EXHIBIT D

TAX PROCESS CHANGES

- Require yearly disclosure of the revenue impact of all tax expenditures.
  - This disclosure should be in a format that would allow policymakers to compare the revenue impact of any one tax expenditure to any other tax expenditure.
  - This disclosure should be in a format that would allow policymakers to understand and calculate how the elimination of any tax expenditure could be used to reduce any particular tax rate.
- Require formal review, and regular approval, of all tax expenditures.
- Incorporate the review/approval process into the regular budget process.
- Implement sunset requirements for tax expenditures.

PROPOSED TAX PROCESS CHANGES

As discussed above, the Tax Foundation has proposed three different options for tax reform in Arkansas that would encourage economic growth. Unfortunately, just changing tax rates is probably not enough: policymakers should also reform other tax provisions that distort the economic climate of the state. This may not be achievable without reforms to the process of tax policy decision-making.

More particularly, policymakers should reform what are called "tax expenditures." Speaking generally, a tax expenditure is a tax credit, tax deduction, or tax exemption. A tax expenditure can benefit a small or large number of people. Tax expenditures can shrink, distort, and damage the economy just as much as imposing a tax can. Economists on both the left and right have criticized tax expenditures: the set of tax expenditures in the tax code is like a shadow budget that gets much less scrutiny than tax rates or government spending.[31]

Consider the example of a sales tax on each can of soda: that tax would probably decrease consumer purchases. On the other hand, a tax expenditure – such as a temporary tax holiday that briefly eliminated all food taxes – might increase consumer purchases. (This kind of tax holiday is a classic instance of a sub-par policy choice, because there is substantial evidence to suggest that tax holidays do not change total consumer purchases of goods; instead, such tax holidays simply make some purchases untaxed and therefore decrease net state revenue.[32]) Tax expenditures typically attempt to encourage activities that policymakers like – such as business growth, child care, or homebuilding. However, tax expenditures will also reduce revenue needed for state government services. Tax expenditures, especially those which benefit only a small number of people, can create both changes in behavior and economic inefficiencies. (Tax expenditures can lead to desired changes, such as creating high-paying jobs in return for investment incentives. However, legislators should audit such tax expenditures for the desired outcome and total cost in lost revenues.)

Arkansas offers a variety of tax expenditures – such as tax abatements, deductions, incentives, and subsidies – to encourage particular activities. Those who receive these privileges benefit either by reduction of taxes owed or by receipt of funds from state government.

One peculiar aspect of the whole family of tax abatements, incentives, and expenditures is that these provisions get much less legislative scrutiny than tax increases. A proposed tax increase can ignite an army of opposition. A proposed tax expenditure, however, will generate less scrutiny and fewer complaints. But both will distort the economy by dampening incentives for productive behavior.

Removing tax expenditures permits rate reductions without, on net, increasing taxes. For example, the Reagan Administration, working in concert with Congress, famously eliminated tax expenditures ("loopholes") in 1986 – which paid for lower tax rates. Congress's Joint Committee on Taxation summed up the aims of Congress in enacting this reform legislation:

> *The sharp reductions in individual and corporate tax rates provided by the Act and the elimination of many tax preferences will directly remove or lessen tax considerations in labor, investment, and consumption decisions. The Act enables businesses to compete on a more equal basis, and the business success will be determined more by serving the changing needs of a dynamic economy and less by relying on subsidies provided by the tax code.* [33]

Arkansas has a large number of these incentives or revenue reductions in its state tax system. In Arkansas, tax abatement and incentives are or will soon be public information. Tax expenditures, the largest in dollar volume, are much less transparent.

Tax abatements are agreements between a government body and a single business, in which the government essentially offers tax reductions in order to purchase desired goals such as more jobs or new plant expansion. A tax abatement is a contract with only a single company, not a broad tax incentive. Beginning in FY 2017, Arkansas's reporting of tax abatements will be governed by General Accounting Standards Board (GASB) Statement 77. (The GASB is a national organization that sets standards for government accounting.) The new GASB standard is a significant improvement in the transparency of tax abatements; those tax abatements can have a marked effect on local governments. GASB 77 will help the public understand the true costs of agreed-upon economic incentives. GASB 77 standards will be developed by DF&A, but legislators should review DF&A's implementation for completeness and accuracy.

Tax incentives originate from the Arkansas Economic Development Commission (AEDC) or DF&A. Tax incentives are direct cash subsidies to a single business for meeting performance goals. Legislative Audit annually examines tax incentive outcomes and performance as found in the Arkansas Consolidated Incentives Act, 15-4-220. Legislative Audit reports have been critical of InvestArk programs for many years, because InvestArk programs did not require job creation. Act 465 of 2017 eliminated the InvestArk program, a significant advance in tax expenditure reform. Repeated, regular reviews of the InvestArk program by the legislature helped build consensus to end the program.

Tax expenditures are by far the costliest tax reduction offered by Arkansas. Tax expenditures are available to thousands of people, often as part of state income tax filing. Tax expenditures reduce the amount of revenue that would otherwise be generated, including exemptions, deductions, credits, and lower tax rates. Tax expenditures include very broad deductions as well as those narrowly targeted for certain business activities or worthy groups. DF&A publishes a limited list of such tax expenditures online, "Business Incentives and Tax Credits."[34] (Notably, DF&A's report only lists historical data for business incentive tax expenditures; it provides no projections of future revenue costs. Other states provide much broader data.)

Consolidated Incentive Act of 2003 - Payroll Rebate

ACT 182 OF 2003, as Amended
ACA § 15-4-2707
CREATE REBATE PROGRAM

PAYROLL REBATE PAYMENTS

	CREATE REBATE PAYMENTS AUTHORIZED (Calendar Yr)
2003	0
2004	0
2005	0
2006	960,851
2007	3,039,334
2008	1,955,828
2009	7,441,553
2010	13,346,749
2011	9,875,503
2012	14,328,603
2013	11,499,954
2014	9,935,999
2015	10,246,711
TOTALS	82,631,085

Most large-scale tax expenditures also reflect social priorities for the Arkansas legislature. These tax expenditures benefit certain individuals such as veterans, children, homeowners, etc. However, these socially beneficial tax expenditures also shrink state tax collection.

Tax expenditures add up quickly to a significant revenue loss for the state. Most states have annual reporting of such tax expenditures, or even a separate budget off all current items with proposed changes. A tax budget, a comprehensive picture of all tax expenditures, most importantly helps the legislature see the revenue lost to government services. Here's a snapshot of just one analysis of just one tax expenditure: the Indiana tax expenditure report's section on the child exemption.[35]

Indiana Tax Expenditure Report for Child Exemption

Totals

Tax Year	Number of Child Exemptions Claimed	Amount Claimed	Average Exemption per Return	Dynamic State Tax Reduction	Dynamic Average State Tax Reduction per Exemption
2007	971,934	$2,545,921,359	$2,619	-$83,060,438	-$85.46
2008	958,706	$2,524,007,748	$2,633	-$81,982,997	-$85.51
2009	945,752	$2,519,840,664	$2,664	-$81,109,375	-$85.76

Indiana calculates the dynamic effect of eliminating of child exemption and other deductions. What would be the overall tax effect if this exemption didn't exist? Typically, states provide tax expenditure reports which contain estimates of the size of each tax expenditure's foregone revenue. Indiana's reporting actually calculates the number of taxpayers affected by each expenditure; furthermore, it calculates the dynamic effect of removing the tax expenditure.

To better capture the total loss to state revenues from tax expenditures, Arkansas should strengthen its current tax expenditure report: in particular, it should expand its reporting of tax expenditures outside of economic development, and it should offer greater detail of the operation of each tax expenditure. This was the goal of Rep. Justin Gonzales's proposed HB2276 of 2017. Some observers might find the cost estimate produced by DF&A on this bill – $800,000 – to be eyebrow-raising: Minnesota, which has produced a tax expenditure report for many years, estimates its cost to be $130,000.[36] Producing an Arkansas tax expenditure report might have relatively large costs initially; however, those costs might be dwarfed by the savings that could be created by better management of state tax expenditures.

The next page contains a portion of Ohio's tax expenditure report.[37] That report projects a grand total of $9 billion a year in foregone revenue.

Ohio Tax Expenditure Report Showing All Foregone Revenue

FY 2016 – 2019
Tax Expenditure
Summary of Revenue Foregone
(in millions)

	General Revenue Fund Revenue Foregone			
	FY 2016	FY 2017	FY 2018	FY 2019
Cigarette and Other Tobacco Products Taxes				
8.01 Discount for cigarette tax stamps	$16.4	$16.1	$15.9	$15.6
8.02 Discount for timely payment of other tobacco products' excise tax	1.5	1.6	1.6	1.7
Total Cigarette and Other Tobacco Products Taxes	**$17.9**	**$17.7**	**$17.5**	**$17.3**
Alcoholic Beverage Tax				
9.01 Advanced payment credit/discount	$1.5	$1.5	$1.5	$1.5
9.02 Small brewer's credit	1.1	1.1	1.1	1.1
Tax expenditures with revenue impact below $1 million				
9.03 Sacramental wine exemption	Minimal	Minimal	Minimal	Minimal
9.04 Small wine producer's exemption	Minimal	Minimal	Minimal	Minimal
Total Alcoholic Beverage Tax	**$2.6**	**$2.6**	**$2.6**	**$2.6**
GRAND TOTAL ALL TAXES	$8,341.5	$8,794.5	$9,115..4	$9,439.9

Ohio's total budget for fiscal year 2013 was $63 billion, so the tax expenditures have a large impact on government finances. That is the level of impact tax expenditures have in Ohio; the Arkansas impact should be tracked and reviewed by the General Assembly.

Access to reliable data on tax expenditures is a necessary part of tax reform. Legislators will need to evaluate the information in such reports once created. The National Council of State Legislatures (NCSL) issued a report on best practices in state tax expenditures:[38]

1. *Tax expenditures should be an integral part of the state's budgeting process, subject to a comparable regular review and approval process as other expenditures. All tax expenditures should be reviewed regularly, with a frequency of review considering the trade-off between available resources to undertake the review and the cost of the tax expenditure.*

2. *Evaluations should be based on measurable goals and draw clear conclusions on the effectiveness of the tax expenditures.*

3. *Rigorous evaluations should determine costs and benefits of each tax expenditure, and allow policymakers to ask critical questions, including:*

   a. *To what extent did the tax expenditure affect choices made by taxpayers?*

   b. *Did the expenditure achieve its purpose?*

   c. *Who was affected by the tax expenditure?*

   d. *Did the benefits of the tax expenditure outweigh the effects of the tax increases or spending cuts needed to offset it?*

4. *The Governor and appropriate legislative committees should review the reports to determine whether tax expenditures should be continued, modified, or eliminated. This should be part of the state's normal budgeting process.*

The current structure of the General Assembly is well-suited for continued tax expenditure review: the Economic and Tax Policy Committee or the Revenue and Tax Committee could review tax expenditure reports. The Tax Reform and Tax Relief Task Force could also make recommendations for the appropriate institutional source of tax expenditure reports in future years. Furthermore, such reports should provide data about the fiscal impact of removal of those tax expenditures; in particular, they should explain how income tax rates might be lowered to take advantage of the revenue increase that the elimination of tax expenditures would create.

One of the best methods to limit tax expenditures is to require sunset clauses for each one of them. A sunset clause for a tax expenditure requires that the tax provision end after a specified period of time (for example, six years). After that time elapses, the tax expenditure ends – unless the legislature decides to renew it. The General Assembly could even pass internal rules requiring a supermajority vote threshold for renewal.

In 2009, Oregon enacted a sunset clause for all existing tax credits as well as any future tax credits.[39] As a result, tax credits do not stay in force without regular majority support from its legislature. Sunset clauses require special-interest lobbying groups (such as, for example, the Oregon Hearth, Patio and Barbeque Association) to justify their tax privilege. Regularly requiring special-interest groups to defend such measures would presumably make it more difficult for unjustifiable tax privileges to remain in force.

Lawmakers who want to increase the popularity of tax reform could combine two policies into one tax bill; they could, for instance, combine the sunsetting of tax expenditures with lower rates. Depending on the design of the bill, the General Assembly could create a revenue-neutral tax reform that lowered rates for most Arkansans. Any political pain that accompanied the elimination of tax expenditures could also be minimized by modifying the measure so as to push the establishment of both the lower rates and the sunset provisions two years (for example) into the future; if that option were chosen, advocates of lower tax rates would have an incentive to preserve them (as well as a similar incentive to preserve a cleaner tax code).

Arkansas has made great progress in improving its tax abatements and incentives. Policymakers should now seek a long-term system to report on tax expenditures, regularly review them, and add sunset clauses as necessary. Policymakers will likely find the Tax Foundation's analysis of particular tax expenditures to be of interest.[40]