Arkansas Sales Tax Policy: Recommendations for Reform

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INSTITUTE ON TAXATION &
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Overview

- About ITEP

- Tax Policy Principles

- Observations on Arkansas' Current Tax System

- Recommendations for Reform

Introduction to ITEP

The **Institute on Taxation and Economic Policy** (ITEP) is a non-profit, non-partisan research organization that works on federal, state, and local tax policy issues.

ITEP's mission is to ensure that elected officials, the media, and the 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.

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What Is Tax Incidence Analysis?

- Provides answers to two vital policy questions:
  - Cost (or yield) of proposed tax cuts (or tax increases)
  - Impact of tax changes on taxpayers at different income levels

- Why is it important?

Example: 2016 Arkansas Tax Cut

- Intention
  - "The Governor's plan will focus on lower income Arkansans who earn between $0 and $20,999 annually…"

  - *"I am excited to unveil this new round of tax cuts as a part of my continued commitment to flattening the state income tax. This cut moves the state toward that goal by removing the tax burden on the lowest income Arkansans."*

Example: 2016 Arkansas Tax Cut

- Impact

All Arkansas Residents, 2016 Incomes

2016 Income	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less than $18,000	$18,000 – $32,000	$32,000 – $53,000	$53,000 – $87,000	$87,000 – $168,000	$168,000 – $394,000	$394,000 – Or More
Average Income in Group	$11,000	$25,000	$42,000	$68,000	$110,000	$232,000	$969,000

2016 "Low-Income" Tax Cut

	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
% with Income Tax Cut	12%	33%	40%	40%	20%	2%	1%
Avg. Tax Cut for Those w/Cut	−67	−112	−114	−135	−196	−98	−119
Share of Tax Cut	5%	21%	26%	30%	18%	0.3%	0.05%

5% Refundable Credit

	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
% with Income Tax Cut	32%	35%	28%	—	—	—	—
Avg. Tax Cut for Those w/Cut	−109	−159	−112	—	—	—	—
Share of Tax Cut	26%	42%	24%	—	—	—	—

Source: Institute on Taxation and Economic Policy, January 2017

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Principles to Guide Tax Reform

- Adequacy, Sustainability
- Neutrality, Equity
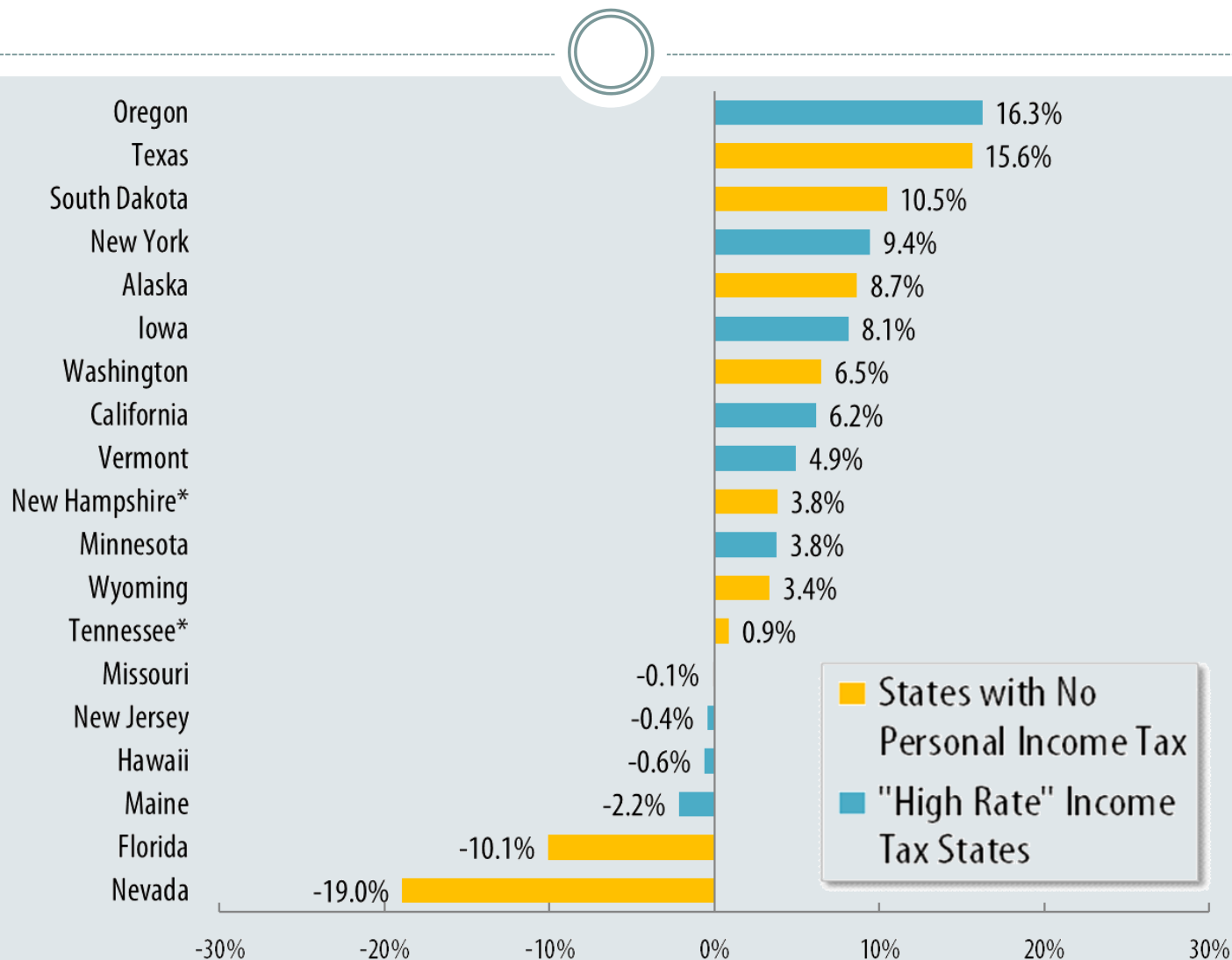- Simplicity, Transparency
- Competitiveness

Values of Taxation

- Adequacy, Sustainability
- Neutrality, Equity
- Simplicity, Transparency
- Competitiveness

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Economic Growth in States with High Income Taxes and No Income Taxes
Growth in Real GDP per Capita, 2005-2015

State	Growth
Oregon	16.3%
Texas	15.6%
South Dakota	10.5%
New York	9.4%
Alaska	8.7%
Iowa	8.1%
Washington	6.5%
California	6.2%
Vermont	4.9%
New Hampshire*	3.8%
Minnesota	3.8%
Wyoming	3.4%
Tennessee*	0.9%
Missouri	-0.1%
New Jersey	-0.4%
Hawaii	-0.6%
Maine	-2.2%
Florida	-10.1%
Nevada	-19.0%

Legend:
- States with No Personal Income Tax
- "High Rate" Income Tax States

Sources: Federation of Tax Administrators, US Bureau of Economic Analysis

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How Does Arkansas Fare?

- Adequacy
- Sustainability
- Neutrality, Equity

How Does Arkansas Fare?

- Adequacy
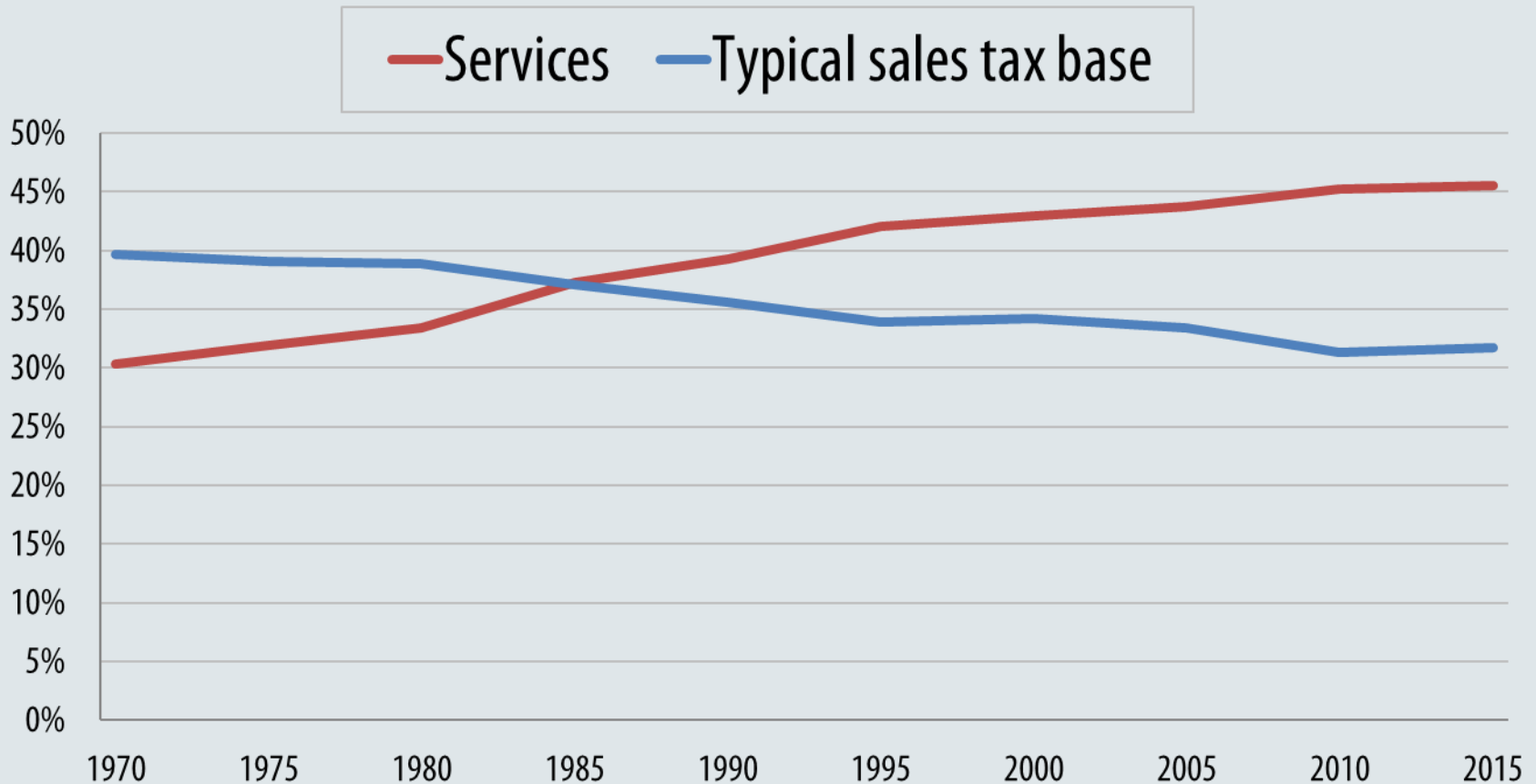- **Sustainability**
- Neutrality, Equity

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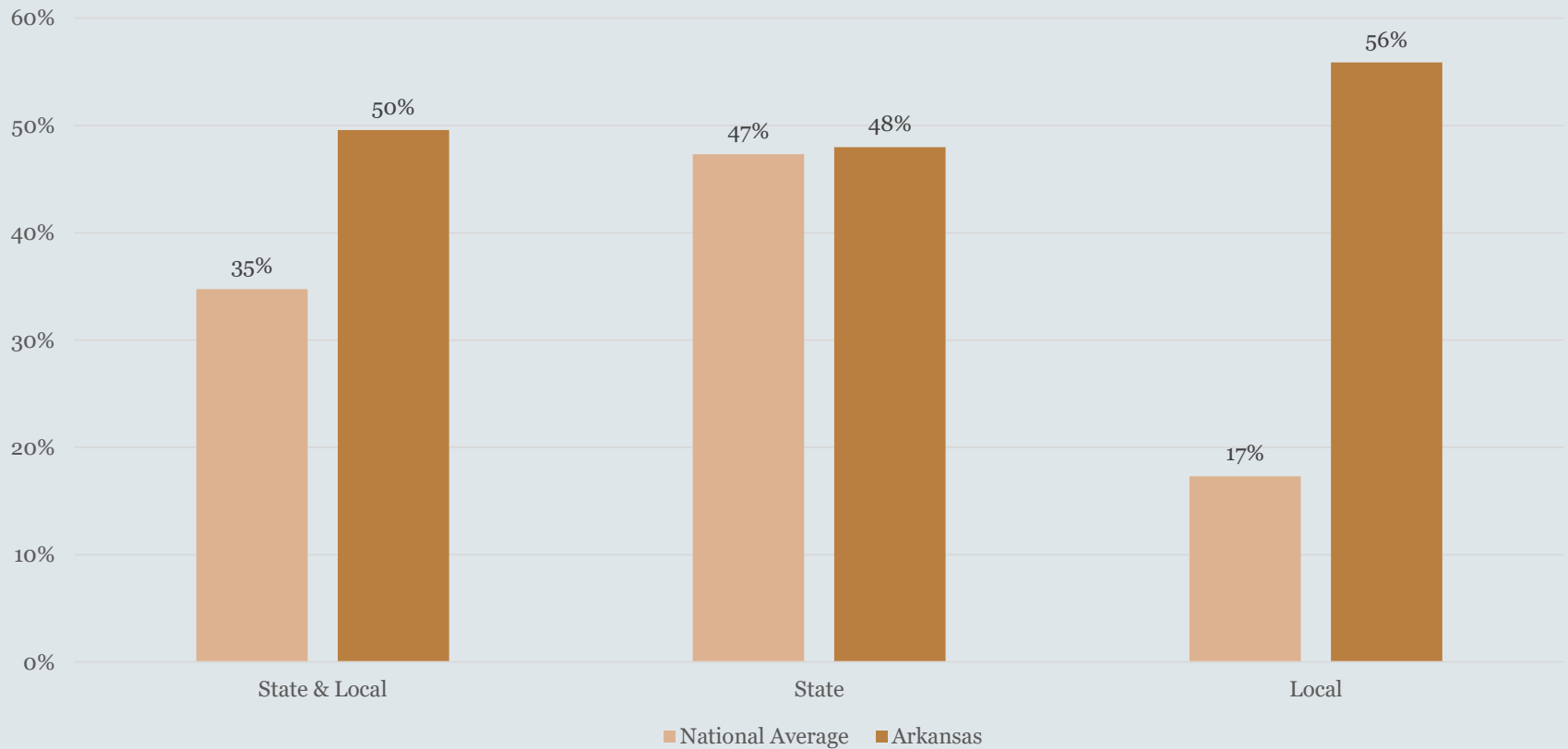
Base Erosion Over Time

Source: US Bureau of Economic Analysis, *National Income and Product Accounts, Table 2.4.5U*

How Does Arkansas Fare?

- Adequacy
- Sustainability
- **Neutrality** (aka Equity)

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How Does Arkansas Fare?

ARKANSAS STATE & LOCAL TAX TABLE

Income		Rate
$0	$21,000	11.9%
$21,000	$34,000	12.0%
$34,000	$53,000	11.3%
$53,000	$86,000	9.8%
$86,000	$179,000	9.2%
$179,000	$482,000	8.1%
> $482,000		6.8%

CALCULATE YOUR TAX

Step 1. Enter your income.

$80,000

Step 2. Find your tax rate from the table above.

9.8%

Step 3. Multiply amount entered in Step 1 by rate entered in Step 2.

$80,000 * 9.8%

Step 4. Pay this amount in taxes.
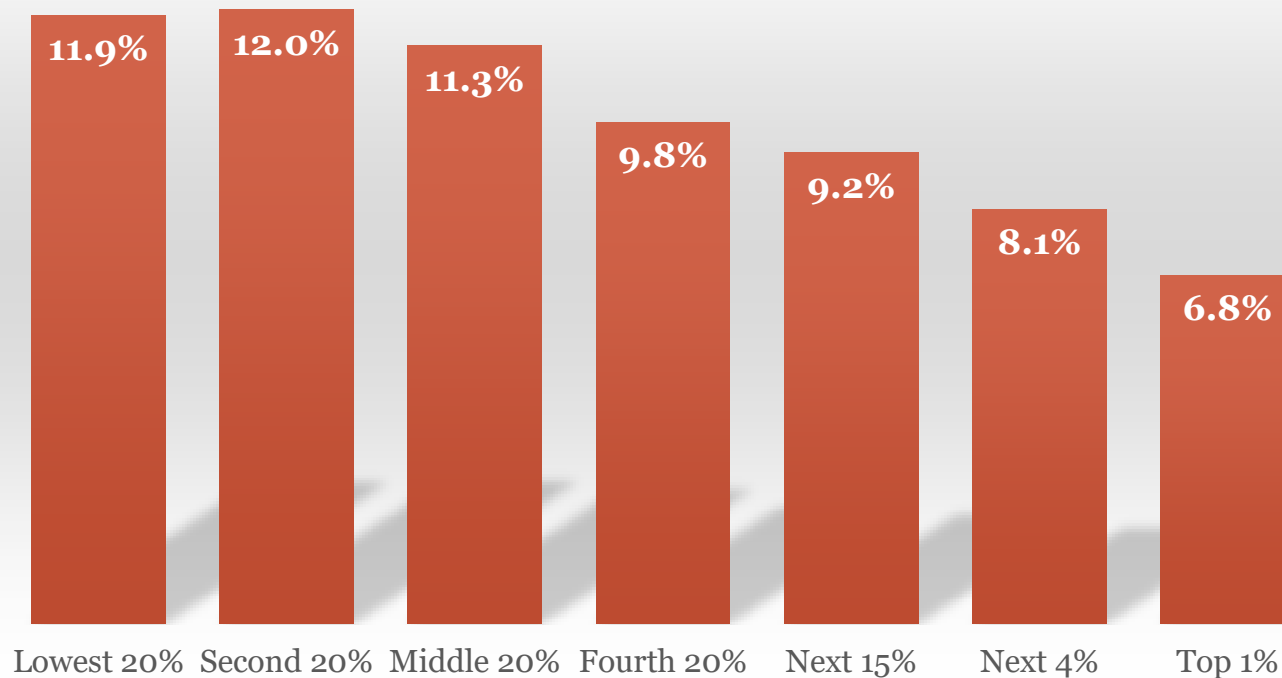
$7,840

TO:

Arkansas State Income Tax

P.O. Box 1000

Little Rock, AR 72203-1000

State/Local Tax Codes are Regressive
Taxes as share of income by income group

Arkansas

11.9%	12.0%	11.3%	9.8%	9.2%	8.1%	6.8%
Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%

Income Inequality Index

Appendix B: ITEP's Tax Inequality Index

Rank	State	Index	Lowest 20%	Middle 60%	Top 1%	Ratio of Poorest 20% to Top 1%	Ratio of Middle 60% to Top 1%
1	Washington	−12.6%	16.8%	10.1%	2.4%	687%	412%
2	Florida	−9.5%	12.9%	8.3%	1.9%	664%	429%
3	Texas	−8.5%	12.5%	8.8%	2.9%	433%	307%
4	South Dakota	−8.4%	11.3%	7.9%	1.8%	619%	431%
5	Illinois	−8.1%	13.2%	10.9%	4.6%	289%	238%
6	Pennsylvania	−7.3%	12.0%	10.1%	4.2%	286%	241%
7	Tennessee	−7.3%	10.9%	8.4%	3.0%	366%	280%
8	Arizona	−7.1%	12.5%	9.5%	4.6%	272%	207%
9	Kansas	−6.9%	11.1%	9.2%	3.6%	310%	258%
10	Indiana	−6.6%	12.0%	10.6%	5.2%	231%	204%
11	Arkansas	−6.4%	11.9%	11.1%	5.6%	212%	197%

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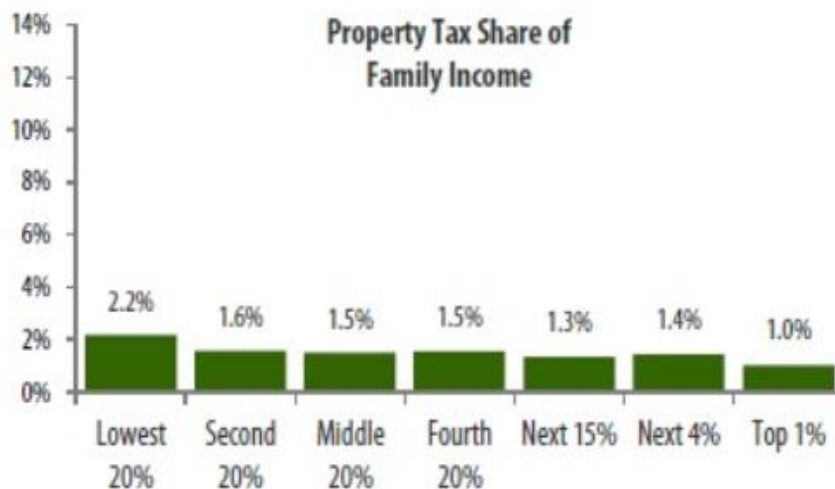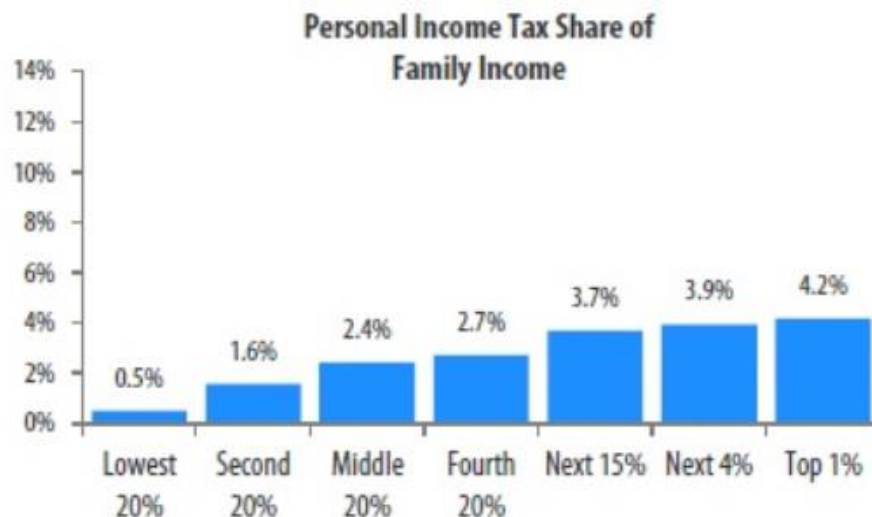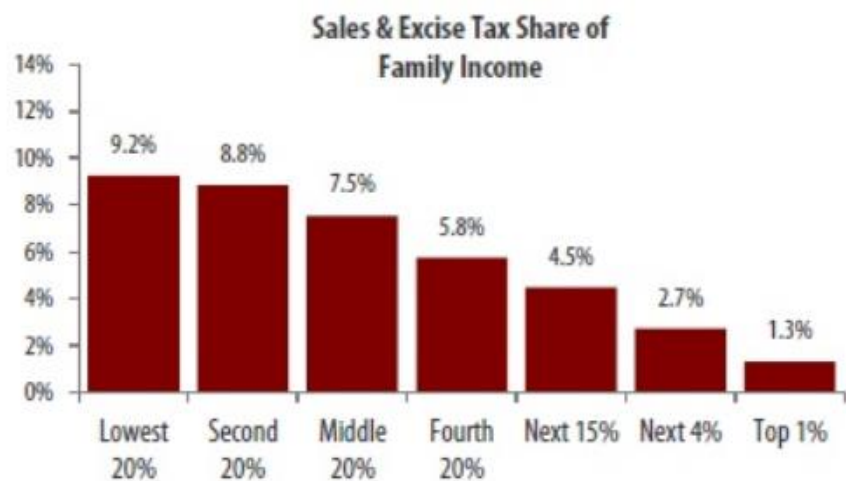INSTITUTE ON TAXATION AND ECONOMIC POLICY

Highest Taxes on the Poor

The 10 States with the Highest Taxes on the Poor

State	Taxes Paid by Bottom 20%
Washington	16.8%
Hawaii	13.4%
Illinois	13.2%
Florida	12.9%
Rhode Island	12.5%
Arizona	12.5%
Texas	12.5%
Indiana	12.0%
Pennsylvania	12.0%
Arkansas	11.9%

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This regressive pattern results from the interaction between personal income taxes, sales and excise taxes, property taxes, and other taxes.
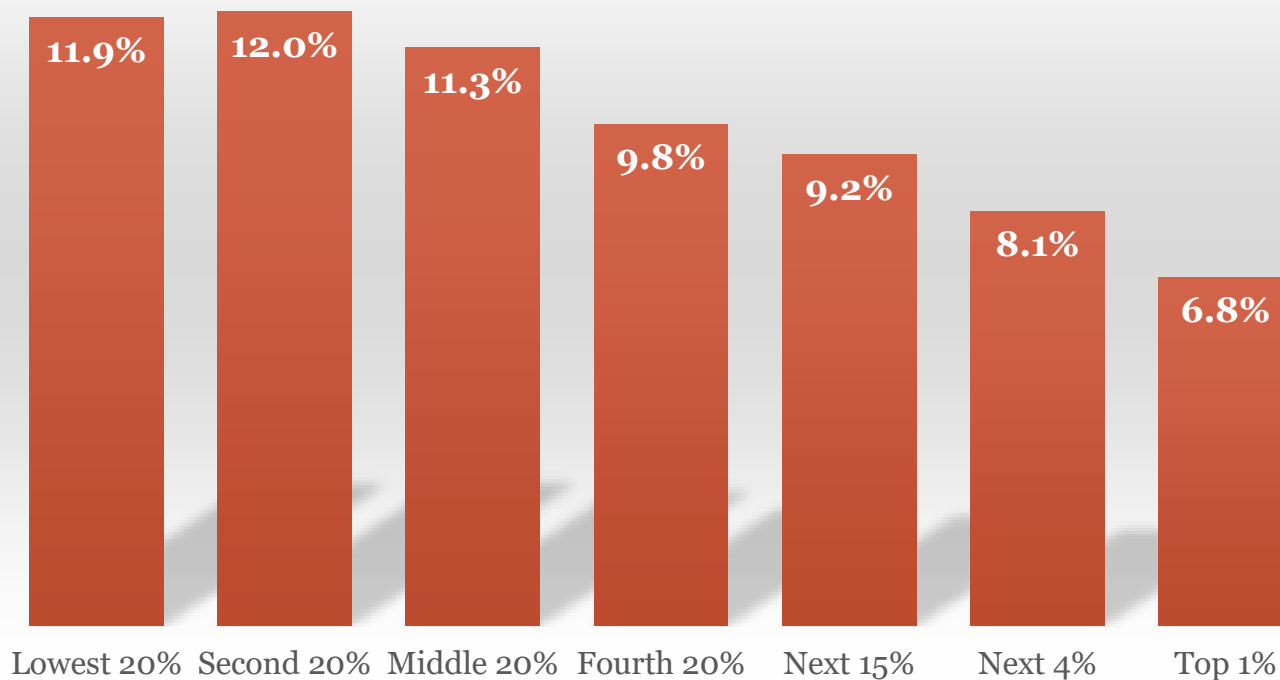

Sales & Excise Tax Share of Family Income

Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
9.2%	8.8%	7.5%	5.8%	4.5%	2.7%	1.3%

Personal Income Tax Share of Family Income

Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
0.5%	1.6%	2.4%	2.7%	3.7%	3.9%	4.2%

Property Tax Share of Family Income

Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
2.2%	1.6%	1.5%	1.5%	1.3%	1.4%	1.0%

State/Local Tax Codes are Regressive
Taxes as share of income by income group

Arkansas

|	
Lowest 20%: 11.9%	
Second 20%: 12.0%	
Middle 20%: 11.3%	
Fourth 20%: 9.8%	
Next 15%: 9.2%	
Next 4%: 8.1%	
Top 1%: 6.8%	

Prominent Features of Regressive Tax Systems

- High reliance on sales / consumption taxes
- Groceries included in sales tax base
- Income taxes
  - Low
  - Flat
  - Nonexistent
- Lack of refundable credits to offset regressive taxes

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Wide Variation in "Progressive" Income Taxes

Distribution of Personal Income Taxes in Alabama, Arkansas, and California
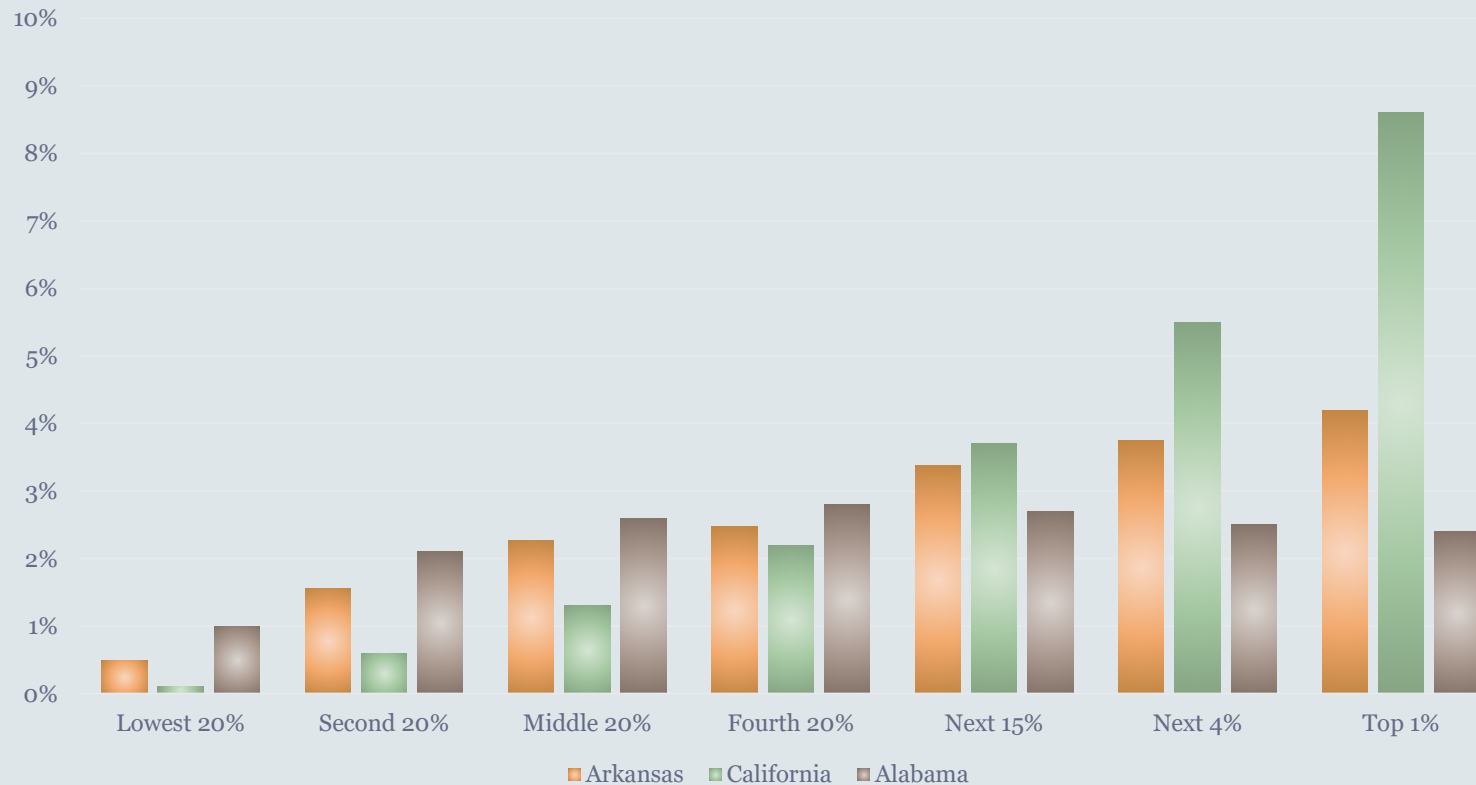
Recommended Reforms

- **Modernize the sales tax**

- Avoid harmful shifts from the Income to Sales Tax

- Enact a refundable Earned Income Tax Credit (EITC)

Offer a Targeted Credit instead of a Broad Exemption

- Grocery exemption cost approximately $190 million in 2018

- Exemption vs. Refundable Credit:
  - Lost tax revenues
  - Targeting
  - Volatility
  - Administrative costs

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Credit Options

Credits Designed to Offset Sales Tax/Taxes on Food

State	Description of Credit
AZ	Refundable "Increased Excise Tax Credit" for low-income taxpayers of all ages
HI	"Refundable Food/Excise Tax Credit" for taxpayers with FAGI below $50,000. In 2016, eligibility changed for single taxpayers to $30,000 FAGI
ID	Refundable "Grocery Credit" to all families regardless of income. The credit is $100 per family member. Elderly taxpayers receive an extra $10 per filer
KS	Targeted, nonrefundable food sales tax credit to families with income below $30,615 with at least one dependent or who are over 55 years of age; the maximum credit is $125 per exemption
ME	Targeted, refundable Sales Tax Fairness Credit to low- and middle-income families dependent on family size and income; the maximum credit is $225
NM	Refundable "Low Income Comprehensive Tax Rebate" for all low-income taxpayers
OK	Refundable "Credit/Refund of Sales Tax" for low-income taxpayers of all ages

Credit Options

- Design choices:
  - Refundability a must
  - Family Size?
  - Income test?
  - Phase out?

- Earned Income Tax Credits (EITC) good alternative / complementary policy

Source: Maine Sales Tax Fairness Credit

If your filing status is **Married filing jointly** or **Qualifying widow(er)**, find the amount for your income and number of exemptions below:

If Schedule PTFC/STFC, line 3 is:		And the number of Exemptions is (Form 1040ME, line 13)*:			
At least:	But not more than:	1	2	3	4+
0	40,100	125	175	200	225
40,101	41,100	105	155	180	205
41,101	42,100	85	135	160	185
42,101	43,100	65	115	140	165
43,101	44,100	45	95	120	145
44,101	45,100	25	75	100	125
45,101	46,100	5	55	80	105
46,101	47,100	0	35	60	85
47,101	48,100	0	15	40	65
48,101	49,100	0	0	20	45
49,101	50,100	0	0	0	25
50,101	51,100	0	0	0	5
51,101	52,100	0	0	0	0

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Credit Options

- Credit Option 1:
  - Refundable sales tax credit of $75 per filer and dependents
  - Available up to $75,000 for taxpayers without children; increase income eligibility by $5,000 for each kid up to maximum of $100,000
  - Cost: $119 million

- Credit Option 2:
  - Refundable sales tax credit of $125 per filer and dependents
  - Available up to $50,000 for taxpayers without children; increase income eligibility by $5,000 for each kid up to maximum of $75,000
  - Cost: $190 million

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Credit Options

Impact of Increasing Sales Tax Rate on Food from 1.5 to 6.5% in Arkansas
2018

2018 Income Groups	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Tax Change as % of Income	0.5%	0.4%	0.3%	0.2%	0.2%	0.1%	0.03%
Average Tax Change	+59	+99	+124	+160	+204	+277	+378
Share of In-State Tax Change	9%	15%	18%	24%	23%	8%	3%

Sales Tax Credit 1, $75 up to $75,000

	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
	-1.4%	-0.4%	-0.2%	-0.1%			
Average Tax Change	−174	−102	−98	−41			

Sales Tax Credit 2, $125 up to $50,000

	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Tax Change as % of Income	-2.3%	-0.6%	-0.4%	-0.02%			
Average Tax Change	−296	−179	−166	−16			

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Recommended Reforms

- Modernize the sales tax

- Avoid harmful shifts from the Income to Sales Tax

- Enact a refundable Earned Income Tax Credit (EITC)

Arkansas' Income Taxes Fall More on Well-off, Sales Taxes Take More from Typical Families
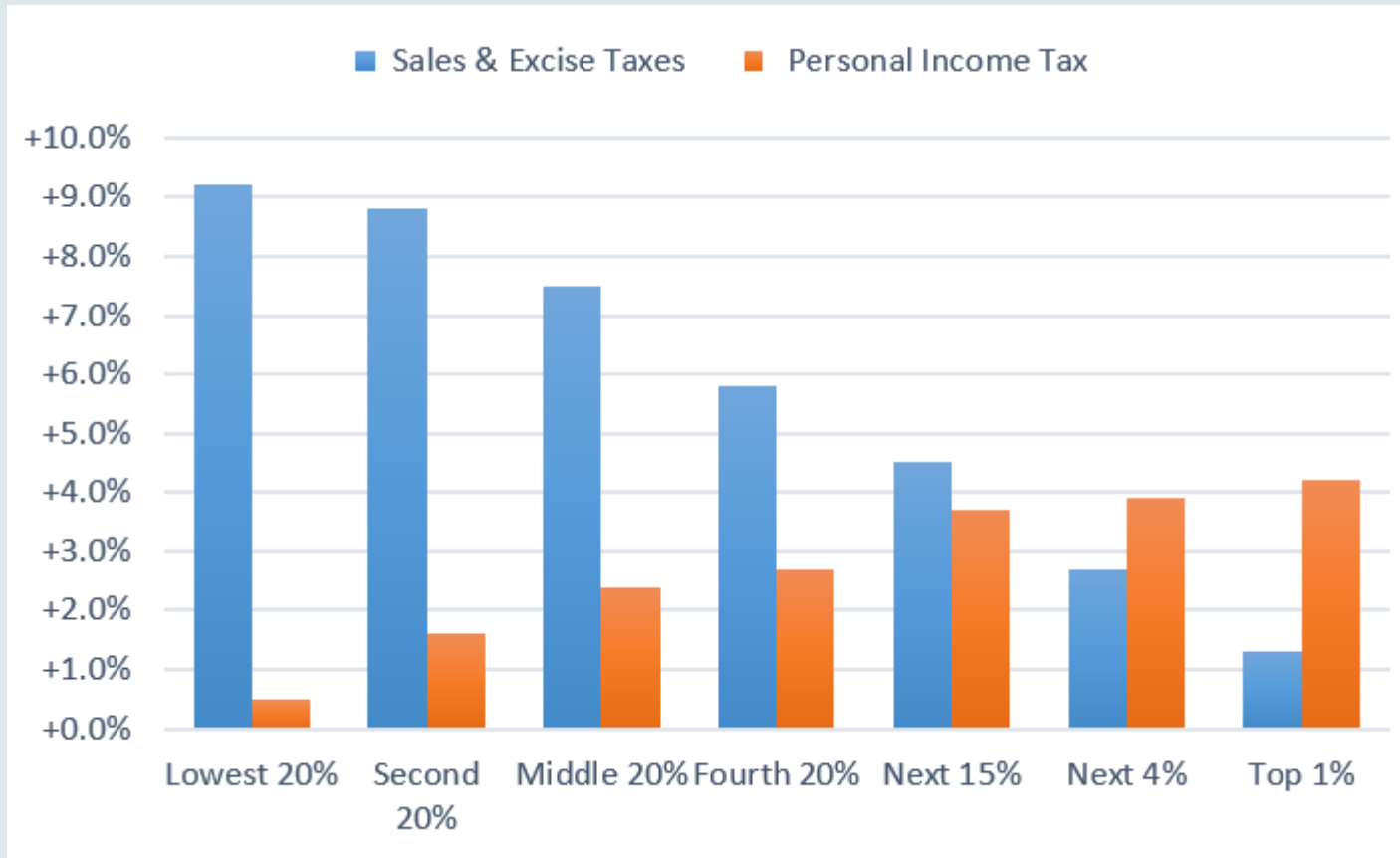
Lessons from Kansas

- Kansas Gov. Brownback and legislators enacted a nearly $800 million personal income tax cut
  - Exempted all pass through income from PIT
  - Repealed low-income tax credits
  - Reduced tax rate structure from three brackets to two and lowered rates.
  - Later hiked sales and cigarette taxes

Impact of Kansas Tax Changes Between 2012 and 2015

2015 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Tax Change as % Income	1.5%	0.2%	-0.1%	-0.4%	-0.7%	-1.2%	-1.9%
Average Tax Change	$197	$66	-$29	-$316	-$983	-$3,587	-$24,632

Lessons from North Carolina

- Hoped for economic gains haven't happened

  o Before 2014 cuts, NC outpaced nation and performed in line with neighboring states even with highest income tax rates in the region (and higher rates than today).

  o Since 2014 cuts, lagging GA & SC in GDP and private sector job growth and lagging nation's growth
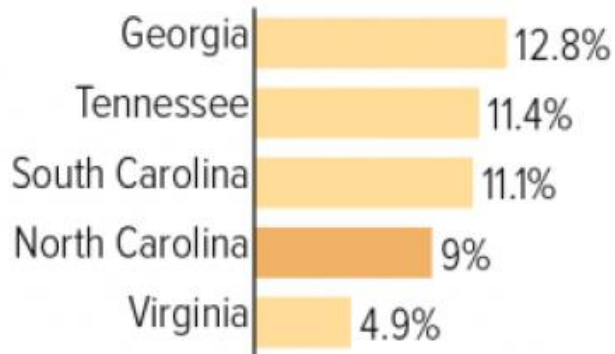
- The budget crisis is coming

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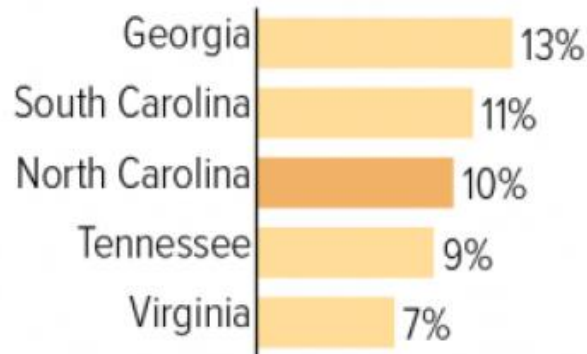
Lessons from North Carolina

North Carolina Not Showing Exceptional Growth Since Cutting Taxes

Growth in private-sector gross domestic product, Oct. 2013-Sept. 2017, adjusted for inflation

Georgia	12.8%
Tennessee	11.4%
South Carolina	11.1%
North Carolina	9%
Virginia	4.9%

Growth in private-sector jobs, Dec. 2013-Dec. 2017

Georgia	13%
South Carolina	11%
North Carolina	10%
Tennessee	9%
Virginia	7%

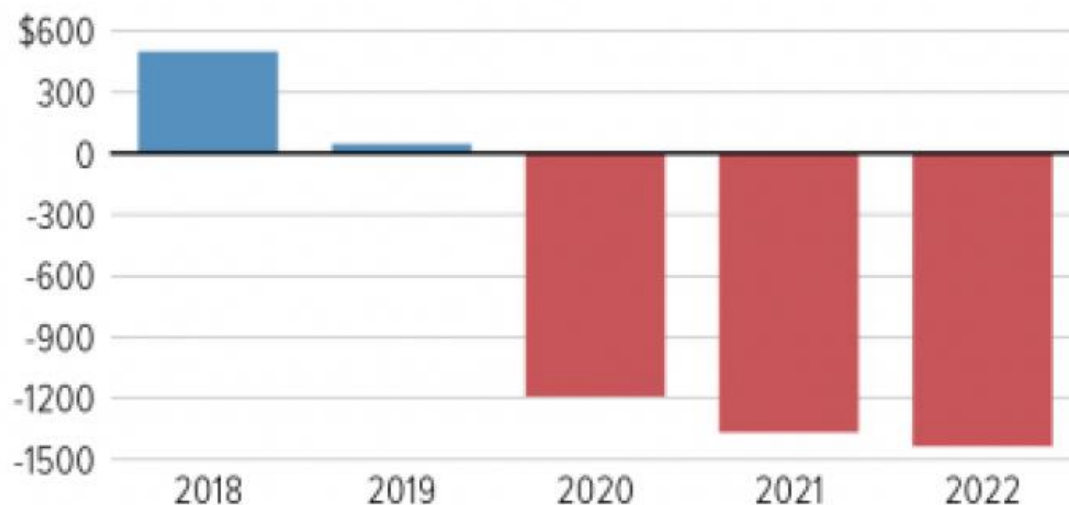Source: Bureau of Economic Analysis and Bureau of Labor Statistics

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Lessons from North Carolina

Large Budget Shortfalls Loom for North Carolina Due to Tax Cuts

Estimated end-of-year general fund balance, in millions

Note: Assumes that current laws remain in effect, including the tax cuts, and that policymakers fund current levels of services in programs, as adjusted by inflation and growth in enrollment. Estimate excludes one-time revenue, such as withdrawals from the "rainy day" fund or unused appropriations.

Source: Fiscal Research Division, North Carolina General Assembly

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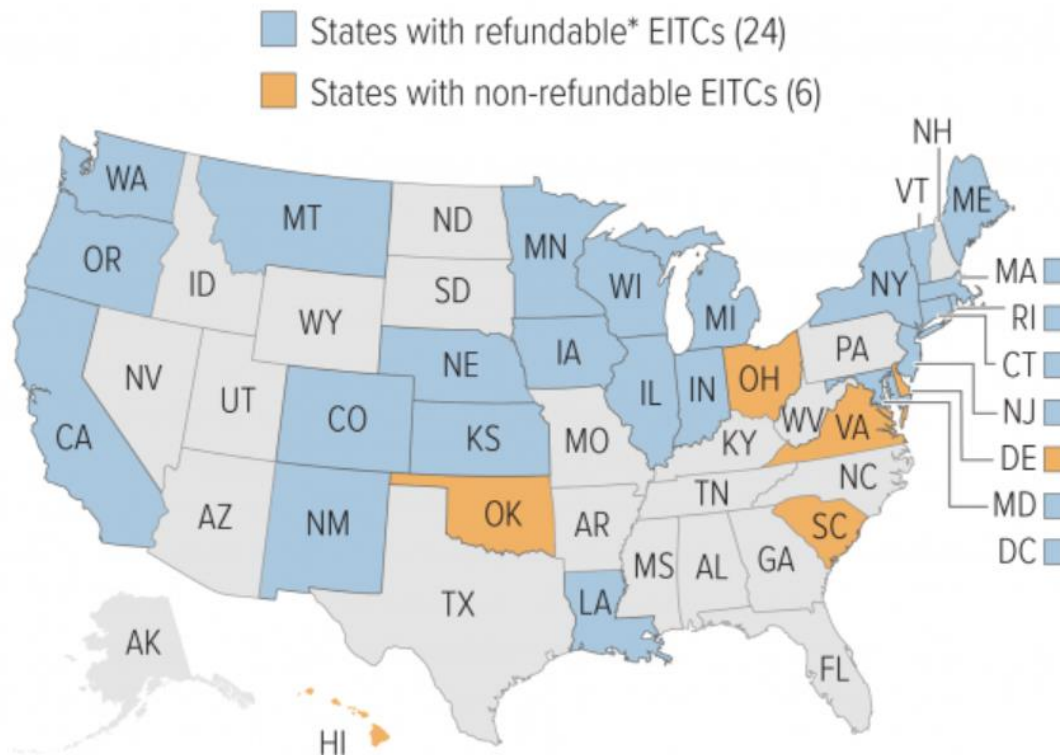
Recommended Reforms

- Modernize the sales tax

- Avoid harmful shifts from the Income to Sales Tax

- Enact a refundable Earned Income Tax Credit (EITC)

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Earned Income Tax Credits (EITC) in the States

Twenty-nine States and D.C. Have Enacted EITCs

As of 2017

States with refundable* EITCs (24)

States with non-refundable EITCs (6)

*Refundable EITCs give working households the full value of the credit they earn even if it exceeds their income tax liability.

Source: CBPP analysis

Earned Income Tax Credit (EITC) Distribution
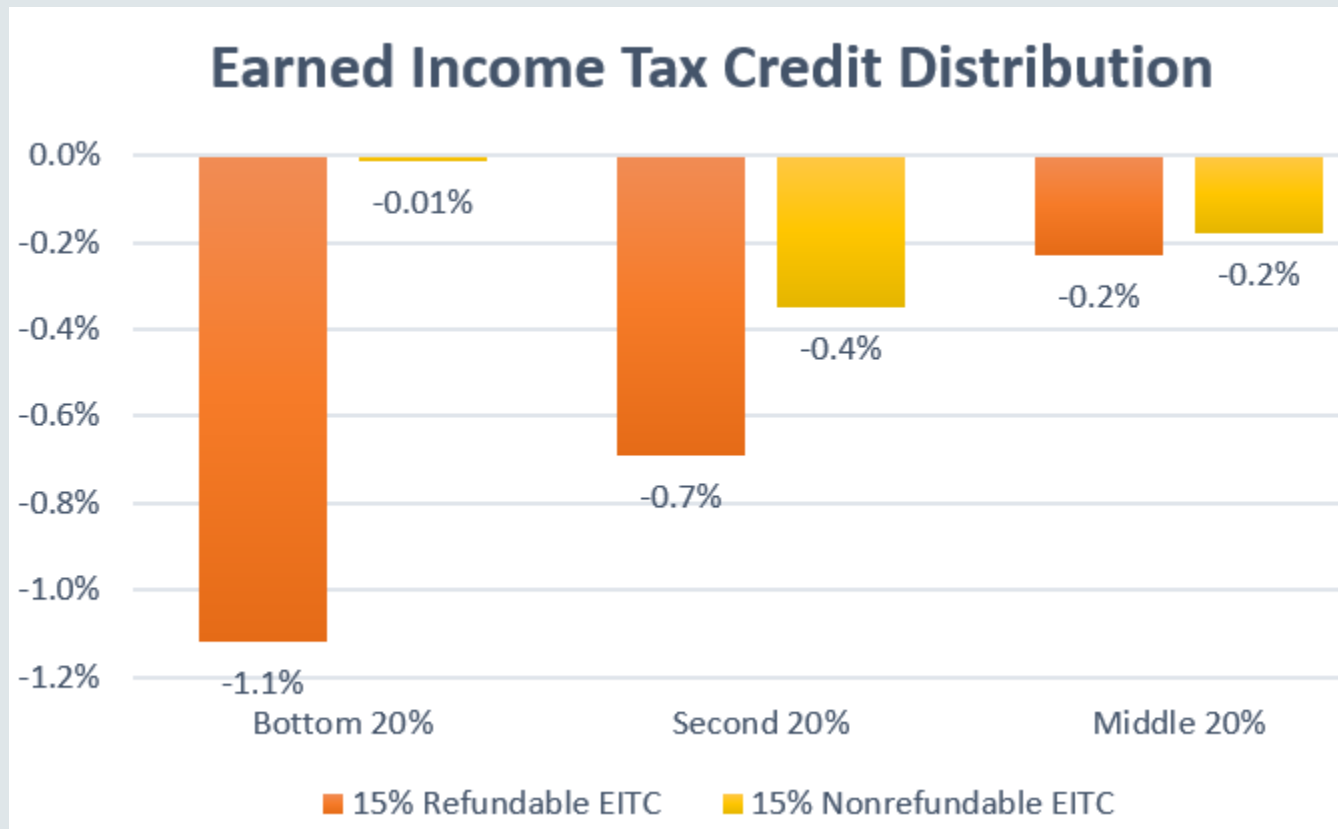
Earned Income Tax Credit (EITC) Distribution

	Bottom 20%	Second 20%	Middle 20%
15% Refundable Credit			
Tax Change as % of Income	−1.1%	−0.7%	−0.2%
Average Tax Change	−129	−174	−96
% with Income Tax Cut	33%	36%	29%
Avg. Tax Cut for Those w/Cut	−388	−489	−330
Share of Tax Cut	30%	40%	22%
15% Nonrefundable Credit			
Tax Change as % of Income	−0.01%	−0.4%	−0.2%
Average Tax Change	−1	−89	−74
% with Income Tax Cut	4%	26%	27%
Avg. Tax Cut for Those w/Cut	−37	−337	−273
Share of Tax Cut	1%	52%	44%

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Summary

By…

- Modernizing the sales tax

- Avoiding harmful shifts from the Income to Sales Tax

- Enacting a refundable Earned Income Tax Credit (EITC)

…Arkansas lawmakers can improve the adequacy, sustainability, and neutrality/equity of its tax system, thereby ensuring it has the resources to meet the needs for public goods today and in the future and raises those resources in a way that doesn't advantage or disadvantage certain residents over others.

Questions?

Thank you for your time and attention!

Contact Info

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www.itep.org

About the ITEP Microsimulation Model

- A **tax incidence model**. Built in 1994-1996, but still evolving in 2016

- 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**

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Data Sources