A Practical Plan to Lower Arkansas's Income Tax Rates

By Dan Greenberg and Robert Steinbuch
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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)

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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

Bracket	Revenue Loss
$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.

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[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.