A TAX AND BUDGET BLUEPRINT FOR A BETTER ARKANSAS

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ARKANSAS ADVOCATES FOR CHILDREN & FAMILIES

5 COMMON-SENSE CHANGES

There are five common-sense reforms to our tax and budget structure that will improve economic opportunity for Arkansas's working families, while also improving the state's long-term economic competitive edge. Making those changes will improve tax fairness for all families and, more importantly, open up new opportunities for investments in our most vulnerable kids and families. Reforming our tax structure means we will have the funding to finally put the needs of kids first by financially backing quality pre-K, helping reduce caseloads for social workers, and positively impacting many other life-changing programs. The five common-sense reforms are:

1. Cut income taxes from the bottom up.
2. Make special deductions less generous.
3. Level the playing field for all businesses (make corporations pay their fair share).
4. Modernize and streamline our sales tax.
5. Use the new revenue to make kids and families a priority.

BLUEPRINT FOR A BETTER SYSTEM

Change #1: Cut taxes from the bottom up

Everyone pays taxes in Arkansas, but if you are poor, you pay a much higher share of your income to taxes than if you are rich. In fact, Arkansas is one of the worst tax states to work in if you are poor. If you add up all state and local taxes in Arkansas (think income tax, property tax, sales tax, registrations, and other fees) the portion of a family's paycheck that goes to those taxes is twice as high if you are poor than if you are well off. Our state and local tax system asks the lowest fifth of Arkansas families (with incomes less than $16,000 a year) to pay 12 cents in state and local taxes for every dollar they earn. In contrast, the top 1 percent (who make over about $350,000 a year) pays less than 6 cents on the dollar. On the opposite page, learn about some common-sense ways to cut taxes from the bottom up and benefit hard-working families in Arkansas.

- **Adopt a tax credit for working families ($40 million)**: An Arkansas Earned Income Tax Credit (EITC) would supplement the wildly successful Federal version which encourages work and helps financially vulnerable families across the nation make ends meet with tax-time credits. The credits are usually spent on catching up on bills, furthering education, or providing essentials for kids like school clothes. A state EITC would be a powerful new anti-poverty and tax fairness tool in Arkansas, a tool that has proven to be incredibly successful in other states. A basic 5 percent EITC would cost $40 million and help thousands of Arkansans move permanently out of poverty. The EITC helps to chip away at the major inequities in our tax structure, but it by no means allows working families to receive more than they pay in. Even with a very generous 50 percent EITC[1] in Arkansas, the top 1 percent of earners would still pay by far the lowest tax rate as a share of their income compared to all other income groups.

- **Add a new income tax bracket for those who can afford to pay more ($83 million)**: Given that our state's tax system is heavily weighted against the families who earn the least, it is reasonable to add a top tax bracket (7.5 percent) for our state's highest earners (individuals with incomes above $250,000). That change would bring in $83 million in state general revenue that could be spent on reducing the caseload of our social workers, vision and dental care for our families, and new books for our libraries.

  Economic research suggests that this increase will not hurt jobs in Arkansas. Most major studies over the past 15 years find that low personal income taxes don't cause economic growth.[2] In other words, a lower personal income tax isn't a good predictor of how many people will want to start new businesses and hasn't been shown to increase job opportunities. Instead of promoting economic growth, neighboring states like Louisiana and Oklahoma are facing huge cuts to public programs because of their major income tax cuts. Round after round of tax cuts has left Louisiana lawmakers with a $1.6 billion revenue shortfall.[3] Oklahoma passed a tax cut for top income earners last year, and is also headed for a major budget shortfall (over half a billion dollars).[4] Oklahomans already suffered major cuts to state programs (down 7.5 percent) last year.[5] In both states, tax cuts for the wealthy will likely be paid for by even deeper cuts to public programs. These tax cuts just don't work. Taxing upper incomes fairly will allow us to invest in what really fuels economic growth: educating our workforce and investing in our kids.

Change #2: Make special deductions less generous

Our tax code is already unfair to low-income families and, unfortunately, recent tax changes haven't helped. During the last two legislative sessions, lawmakers passed $242 million in tax cuts that did nothing to benefit the bottom 20 percent of earners in our state. Instead, many of those cuts overwhelmingly benefited people who are already very wealthy. The cuts included a free pass on taxes for capital gains income that exceeds $10 million. That tax cut was aimed at just a handful of the wealthiest people in our state and undermined our ability to pay for roads, after-school programs, updated parks, and excellent libraries. Chipping away at this and other overly generous tax exemptions opens the door to investments that can make Arkansas a more wonderful place to live for kids.

- **Eliminate capital gains tax breaks for the rich ($74 million)**: Since the very wealthy take home the majority of capital gains income, tax breaks on that type of income give a break to folks who need it least. When a taxpayer makes a profit from the sale of real estate, fine art, or parts of a stock portfolio, the difference between the purchase price and the selling price is taxed as "capital gains" income. We allow 50 percent of capital gains income to be tax-free in our state, and all capital gains in excess of $10 million are completely untaxed. Low-income workers in our state have nowhere near that level of generous tax breaks. Eliminating this giveaway would also save $74 million in state revenue every year without making it harder for lower-income families. Ninety-eight percent of the tax change would come from folks making more than $90,000 a year (the top 20 percent of earners in our state).

Asking the Top to Pay their Fair Share:
middle and lower-income groups are not hurt by these tax changes.

2016 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%	State Tax Change
Income Range	Less than $19,000	$19,000-$33,000	$33,000-$56,000	$56,000-$90,000	$90,000-$178,000	$178,000-$409,000	$409,000-and up	--
Avg. Income in Group	$11,700	$26,200	$44,000	$71,300	$117,000	$245,700	$1,114,600	--
Add a top bracket for individuals making >$250,000/year	--	--	--	--	--	+$106	+$5,898	+$83,000,000
Remove capital gains exclusion	--	+$0	+$1	+$1	+$12	+$81	+$1,539	+$73,800,000
Limit itemized deductions	--	+$7	+$26	+$125	+$207	+$587	+$4,125	+$167,900,000
Total tax change for group	--	+$7	+$27	+$126	+$219	+$774	+$11,563	+$324,700,000

Source: ITEP; All Arkansans, 2016 income levels.

- **Place sensible limits on itemized deductions ($168 million)**: Itemized deductions currently cost the state about $258 million a year, and only a tiny fraction of these benefits goes to middle- and low-income working families. There are two easy ways to make these deductions work for our working families. First, limit these special deductions to three of the most important: home mortgage interest, charitable contributions, and extraordinary medical expenses. Reducing the number of deductions simplifies our tax code while also supporting home ownership, our nonprofit sector, and families with high medical costs. Second, cap the total available value to be deducted. If the maximum deduction was capped at $10,000 for individuals and $20,000 for couples filing jointly, we could increase revenue while limiting what is now an almost-limitless tax offset.

  Higher income families benefit more from itemized deductions because they are more likely to spend money on things that can be itemized, and because they have higher income tax rates.[6] Putting these sensible limits on itemized deductions would cost middle-income Arkansans (people making between $33,000 and $56,000 a year) only about $2 a month.

  At the end of the tax year, a family or individual can choose a “standard deduction” on their taxes or they can try to get a bigger deduction by “itemizing.” Both options reduce the amount of income subject to taxes, but many wealthy people end up getting a huge break by itemizing. Some states are already limiting the amount of itemized deductions tax filers can claim, and some do not allow itemized deductions at all. Because Arkansas generally follows federal rules for itemized deductions, it has deduction options that are very generous to the best-off families.

Change #3: Level the playing field for all businesses

The corporate tax system is structured to benefit larger corporations. This means that while small local businesses pay normal Arkansas tax rates, larger multi-state corporations can get away with paying little to no taxes. If large businesses benefit from our roads, infrastructure, and educated workforce, they should all have to chip in their fair share. Loopholes for multi-state corporations don't mean more jobs or money in our economy. These tax breaks are by definition going to corporations who have subsidiaries outside of Arkansas. The best way to level the playing field is by enacting "combined reporting."

- **Close loopholes with combined reporting ($37-$74 million)**: Arkansas tax law allows corporations who operate in multiple states to pay much less than the mom-and-pop stores who only operate in Arkansas. Fortunately, we can level the playing field by requiring all corporations to file a combined report.[7] Here's how it works: For corporations that only do business in Arkansas, paying corporate income taxes can be pretty simple – all of their profits are taxable in Arkansas. For corporations with operations in multiple states, paying corporate taxes is more complicated. Without combined reporting, companies can report the profit of each of its parts separately, leaving ample opportunity for the corporation to shelter or shift certain types of income to places without corporate taxes (think Delaware) and away from Arkansas. With combined reporting, the corporation adds together the profits of all of its parts, regardless of location, into one report, which allows Arkansas to tax the corporation at the same rate as its in-state peers. Making this simple change to our tax forms will result in additional state revenue of between $37 and $74 million[8] and will make Arkansas a place that is fair to businesses of all sizes and types.
- **Make corporations pay their fair share ($68.8 million)**: Some corporations in Arkansas pay very low or even no tax. In addition to closing the corporate tax loopholes, we can address this issue by bumping up the corporate income tax rate by one percentage point. This is another way to make sure that the most profitable businesses are still contributing to Arkansas's future.

Change #4: Modernize, streamline our sales tax

Sales tax hits harder on low-income families because they spend a higher share of their income on taxable items like groceries and gasoline. To make matters worse, there are numerous unfair special interest sales tax breaks that only benefit large corporations. If we clean up our sales tax structure in a smart way, we could make taxes fair for all consumers and have funds to invest in summer reading classes, quality pre-K, and other programs for our kids.

HOW WOULD *YOU* BE IMPACTED?

Reversing special tax breaks for the wealthy in Arkansas would give us the revenue to be a leader among Southern states for education, juvenile justice reform, and paid family leave. Adding a top tax bracket, removing the capital gains exemption, and limiting itemized deductions would have little to no cost to low- and middle-income working families who are already overburdened by our unfair tax system. Instead of being strapped by taxes, working families in Arkansas would all see brighter futures:

A middle-income mother of two making $44,000 a year would pay just a couple of dollars a month in extra tax dollars with all of these changes. In exchange, the state could afford to continue quality pre-K and start after-school and summer programs for her children.

A student working part time would likely pay no additional tax dollars as a result of these changes. Instead, he could rest assured knowing that the extra revenue from these tax policy changes would be enough to keep institutions of higher education from being forced to drastically hike tuition rates.

A surgeon making around $250,000 a year would pay an additional $774 a year (less than half of a percent of his or her annual salary). With the extra revenue to the state, Arkansas physicians could count on adequate payments for treating their Medicaid patients.

A successful business owner making $1 million a year would pay just 1 percent of her annual income to this tax change. That small percentage would contribute to the education of the workforce and the infrastructure that her business counts on to be successful.

- **Eliminate frivolous sales tax exemptions ($24.1 million)**: Arkansas state revenue is being nickeled and dimed by special-interest tax breaks. Each legislative session, dozens of bills are brought forward that seek to eliminate the sales tax on everything from chickens to airplanes.[9] These special-interest tax breaks add up quickly and make the sales tax even more unfair; things that working families purchase are taxed, things valued by large corporations are not. Just eliminating the tax break on rental cars, charter planes, and newspaper sales and advertisements would save Arkansas $24.1 million[10] a year. Other states are also lining up for huge revenue gains by using tools that collect taxes due on internet sales[11], by taxing digital goods (in Arkansas there are no state taxes on digital goods or services[12] like e-books and music), and by closing the online hotel tax loophole[13] that allows travel companies like Priceline to skirt parts of the sales tax code. We tax sales at brick-and-mortar stores for paperback books as well as the sale of DVD's and old-fashioned hotel bookings. E-books, streaming video, and digitally booked hotels should be no different.
- **Make smart changes to our fuel tax ($49 million)**: We need good roads and other infrastructure to keep our economy healthy (that means good jobs for working families), but we need to pay for that in a way that doesn't overburden low-income families or leave the programs they rely on underfunded. The fair and reasonable solution is to bump up fuel taxes and pair that with a tax credit for working families. A state Earned Income Tax Credit (EITC) would provide tax relief to the group hit hardest by a gas tax increase: low-income Arkansans.

  To keep us from running into these same highway funding problems a few years down the road, we need to index our fuel tax increase to inflation as well as fuel efficiency. Starting off with just a 2.5-cent-per-gallon increase (which will cost about 37 cents extra every time you fill up your 15 gallon tank) will more than meet the Governor's first-year highway funding totals with no need to raid the rainy day fund or surpluses. The first year we can expect that change to bring in $49 million. By year five, because of indexing, the state could see $150 million in new revenue. After the first 2.5-cent increase, we can cap those increases at 1.5 cents per year. That means that every year you'll pay less than one extra quarter each time you fill up (assuming a 15 gallon tank). Small annual increases like this mean we won't have to go back to the drawing board year after year. If you're afraid of higher taxes, keep in mind that if our gas tax kept up with inflation, it would be 29 cents per gallon today. Instead it has been stuck at 21.5 cents per gallon since 2001.

WHAT MIGHT HAVE BEEN

Thousands of kids in Arkansas would have brighter futures if lawmakers had invested in families instead of passing $242 million in tax cuts during the 2013 and 2015 legislative sessions. The cuts included an incredible free pass on taxes for capital gains income that exceeds $10 million and completely left out low-income workers (the bottom 20% who make less than about $16,000 a year). That $242 million would have been better spent on:

- Support for Arkansas's high-quality pre-K program *($42.5 million).*
- Tax credits that help working families stay at work *($40 million).*
- More social workers to give abused and neglected children the help they need *($8 million).*
- New after school and summer programs for kids *($7 million).*
- Paid leave for more Arkansans *($14.4 million).*
- Programs that keep non-violent kids out of jail with community-based alternatives *($10 million).*
- Reinvestments in our libraries *($1 million).*
- Fair pay for doctors so they don't have to turn people away *($28 million).*
- Improved state parks and a new youth conservation corps *($4 million).*
- Improved highways and roads without underfunding other programs *($47 million).*
- A *$40 million* investment in our Rainy Day Fund.

TOTAL: $242 million

Change #5: Use the new revenue to make kids and families a priority

Bringing in new revenue doesn't do us any good if we don't spend it wisely. Arkansas legislators need to focus on programs that let parents be good parents, and help kids grow up healthy and happy. Below is a list of vetted, data-backed, no-brainer investments that would make businesses and families across the nation flock to Arkansas.

- **Support Arkansas's high-quality pre-K program for low-income kids ($42.5 million)**: The wonderful and dedicated pre-K providers in Arkansas haven't seen a meaningful, permanent funding increase since 2008. That makes it harder every year for them to provide quality care, and research shows that it's the "quality" in quality pre-K that gets kids ready for what's next. Arkansas must increase funding for the ABC program to keep the quality of our program. A comprehensive look at our pre-K cost model shows that we need a minimum of $42.5 million, with annual increases after that, to make sure that providers have what they need. The governor and the legislature gave pre-K a small temporary funding bump during the last legislative session (only $3 million). But that was one-time money and doesn't scratch the surface of meeting the needs of programs statewide.
- **Help working families stay at work ($40 million)**: Tax credit programs like the Earned Income Tax Credit (EITC) allow the lowest-income workers in our state to keep more of what they earn and stay in the workforce. EITCs are widely regarded as one of the best pro-work tools ever introduced. A basic 5 percent EITC would cost $40 million and help thousands of families move permanently out of poverty.
- **Reduce the caseload for social workers (a minimum of $8 million)**: Arkansas's foster care system is overloaded. Eight million dollars is the minimum amount needed to begin reducing caseloads for social workers. Reasonable caseloads make sure that social workers are able to give our most vulnerable children the services and attention they need like appropriate foster home placement, and regular check-ins in their own homes to make sure they are safe.
- **Start after-school and summer programs for kids ($7 million)**: After-school and summer programs are proven to inspire children to learn, keep them safe, and support working families. However, the after-school programs set forth in law in 2011 were once again denied the money they need to operate this year. Just $7 million would get these programs off the ground and help kids reach their potential.

- **Provide paid leave for more Arkansans ($14.4 million total)**: Families need paid leave programs to be financially and physically healthy. The cognitive and developmental benefits of paid maternity leave on babies are well documented, but paid leave is hard to come by (especially for low-income working families in Arkansas). Providing paid maternity leave for state employees would cost only about $354,000 a year, a small fraction of the state budget. Establishing a credit to encouraged employers to provide paid leave in Arkansas would cost $14 million. Together, these two measures would help working families avoid having to choose between their jobs and their famililes' health.
- **Keep non-violent kids out of jail with community-based alternatives ($10 million)**: Many youthful offenders who aren't a risk to public safety end up incarcerated instead of placed in more effective community programs. Locking up kids is damaging and expensive. Unfortunately, plans to reduce youth incarceration were dashed when Department of Youth Services (DYS) funding took a $500,000 cut in 2015. DYS also did not receive funding to replace one-time funds that had been provided by stimulus money in past years. That amounted to another loss of $2.05 million.
- **Reverse the cuts to libraries[14] ($1 million)**: Libraries, especially in small, low-income communities, count on state funds to operate. Cutting library funds means shorter hours and fewer summer reading programs for kids. A recent $1 million cut to Arkansas public libraries means several locations will lose nearly a quarter of their funding.[15]
- **Make sure doctors are paid fairly so they don't have to turn people away ($28 million)**: To ensure Arkansans continue to have access to important health care services, doctors must be paid for their services. The amount the Medicaid program pays doctors is much lower than what private insurance and Medicare pays for the same services. The Affordable Care Act bumped up this amount for two years, but Arkansas did not invest state dollars to maintain this rate increase for doctors. This issue can be addressed if the state invested about $28 million into physician services, which is about 3 percent of what we currently spend in the Medicaid program.
- **Improve state parks and enact a youth conservation corps ($4 million)**: Funding for our state parks hasn't been enough to maintain Arkansans' access to the great outdoors. This additional funding would help protect and maintain our state's natural beauty and will start a program that encourages young people to get out into nature.
- **Improve highways and roads without underfunding other programs ($47 million)**: We need a good infrastructure to keep our economy healthy (that means good jobs for working families). Unfortunately, gas tax revenue, the biggest state revenue source for highways, has been declining steadily for years. People are just buying less gasoline than before (this is due to a combination of factors like price sensitivity and an increase in fuel-efficient vehicles). The Governor's recent highway plan asks for $47 million in the first year to go to highways, but there are serious concerns about that money coming from other critical programs in future years.
- **Invest in our Rainy Day Fund**: By law, Arkansas has to have a balanced budget. That means in the case of an economic downturn, we can't spend more than we take in. The recent recession proved just how important a rainy day fund can be. The current rainy day fund is about to drop from $40 million to $20 million (and could go even lower) as part of the Governor's plan to fund highways. As our economy recovers, it is time to build up reserves and not spend them down.

NOTES

[1] http://www.itep.org/eitc/pdf/ar_eitc.pdf
[2] http://www.cbpp.org/research/state-budget-and-tax/state-personal-income-tax-cuts-still-a-poor-strategy-for-economic
[3] http://www.labudget.org/lbp/2015/02/louisianas-1-6-billion-problem-how-did-we-get-here/
[4] http://okpolicy.org/wp-content/uploads/2016_Budget_Highlights.pdf?94cc4d
[5] http://okpolicy.org/is-oklahoma-headed-for-a-revenue-shortfall
[6] http://www.cbpp.org/research/policy-basics-tax-exemptions-deductions-and-credits
[7] http://itep.org/itep_reports/2011/08/combined-reporting-of-state-corporate-income-taxes-a-primer.php#.VipGF_lVhBd
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[9] http://www.arkleg.state.ar.us/assembly/2015/Summary%20Budget%20Manuals/2014TaxHandbook.pdf
[10] http://www.dfa.arkansas.gov/offices/exciseTax/salesanduse/Documents/SalesTaxExemptionsFY2011.pdf
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