABAMA *	Double wtd Sales	NEBRASKA	Sales
ALASKA*	3 Factor	NEVADA	No State Income Tax
ARIZONA *	Sales/Double wtd Sales	NEW HAMPSHIRE	Double wtd Sales
ARKANSAS *	Double wtd Sales	NEW JERSEY	Sales
CALIFORNIA *	Sales	NEW MEXICO *	Sales
COLORADO *	Sales	NEW YORK	Sales
CONNECTICUT	Sales	NORTH CAROLINA *	Sales
DELAWARE (3)	Triple wtd Sales	NORTH DAKOTA * (4)	75% Sales, 12.5% Property & Payroll/3 Factor
FLORIDA	Double wtd Sales	OHIO	N/A (2)
GEORGIA	Sales	OKLAHOMA	3 Factor
HAWAII *	3 Factor	OREGON	Sales
IDAHO *	Double wtd Sales	PENNSYLVANIA	Sales
ILLINOIS *	Sales	RHODE ISLAND	Sales
INDIANA	Sales	SOUTH CAROLINA	Sales
IOWA	Sales	SOUTH DAKOTA	No State Income Tax
KANSAS *	3 Factor	TENNESSEE	Triple wtd Sales
KENTUCKY *	Double wtd Sales	TEXAS	Sales
LOUISIANA	Sales	UTAH	Sales
MAINE *	Sales	VERMONT	Double wtd Sales
MARYLAND	Sales/Double wtd Sales	VIRGINIA	Double wtd Sales/Sales
MASSACHUSETTS	Sales/Double wtd Sales	WASHINGTON	No State Income Tax
MICHIGAN	Sales	WEST VIRGINIA *	Double wtd Sales
MINNESOTA	Sales	WISCONSIN *	Sales
MISSISSIPPI	Sales/Other (1)	WYOMING	No State Income Tax
MISSOURI *	3 Factor	DIST. OF COLUMBIA	Sales
MONTANA *	3 Factor		

Source: Compiled by FTA from state sources.

CORPORATE INCOME TAX

TAX BASE REFORMS

- But Arkansas also has a throwback rule.
 - This seeks to capture “nowhere income.”
 - It penalizes firms based in Arkansas that sell out of state, such as manufacturers.
 - AR should repeal the throwback rule.
- Additionally, AR’s treatment of net operating losses is uncompetitive.

Arkansas and Selected Regional Competitors (as of July 1, 2017)

	Carryback (Years)	Carryback Cap	Carryforward (Years)	Carryforward Cap
Arkansas	0	\$0		5 Unlimited
Louisiana	0	Unlimited		20 Unlimited
Mississippi	2	Unlimited		20 Unlimited
Missouri	2	Unlimited		20 Unlimited
Oklahoma	2	Unlimited		20 Unlimited
Tennessee	0	\$0		15 Unlimited
Texas	n.a.	n.a.	n.a.	n.a.

CORPORATE INCOME TAX

TAX BASE REFORMS

- Arkansas should also look towards expanding the expensing of capital investments.
 - The Tax Cuts and Jobs Act expanded both Section 179 expensing and created temporary full expensing for short-lived assets.
 - Expensing is arguably the most pro-growth aspect of tax reform.

CORPORATE INCOME TAX

TAX BASE REFORMS

- Finally, Arkansas should continue its work of eliminating economic development tax credits in the tax code.
 - Repealing InvestArk was a great first step.

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

OTHER ITEMS TO CONSIDER

- Tax triggers are a great policy tool to facilitate lower individual and corporate income tax rates.
 - In general, want to consolidate four major things.
 - 1-Ensure that any sort of tax trigger is using a measure of revenue as its basis, not a measure of spending, like a surplus.
 - 2-Include some sort of revenue measure that does allow for a year-over-year revenue growth, something like 2-3% growth. This allows for revenue to increase as spending increases due to inflation. You could even add a population element to this if that's a concern.
 - 3-Tax triggers can be combined with a phaseout. They can work in tandem to accelerate the tax phaseout, if revenue grows faster than expected.
 - 4-The best benchmark is going to be past year collections.

CONCLUDING THOUGHTS

- Arkansas's individual and corporate income taxes have high rates both regionally and nationally.
- Due to the impact on economic growth, Arkansas should consider lowering the rates of both taxes.
- These changes can be financed with sales tax base expansions or eliminating individual and corporate income tax expenditures.

QUESTIONS

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