Arkansas:

Options for Tax Reform

Presentation to the Arkansas Tax Reform and Relief Task Force
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TAX FOUNDATION

TOPICS OF DISCUSSION

- Regressivity in Arkansas's Tax Code
- Discussion of ITEP's Analysis
- Designing Tax Triggers

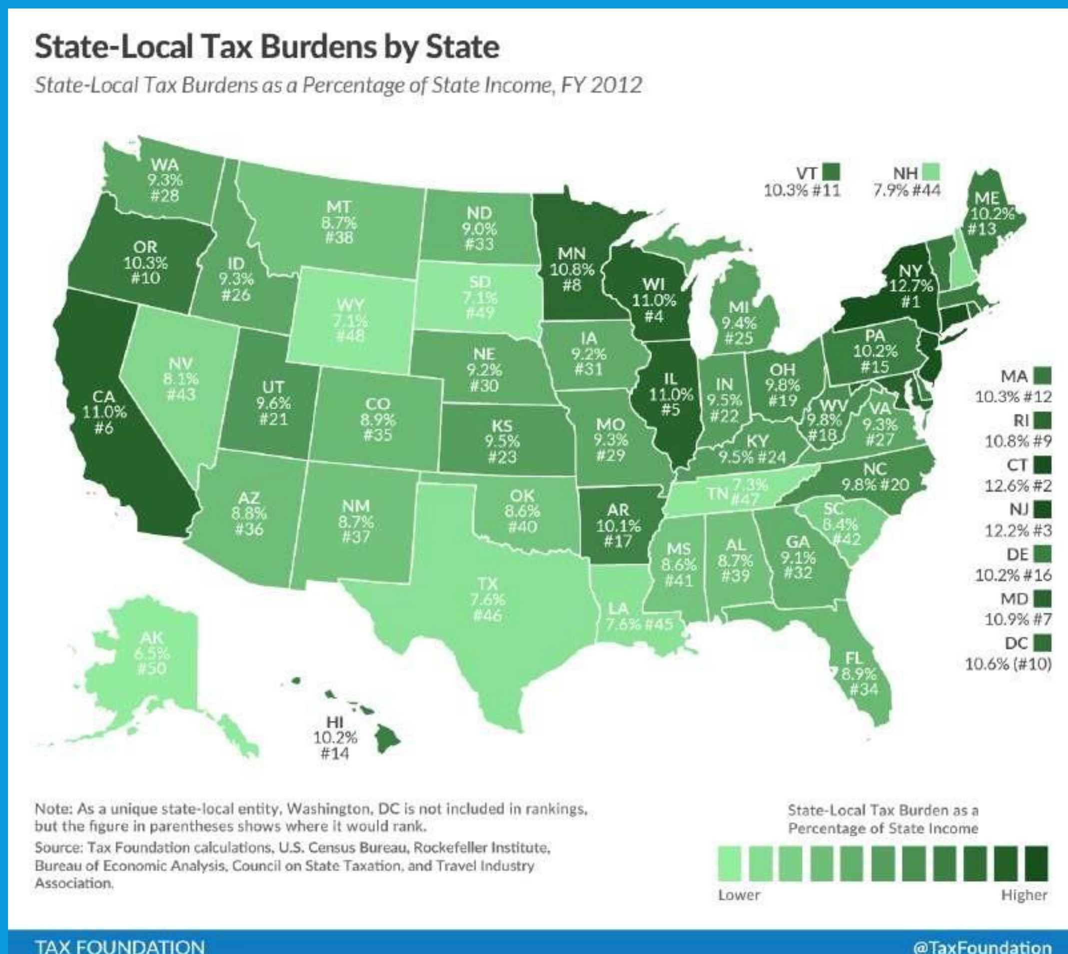
TAX REFORM
GENERAL PRINCIPLES

- Designing a tax code requires balancing numerous different principles at the same time.
  - Tax systems should consider neutrality, simplicity, transparency, stability, and retroactivity.
  - Additionally, others push to consider both horizontal and vertical equity.
- Designing any tax system requires trade offs among these various principles.

TAX REFORM
GENERAL PRINCIPLES

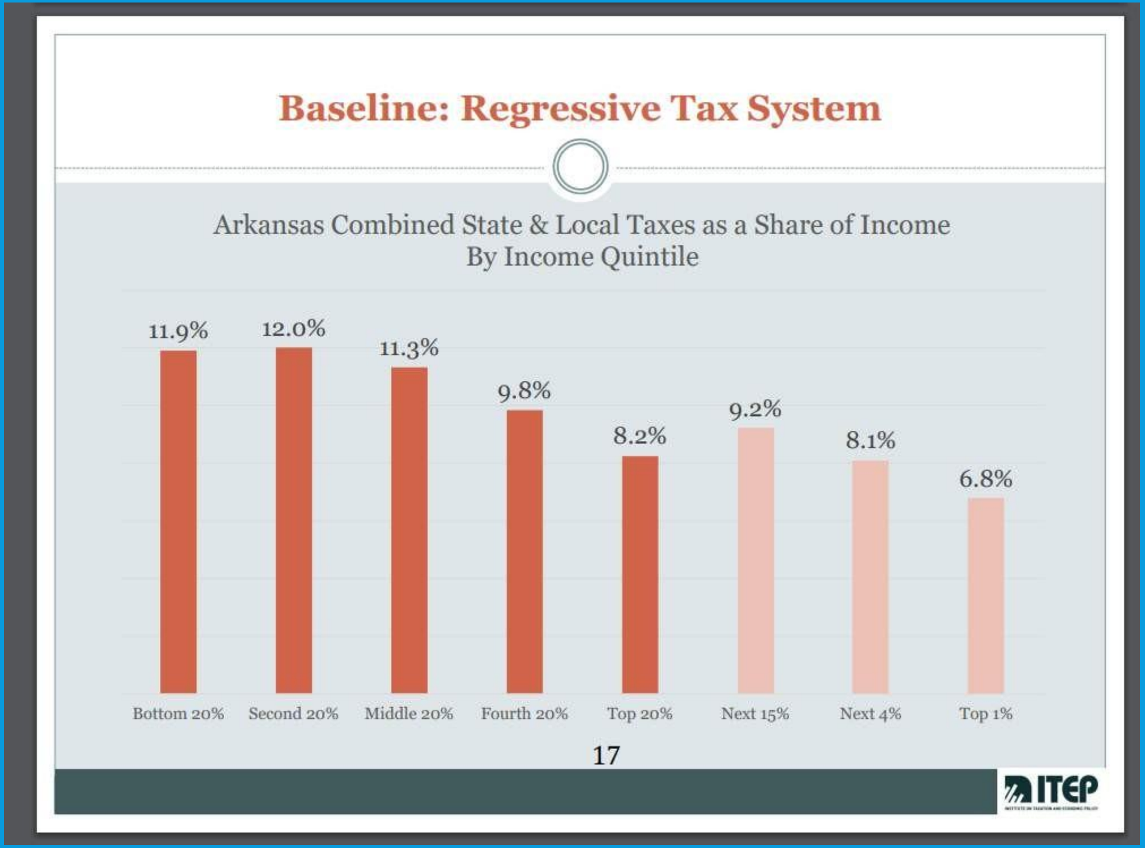
- As we dig into vertical equity today, there are a few important things to consider.
- Categorizing a tax as "regressive" or "progressive" isn't an all-or-nothing proposition.
- For instance, sales taxes are generally considered to have regressive elements, but sales taxes assessed to certain goods, like high-end personal services, can make the tax much more progressive.

TAX REFORM
STATE TAX BURDENS



ITEP'S "WHO PAYS?"
A DISCUSSION

- Much of the discussion on regressivity at the task force meetings has focused on ITEP's "Who Pays?" analysis.

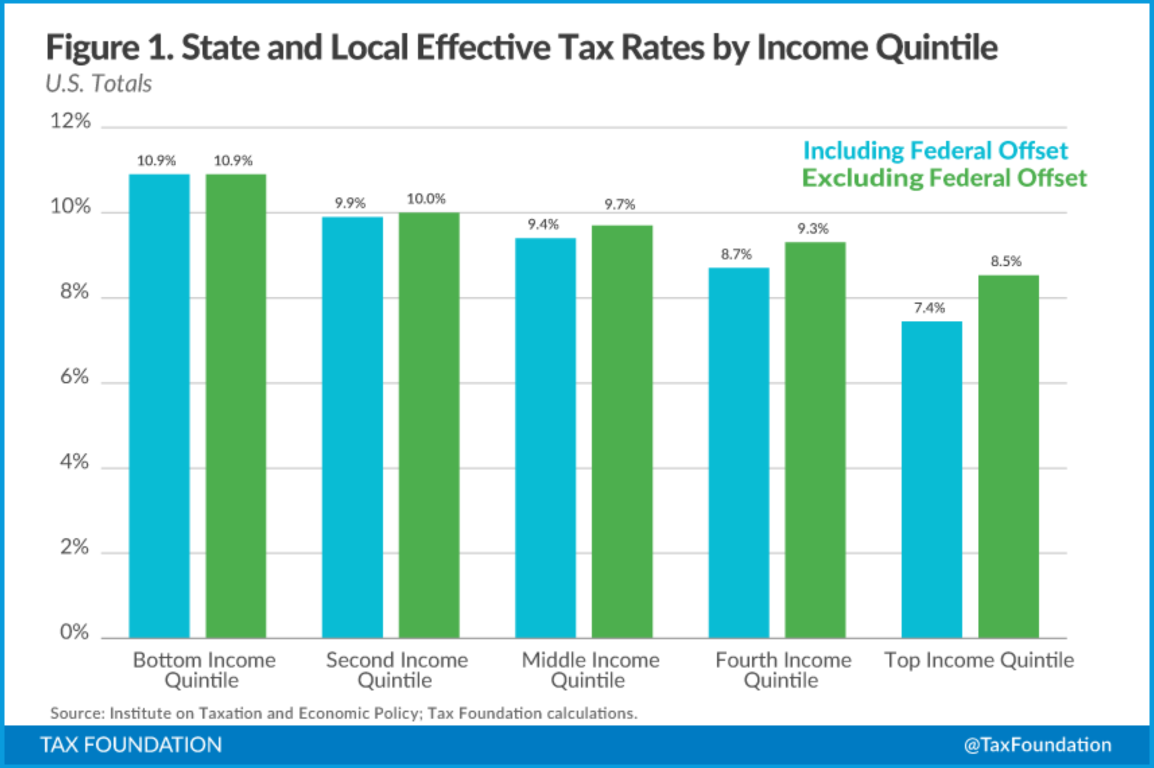


ITEP'S "WHO PAYS?"
A DISCUSSION

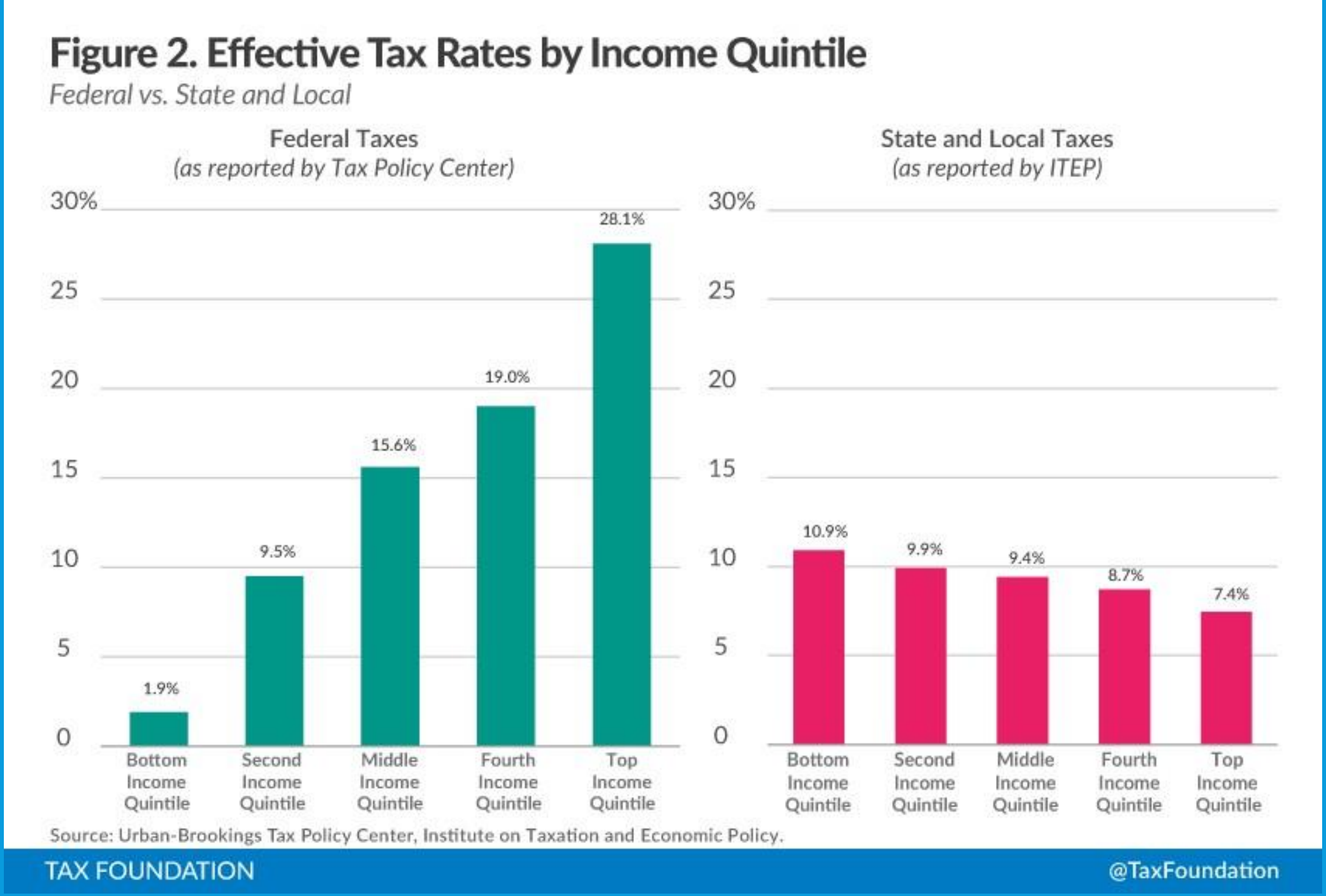
- First, ITEP's data uses old data from the IRS for its analysis.
  - ITEP's microsimulation model is based on the 1988 IRS public use file (PUF).
  - While the group makes attempts to update that data, this is quite difficult to do.
  - For comparison, the Tax Foundation Taxes and Growth model uses the 2011 PUF.

ITEP'S "WHO PAYS?"
A DISCUSSION

- Second, the data selectively includes federal tax policy.
  - It includes the impact of the federal SALT deduction, but doesn't include the progressive federal income tax.



ITEP'S "WHO PAYS?"
A DISCUSSION

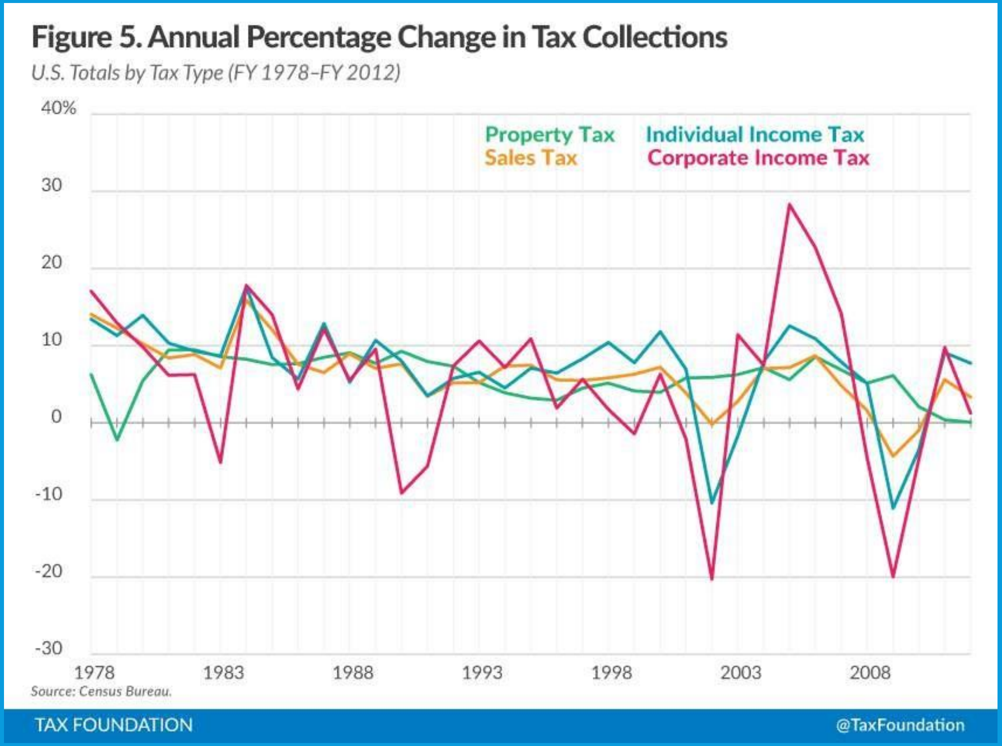


ITEP'S "WHO PAYS?"
A DISCUSSION

- Third, the analysis doesn't include all taxes.
  - ITEP includes sales taxes, individual income taxes, and corporate income taxes, but doesn't include a number of other broad business taxes, which are progressive.
  - In the context of Arkansas, the state's severances taxes would not be included.

ITEP'S "WHO PAYS?"
A DISCUSSION

- Fourth, following ITEP's recommendations would make the state's revenue streams more volatile.
  - ITEP praises states that rely heavily on income taxes.



ITEP'S "WHO PAYS?"
A DISCUSSION

- Fifth, ITEP does not account for exporting of taxes, other than property taxes.
- Sales taxes and corporate income taxes are exported. Failing to account for the exporting would overstate how regressive Arkansas's tax code is, especially given the state's heavy reliance on the sales tax.

ITEP'S "WHO PAYS?"
A DISCUSSION

- Finally, what ITEP's data really shows is that sales taxes are regressive. But even that isn't universally accepted among the economic community.
- Looking at only one year in isolation can overstate the amount of regressivity.
  - First, low-income households tend to have volatile income year-to-year, due to job instability. And individuals do not tend to reduce consumption due to temporary income decreases.
  - Lifetime earnings and consumption tend to be balanced.

TAX TRIGGERS
SUGGESTED REFORMS

- Tax Triggers
  - Are a helpful way to manage revenue availability.
  - Have been used extensively in more than a dozen states in recent years.
  - Other state examples have demonstrated what to do and what not to do.

TAX TRIGGERS
SUGGESTED REFORMS

- Tax Triggers
  - There are several key components to include when designing a properly constructed tax trigger.
    - Any tax cuts should be triggered based on revenue, not spending, growth.
    - Need to consider what measure of revenue. Tax collections, general revenues, etc.
    - Also, generally want to build in some natural growth, such as population growth plus inflation.
    - Triggers can also be combined with tax phaseouts.
      - They can help accelerate reforms.

TAX TRIGGERS
NORTH CAROLINA

- The state's 2013 legislation cut the corporate income tax rate from 6.9 percent to 6.0 percent while broadening the tax base by reducing certain tax credits and exemptions, and scheduled a further reduction to 5.0 percent in 2014.
- Subsequent reductions, however, were made contingent on achieving statutorily-set revenue targets.
- The law established that if net general fund tax collections for the 2015 fiscal year exceeded $20.2 billion, the tax rate would be reduced by one percentage point, with a similar provision in place should revenue exceed $20.975 billion in fiscal year 2016.

TAX TRIGGERS
DISTRICT OF COLUMBIA

- In 2014, DC approved a tax reform package which reduced corporate and individual income tax rates, adopted more generous standard deductions and personal exemptions, and expanded the Earned Income Tax Credit, among other changes. Additional tax reform priorities were made contingent upon midyear annual revenue estimates exceeding preliminary annual revenue estimates, with any additional monies in FY2015 and 2016 funneled into implementation of 17 proposals. Broadly speaking, these provisions can be summarized as:
  - Reducing individual income tax rates across multiple brackets;
  - Cutting the corporate income tax, known as the business franchise tax;
  - Raising the estate tax threshold; and
  - Increasing the standard deduction and personal exemption.
- Rather than using triggers to reduce tax rates gradually in the out years, the DC tax plan conditions a portion of the tax cuts intended for implementation over a two-year period on rising revenue projections.

TAX TRIGGERS
KANSAS

- Kansas's tax cuts in 2012 and 2013 included an improperly structured tax trigger.
- By pegging triggers to year-over-year revenue growth, without regard to any static baseline, Kansas could trigger tax cuts without any meaningful economic growth, a critical drawback.
- For instance, if revenues declined by 3 percent in year one and then recovered in year two, two-year revenue growth could be flat, but year-over-year growth would be sufficient to trigger a tax cut. Conversely, if revenue grew by 2 percent every year for a decade, no tax cuts would ever be triggered.

TAX TRIGGERS
RESPONDING TO CRITIQUES

- Tax triggers are sometimes critiqued.
  - "[i]f you have a tax based on a blind formula, that formula doesn't know when the next recession might hit or when another need might arise in the state."-Michael Leachman, Center for Budget and Policy Priorities
  - But the same is true for tax rates or other aspects of a state's tax code. If Arkansas adopts a tax trigger, it should not be viewed as meaning the work is done.
- But other critiques center on items I discussed previously: improperly structuring the triggers, such as Kansas or Oklahoma.

CONCLUSION

- Questions?

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