Taxation and State Government Spending

Policy Issues and Solutions

Reform State Spending Through Structural Budget Changes

Problem: Arkansas general fund revenue has increased by a nominal 205 percent between 1992 and 2021. This growth rate is much faster than the overall rate of population growth plus inflation, which is one benchmark that is used to measure how much state revenue should grow. In other words, if state general fund revenue had only kept up with population growth and inflation, the growth rate would have been cut in half.

The Arkansas budget process is also overly complex and cumbersome and could benefit from structural changes made to the Revenue Stabilization Act, or RSA, which governs the overall budget process in Arkansas. The RSA limits legislative spending authority during fiscal years when actual revenue collection falls short of expected revenue forecasts by reducing the number of categories of spending that can be considered during any budget year. However, it is silent as to how to handle revenue that is collected above the current RSA revenue projections for each fiscal year, as has happened for 22 of the past 31 years.

Solution: Arkansas should adopt a Tax and Expenditure Limit, or TEL, to reduce total general fund spending at the state and perhaps local levels as Colorado does through its TEL, known as the Colorado Taxpayer Bill of Rights, or TABOR. As Arkansas attracts more residents, state spending is allowed to increase in an effort to accommodate the needs of a larger population. Including inflation helps tie the limit to a standard measure of the ability of taxpayers to fund government services. As noted above, Arkansas already has a strong foundation to build on in its RSA, but could benefit from adopting a spending growth limit, such as the growth of population and inflation in future fiscal years. Oregon utilizes a similar set of budget rules known as, the Kicker Rule, and limits state “appropriations to no greater than eight percent of projected personal income in Oregon” during the current biennium.

Arkansas should also consider refunding taxpayer dollars to those who paid taxes to the state. Colorado has a four-tiered structure for how funds collected above the TABOR limit must be refunded to municipalities and taxpayers. The tiers in the TABOR refund method could also be changed to route more of any potential future surplus back to taxpayers. This would prevent Arkansas from holding onto taxpayer dollars over long periods and time by returning state money to its original source, the people.

Arkansas would also benefit from reforming its Rainy Day Fund by requiring supermajority rules to utilize any of the over $550 million currently left in the fund- as of the most recent legislative session. Currently, the Governor has close to full discretion in spending taxpayer dollars, with only a simple majority legislative approval necessary for him to utilize these funds

Additional Resources: ACRE staff have published a number of op-eds, blog posts, and other forms of original research about to improve the Arkansas budget process, some of which can be found at the ACRE Blog.

Check out the Colorado Department of Revenue website which describes how the Centennial State structured its Taxpayer Bill of Rights, or TABOR. These reforms are being analyzed and applied to Arkansas by ACRE staff and will be available by the 2023 legislative session

Texas is another example of how states can control spending by limiting state spending growth to growth in population plus inflation. The Lone Star State recently adopted the Consolidated General Revenue Limit, which "limits the biennial growth of [state] appropriations to the estimated compounded growth of state population and monetary inflation."

Oregon also has a Constitutional budget rule that requires the state to refund surplus funds to taxpayers when actual revenue is 2 percent or higher than forecasted. This refund can either consist of an individual income tax refund or credit, or a corporate income tax refund or credit, depending on which tax was in excess of 2 percent above forecast.

Multiple other states such as California, Massachusetts, Iowa and Montana have budget rules that limit spending by the growth in population and inflation.

Reduce the cost of living for all Arkansans by further lowering the individual and corporate income tax rates

Problem: Arkansas recently adopted a plan to lower the top marginal individual income tax rate to 4.9 percent, the lowest since the state began taxing individual income 93 years ago in 1929.[1] Likewise, the state lowered its top marginal corporate income tax rate to 5.3 percent during the most recent legislative session

However, the state still has progress to make in further lowering both the individual and corporate income taxes since ten states reduced both their individual and corporate income tax burdens this year alone. There have been multiple studies that show both households and businesses prefer to leave locations with higher tax burdens and relocate to states and municipalities that have lower tax burdens.

Arkansas's neighboring states also implemented individual income tax rate cuts and other tax savings reforms in the past year. Mississippi eliminated its 5 percent income tax bracket and will reduce its current flat income tax rate from 5 percent to 4 percent by 2026.

Missouri also adopted incremental individual income tax rate reductions beginning in 2023, with further cuts conditional on sufficient state revenue collections. The second round of cuts could come about through a budget tool known as a revenue trigger. These safeguards prevent structural fiscal deficits from occurring and ensure essential government services can continue to be provided while phasing in statewide income tax relief. If the revenue triggers are met, Missouri will have a top marginal individual income tax rate of 4.5 percent by 2027.

Louisiana voters also approved Constitutional Amendment 2, which capped the top marginal individual income tax rate at 4.75 percent. Subsequently, the Louisiana state legislature also reduced the top marginal individual income tax rate to 4.25 percent beginning in the current (2022) tax year.

[1] Sims, Richard G. "A short history and recent trends in the Arkansas income tax." Arkansas Business and Economic Review 26.4 (1993): 9-21, Accessed Oct 4, 2022.

Solution: There are many pathways Arkansas could take to further cut its tax burden. It is important for Arkansas to keep moving forward since five of Arkansas' bordering states implemented or enacted reductions in their personal or corporate income tax rates or both in the past year. Arkansas should be mindful as to how it plans to further cut its corporate and individual income taxes to avoid a Kansas-like situation, where the state budget is significantly impacted by cutting taxes too quickly. Many states have enacted successful tax reforms in recent years without the problems that Kansas experienced. The legislature has taken cautionary tales such as this into account by including revenue collection triggers to avoid revenue shortfalls in its most recent tax cut in August 2022

Additional Resources: Op-eds and blogs by ACRE staff discuss how Arkansas can move forward in improving its individual and corporate income tax rates.

There are a variety of resources available through the Tax Foundation that explain the significance of lowering income tax rates on interstate migration, gross state product, patent formation, and state level economic growth.

Enhance state and local government spending efficiency through targeted spending reforms

Problem: Government spending has increased dramatically for specific programs in Arkansas over the past thirty years. These programs could be reformed to reduce taxpayer dollars from going to fund programs that failed to spend taxpayer dollars efficiently and create a stronger spending plan for the state.

Examples:
Administrative spending on K-12 teachers and principals has kept pace and even exceeded its proper limit given the recent decline in student enrollment. As of 2021, statewide student enrollment fell by 1.3 percent, while the number of teachers and principals increased by 0.3 percent, relative to the prior 2020 baseline. Arkansas needs to consider how to remain competitive with other states that pay teachers more than the Natural State.

Programmatic rules within the Department of Transportation which could reduce the rapid budget increases usually associated with so called mega projects need evaluation as well to ensure Arkansas is not overspending for its road construction and maintenance contracts. It is also worthwhile to consider the overall concentration of contractors bidding on projects in Arkansas relative to other states. Utilizing a standard measurement of industry concentration and competition, known as the Herfindahl Hirschman Index, Arkansas scored a 702 while states such as North Carolina and Tennessee scored higher at 837 and 1159 respectively. While this is not conclusive proof that Arkansas has a more efficient highway transportation system, it is clear that there is robust competition for these contracts, which has been shown by Krueger to reduce economic, deadweight loss.

Arkansas could also choose to reduce state expenditures on employee spending by tying incremental increases in public employee spending to a budget rule known as a Tax Expenditure Limit. This would decrease the possibility for self-interested public employees from advocating for increases in pay that do not correspond to increases in productivity. This sort of activity, known as rent-seeking, is pervasive in state governments. Public employee pay schedules could also be tied to the rate of growth of disposable (after-tax) personal income in the state of Arkansas. This would help reduce any premium in pay for public employees that is not concomitant with increases in private sector wages.

Solution: The solutions to these problems are as diverse as the problems themselves. However, Arkansas can learn from other states that reformed their spending patterns in similar areas. For instance, Tennessee modified their K-12 education financing formula to shift more than $1 billion away from administrators and toward the classroom. They also modified their construction funding rules to reduce mega project waste, which provides Arkansas a potential model to imitate. Economic development incentives spending could be improved by enhancing metering and monitoring efforts by state watchdogs such as the Arkansas Office of Legislative Audit and enhancing provisions in state law that allow the state to reclaim or draw back EDI funding when firms fail to meet the stated goals of their contracts with the state. Finally, Arkansas could build on prior reforms to state employee spending by expanding on past legislative spending reforms in this area.

Additional Resources: There are a variety of resources available about state spending trends. They include the pending publications ACRE Policy Analyst Joseph Johns will release before the beginning of the 2023 legislative session, as well as a 2017 paper by Jacob Bundrick and Jeremy Horpedahl on trends in state spending in Arkansas and competitor states. The ACRE blog can also be accessed now to search for various topics of interest related to state spending trends.

ACRE affiliated scholar, Dr. Jacob Bundrick, has also published multiple resources related to EDI spending in Arkansas. Further content related to this project will be released prior to the upcoming 2023 legislative session.

Reduce state spending on economic development incentives and reallocate these funds toward programs and policies that directly benefit Arkansans

Problem: The state of Arkansas has experienced a rise in economic development incentive spending since the beginning of the COVID-19 pandemic. According to research using the Council for Community and Economic Research's State Economic Development Expenditure Database, Arkansas EDI spending increased by 21.2 percent more per year between FY 2020 and FY 2023 than the preceding 13 previous comparison periods from FY 2007- FY 2008 through FY 2019- FY 2020. During the first 13 years, Arkansas increased spending on EDI projects by an average of 30.6 percent per year. Annual growth in EDI spending increased sharply between FY 2020 through FY 2023 to 41.8 percent average annual change per year. The large majority (65 percent) of this increase occurred between FY 2021 and FY 2022 with a slight 0.9 percent reduction in spending for FY 2023.

Certain programs such as the Governor's Economic Development Quick Action Closing Fund (QACF) experienced a sharp increase in state allocations to accommodate the temporary need of Arkansas businesses and households to sustain their livelihoods post 2020. However, these programs are growing at a faster rate and have less fiscal controls than other similar southern states such as North Carolina and Tennessee. There is also work to be done to improve the overall transparency of Economic Development Incentive programs in Arkansas. Research by labor economist Timothy J. Bartik found that EDI spending has a negligible effect on firm location decisions. This implies that since most subsidies do not pay for themselves through increased economic growth, the money spent on these subsidies should be spent where it can directly benefit Arkansans.

Solution: EDI spending should be reallocated toward one of three distinct policies that will have positive spillover effects on all Arkansans, as opposed to only subsidizing a select number of firms through EDI spending. The first alternative to EDI spending is to lower the individual income tax rate. Reducing this tax burden will help Arkansas attract more entrepreneurs and inventors. There are many positive effects of cutting income taxes discussed above in Issue 2. The second alternative is to reduce the corporate income tax rate with the reallocated EDI funding, which would benefit all corporations in Arkansas, rather than the few politically-connected firms that are able to secure EDI funds. Finally, Arkansas could pursue public programs that have clear positive spillover benefits.

Additional Resources: Check out how Arkansas could implement these programs as described by UCA Lecturer of Economics, Jacob Bundrick's essay on how to reform EDI spending in Arkansas.