Arkansas Advocates for Children & Families
State Fiscal Analysis Initiative

PAYCHECK$ and POLITICS

Amy L. Rossi, Executive Director
Richard Huddleston, Research Director
James Metzger, Consulting Economist

State Government & Your Family's Budget
Issue IX, April 2002

INTRODUCTION & SUMMARY POINTS

In May 2001, Judge Collins Kilgore issued a historic ruling in the *Lake View School District v. Huckabee et al* – the state's current school funding formula is unfair to poorer school districts and provides inadequate funding for education. The case is expected to have major implications on education funding, other programs serving children and families, tax equity and fairness, and state and local tax systems.

This brief from the Arkansas State Fiscal Analysis (SFAI) is the third in a series devoted to the Lake View School District case, and examines sales tax exemptions and their impact on state tax revenues. Upcoming briefs will examine lotteries and gambling, property taxes, early childhood financing and low-income tax issues.

- "Mandatory" sale tax exemptions cost the state about $1.2 billion in lost revenue. "Discretionary" exemptions cost the state $582 million.
- Most of the revenue lost from discretionary sales tax exemptions directly benefits business or economic development (64%); 14% benefits nonprofit organizations, school districts or local governments; 5% benefits individuals; and 16% is of general benefit.
- At least 100 services, such as legal, accounting and medical, are not subject to sales taxes.
- Reducing or eliminating sales tax exemptions could generate new funding for education or other services, but also could impact the overall equity/fairness of the state tax system and economic development. The state should carefully examine the costs and benefits of reducing or eliminating exemptions.

A Source of Revenue for Public Education?

Sales Tax Exemptions

By Richard Huddleston

Times are tight for the state budget. Even prior to the September 11 terrorist attack, the U.S. and Arkansas economies were slowing and tax revenues were tight. In recent months, many states lowered revenue forecasts for the coming years.

On November 15, 2001, the Arkansas Department of Finance and Administration (DF&A) revised its revenue forecasts for the 2002 and 2003 fiscal years. The revised forecasts for both years was significantly lower than the original forecasts for those years released in March 2001. For 2002, DF&A projected revenues would be $142 million less than forecasted last March. For 2003, DF&A projects that revenues will be $160.7 million less than previously forecasted.

As a result of the slowdown in revenue, less money will be available to fund state government programs so budget cuts have been made (Arkansas' revenue stabilization law requires that cuts be made when projected expenditures are greater than anticipated revenues). A cut of $142 million was made in the 2002 fiscal year budget. Barring a large and quick turnaround in the economy, DF&A estimates that the 2003 budget will have to be cut by $160 million. Most state agencies have felt the impact, including public education and human services (through various cuts in state Medicaid programs).

The slowdown in revenue and associated budget cuts come at a time when state policy-makers and others are considering the implications of the recent court decision in the Lake View school funding case, and what it might mean for the state if the ruling is upheld by the Arkansas Supreme Court. If upheld by the Court, as most experts think it will be, the need for new state revenue will be greater than ever. Preliminary estimates are annual spending on education will have to be increased by $500 million to $1 billion.

This issue brief examines one possible revenue source — sales tax exemptions — that might be better utilized to help meet the state's growing need for tax revenue. Among the issues considered:

- How much state tax revenue is lost each year because of sales tax exemptions?
- How much control or discretion does the state have over sales exemptions?
- Who benefits from existing sales tax exemptions?
- What is the role of services in the

debate over sales tax exemptions; and
- What issues should the state consider in its examination of sales tax exemptions?

What Are Exemptions and Why Are They Important?

Sales tax exemptions exclude purchases of goods and services from the state sales taxes. Sales tax exemptions are "tax expenditures," preferences in the state tax code — in the form of exemptions, exclusions, credits, preferential tax rates, etc. — that reduce the state tax liability of individuals, businesses, or other organizations to achieve some "public" purpose. Tax expenditures, because they are losses to the state treasury, represent lost tax revenues that could have been used to fund other government programs, such as education, health care and child care.

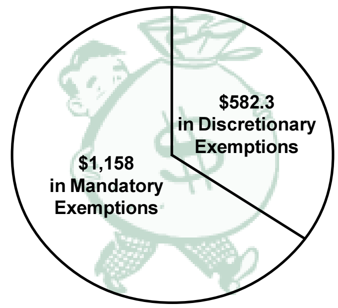
The Arkansas Sales and Use Tax

The Arkansas sales and use tax generates approximately $1.7 billion annually in revenue. The overall state sales tax rate is 5.125 percent. Actually, the sales and use tax has three components:

1. a general sales tax rate of 4.5 percent, the revenue from which goes into state general revenue;
2. a state sales tax of 0.125 percent for natural resources and conservation; and
3. a state sales tax of 0.5 percent (half a penny) replacing property tax revenue lost as a result of a new state constitutional amendment adopted by the voters in 2000.

Which items are subject to the Arkansas sales and use tax? In general, all tangible personal property (typically a finished or produced good, such as a CD player) is subject to the Arkansas sales and use tax unless otherwise exempted by state law. An exemption usually requires the Arkansas General Assembly to pass legislation specifically excluding an item from the sales and use tax.

STATE TAX REVENUE LOST FROM SALES TAX EXEMPTIONS
In Millions



Note: AACF calculations based on DF&A data

ARKANSAS SALES AND USE TAX EXEMPTIONS
Organized into Broad Categories of Exemptions

	Millions	Exemptions
Discretionary Exemptions		
Agricultural Exclusions of Goods for Resale, Export or Inputs	$167.0	12
Industrial/ Agricultural/ Newspaper Machinery	$166.9	8
Industrial Machinery	$134.2	3
Agricultural Machinery	$32.2	4
Newspaper Machinery	$0.5	1
Motor Fuel	$94.3	3
Nonprofit, Religious or Charitable Organizations	$72.2	22
Media (sale of newspapers, advertising, services)	$23.0	5
Low-income Households	$19.8	4
Other (sewage/garbage collections to car washes)	$14.7	15
Medical (prescriptions, insulin, medical equipment)	$8.4	4
School Districts and Other Educational Institutions	$7.9	8
Energy or Waste Fuel	$4.8	7
Aviation or Aerospace	$1.7	2
Local Governments	$1.6	6
SUBTOTAL	$582.3	97
Mandatory Exemptions		
Sales for Resale or Inputs into the Production of Goods	$1,097.5	8
Federal Government	$34.6	5
Interstate Commerce Clause	$25.9	10
SUBTOTAL	$1,158	23
GRAND TOTAL	**$1,740.3**	**120**

Source: Arkansas Department of Finance and Administration memo, October 30, 2001

TOP 20 DISCRETIONARY STATE SALES TAX EXEMPTIONS	Millions
Motor Fuel, Special Fuels	$93.4
Seed for Commercial Production of Agri Products	$81.3
Pollution Control Machinery, Equipment Manufacturers, Cites	$73.1
Nonprofit Hospitals, Sanitariums, Nonprofit Nursing Homes	$70.2
Manufacturing Machinery, Equipment	$54.9
Feedstuffs for Commercial Producation of Livestock, Poultry	$51.4
Machinery, Equipment for Exclusive, Direct Use in Farming	$32
Motor Vehicles Less than $2,500	$17.8
Advertising Space in Newspapers, Publications	$17.2
Agri Fertilizer, Chemical, Pesticide, Vaccine, Medicine	$16.2
Cotton, Cotton Seed, Lint Cotton, Baled Cotton	$13.8
Prescriptions, Oxygen at Retail Stores, Health Care Facilities	$7.4
Machinery, Equipment for Remanufacturing Used Parts, Re-treading Tires	$4.9
Used Property taken as a Trade-in	$4.6
Food in School, College Lunchrooms	$3.9
Natural Gas, Electricity in Steel Mills	$3.2
Motor Vehicles to Motor Vehicle Rental Businesses	$3
Newspapers	$2.9
Cotton Seed in its Original Production	$2.4
Used Manufactured Homes	$2.1

Note: This list excludes any mandatory exemptions, such as resale sales, purchases by the federal government, and interstate commerce clause exemptions.
Source: DF&A memo, October 30, 2001

DF&A occasionally produces a comprehensive list of sales tax exemptions and corresponding revenue losses. The most recent list contains more than 120 exemptions classified into 15 categories.

According to DF&A, sales tax exemptions result in the loss of $1.7 billion in tax revenue annually. But how much of this revenue loss is really under the state's control? Could the state really eliminate all of its existing exemptions if it wanted to do so? The answer is no.

Nearly 67 percent (about $1.2 billion) of the revenue lost from sales tax exemptions is because of "mandatory" exemptions. Mandatory exemptions are those over which the state has little, if any, control. Mandatory exemptions fall into three categories

1. sales for resale or inputs into the production of goods;
2. federal government exemptions; and
3. interstate commerce clause exemptions.

The largest category of mandatory exemptions is sales for direct resale and sales of materials that become physical ingredients of goods purchased by consumers. These exclusions cost the state treasury about $1.1 billion annually. Arkansas, like all other states with sales taxes, exempts resale items from the sales tax. Why? It is considered sound economic practice to do so. The sales tax is designed to be a tax on final products sold to consumers. If a tax were levied on goods at different stages of production, then some items would be taxed twice. States exempt resale items from the sales tax to avoid taxing the same item twice, also known as "double taxation." Examples in this category include cups, containers and wrappers sold to restaurants to dispense food items. Another is the sale of materials used by manufacturers to package finished products for delivery.

The state also has little control over two other categories of exemptions required under federal law. The state cannot tax sales to the federal government (i.e., food items purchased with federal Food Stamps), nor can it tax purchases exempt under the federal interstate commerce clause. These categories of exemptions result in the loss of $34.6 million and $25.8 million, respectively, in state tax revenue.

Discretionary Exemptions Still Equal Big Bucks

Although mandatory exemptions account for the lion's share of lost revenue, there are still big bucks to be had in sales tax exemptions. According to DF&A data, discretionary sales tax exemptions — those over which the state really does have control — cost Arkansas citizens nearly $582 million in lost state tax revenue annually.

Arkansas' existing sales tax exemptions include a mix of exemptions. The two largest categories of discretionary exemptions benefit businesses and corporations. These include exemptions for

1. industrial and agricultural machinery or equipment; and
2. agricultural producer purchases.

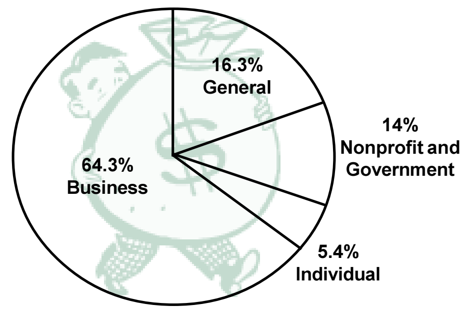
Together, these two categories represent about $333 million (57%) of the cost of discretionary exemptions.

According to DF& A, *industrial and agricultural machinery and equipment* is exempt in Arkansas and most states. Sales tax exemptions for machinery and equipment purchases cost the state about $167 million annually in forgone tax revenue. The largest exemptions for machinery and equipment purchases include

1. sales of pollution control machinery and equipment utilized by manufacturing or processing plants/ facilities or cities to reduce air or water pollution, $73 million;
2. sales of machinery or equipment used directly in manufacturing or processing, $55 million; and
3. sales of machinery/equipment used exclusively and directly in farming for commercial purposes, $32 million.

Similarly, exclusions of *purchases by agricultural producers* from the sales tax cost the state about $167 million annually in tax revenue. The most costly exemptions in this category include:

1. sales of feedstuffs used in commercial productions of livestock or poultry, $51 million;
2. sales of fertilizer, chemical, pesticides, vaccines, and medications used in treating livestock and poultry, $16 million; and
3. sales of cotton, cotton seed, lint cotton or baled cotton, $14 million.



Note: AACF calculations based on DF&A data

Although agriculture comprises the most expensive category, the costs of other exemptions are significant. Exemptions for nonprofit, religious or charitable organizations, for example, cost the state approximately $72 million in lost tax revenue annually. Exemptions for school districts and other educational institutions cost the state $7.9 million, and local governments, $1.6 million. Low-income households receive about $19.8 million annually through various sales tax exemptions.

Who Benefits from Sales Tax Exemptions?

The $582.3 million lost becauase of discretionary Arkansas sales tax exemptions each year go to groups of beneficiaries:

Business or Economic Development Benefit. Some exemptions provide relief to specific industries or were created with the intent of promoting economic development. Notable examples include sales of seed for commercial production of agricultural products and sales of manufacturing machinery and equipment. Exemptions for this purpose comprise about 64.3 percent of the value of all exemptions ($374 million).

Nonprofit and Government Benefit. Some exemptions reduce sales taxes for specific nonprofit, religious or charitable organizations, local governments, and school districts and educational institutions. The largest of these is the exemption for sales to hospitals, sanitariums, or nonprofit nursing homes. Exemptions for these purposes comprise 14 percent of the $582.3 million in exemptions ($82 million).

Individual Benefit. Some sales tax exemptions benefit individuals or certain populations of individuals. Examples include sales of the first 500 kilowatt hours of electricity per month to residential customers with household incomes less than $12,000; sales of used motor vehicles with values less than $2,500; and sales of prescription drugs when sold to patients by physicians or retail stores. All together, exemptions for individuals represent less than 6 percent of the cost of exemptions (about $32 million).

General Benefit. Other exemptions are available equally to businesses, individuals, nonprofits, local governments, and educational institutions. Exemptions that benefit everyone comprise about 16 percent of the value of sales tax exemptions. The largest example includes sales of motor fuel, an exemption that costs the state about $93 million annually.

But What About Services?

A major issue in sales tax exemptions is services. Arkansas, like many states, does not tax many services. A sales tax on services works in essentially the same way as a tax on the sale of goods. The vendor providing and selling the service adds the cost of the sales tax to the customer's bill and collects the tax from the customer. The retailer then remits the sales tax revenue to the state.

All finished goods are subject to the Arkansas sales and use tax unless specifically exempted under state law. The tax treatment of services is just the opposite. All services are presumed to be exempt unless specifically taxed under state law. Thus, for a particular service to be taxed, the Arkansas General Assembly must pass a law authorizing it be taxed.

Because most services are presumed to be exempt under state law, DF&A typically produces no list of exempt services and how much revenue is lost from not taxing particular types of services. However, a 1997 study by the Federation of Tax Administrators (FTA) provides some insights into the types of services that are taxed (or not taxed) in Arkansas.

According to the FTA, most services are not part of the Arkansas sales and use tax base (see sidebar "Services Exempt from the Arkansas Sales and Use Tax"). Notable examples of the types of exempt services include

- professional services — legal services, accounting, and medical;
- business services — sales of advertising time or space, packing and crating, and bail bond services; and
- personal services — barber shops and beauty parlors, debt counseling, and diaper services.

Occasionally, the Arkansas General Assembly adopts legislation taxing services. During 1992, for example, the Legislature levied sales taxes on certain services (debt collection, pool cleaning, lawn care and landscaping, auto parking, etc.,) as well as dues and fees from spa,health and fitness clubs (Act 5 of the 2nd Extraordinary Session of 1992).

Currently, no data is available for the sales tax revenue lost by not taxing services because such exemptions are not tracked by DF&A. The value of services, especially professional, business and personal, is very significant in Arkansas. For example, three services — legal, accounting, and medical — generate nearly $3.2 billion in annual receipts (based on inflation-adjusted data from the 1997 Census of Service Industries). Including these services in the state sales tax base would generate over $160 million in tax revenue annually.

Should the State Eliminate Discretionary Exemptions?
During the next year, state policy-makers will examine new ways to fund education and other state services. Sales tax exemptions likely will be one of the potential revenue

Services Exempt from the Arkansas State Sales Tax

Business Services
Sales of advertising space, time
Billboards
Radio and television, national advertising
Radio and television, local advertising
Newspapers
Magazines
Advertising agency fees (not ad placement)
Bail bond fees
Commercial art, graphic design
Commercial linen supply cleaning
Credit information, credit bureaus
Employment agencies
Interior design and decorating
Lobbying and consulting
Marketing
Packing and crating
Exterminating
Private investigation services
Process server fees
Public relations, management consulting
Secretarial, court reporting services
Security services
Sign construction, installation
Telemarketing on contract
Temporary help agencies
Test laboratories

Professional Services
Accounants, bookkeepers
Attorneys
Dentists
Engineers
Land surveyours
Medical testing laboratories
Out-of-hospital nursing services
Physicians

Fabrication, Installation and Repair Services
Labor, repairs, remodeling of real property
Custom processing on customer's property
Custom meat slaughtering, cutting, wrapping
Taxidermy

Personal Services
Barber shops, beauty parlors
Dating services
Debt counseling
Diaper services
Income from funeral services
Fishing, hunting guide services
Garment services
Gift, package wrapping services
Weight loss clinics, reducing salons
Coin-operated laundry, dry-cleaning services
Non-coin-operated laundry, dry-cleaning services
Massage services
Personal instruction (dance, golf, tennis)
Tax retern preparation
Water softening, conditioning
Computer Services
Software, modifications to canned program
Software, custom programs, professional services
Information services
Data processing services
Mainframe computer access, processing services

Automotive Services
Coin-operated car washing, waxing
Automotive read service, towing service
Auto service, except repairs, including paint, lube

Agricultural Services
Soil prep, custom bailing, other agri services
Veterinary services
Horse boarding, training (not race horses)
Pet grooming

Industrial and Mining Services
Metal, nonmetal, coal mining services
Seismograph, geophysical services
Oil field services (excluding repair)
Typesetting, plate-making services

Admission and Amusement Services
Admission to school, college sports events
Rental of films, tapes by theaters

Leasing and Rental Services
Limousine services (with driver)
Chartered flights (with pilot)
Construction Services
Gross income of construction workers
Carepentry, painting, plumbing, similar trades
Construction service (grading, excavating)
Water well drilling

Transportation Services
Income from intrastate transport of people
Local transit buses
Income from taxi operations
Intrastate courier services
Interstate air courier (billed in-state)

Storage Services
Food storage services
Fur storage services
Mini storage services
Cold storage services
Marina services
Marine towing services

Utility Services
Intrastate industrial, residential telegraph
Interstate industrial, residential telegraph
Electricity sold, used for making of aluminum by electrolytic reduction and in qualifying steel mills
Electricity (1st 500 KWH a month for residential customers with income no more than $12,000 a year)
Natural gas used in qualifying steel mills
Residential, industrial sewer, refuse services

Finance, Insurance and Real Estate Services
Services charges of banking institutions
Insurance services
Investment counseling
Loan broker fees
Property sales agents (real estate, personal)
Real estate management fees (rental agents)
Real estate title abstract services
Ticker tape reporting (financial reporting)

Note: The items on this list are generally considered to be exempt from the sales tax. In some cases, there may be qualifying circumstances that govern when a service is exempt or subject to sales taxes. Readers with questions about the taxability of a particular service should contact DF&A for more information.

Source: Adapted from Federation of Tax Administrators, "Sales Taxation of Services: 1996 Update," April 1997, and information provide by DF&A.

sources they consider, along with increases in local property taxes, severance taxes, personal and corporate income taxes, sales taxes, and making the existing education system more efficient through the merging of school districts or increasing student teacher ratios.

Eliminating or reducing sales tax exemptions could be a major source of new revenue for state government. According to DF&A, existing discretionary exemptions cost the state about $582.3 million annually. This amount does not include the significant revenue that is lost by not taxing various services. *Together, eliminating existing exemptions and adding services to the sales tax base could easily fund a major new investment in education (such as that required by the Lake View case) or other critical government services such as health care (such as the state match for various Medicaid services).*

The elimination of sales tax exemptions, however, could have consequences. Here are several important issues that should be considered in the debate over exemptions.

1. *What impact would the additional tax revenue have on state services?* Let's face it. Not all state services have equal benefits for its citizens.

Some services, such as health care and public education, are more important to the well-being of children and families. Medicaid, for example, brings in large federal dollars ($3 federal for every $1 state) and is vital to the health of the state's families. Quality public education is essential to a well-trained workforce, state economic development, and the economic success of our children (not to mention a healthy democracy).

Moreover, state spending on some services, such as preventative health care and education, pays for itself many times over in the long run. The impact of eliminating sales tax exemptions will ultimately depend on how any new revenue gained from changing tax exemptions is spent.

2. *What impact would the elimination of sales tax exemptions have on the overall equity/tax equity of the state tax system?* Depending on which exemptions are reduced or eliminated, the fairness of the tax system could be affected. Eliminating exemptions that currently benefit low-income households could make the system less fair. Eliminating other exemptions, such as engineering or attorney services, could make the system more progressive.

3. *What would be the impact on regional or state economic development?* In some cases, taxing services could impact economic development. Taxing the services provided to businesses could adversely affect the state's many small businesses, such as legal or accounting services, that provide the services. It is possible, although very unlikely, that some large companies would decide to move some services in-house or out-of-state to avoid having to pay sales taxes for the services they currently purchase from outside vendors.

4. *What would be the overall impact on state tax revenue*? In many cases, eliminating a sales tax exemption will increase state tax revenue. In some cases, however, eliminating an exemption could reduce the overall tax revenue generated by a particular company or industry. While it is unlikely that the survival of a particular company or industry depends on the benefits gained from a sales tax exemption (other factors such as a well-trained workforce or access to customers are more important), it is possible that removing an exemption could reduce the competitiveness or profitability of a company or industry or force it out of business. If that occurs, the state may lose other tax revenue generated by the business, such as local property taxes or corporate income taxes, thereby resulting in a net loss of tax revenue.

In the final analysis, policy-makers will have to make tough choices and calculated risks in their decisions about which, if any, exemptions to reduce or eliminate. This will require a comparison between the benefits of eliminating an exemption — more money for state services — against the costs — any negative impacts on economic development.

For More Information
Rich Huddleston, Research Director
Arkansas Advocates for Children & Families
501/ 371-9678
rich.huddleston@aradvocates.org
www.aradvocates.org

The State Fiscal Analysis Initiative at Arkansas Advocates for Children & Families is jointly funded by the Ford Foundation, the Annie E. Casey Foundation, the Charles Stewart Mott Foundation and the Open Society Institute. Technical assistance and support is provided by the Center on Budget and Policy Priorities.