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REBUILDING OUR FISCAL FOUNDATION:

Seven steps to overcoming Arkansas' long-term structural budget deficit

By James Metzger and Ginny Blankenship

EXECUTIVE SUMMARY

Many sighs of relief were heard recently when state economists announced there would be no shortfall in state revenues. But that relief may be temporary, just like the estimated surplus.

Arkansas' unstable revenue foundation is cracked. We focus too much time and energy on filling the cracks: looking for ways to cover shortfalls for critical programs. We should be spending that effort working to make programs more efficient and effective.

This "structural budget deficit" is defined as the chronic inability of state revenues to grow in tandem with economic growth and the cost of government.

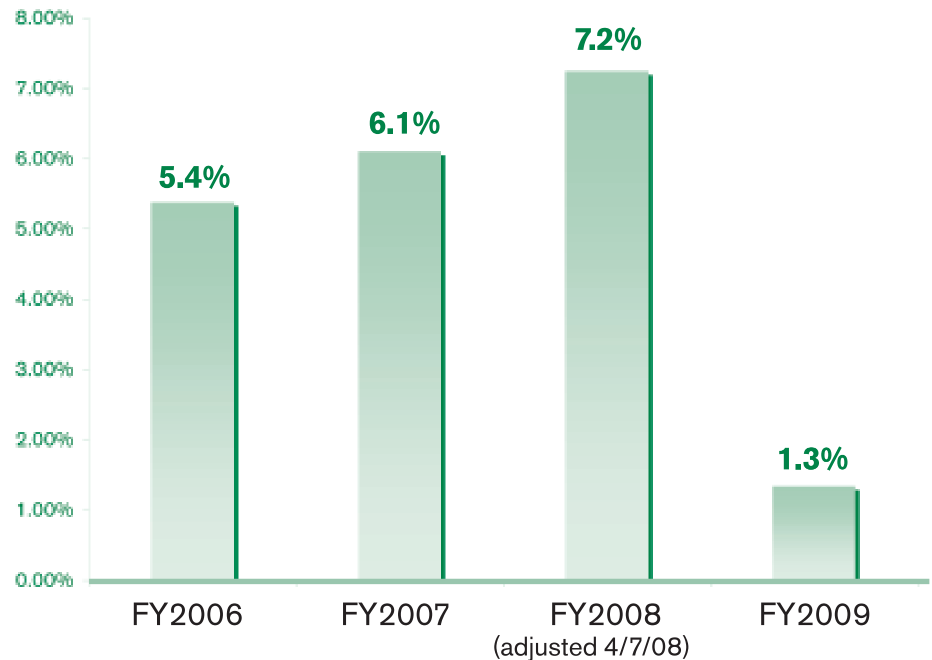
Arkansans shouldn't have to wait for last-minute forecasts or a post-mortem analysis of the fiscal year to know whether critical services will be disrupted. Likewise, we can't hope for unexpected windfalls and selective tax increases to finance everything from core services to new innovations.

We need to modernize our tax and budget system to allow the state economy to grow and our people thrive in the 21st century, including:

1. Expanding the sales tax base to reflect the economic shift from goods to services;
2. Mitigating the local revenue losses that property tax caps are causing in certain areas of the state and their unintended consequences for school funding;
3. Closing corporate income tax loopholes, for example, by requiring combined reporting of profits from out-of-state subsidiaries, as is now required in many other states;
4. Revitalizing and strengthening the state personal income tax to respond more efficiently to changes in the state economy;
5. Ensuring that the state is prepared to capture tax revenue from Internet sales as soon as it is allowed under federal law;
6. Reversing the expiration of the estate tax on wealthy estates, possibly setting a higher threshold but maintaining the basic principle of taxing large wealth transfers; and
7. Establishing a rainy day fund for essential state services such as health care and education, which are crucial for the well-being of the state's children and families.

INTRODUCTION

Arkansas's state and local governments play an important role in providing a wide variety of critical services to their citizens. They ensure that our children and the elderly have adequate health care; that roads and parks are well maintained; and that our public schools and universities are excellent places to learn. During these tough economic times, our government plays an especially vital role in helping meet the basic needs of its citizens. State budget cuts, such as the recent announcement to slash Arkansas's budget by $107 million (2.4%) for fiscal year 2009, hit our most vulnerable children and families the hardest.[1]



Source: AACF calculations of Arkansas Department of Finance & Administration data

Even when the economy is relatively strong or the state is lucky enough to have a modest or temporary surplus, Arkansas still struggles to raise adequate funds to pay for many crucial services. Arkansas is strapped by what is known as a "structural deficit," defined as "the chronic inability of state revenues to grow in tandem with economic growth and the cost of government."[2] In other words, revenues in Arkansas do not keep pace with the need to fund current programs and services.

This fundamental structural problem not only makes it difficult to provide essential services or meet new and emerging needs, but it also limits the state's ability to create a tax system that is fair to all of its citizens, especially low- and middle-income families who bear a disproportionate share of the tax burden.[3] The solution, however, is not simply to cut the budget and curtail vital services. Nor is it to increase taxes that take the greatest toll on low-income families, such as the 2004 increase in the state's sales tax to pay for education reform. Arkansas also should not rely on stop-gap measures, such as lotteries, when times get tough. Instead, to truly meet the needs of all state residents in the 21st century, Arkansas must undertake an overall modernization of its tax and budget system.

CRACKS IN THE FOUNDATION

Arkansas's constitution requires that the state balance its budget each year, which keeps us from spending beyond our means. The flip side of this equation is that: 1) the cost of providing government services like health care often rises faster than inflation; 2) the state's changing demographics mean that more and more people will need services each year;[4] and 3) natural, cyclical fluctuations in the economy make it hard to predict whether we will have enough revenue to meet this demand. The state legislature often responds to these challenges by raising taxes to cover shortfalls in bad times—and cutting taxes too much in good times. The result is an unpredictable and volatile climate for dozens of programs that help children and families.

The state's economic growth over most of the past 15 years has hidden our underlying structural budget deficit, and the Arkansas Department of Finance and Administration's admittedly conservative revenue forecasts have provided a cushion against unexpected revenue shortages during recent years. However, Arkansas is now facing an economic slowdown that has already begun to cripple the revenue for state services in other parts of the U.S.[5] Recent headlines indicate that the worst is yet to come.

Beyond the usual rise and fall of tax revenue coming into the state,

Arkansas suffers from a more insidious problem: the very structure of its tax system is outdated, archaic, and incapable of adjusting to the 21st century economy. In the past ten years, at least three national reports have warned that Arkansas is one of the top states at high risk for a structural budget deficit.[6] For example, a 2005 report by the Center on Budget and Policy Priorities (CBPP) showed that Arkansas relies too heavily on sales taxes and has lost a substantial amount of revenue through corporate tax loopholes. Arkansas also requires a "supermajority" (three-quarters) vote of the legislature to raise most taxes (such as income taxes), which makes tax reform more difficult to achieve. Unless steps are taken, the existing structural budget deficit will make it increasingly difficult to meet the critical needs of Arkansas's children and families in the future.

Consider the case of K-12 education. Arkansas has taken historic steps to reform its education system as a result of the *Lake View* school funding litigation. While the state should be applauded for this effort, much more work needs to be done. To keep the system at an "adequate" level and stay out of court, the state will have to regularly increase K-12 education spending. In fact, Act 108 of 2004, known as the "Doomsday" legislation, requires that spending for K-12 education must be kept at an "adequate" level at the expense of other spending needs, even if spending in other areas needs to be reduced or programs inadequately funded to meet the state's balanced budget requirement.

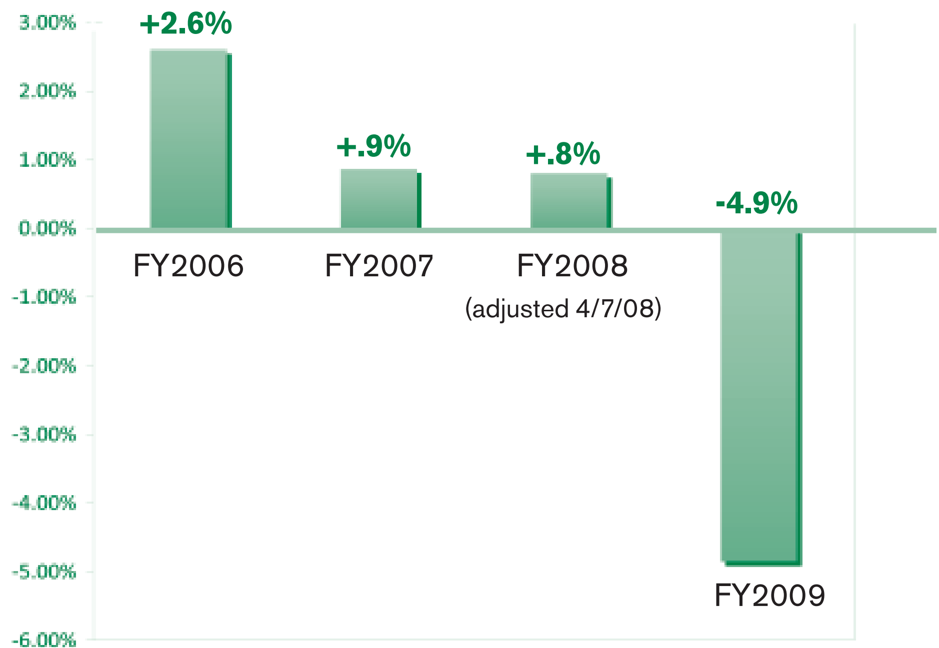
In addition, a recent study sponsored in part by Arkansas Advocates for Children & Families (AACF) found that new steps must be taken to reduce the educational achievement gap between rich and poor students and minority and non-minority students.[7] Closing this achievement gap will either require changing existing priorities for education spending, or generating new revenue.

The state's emerging critical needs are not limited to education. An increased demand for investment in health care programs like Medicaid will likely result as the costs of health care continue to rise faster than overall economic growth and as more employers drop coverage for children and families. In other areas, such as the state's welfare system for abused and neglected children, the state has for far too long neglected its responsibility. That system now borders on the verge of collapse.[8] For example, the chart below illustrates how funding for the state's Division of Children and Family Services (within the Department of Human Services) has not kept pace in the state's budget in recent years.

These needs, however, cannot be met simply by changing budget priorities and re-allocating how any new revenue is spent. Education already accounts for the lion's share of the state budget. In FY 2009, 44 percent ($1.8 billion) of Arkansas's general revenues are forecasted to go towards public schools.

While the mandate to put education first is a vital part of the state's effort to improve the adequacy and equity of its school finance system, an unfortunate trade-off is that as more state general revenue that is dedicated to school funding, less will be available for other, important public programs. This is especially true if state revenues are declining.

Percent Change in Available Revenue for DHS's Division of Children & Family Services



Source: AACF calculations of Arkansas Department of Finance & Administration data

7 REASONS FOR ARKANSAS'S STRUCTURAL BUDGET DEFICIT
— AND HOW TO FIX IT

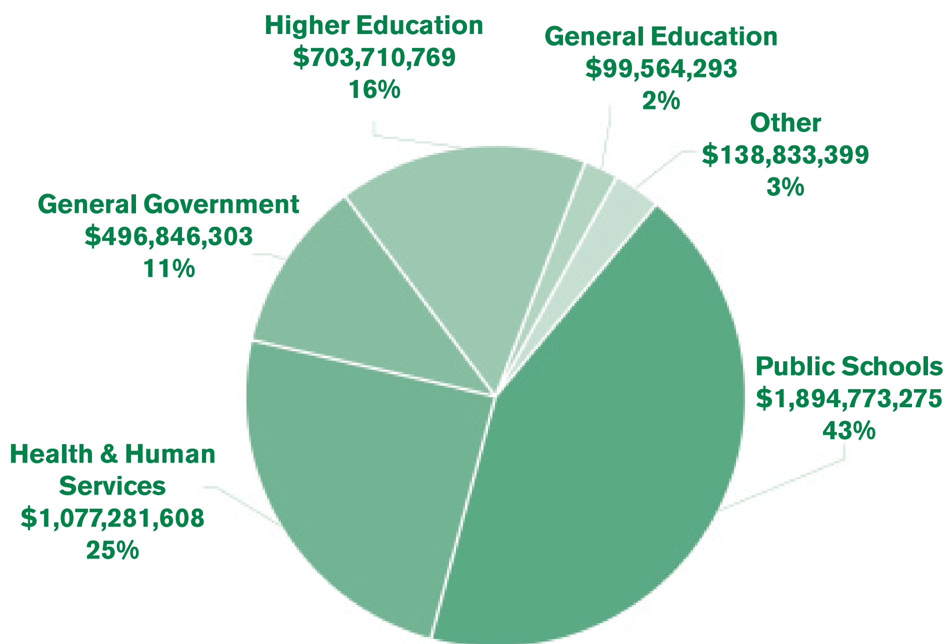
The following section explains how Arkansas's precarious budget situation came to be. It also offers solutions for making the state more fiscally responsible by modernizing its tax and budget system, while also protecting vital services for children and families.

1) Economic Shift From Goods to Services = Less Sales Tax Revenue

Over the past 20 years, the U.S. economy has seen a dramatic shift away from manufacturing and goods production into service areas such as trade, finance, health, real estate, and government. The Arkansas economy has followed this trend: in 2006, only one-quarter of the state's output still came from manufacturing, construction, and mining.[9] As services become a growing part of the economy, sales taxes bring in proportionately less revenue, because most sales taxes only apply to tangible goods, such as food or clothing. Therefore, the state must look for additional revenue through other means. While the sales tax base was expanded to include some services in 2004, many, such as legal services and advertising, remain exempt from taxation.

Solution: Broaden the sales tax base to include more services that are currently exempt from sales taxes. By relying less on sales tax revenue from goods, which hit the poor the hardest, the state would also move toward making our tax system less regressive as a whole.

Forecast of General Revenue Available for FY 2009



Source: AACF calculations of Arkansas Department of Finance & Administration data

2) Property Tax Caps, Cuts & Exemptions

Amendments 59 and 79 of the Arkansas constitution limit how much additional local funding for education and other services can be raised by local property taxes, even among relatively wealthy communities and individuals. These limits cap the amount of property tax increases that must be paid each year and exempt retirees from future increases, regardless of their income level. In addition, Amendment 79 provides an annual "homestead tax credit," now set at $350 per household (again, regardless of the ability to pay).

As a result of these caps, growth in assessed values in many counties has now become restricted to values that are well below the normally-recorded amounts. In 2006, for example, approved assessments for real property were about $22.9 billion.[10] That amount is $3.2 billion below the amount originally certified to the county boards—a nearly 14 percent drop in property wealth available to local taxing units in just four years. As a result, even wealthy counties often cannot raise enough money to cover rising education costs due to factors such as a rapid influx of students. They must therefore rely on the state's general revenue to meet the minimum amount of per pupil expenditures required under state law ($5,719).

These caps have created a system in which extra income and sales tax

revenue from all parts of the state–rich and poor, fast-growing and slow-to-no growth areas–must be used to support fast-growing, wealthier areas restricted from using rapidly increasing property values in their own jurisdictions. Having low- and middle-income taxpayers subsidize schools in wealthier areas, at a time when they are struggling to support schools in their own communities, is good for neither educational equity nor long-term fiscal policy.

More importantly, these caps on local property taxes require the state to raise more funding for education through other means that disproportionately hurt low- and middle-income families, such as the 7/8-cent sales tax increase of 2004. They also limit the state's ability to pay for other critical needs using state-level revenue sources.

Solution: Mitigate the local revenue losses that property tax caps are causing in certain areas of the state and their unintended consequences for school funding.

3) Corporate Tax Loopholes

Arkansas has missed many other opportunities to garner adequate revenue due to loopholes in the corporate income tax system. For example, large corporations in Arkansas are allowed to attribute portions of their revenue to out-of-state subsidiaries that are conveniently located in low- or no-income-tax states, thereby avoiding paying taxes in Arkansas. Most states that have estimated the resulting loss of revenue conclude that the adoption of combined reporting would increase corporate income tax receipts by approximately 10 to 25 percent.[11] For Arkansas, this would have represented an additional $38 to $95 million in corporate-tax revenue for FY 2008, based on corporate income-tax revenue that year of $379 million.[12]

Twenty-two states, including Texas, have recently passed reforms to their tax codes that require some kind of combined reporting.[13] Although the Arkansas General Assembly held hearings on a proposal in 2006, no bill has ever been voted on by a committee.

The lack of combined reporting is just one of many examples that demonstrate the need for the state to move toward a fairer, sustainable, and more transparent system of taxation and spending in Arkansas. Such a system must balance the need for good jobs and a healthy business environment with the state's responsibility to provide essential services for children and families.

Solution: Close corporate income tax loopholes by adopting the "combined reporting" system now used in many other states.

4) Income Tax Inequities

The income tax and the sales and use tax are the largest sources of state tax revenue. Of these two sources, only the state income tax has the potential to grow as quickly as increases in personal income. A structurally sound state tax system requires an income tax that is progressive in nature and applies to as much income as possible. However, Arkansas's top income tax bracket of 7 percent starts at a relatively low income level, making it less progressive than what is found in more structurally sound tax systems. For example, an individual earning just over $30,000 in Arkansas pays income tax at the same top rate as someone earning $300,000.

Arkansas also loses revenue because it gives favorable treatment to certain types of income that primarily benefit wealthier taxpayers, such as capital gains income. A capital gain is the profit or gain from the sale of an asset, such as stocks, bonds, and real estate. Arkansas excludes 30 percent of the income from the capital gains tax, resulting in lost revenue during both good and bad economic times.

Solution: Revitalize and strengthen the state personal income tax to respond more efficiently to changes in the state economy.

5) No Tax on Internet Sales

All states are losing potential revenue from sales taxes as consumers increasingly turn to the Internet for their purchases. The landmark *Quill* Supreme Court ruling of 1992 placed these sales under the protection of the interstate commerce clause, and suggested that the U.S. Congress "is now free to decide whether, when, and to what extent the States may burden

interstate mail-order concerns with a duty to collect use taxes."[14] Without federal intervention, individual states will not be able to institute sales taxes covering these growing areas of consumer activity. In addition, the Internet Tax Freedom Act, which prohibits states from taxing consumer-access fees for the Internet, makes it more difficult for revenues to increase as the future use of online communications continues to grow.

The good news is that nearly half of all states, including Arkansas, have prepared compatible plans to "streamline" eventual Internet sales taxation when federal laws allow it. The streamlining is intended to coordinate efforts so that little or no overlap would occur when and if they are permitted to begin taxing these sales.[15] In 2005, CBPP estimated that Arkansas could lose an estimated $230 to $360 million in revenue a year due to the growth of e-commerce—even greater than the national average as a share of total revenue. Congress recently voted to extend the moratorium on taxing Internet sales, so Arkansas and other states will have to wait longer before this revenue source becomes a reality.

Solution: Ensure that the state is prepared to capture tax revenue from Internet sales as soon as it is allowed under federal law.

6) Failure to "Decouple" from Federal Tax Changes

Arkansas suffers a major state revenue loss by failing to "decouple" its estate tax from the federal tax law. For more than 50 years, all states levied an estate tax that was then applied as a deduction against the larger amount of federal estate taxes due upon settlement of a deceased's property and assets. When Congress repealed the federal estate tax in 2002, most states (including Arkansas) did not "decouple" their estate tax from this change in federal law and therefore began losing billions of dollars annually in foregone revenue.[16] In 2005, CBPP estimated that Arkansas alone stood to lose $25 million per year by failing to decouple from the federal phase-out of the estate tax. Reinstating that tax in Arkansas would not require the usual supermajority vote by the state legislature, which is required of all other tax increases since 1934.

Solution: Reverse the expiration of the estate tax on wealthy estates, possibly setting a higher threshold but maintaining the basic principle of taxing large wealth transfers.

7) No Rainy Day Fund

Unlike the federal government, Arkansas cannot run a budget deficit during business downturns. However, unlike the vast majority of states, Arkansas does not have a "rainy day fund" (RDF) to help pay for critical services when state revenues are declining.

The recent budget surpluses in Arkansas have been a definite benefit to the state's children and families. Increased funding for K-12 schools, pre-K programs, and the tax relief provided by the decrease in sales taxes on groceries were good uses of this "extra" money, and have all improved our situation. Yet we cannot depend on those surpluses in the future, and like most states Arkansas cannot operate the state budget in the red. The state sets its biennial budget based on revenue forecasts that may not always be accurate, and when the economy turns downward the Revenue Stabilization Act requires that cuts be made rapidly in many services.

Without a RDF, our state does not have the flexibility to respond meaningfully to economic downturns. As AACF pointed out in an earlier report, "our state, like many of our families, lives paycheck to paycheck–unable to achieve long-term goals because of the need to focus on short-term contingencies."[17]

Meanwhile, 45 other states have created separate funds that are carried from one budget-year to the next in anticipation of years when revenues are lower due to economic downturns.[18] Most states have established multiple funds, and 38 of these states do not have limits on the use of at least one of the reserves. The sources of the funds are widely varied, generally coming from general budget reserves, tobacco settlement money, or mineral wealth. The funds are generally restricted in size to 3 to 10 percent of the state budget, and in most cases the funds must be replenished within one to five years when they are used. The advantage for these states is evident when one considers the many areas of discretionary spending that tend to suffer in times of economic slowdowns. Yet it is exactly during these periods of fiscal stress that increased aid is needed for children and families with limited means.[19]

Solution: Establish a rainy day fund for essential state services such as health care and education, which are crucial for the well-being of the state's children and families.

CONCLUSION

This report illustrates just a few of the many ways that a changing economy, antiquated tax systems, and lack of tax reform have left Arkansas with a fragile revenue system. Every year the needs of children and families are held hostage by the performance of the overall economy and the ability of the tax system to provide adequate revenue to fund services. This is why alleviating Arkansas's structural deficit is so important. Particularly during difficult economic times, structural deficits exacerbate the problem of revenue shortfalls and result in cuts in services to low- and middle-income families who need them the most. No single change will correct a pattern of structural weakness that has developed over the past 40 or more years in Arkansas's tax system, but some combination of reforms would help bring the system into the 21st century.

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