

Arkansas Tax Issues: Distributional Analysis & Tax Cut Triggers

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About ITEP

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The Institute on Taxation and Economic Policy (ITEP)

Non-profit

Non-partisan research organization

Federal, state, and local tax policy issues

Mission:

Ensure elected officials, media, and general public have access to accurate, timely, and straightforward information that allows them to understand the effects of current and proposed tax policies with an emphasis on tax-incidence analysis.

Presentation Overview

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Distributional Analysis of Arkansas Taxes

- Overview of ITEP Microsimulation Model
- Distribution of Arkansas's state and local taxes
- Comparison to other states
- Policy features explaining distribution of Arkansas taxes

Tax Cut Triggers

- Problems with tax cut triggers broadly
- Problems with specific tax cut trigger designs
- Designing a “least bad” tax cut trigger

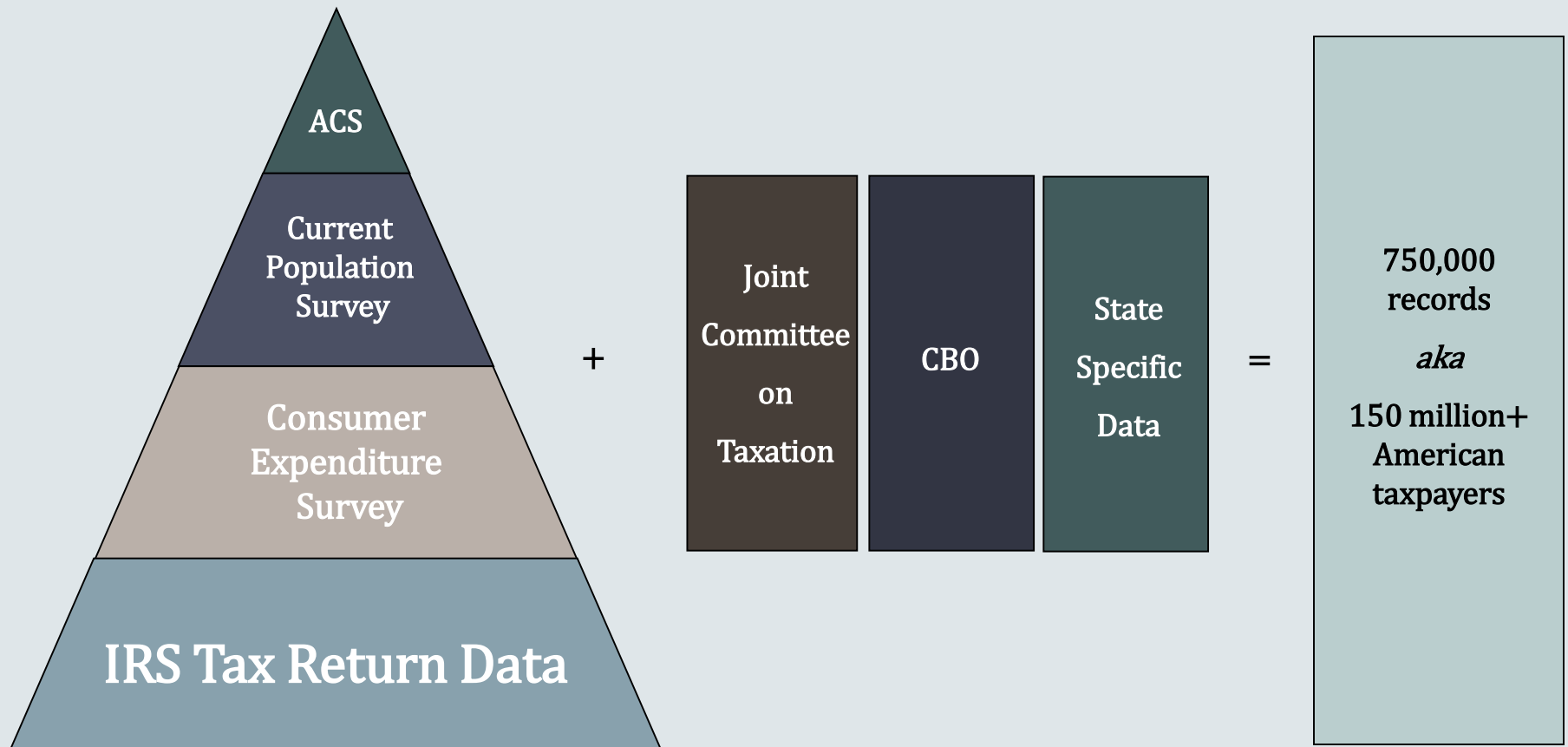
About the ITEP Microsimulation Model

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- A **tax incidence model**. Built in 1994-1996, but still evolving in 2018
- Designed to:
 - ❖ Predict the distributional effect of proposed tax changes on taxpayers at different income levels
 - ❖ Predict the revenue gain (loss) from proposed tax changes
 - ❖ Estimate the impact of current state and local taxes in all 50 states
 - ❖ Measure the interaction between state and federal tax changes
- Employs the same technology used by the US Treasury, Congressional Joint Committee on Taxation, Congressional Budget Office, and some state departments of revenue (e.g. TX, MN, ME)
- Consists of four basic modules: **personal income tax, property tax, consumption tax, and business tax**

Data Sources

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About the ITEP Microsimulation Model and the Findings in this Presentation

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- ITEP Model database was constructed based primarily on 2015 tax information, and then aged to present day.
- This distributional estimates included in this presentation are state and local only, and omit the offsetting impact of the federal deduction for state and local taxes (SALT) paid.
 - Federal deduction is now capped at \$10,000 for 2018 through 2025.
- ITEP analysis covers over 90% of tax dollars collected in Arkansas
 - Taxes omitted due to data limitations include a mix of gambling, severance, insurance, utilities, etc.
 - ✦ Review of a more comprehensive study by the Minnesota Department of Revenue reveals that these taxes are typically regressive.
- Fees and fines are omitted
 - Court fees, drivers license fees, college tuition payments, etc.

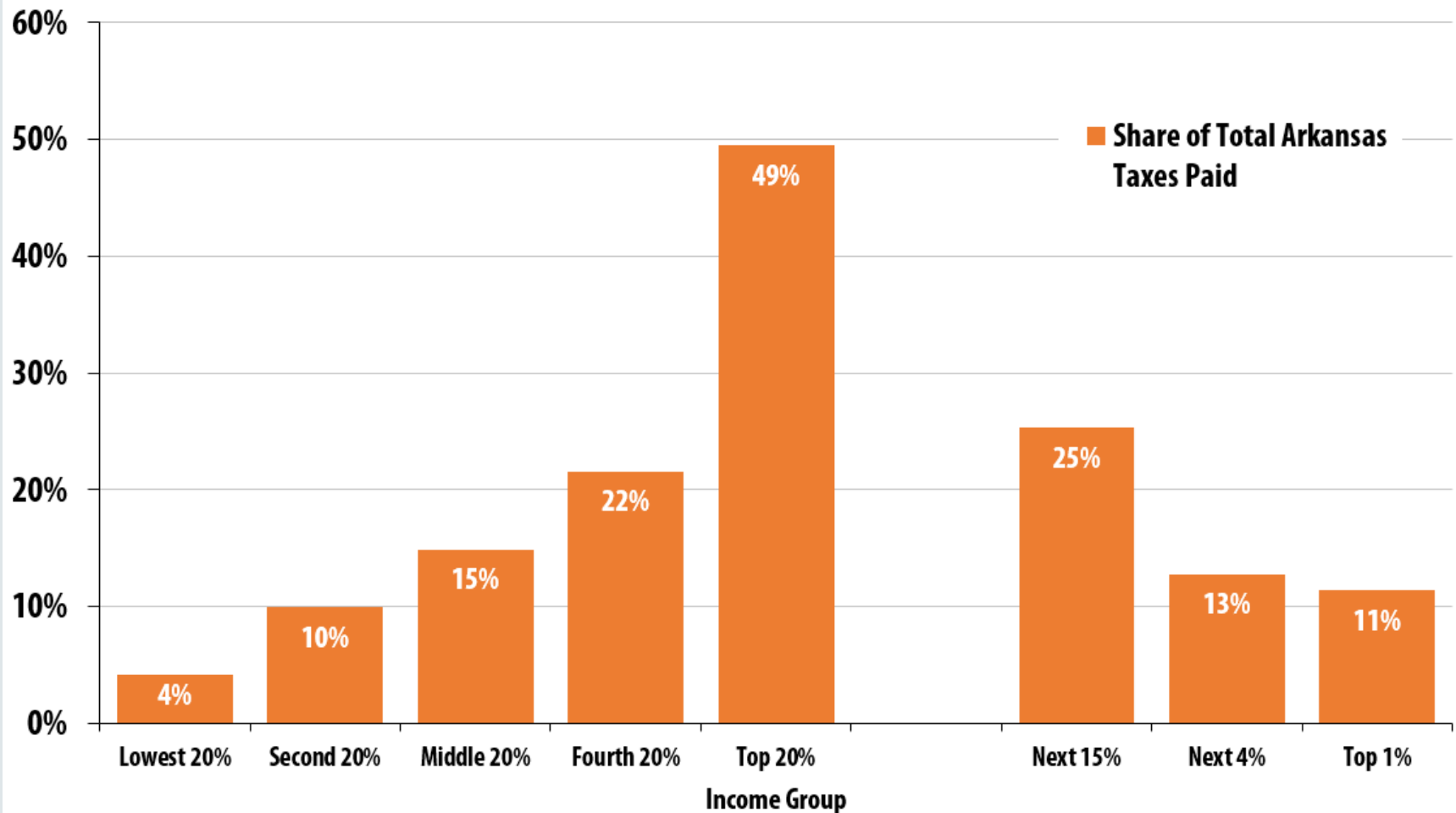
Comments on the ITEP Model by State Revenue Officials

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- “In my experience, ITEP produces reliable estimates of the likely impacts of tax policy changes.”
 - Scott Palladino, Deputy Commissioner of the New York State Department of Taxation and Finance, July 2018
- ITEP’s state distributional analysis “is of high quality” and “not far” from the Department’s analysis in its overall findings.
 - Minnesota Department of Revenue, March 2017
- ITEP’s analysis of federal tax changes in Maine “aligns with MRS estimates.”
 - Maine Revenue Services (MRS), January 2018

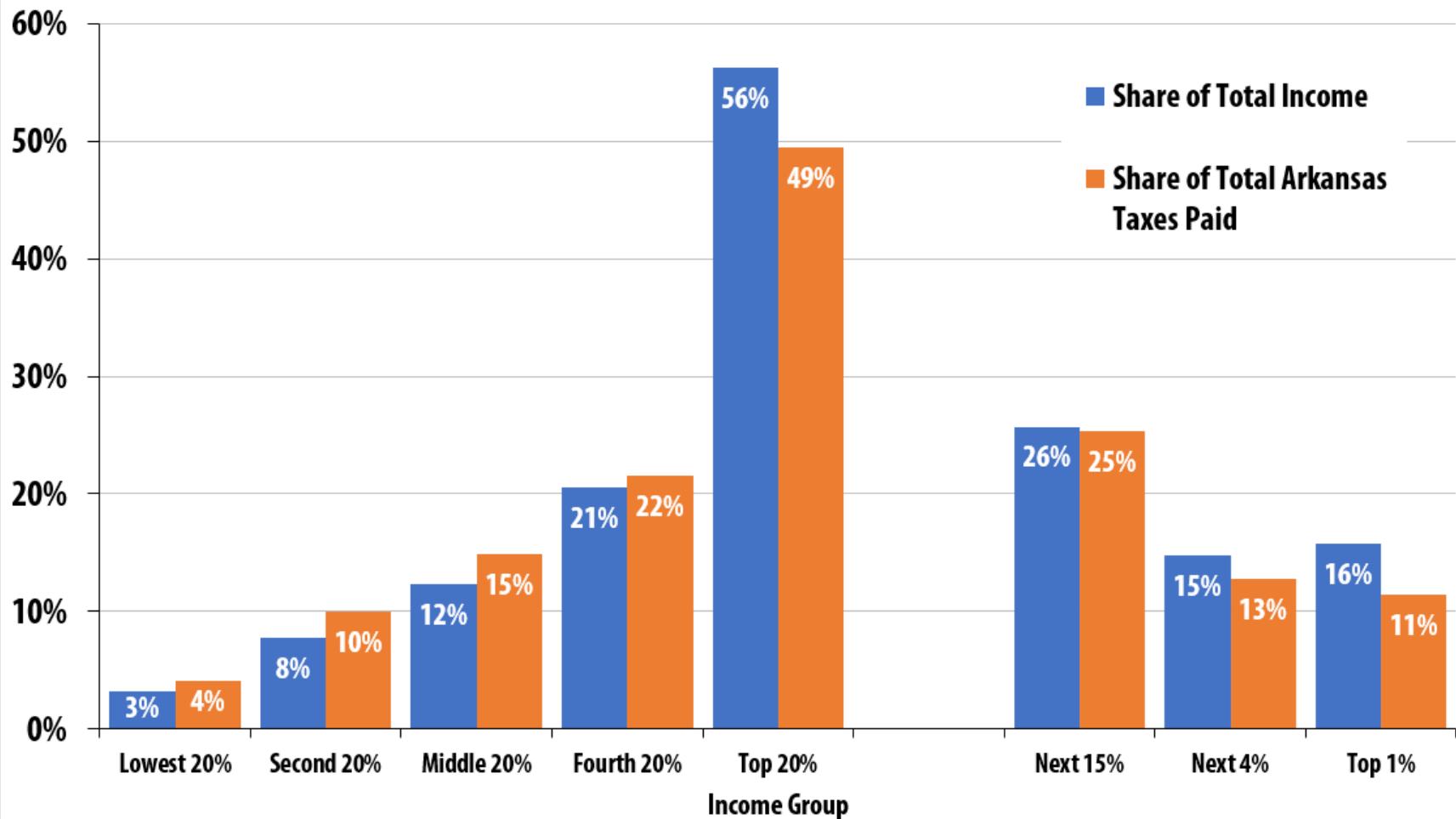
Share of Total State and Local Taxes Paid

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Share of Total Income vs. Share of Total State and Local Taxes Paid

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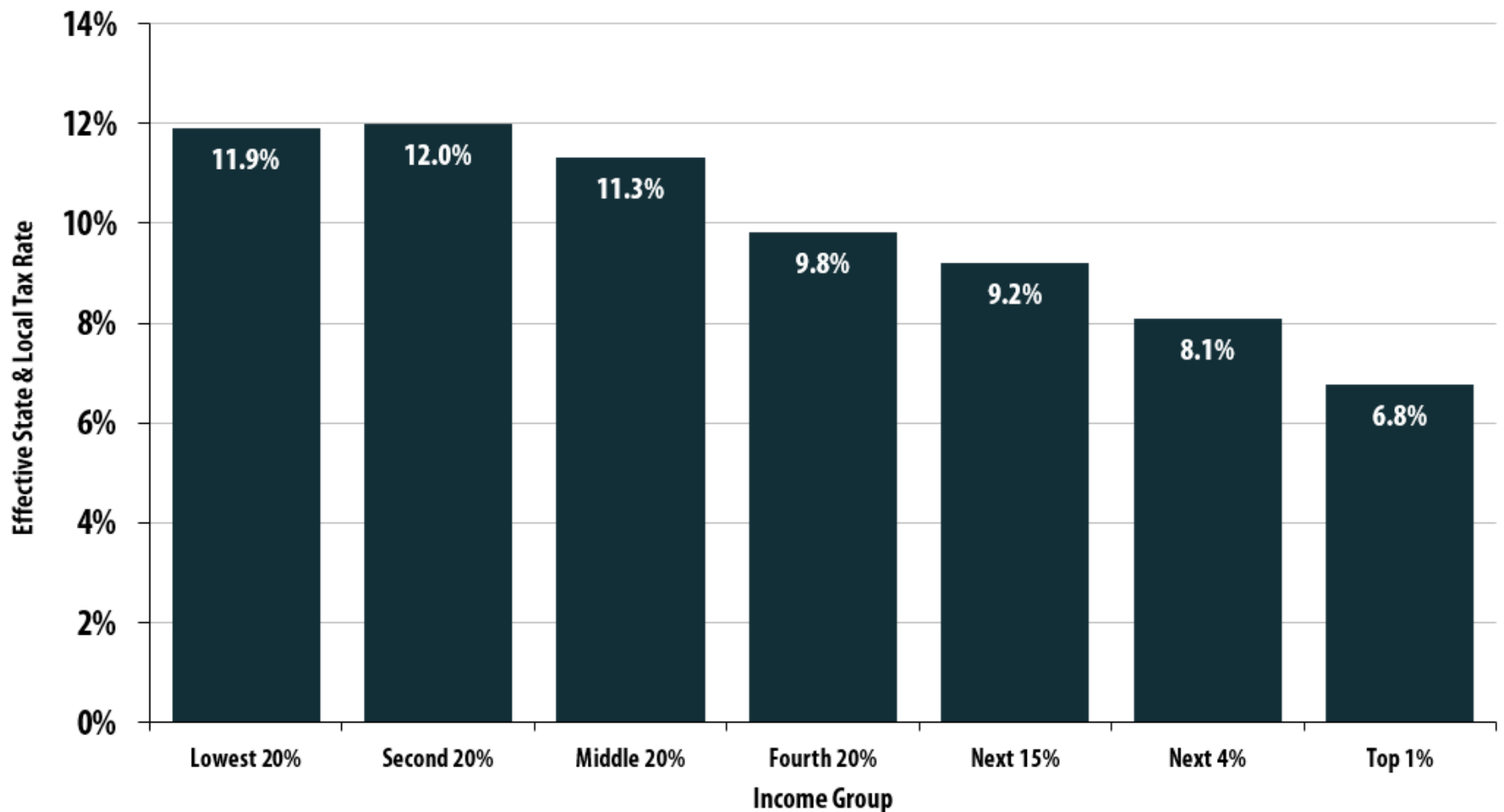
Why Tax Change as a Percentage of Income?

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- Puts payment into context.
 - Is this a lot of money for this person? How does it impact their monthly budget? Their ability to make ends meet?
- Which is a heavier lift?
 - \$2,400 tax payment
 - \$70,000 tax payment
- What if...
 - The person paying \$2,400 only earns \$20,000 (paying 12% of income in tax)
 - The person paying \$70,000 earns \$1,000,000 (paying 7% of income in tax)

Distribution of State & Local Taxes in Arkansas

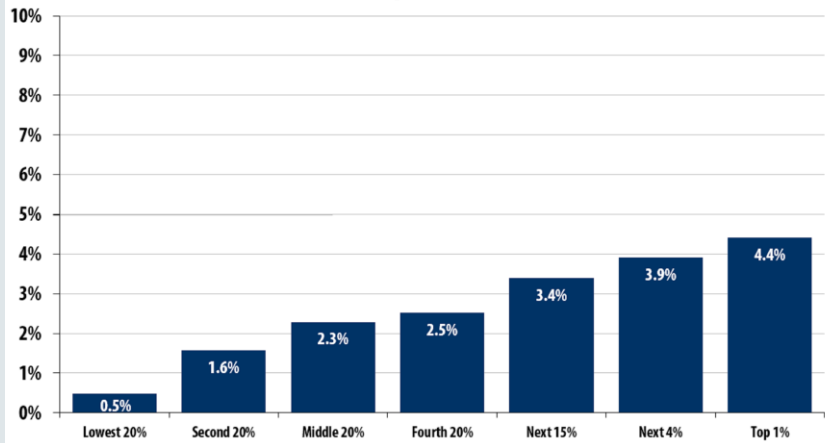
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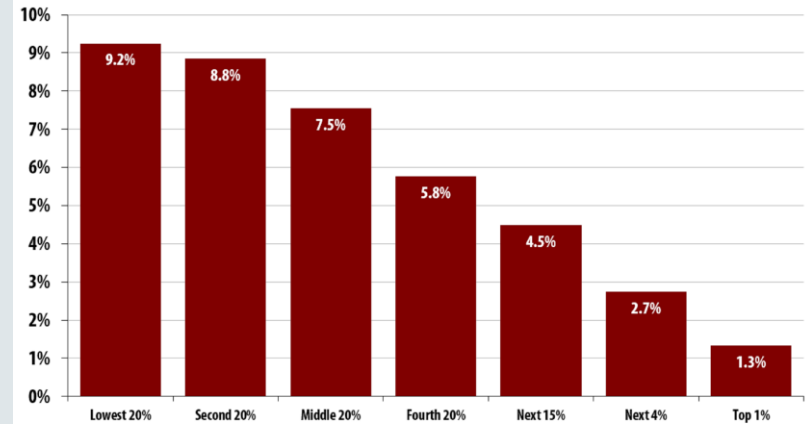
Distribution of State & Local Taxes in Arkansas

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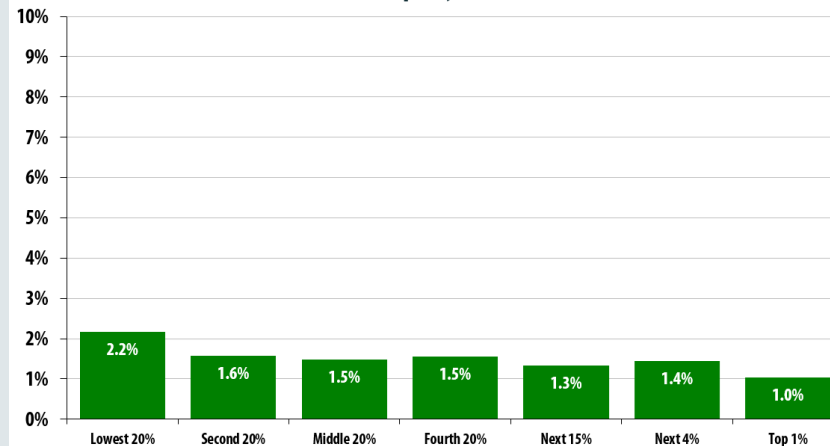
Personal & Corporate Income Taxes



Sales & Excise Taxes

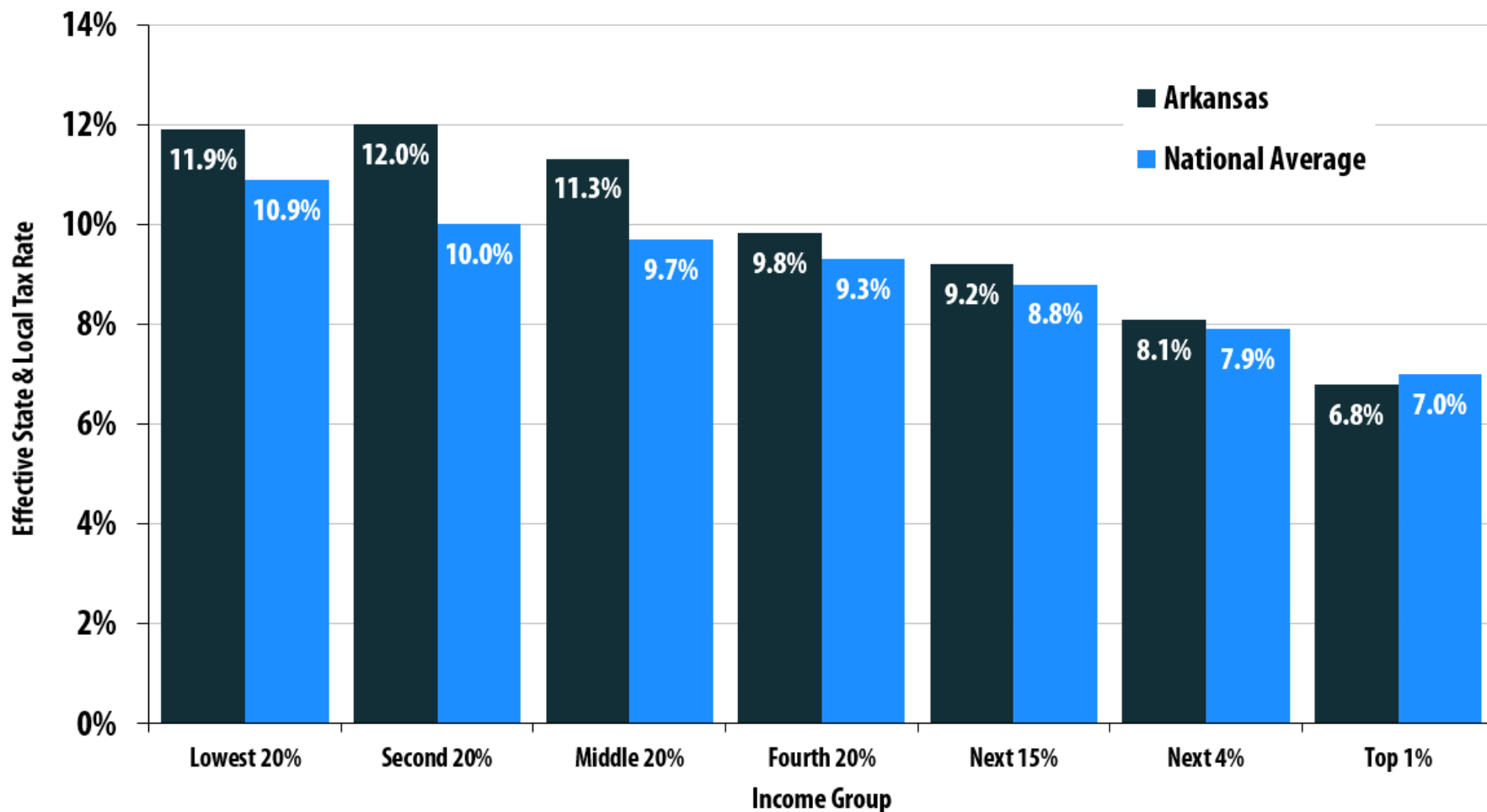


Property Taxes



Comparing Arkansas's Distribution to the National Average

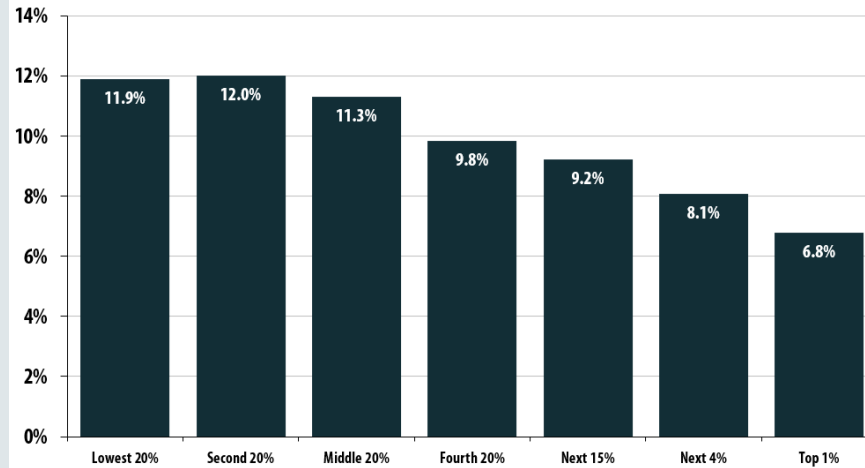
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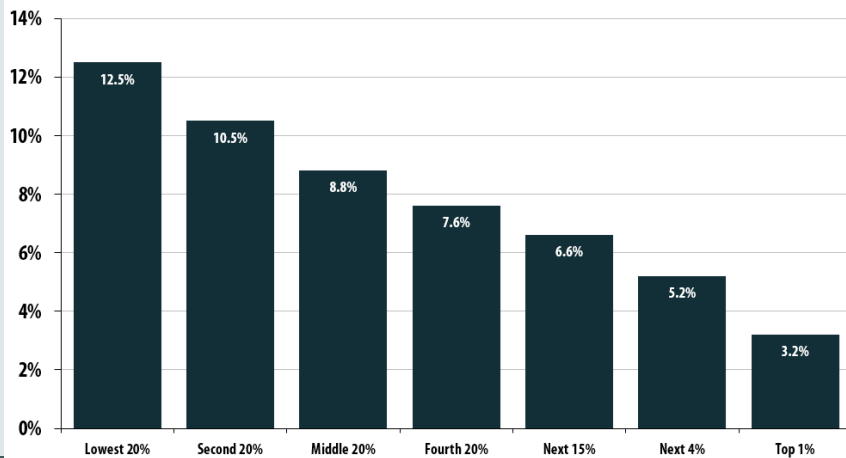
Comparing Arkansas's Distribution to Neighboring States

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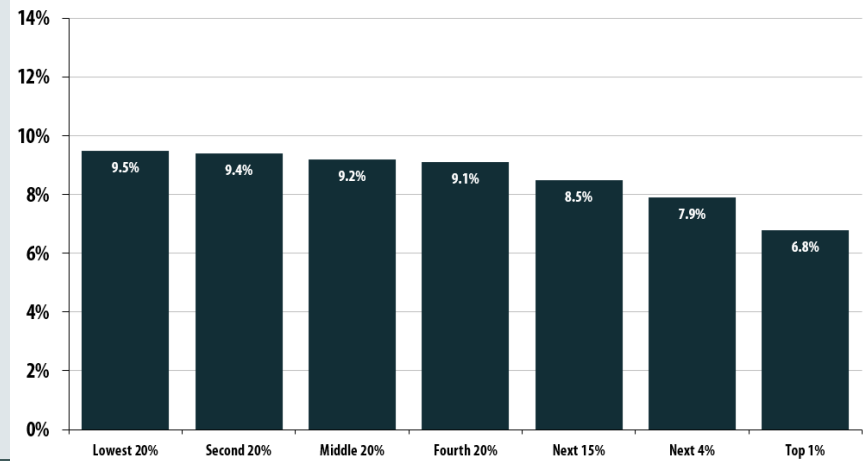
Arkansas



Texas



Missouri



Distributional Comparison to Neighboring States

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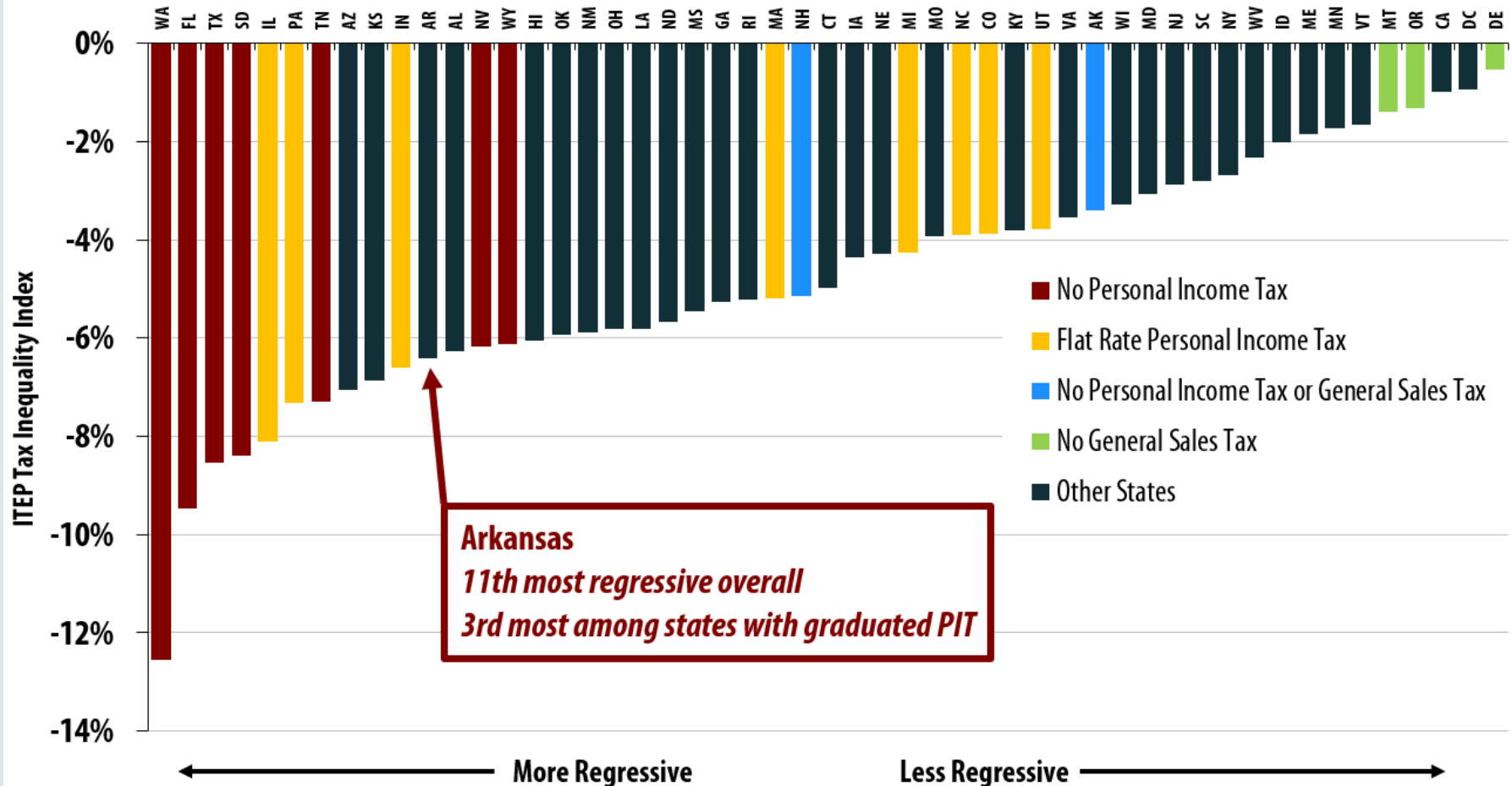
ITEP Inequality Index Ranking

Lower Number = More Regressive

Texas	3rd
Tennessee	7th
Arkansas	11th
Oklahoma	16th
Louisiana	19th
Mississippi	21st
Missouri	30th

Tax Regressivity by State

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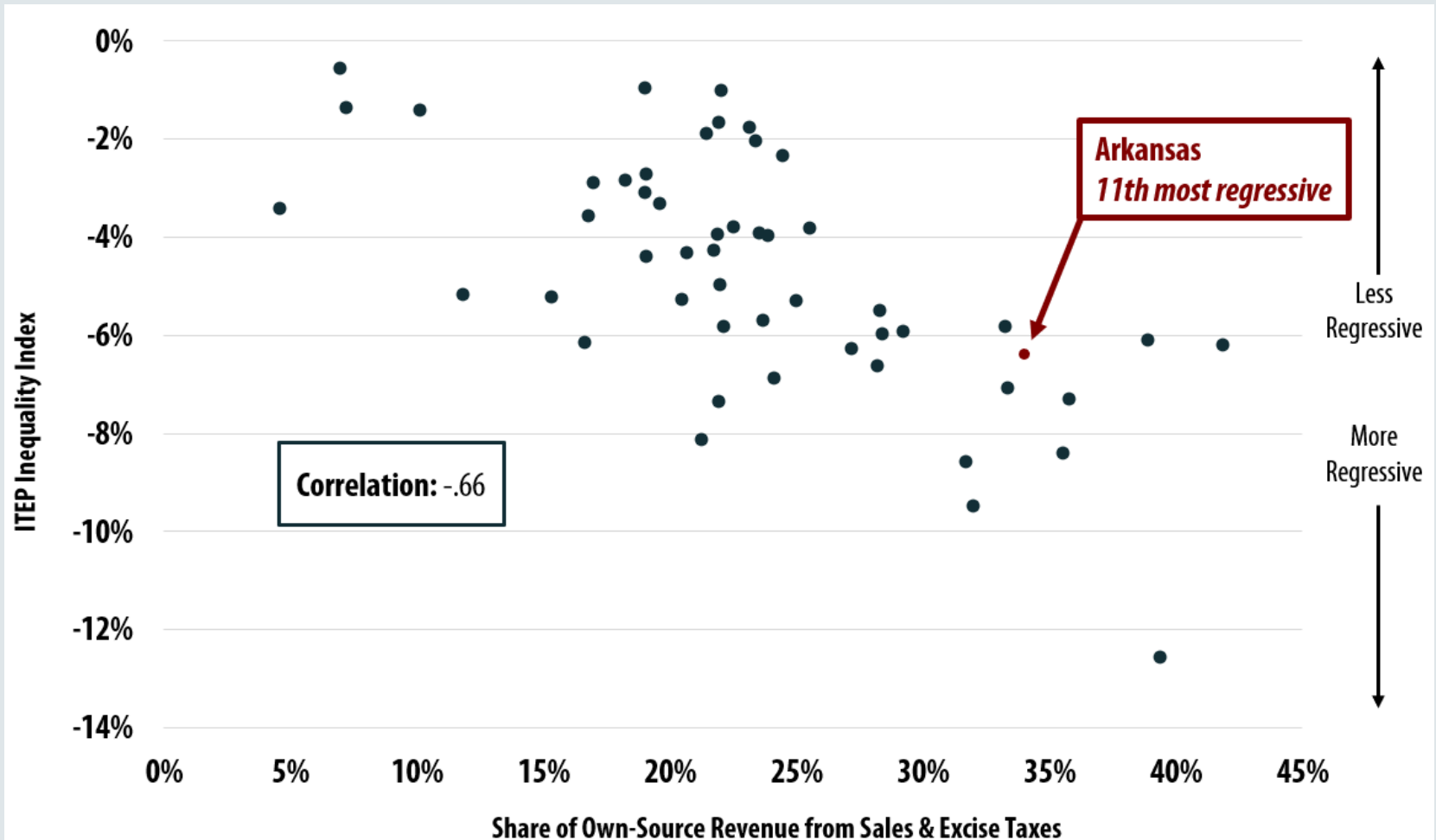
Why Are Arkansas Taxes So Regressive?

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1. Sales taxes (state and local) are far above the national average
2. Income tax is fairly typical by national standards
 - Notable exception is lack of a refundable EITC or similar credit
3. Property taxes are below average

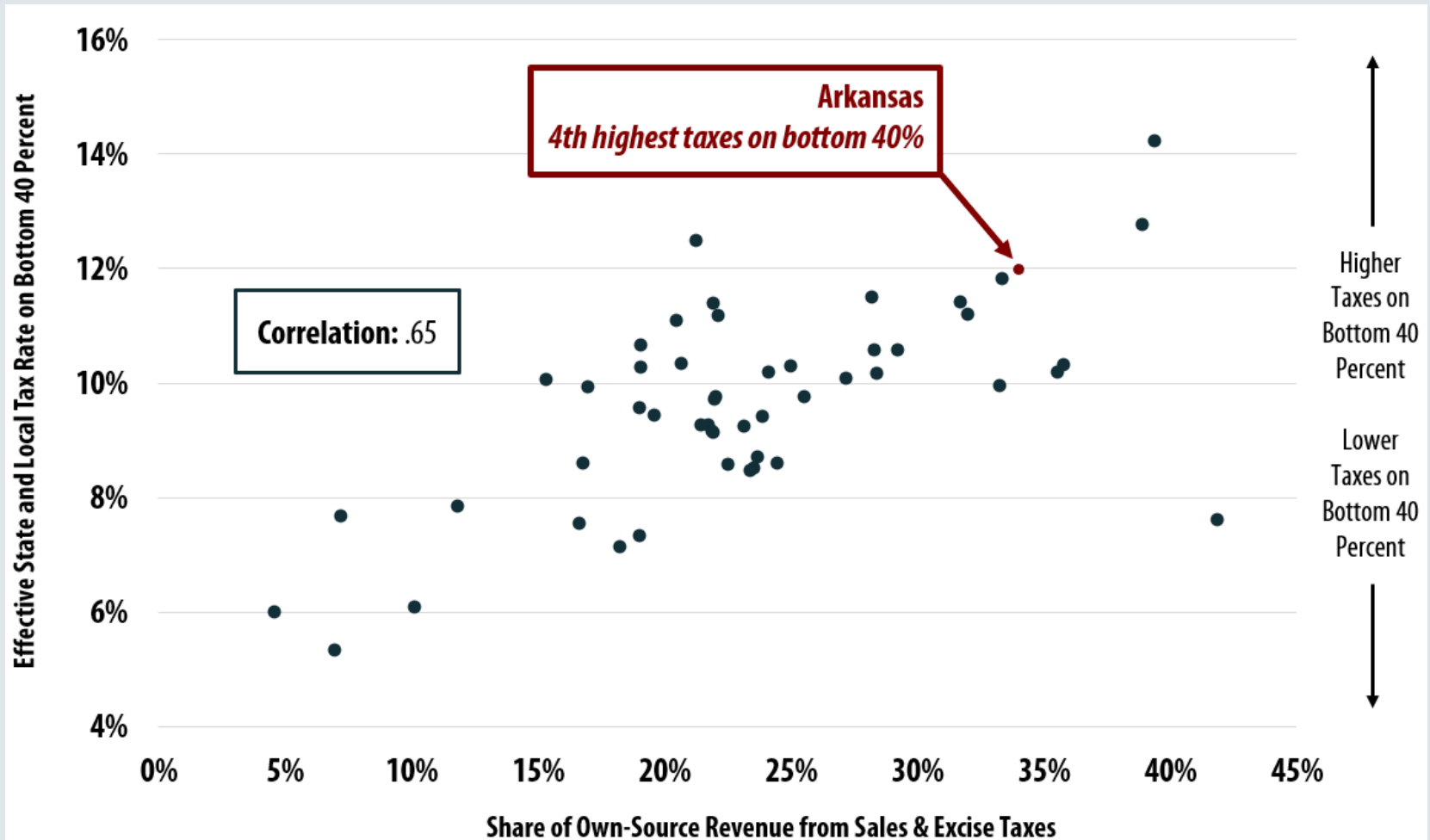
Heavier Reliance on Sales & Excise Taxes is Associated with More Regressive Tax Systems

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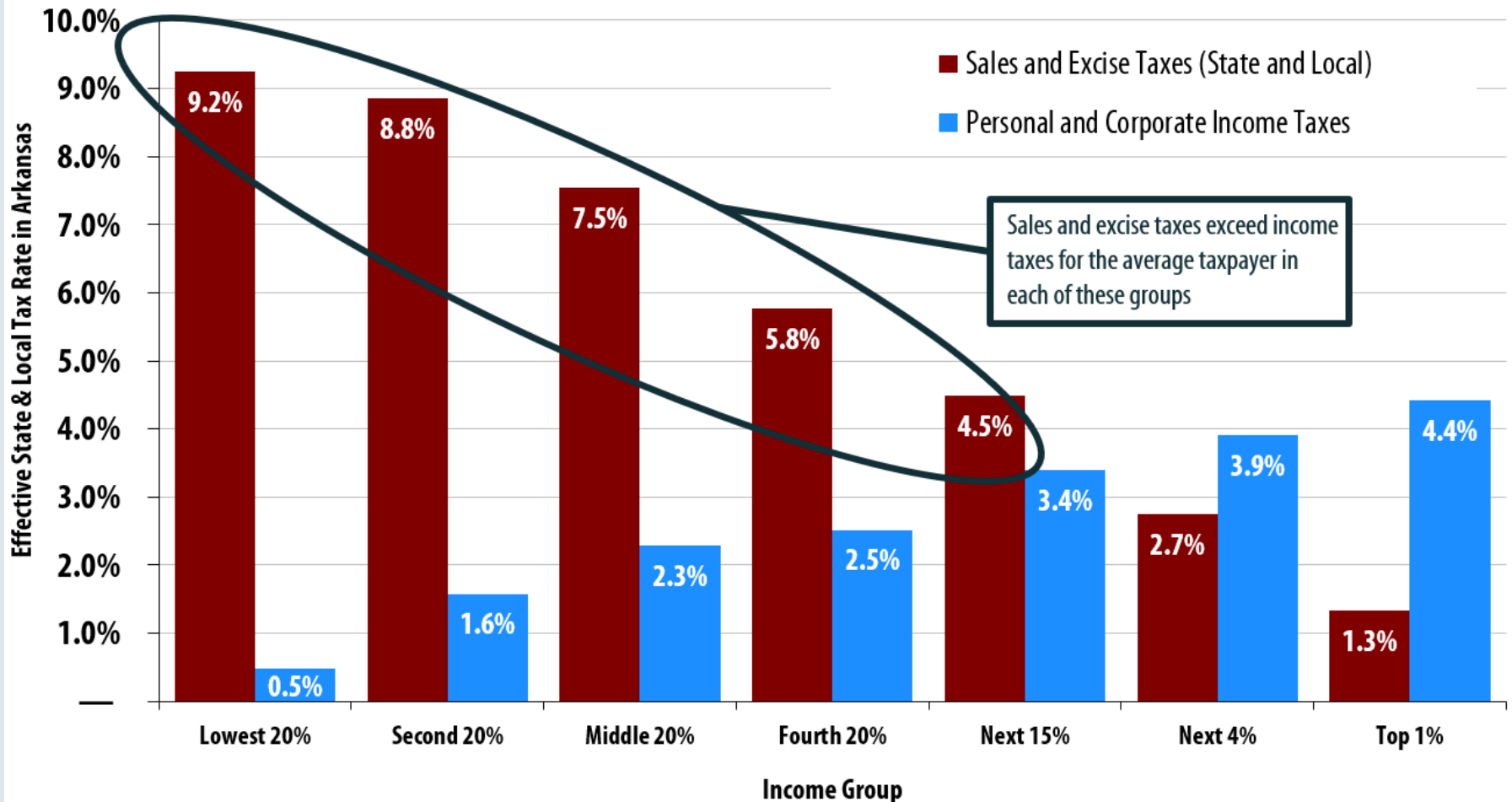
Heavier Reliance on Sales & Excise Taxes Leads to Higher Taxes on Moderate-Income Families

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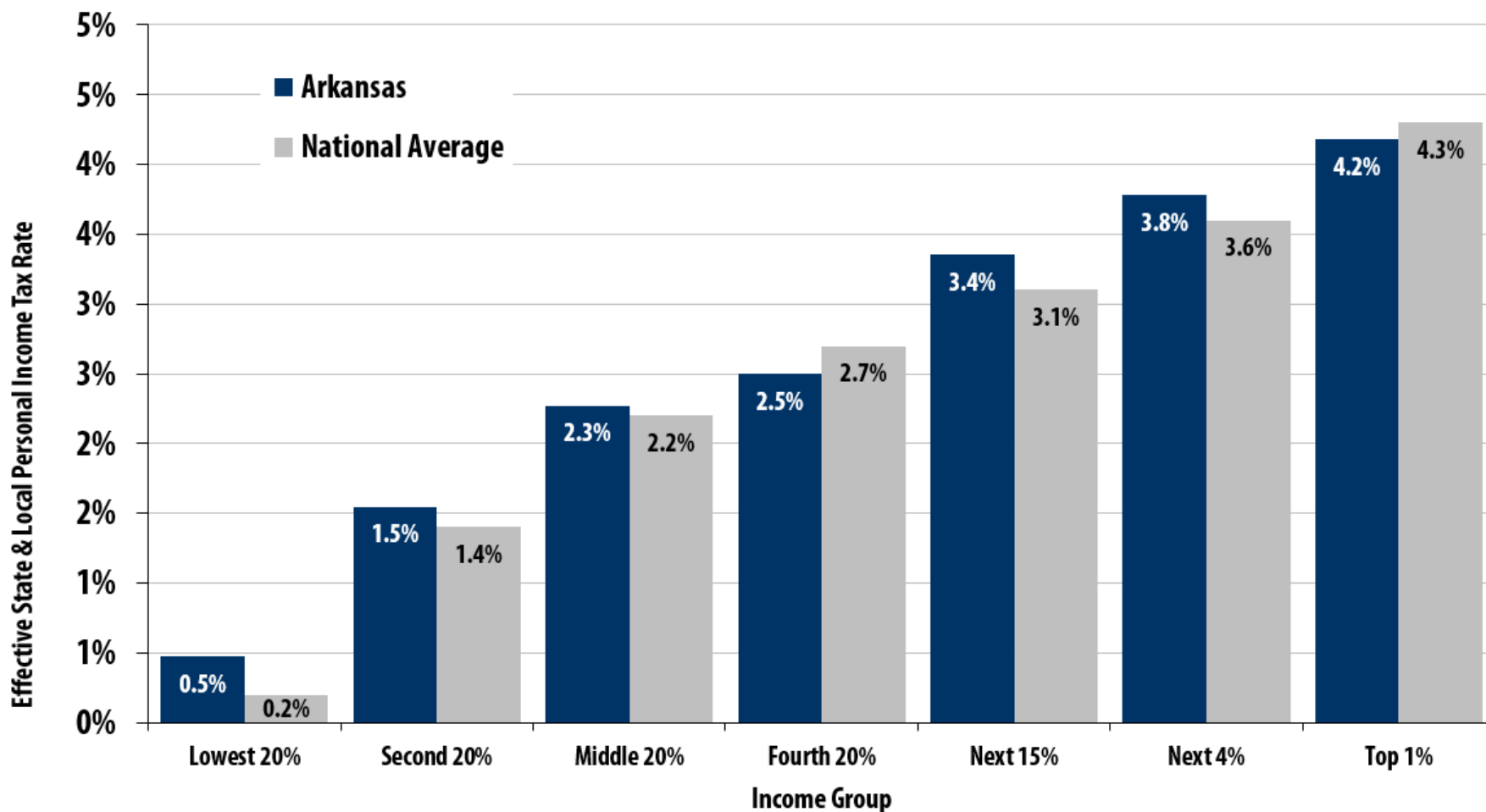
Most Arkansas Taxpayers Pay More in State and Local Consumption Taxes than in Income Taxes

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Arkansas's Personal Income Tax is Similar to the Average State's Tax

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Putting it together...

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**Above-
average sales
and excise
taxes
(regressive)**

+

**Relatively
typical
personal
income tax
(progressive)**

=

**11th Most
Regressive
State &
Local Tax
System in
the Nation**

Graduated Income Tax Only Partly Balances Arkansas's Tax System; More Regressive States Often Lack This Counterbalance

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Personal Income Taxes in the 10 States with Overall Tax Systems More Regressive than in Arkansas

Washington	None
Florida	None
Texas	None
South Dakota	None
Illinois	Flat Tax
Pennsylvania	Flat Tax
Tennessee	Dividends and interest only
Arizona	Graduated Tax, But Flatter than in Arkansas
Kansas	Graduated Tax, But Flatter than in Arkansas
Indiana	Flat Tax

Low-Income Credits are Associated with Less Regressive Tax Systems

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- 29 states offer state Earned Income Tax Credits (EITC)
- 13 of the 15 states with the least regressive tax systems offer EITCs
- Just 4 of the 15 states with the most regressive tax systems offer EITCs

Distributional Takeaways

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- Arkansas has the nation's 11th most regressive tax system because:
 - Low- and moderate-income families face some of the highest effective tax rates in the nation.
 - Taxes at the top, however, are below average in Arkansas.
- Heavy reliance on consumption taxes is a central feature of Arkansas's tax system.
- The state's personal income tax offers only some balance against steeply regressive consumption taxes. But the income tax is neither especially high nor progressive.
- Arkansas is unusual in not offsetting (some) regressive tax payments made by low-income families with an EITC.

Moving on...

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Tax Cut Triggers

The Trigger Temptation: Reasons to Avoid Tax Triggers

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- Offer no meaningful benefits compared with deferring action on tax cuts until closer to the implementation date, when policymakers will know more about whether they are affordable.
- There is no such thing as a “good” trigger design. Tax and budget policy is complex. It’s impossible to write an auto-pilot formula that can match the analytical capabilities, and professional judgment, of future lawmakers and their staffs.
- Trigger enactment effectively acknowledges that the tax cut is unaffordable today, and places undue faith in a mathematical formula to determine whether it will be affordable in the future.
- Income tax triggers are particularly problematic in Arkansas because of the 3/4ths supermajority requirement to raise taxes / prevent triggered cuts.

The Supermajority Problem, part 1 of 3

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- No automatic trigger formula can replace the best judgment of lawmakers who talk to their constituents and other stakeholders, and who understand what types of spending reductions are, or aren't, worth undertaking to bring about a tax cut.
- This is why the Tax Foundation attempts to reassure readers by stating that even with a trigger in place: “legislators ... retain the ability to postpone or reverse triggered tax cuts.”
- But once an income tax cut is set in motion in Arkansas, future legislatures face a very high hurdle to reversing it: the supermajority requirement under which 3/4ths of each legislative chamber must agree to reverse the cut.
 - No state sets a higher bar for its legislature than Arkansas (3/4ths support in both chambers) to reverse an income tax cut.

The Supermajority Problem, part 2 of 3

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- Consider the following chain of events:
 - One legislature enacts, with a simple-majority vote, a far-off tax cut based on an imperfect trigger formula.
 - The state's fiscal situation and/or priorities change, and a majority of lawmakers come to regret the trigger's design.
 - Future legislatures cannot undo the trigger unless they muster a daunting 3/4ths support in both legislative chambers.
 - ✦ Put another way, just 9 senators *or* 26 representatives can stand in the way of undoing a tax trigger that a majority of the legislature, working off the most recent information available, has judged to be flawed.

The Supermajority Problem, part 3 of 3

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- In one sense, this is a common problem across states. Triggers allow the current crop of lawmakers to pass tough choices along to their successors, who are charged with rebalancing the budget once a triggered tax cut takes effect.
- But the problem is particularly acute in Arkansas, where the lawmakers who must ultimately deal with the trigger's fiscal consequences have their options severely limited by the 3/4ths supermajority requirement.
- Bottom line: Future lawmakers will undoubtedly have better information about the affordability of income tax cut triggers enacted today. But that does not mean they will be able to act on that information. Reversing a triggered income tax cut in light of new evidence is remarkably difficult in Arkansas.

Trigger Recommendations

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- **Best option:** Don't do it.
 - A solution in search of a problem.
- **Next best:** Enact “intent of the legislature” language, allowing future lawmakers to evaluate fiscal situation and vote on implementation.
 - Tennessee-style
 - For income tax: allows future legislature to decide appropriateness of tax cut with simple majority vote, rather than allowing a minority to force tax cut implementation to proceed
- **Second-worst:** A multi-layered trigger that only takes automatic effect if the budget is in exceptionally good shape.
 - Better safe than sorry.
- **Worst:** A simple trigger that badly mismeasures tax cut “affordability.”
 - See: Oklahoma, among others

Triggers: Things to Avoid, part 1 of 2

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- Don't allow a single year of strong revenue-growth (tied to a stock market bubble, for instance) to trigger a permanent tax cut.
- Don't allow a lackluster economic recovery, wherein revenues are merely making up lost ground, to trigger a permanent tax cut.
- Don't allow a permanent tax cut to go into effect if the state is unprepared for future fiscal challenges such as:
 - An economic downturn
 - A natural disaster
 - Rising health care or pension costs
 - Tax base erosion due to changing economy or demographics (shifts toward a service-oriented economy, retiree tax breaks, etc.)
 - Popular demand for new/expanded services: teacher pay raises; reduced classroom sizes, universal Pre-K, etc.

Triggers: Things to Avoid, part 2 of 2

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- Don't rely solely on (unavoidably) speculative revenue forecasts rather than actual revenue performance. (see: Oklahoma)
- Don't mismeasure tax cut "affordability" by tying the trigger to inflation in consumer goods and services rather than the more relevant goods and services that states and localities purchase (health care, labor, etc.).
- Don't set arbitrary targets that "sound good" without understanding how those relate to expected cost growth of existing public services.
- Triggered *income tax* cuts, in particular, should be avoided because future legislatures, working on better information, face a very high bar (3/4ths supermajority requirement) to reverse these.
 - Sales tax cuts do not face the same supermajority requirement.
- Don't tilt the benefits toward higher-income households who:
 - Already pay the lowest overall state and local effective tax rates in Arkansas.
 - Already fared very well under the federal tax cut enacted just last year.

Fleshing Out the “Second-Worst” Option: A Multi-Layered Trigger, part 1 of 3

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- Trigger should not be enacted until state fiscal analysts produce a 3-year forecast of both current tax law revenue and a “current services” spending budget.
- Current services budgets are produced at the federal level and in 22 states, including Louisiana and Tennessee.
 - Six of these states produce multi-year forecasts, which are necessary to evaluate the affordability of a long-run tax cut.
- These budgets provide a reality check regarding the resources that will be needed to continue funding existing programs at current levels in the face of changes in population, demographics, program utilization, and program-specific cost growth. For example:
 - Maintaining DMV service speed/quality even as more drivers demand licenses
 - Funding Medicaid sufficiently to cover rising costs or caseloads
 - Funding scheduled salary increases for state employees
 - Funding upcoming policy changes already agreed upon by lawmakers

Fleshing Out the “Second-Worst” Option: A Multi-Layered Trigger, part 2 of 3

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- Actual revenue growth (not just projected growth) must be significant and prolonged.
 - For example: current revenue collections should exceed not just the prior year’s collections, but collections from each of the last 5 years, adjusted for population growth and inflation in the cost of government goods/services. (Significant year-over-year revenue growth routinely occurs even when states are struggling to recover from an economic downturn.)
- Trigger should only take effect if, even with the triggered tax cut, revenues are projected to be sufficient to fund a “current services” budget during each of the following three years.
 - A current services budget is the only way to judge whether a tax cut is completely affordable within the current budget, or whether it will require scaling back the services that the state has been providing.
 - This is an additional condition that should complement the actual revenue growth test described above, not replace it.

Fleshing Out the “Second-Worst” Option: A Multi-Layered Trigger, part 3 of 3

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- Rainy Day Fund should be large enough to cover two months (16.7 percent) of annual spending, as recommended by the Government Finance Officers Association.
- Trigger should include a mechanism reversing the cut if the state’s fiscal situation deteriorates, as evidenced by outcomes such as:
 - Rainy Day Fund falling below 16.7 percent of annual spending.
 - A significant revenue decline.
- Triggered tax cuts should occur bottom-up rather than top-down.
 - High-income families in Arkansas already pay far lower effective tax rates than Arkansas’s lower- and middle-income families.
 - From a national perspective, high-income families in Arkansas already pay below-average state and local taxes. The state’s poorest residents, by contrast, face some of the highest overall taxes in the country.

Questions?



Thank you for your time and attention!

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