

The Future of Arkansas Tax Reform

Next Steps on the Road Map to Competitiveness

By Timothy Vermeer, Jeremy Horpedahl, and Jared Walczak



Tax Reform Then and Now

Major Changes to Arkansas's Tax System since 2016

At the close of fiscal year 2023, Arkansas's state general revenue fund stood with a surplus of over \$1 billion. Despite the fiscal uncertainties of the past three years due to the COVID-19 pandemic and 2020 recession, this was the third straight year that Arkansas finished with a sizable budget surplus. The prior fiscal year was even larger, at \$1.6 billion.

While there was much discussion of what to do with these large budget surpluses, fundamentally they point to a needed policy change for Arkansas: tax reform. These surpluses indicate that the current Arkansas tax system is generating much more revenue than recent legislatures have wanted to spend. In the most recent fiscal year, the legislature enacted a general revenue budget of just \$6 billion, while the state tax system generated over \$7.1 billion in net revenue.

But how should tax reform proceed? This is not a new question for the Arkansas General Assembly. Multiple times since 2015, the legislature has enacted tax reforms and reductions. A recurring reform has been to reduce the top marginal income tax rates on corporate and personal income taxes, though this is by no means the only reform that Arkansas has enacted.

In 2016, near the beginning of the recent wave of tax reductions in Arkansas, experts from the Tax Foundation and the Arkansas Center for Research in Economics conducted an extensive research project to produce the joint publication *Arkansas: The Road Map to Tax Reform*. Many of the reforms we recommended in that publication were implemented in subsequent legislative sessions.

In 2016, Arkansas's top marginal personal income tax rate stood at 6.9 percent, just slightly below its all-time high of 7 percent, which was implemented in the 1970s. This rate was by far the highest among Arkansas's neighboring states, which were at 5 or 6 percent, or zero percent in the case of Texas and Tennessee.¹ Furthermore, Arkansas's 6.9 percent rate was the 2nd highest in the South, with only South Carolina marginally higher at 7 percent. Arkansas's corporate income tax rate was similarly high at 6.5 percent in 2016, though not quite as much of an outlier: Louisiana was higher at 8 percent, and several other southern states were at 6.5 percent, including neighboring Tennessee.

The 2016 book recommended several paths that Arkansas could take to get the personal and corporate rates down to either 5 or 6 percent, more in line with regional competitors. On this measure, the legislature has achieved the full measure of our suggested reform and more on the personal income tax, lowering the rate to 4.4 percent as of 2024, and will come close on the corporate side with a rate of 4.8 percent. The

¹ At the time, Tennessee did have a 6 percent tax on investment income, rather than wages and salaries, but the "Hall tax" has been subsequently phased out as well in Tennessee.

2 | The Future of Arkansas Tax Reform

lowering of rates was done gradually by several subsequent legislatures, and in some cases only when certain revenue targets were achieved (referred to as “tax triggers”). But the cumulative effect is a large reduction in income tax rates.

Beyond the top income tax rate reductions, our 2016 book suggested a number of other reforms, many of which have been enacted. On the individual income tax side, we suggested inflation-adjusting the standard deduction (most other parts of the tax code already were adjusted). This reform was achieved in the 2021 special legislative session (which also enacted one of the key rate reductions). In 2016, Arkansas’s individual income tax also included a complicated set of three different groups of tax brackets, totaling 16 different tax brackets depending on one’s income level. While many states have progressive income tax systems, no state had a system as complex as Arkansas, where rates could retroactively increase as one’s income passed certain thresholds (\$21,000 and \$75,000). Complex credits were inserted into the tax code to smooth out the “tax cliffs” that this system created. We recommended that this system be consolidated down to a single set of tax brackets, even if still progressive in nature. While that goal has not yet been fully realized, Arkansas is now down to two sets of tax brackets, with 8 tax brackets instead of 16. For taxpayers with taxable income over \$25,000, Arkansas essentially has a flat income tax system as of 2023.

For the corporate income tax, we also recommended several changes beyond the headline rate reductions. For example, we recommended a repeal of the state’s throwback rule, which places an excessive burden on certain businesses based in Arkansas with many sales outside of the state. This rule was repealed in 2023. We also recommended extending the state’s net operating loss carryforwards from 5 to 10 years as a first step toward treatment in line with national norms (most states and the federal government use 20 years or set no limit on years). This tax provision is extremely important for businesses that have profits that vary from year to year. This first-stage reform was also achieved starting in 2021.

As with the individual income tax, there are still much-needed reforms that have not been fully implemented yet. Our 2016 book recommended that Arkansas end targeted corporate tax incentives. These credits often benefit politically favored firms, without providing a noticeable benefit to the overall economy. While some progress has been made, such as the repeal of the InvestArk credit (the largest such program at the time), much work remains to be done on this front.

Beyond the income tax, the 2016 reform book suggested several reforms to the state’s sales and property tax systems. Arkansas stands out here as well, but in two different ways: the state has one of the nation’s highest sales tax rates, but also some of the lowest effective property tax rates. One of the reasons for the state’s high sales tax rates is the broad availability of local-option sales taxes for cities and counties in Arkansas, with few limits on the types of functions the taxes can fund and how they can be enacted through special elections. Some progress was made to limit future increases in local-option sales taxes by limiting the dates each year when these elections can be held, through legal changes in 2021 and 2023.

The Future of Arkansas Tax Reform

Many changes have been made to the Arkansas tax system since 2016. But what should come next? One thing is clear, as mentioned above: despite recent cuts to tax rates and other changes, Arkansas's tax system still brings in way more revenue than recent legislatures wish to spend. While surpluses will probably not continue on the magnitude of \$1 billion a year, the legislature has enacted a budget of \$6.2 billion for the 2024 fiscal year, while the tax system is projected to raise about \$6.6 billion. That's less than the \$7.1 billion last year, but still well above enacted spending. Reforming the tax system so that it is raising closer to \$6.2 billion is a clear step that could be taken in the immediate future and could pay for the implementation of several fundamental reforms. It was a rationale for tax cuts adopted in special session, and to the extent that Arkansas continues to experience revenue growth, it can facilitate further reforms in future years.

There is always uncertainty about the prospects of a national recession and the effects this will have on state budgets. But one other important change that Arkansas has made since 2016 is to establish a true "rainy day fund," officially called the Catastrophic Reserve Fund. That fund holds about \$1.5 billion currently, more than enough to offset any declines in state revenue due to a recession. Additionally, in special session, lawmakers established another reserve fund, with an initial deposit of \$700 million, as a buffer in case any future tax revenue comes in below forecast. Tax reform should not focus too much on short-term fluctuations in the business cycle, but instead should look at the steady state levels of tax revenue generated by the system, and the current demands for state spending based on the democratically elected legislature and executive branch.

Another important factor to consider is that neighboring and competing states have not stood still while Arkansas has reduced income taxes in recent years. Arkansas faces stiff competition on the tax front both regionally and nationally. Over the past three years, 25 states have reduced individual income tax rates, including five of the six states that border Arkansas (Texas is the lone exception because it lacks an individual income tax). All of Arkansas's neighboring states now have rates that are below 5 percent or will be in the next few years (Mississippi will have a flat 4 percent rate in 2026). For Arkansas to continue to attract workers, families, and businesses, it must continue to be competitive on the tax front, as well as in other areas, such as education, criminal justice, and infrastructure (e.g., rural broadband)—all areas that recent legislatures have sought to address.

This publication picks up where our previous book left off, offering policymakers a roadmap for continued reform. It shines a spotlight on work left undone, proposes next steps where some efforts have already been made, and helps lawmakers explore the trade-offs involved in some of the new ideas—including the potential phaseout of the individual income tax—that have entered the tax conversation in Little Rock.

Summary of Options

While individual income tax rate reductions have received the most attention from lawmakers, business tax reforms can provide substantial “bang for the buck” in facilitating greater economic growth and opportunity. In addition to corporate income tax rate reductions in line with any individual income tax rate cuts, lawmakers can and should:

- Implement permanent full expensing, thereby reducing the tax code’s penalty on new capital investment
- Repeal the franchise tax, an archaic tax on a business’s net worth that bears no relation to its profitability or ability to pay
- Eliminate its nationally anomalous inventory tax, a highly nonneutral tax with substantial compliance costs that targets select businesses that must keep substantial inventory on hand
- Improve its treatment of net operating losses to better align with the taxation of long-term profitability, consistent with how most states treat such losses

For individual income tax rate reductions, we explore three options:

- Triggered individual income tax rate reductions subject to revenue availability, with an estimated 7 years to get to 3 percent and 22 years to phase out the tax entirely
- Triggered individual and corporate income tax rate reductions in tandem, taking an estimated 8 years to reach 3 percent for the individual income tax, and 27 years for full repeal should lawmakers allow the reductions to continue
- Consolidation of the current dual tables into a single schedule based on the low-income filer rate

Each of these plans, and their revenue implications, are discussed in turn, along with revenue offsets should lawmakers wish to accelerate reductions (rather than waiting to phase them in slowly, paid for out of economic growth) or use other taxes to allow them to retain more of that growth. We also demonstrate a plausible rate reduction pathway should lawmakers choose to implement spending cuts. The trade-offs of each approach are considered, and a projected rank on the Tax Foundation’s *State Business Tax Climate Index* (a measure of the competitiveness of states’ tax structures) is provided.

Individual Taxes

Introduction

Arkansas has seen dramatic improvements to the competitiveness of its individual income tax system in recent years, but these changes have not happened in a vacuum. More than half of the states with income taxes have cut rates since 2021, a list that includes every one of Arkansas's border states but Texas, which already forgoes an individual income tax. (Tennessee, which has never taxed wage income, eliminated its tax on interest and dividend income.) And further reductions may be on the horizon. Legislatures in Missouri and Oklahoma regularly debate income tax rate reductions; it would not be surprising if one or both moved to lower and flatten their rates further than what they achieved in 2022.² Meanwhile, Louisianans approved a reduction to the state's top individual rate via ballot measure in the 2022 election. At 4.25 percent, Louisiana's top rate is still nearly half a percentage point lower than Arkansas's.

This chapter will provide a broad overview of Arkansas's individual income tax system, outline issues with the current system, and discuss possible reform solutions, including the potential for a responsible repeal of the individual income tax. We conclude with how these reforms could affect Arkansas's tax competitiveness as assessed by Tax Foundation's *State Business Tax Climate Index*.

A Brief History of Arkansas's Individual Income Tax

Arkansas's individual income tax was adopted in 1929 but remained largely unchanged over the next 86 years. The legislature increased the top marginal rate from 6 to 7 percent in 1971 but then essentially left the individual income tax system alone until 2015. As neighboring states and others across the country cut rates and enacted other structural reforms, Arkansas's income tax system rapidly became an outlier regionally and nationally.

Aware of the state's declining tax competitiveness and the consequent economic impact, policymakers embarked on a mission in 2015 to begin modernizing the state's individual income tax. In 2016, Arkansas had the highest top individual income tax rate in the region at 6.9 percent, nearly a full percentage point higher than its nearest neighbor. It also presented a particularly stark contrast with Texas, which levies no individual income tax, and Tennessee which only taxed income from interest and dividends (since repealed).

² See Janelle Fritts, "Missouri Tax Package Would Set State Up for Success," Tax Foundation, Apr. 10, 2023, <https://www.taxfoundation.org/missouri-tax-reform-2023/>; and Janelle Fritts, "Oklahoma Lawmakers' Tax Reform Plan Would Put State in Top 10," Tax Foundation, Mar. 14, 2023, <https://taxfoundation.org/oklahoma-tax-reform-2023/>.

6 | The Future of Arkansas Tax Reform

Since then, Arkansas's regional competitiveness has improved markedly. Tennessee has fully phased out its tax on interest and dividends and Texas still imposes no income tax, but Arkansas's top individual income tax rate is now lower than that of Mississippi, Missouri, and Oklahoma. Of all the states that levy an individual income tax, only 10 have a top rate lower than Arkansas's.

In addition to rate cuts, Arkansas now inflation-adjusts its marginal tax brackets, standard deduction, and personal exemption credit. This is good news for individual Arkansans, but it is perhaps even more important for Arkansas small business owners—the S corporations, LLCs, partnerships, and sole proprietorships that pay taxes through the individual income tax system. (The benefit is currently limited, however, because the amount of the possible inflation adjustment is capped.) These pass-through entities have also benefited from the state's conformity to Section 179 of the Internal Revenue Code (IRC), which allows businesses to deduct up to \$1 million of capital investment from annual revenue in the year the investment was made.³

Despite the many positive reforms since 2015, Arkansas still has one of the most cumbersome individual income tax schedules in the country. Every state that levies a tax on individual income has one rate schedule applicable to all taxpayers—except Arkansas, which has two. The primary rate schedule affects those with net income under \$87,000 (adjusted annually for inflation). The secondary schedule applies to those with net income above \$87,000.

While the two-schedule system is an improvement over the three-schedule system in service from 2016 through 2021, it continues to be unusually complex. Under the dual schedule system, individuals must first determine their net income and then apply the unique rate schedule corresponding to that level of net income.

Income tax rate reductions adopted in April, which affect tax rates for 2023, brought the top rate to 4.7 percent. Further reductions adopted in a September special session trimmed the top rate to 4.4 percent.⁴

Table 1. Individual Income Tax Rates, 2023 and 2024

Income Level under \$87,000			Income Level above \$87,000		
Income Bracket	2023 Rate	2024 Rate	Income Bracket	2023 Rate	2024 Rate
\$0 - \$5,099	0.0%	0.0%	\$0 - \$4,400	2.0%	2.0%
\$5,100 - \$10,299	2.0%	2.0%	\$4,401 - \$8,800	4.0%	4.0%
\$10,300 - \$14,699	3.0%	3.0%	\$8,801+	4.7%	4.4%
\$14,700 - \$24,299	3.4%	3.4%			
\$24,300 - \$87,000	4.7%	4.4%			

Source: AR Code § 26-51-201.

Instead of treating all taxpayers and all levels of income the same, the attempt to give lower-income taxpayers a break through dual-rate schedules actually creates new inequities between taxpayers. Under

³ The \$1 million cap is adjusted annually for inflation.

⁴ Senate Bill 8, Arkansas 94th General Assembly, First Extraordinary Session, 2023.

the lower-income schedule, taxpayers' first \$5,099 of taxable income is tax-free, while under the upper-income schedule, the first \$4,400 of taxable income is taxed at a 2 percent rate. The next \$19,200 is also taxed at a preferential rate for those earning less than \$87,000. The top marginal rate of 4.7 percent (4.4 percent in 2024) kicks in at \$24,300 for those in the lower-income schedule, but it kicks in at \$8,801 for those in the upper-income schedule.

The disparity between the rate schedules results in a tax cliff—an instance where a marginal increase in income results in a surge in tax liability. Consider the net income of two comparable businesses at the end of the year: one business had a profit of \$87,000 while the other had a profit of \$87,005. All else equal, the first business owner would have an income tax liability of \$3,059, and the second business owner would have an income tax liability of \$3,940. Despite the second business earning only five more dollars in profit, its tax bill increased by \$430 under the 2023 rate schedule, and \$384 under the 2024 rates. Tax cliffs disincentivize productivity and investment because earning only a marginal amount more triggers a disproportionately higher tax liability, and they add needless complexity to the tax code.

Arkansas's tax code includes a bracket adjustment meant for filers with incomes between \$87,001 and \$91,300. It is explicitly intended to offset the tax cliff effect, but in reality, it only staggers it. The \$430 (or \$384) tax premium paid by those in the upper schedule still exists (relative to what would be paid if the lower schedule was uncapped); the kick-in threshold was just moved \$4,300 up the income spectrum.

Arkansas's two-schedule system is unique—in a bad way. Functionally, Arkansas has eight tax brackets, the most of any state in the South and the fourth most nationwide, behind New York, California, and Hawaii.⁵ That sort of complexity makes the code difficult for individuals to understand and leads to unnecessary administrative and compliance challenges in addition to the horizontal inequalities addressed earlier.

Individual Income Taxes Affect Arkansas Businesses

Individual income taxes are of considerable importance to pass-through entities, which are subject to the tax, and C corporations, which are affected indirectly. The income of limited liability corporations, partnerships, sole proprietorships, and S corporations effectively passes through to the income tax returns of the owners rather than being reported by the business on a corporate return. Traditional C corporations care about individual income tax rates as well because high rates can impede their ability to attract and retain talented employees. And in an era of greater availability of remote work options, employees—even of Arkansas-based businesses—can sometimes locate in other jurisdictions if that makes the most economic sense for them.

⁵ Hawaii stands out nationally for having 12 tax brackets, the most of any state with an individual income tax.

Comparing Arkansas's Individual Income Taxes Regionally and Nationally

In 2016, Arkansas's top marginal individual income tax rate was 6.9 percent and the 14th highest in the nation. When reduced to 4.4 percent in 2024, Arkansas's top tax rate will have declined by 2.5 percentage points and rank 9th lowest in the nation among states with an individual income tax. Arkansas's top income tax rate is also more competitive than the median top rate nationally (5.0 percent).

The top marginal rate of an income tax matters a great deal to the economic competitiveness of a state. It is the top marginal rate, as opposed to the intermediate rates, that is most associated with the migration of residents and wealth, increased levels of investment, and the expansion of gross state product.⁶ However, the structural components that undergird the individual income tax system can play an outside influence on the competitiveness of a state's income tax system. Depending on how well they are designed, the system's structural provisions could enhance the benefits of a competitive rate or erode them.

When evaluated on Tax Foundation's *State Business Tax Climate Index*, Arkansas's overall individual income tax system ranks 35th.⁷ That Arkansas lags behind its neighbors on the *Index*, despite having a lower top marginal rate than Mississippi, Missouri, and Oklahoma, is attributable to various structural issues that its neighbors do not contend with. These include Arkansas's income recapture design (separate rate schedules), the relatively high kick-in threshold for the top marginal tax rate, and the cumbersome election requirement for businesses to file taxes as an S corporation. In short, there is more to an economically competitive tax code than just having low rates.

Table 2. State Business Tax Climate Index Individual Income Tax Component Rankings
Arkansas and Regional Competitors (July 1, 2022)

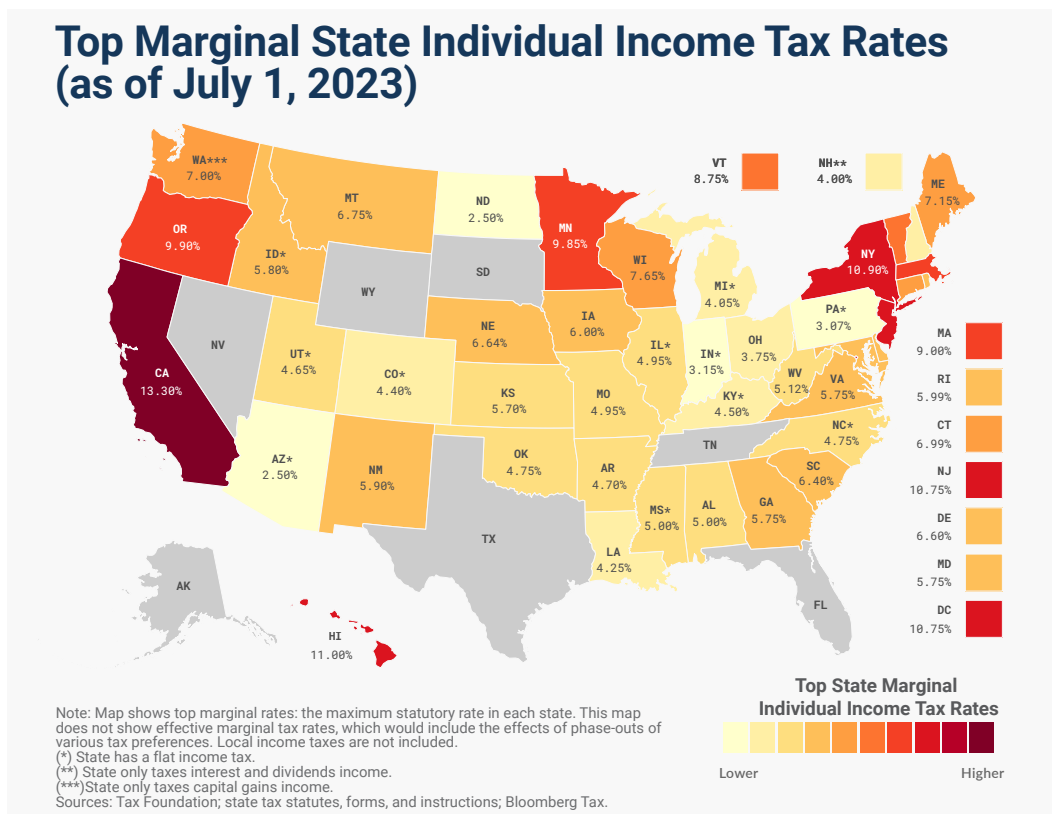
State	Component Ranking
Arkansas	35
Louisiana	25
Mississippi	26
Missouri	21
Oklahoma	31
Tennessee	6
Texas	7

Source: Janelle Fritts and Jared Walczak, *2023 State Business Tax Climate Index*, Tax Foundation, Oct. 25, 2022, <https://taxfoundation.org/research/all/state/2023-state-business-tax-climate-index/>.

6 See Timothy Vermeer, "The Impact of Individual Income Tax Changes on Economic Growth," Tax Foundation, Jun. 14, 2022, <https://www.taxfoundation.org/income-taxes-affect-economy/>.

7 First is the most competitive, and 50th is the least competitive.

Figure 1.



Structural Elements

Inflation Adjustments

Inflation indexing is an important facet of a well-structured individual income tax code. When an income tax system does not adjust tax brackets for inflation, a phenomenon known as bracket creep can occur. Higher nominal incomes can bump a taxpayer into the next tax bracket, even if that higher income does not bring additional purchasing power and is just keeping up with inflation. A lack of inflation adjustment can also push more of a taxpayer's income into the highest bracket for which they already qualify. This leads to higher effective tax rates and is problematic because increased incomes haven't risen in real terms—only nominally. Indexing addresses this by adjusting each bracket's threshold and width by the annual inflation rate.

Arkansas partially adjusts its income tax brackets but caps the adjustment at 3 percent. During years when inflation is low and meeting the Federal Reserve's 2 percent target, a 3 percent cap is of no great concern. However, in years when the average annual inflation rate is greater than 3 percent, as it was between 2021 and 2023, the 3 percent cap fails to prevent the unlegislated tax increase that comes with bracket creep.

Marriage Penalty

Whenever a state does not double its single-filer income tax brackets for married filers—as is the case in Arkansas—a “marriage penalty” exists. Under this construct, a married couple has a higher effective tax rate when filing jointly than they would if each spouse filed separately. This non-neutral tax treatment is particularly harmful to owners of pass-through businesses, whose business income is taxed under the individual income tax system. On average, the top-earning 20 percent of taxpayers are dominated (85 percent) by married couples. This same 20 percent also has the highest concentration of business owners of all income groups.⁸ As a result of these concentrations, marriage penalties have the potential to affect a significant share of pass-through businesses.

While most states require taxpayers to file state tax returns using the same status as their federal return, Arkansas allows married filers to file separate returns, even if they file a joint federal return. This effectively negates the marriage penalty as the standard deduction and personal exemption credit are already doubled. The majority of married filers take advantage of this option, which frequently reduces, but does not altogether eliminate, the marriage penalty.

While separate filings technically offset the marriage penalty, and Arkansas allows separate filings on the same return, it still adds unnecessary complexity to the system as married couples must each complete their own filings to avoid the higher effective tax rate. Beyond the duplicative effort of completing separate filings, this process can lead to additional complexities such as the division of joint assets or the allocation of various interest deductions. A simpler solution that is easier to comply with and enforce would be to double the single tax brackets for married couples.

Reducing or Eliminating the Individual Income Tax

During our conversations with policymakers throughout Arkansas, the consistent theme regarding future tax reforms involved an interest in eliminating the individual income tax. The preferred methods, techniques, and timetable to accomplish that goal varied, but reforms to the individual income tax were the primary concern. Secondary concerns involved modernizing various business taxes and were often raised as a means of facilitating individual income tax reforms.

Income tax rate reduction is good for economic growth because these rates influence how much people work and affect how much they can save. All things being equal, the individual income tax also makes a difference in where people choose to live. Over the previous decade (2010-2019), states that forgo individual income taxes have seen their populations grow at twice the national rate.⁹ But while competitive rates are an important reason for this growth, they are not the only reason.

8 Scott Hodge, “Married Couples File Less Than Half of All Tax Returns, But Pay 74 Percent of all Income Taxes,” Tax Foundation, Mar. 25, 2003, <https://taxfoundation.org/data/all/federal/married-couples-file-less-half-all-tax-returns-pay-74-percent-all-income-taxes/>; Scott Hodge, “Own a Business? You May be Rich: Two-Thirds of Taxpayers Hit by Highest Tax Rate Have Business Income,” Tax Foundation, May 5, 2003, <https://taxfoundation.org/own-business-you-may-be-rich-two-thirds-taxpayers-hit-highest-tax-rate-have-business-income/>.

9 Jorge Barro, Joseph Bishop-Henchman, and Russ Latino, “Better Jobs Mississippi: Tax Structure for Growth,” Empower Mississippi, Feb. 25, 2021, <https://empowerms.org/empower-mississippi-releases-dynamic-modeling-on-elimination-of-income-tax/>.

Businesses and families also care about jobs, access to infrastructure, the availability of skilled labor, crime levels, and the strength of a state's education system, just to name a few factors that enter into location decisions. Some concerns, such as the weather, are uncontrollable, while others, such as infrastructure, police protection, and other public goods are provided nearly exclusively by the government. Thus, any tax relief in Arkansas must also ensure that the state has the resources to continue to provide the services only the government can, or is best suited to, provide.

Importantly, individual income tax relief or ultimate repeal should always be a means to an end, not the end in itself. Eliminating the individual income tax is an ambitious policy goal, one that could bring significant economic benefit to Arkansas. But policymakers should be clear-sighted and careful not to pursue income tax elimination for the purpose of simply entering a seemingly exclusive class among the states. If income tax elimination is funded in part by the adoption of more economically harmful taxes, or if the state is forced to curtail the provision of valuable services, the economic benefit will be attenuated or even reversed. While full repeal is a worthy goal, significant benefits would accrue from reform that drives the top individual and corporate rates down to 3 percent, maintains its nation-leading low property tax rate, and modernizes the sales and use tax system by expanding the base and lowering the rate.

Over the last several years, governors or legislatures (sometimes both) in Arizona, Indiana, Kentucky, Mississippi, North Carolina, North Dakota, and West Virginia have proposed phasing out the individual income tax or repealing it outright. It is unclear at this point if any of them will succeed, although several have achieved very low flat rates. When part of a competitive overall system, a low income tax rate can be just as economically competitive as being a no-income-tax state with an uncompetitive property, sales, or corporate income tax system.¹⁰

Getting to the point where the state government can operate without an individual income tax can be challenging. Yet, there are seven states that do so.

States without an Individual Income Tax

When examining states that do not levy an individual income tax, several commonalities appear. First, as a general rule, states that do not levy an individual income tax today never did. Of the seven states currently without an individual income tax (Alaska, Florida, Nevada, South Dakota, Tennessee, Texas, and Wyoming), the only state that eliminated its tax on wage and salary income having first levied it was Alaska. The other six states never taxed wage or salary income. At one time, Tennessee taxed interest and dividend income, but it phased out the tax (known as the Hall income tax) on January 1, 2021.¹¹ New Hampshire, another state that never taxed wage and salary income, is on track to become the eighth state without an individual income tax when its tax on interest and dividend income phases out in 2027.

¹⁰ As of 2023, Arizona has a flat rate of 2.5 percent, Indiana has a flat rate of 3.15 percent, and North Dakota has a nearly flat rate of 2.5 percent. Each state levies all of the five major tax types.

¹¹ See Tennessee Department of Revenue, "Hall Income Tax," referenced Jul. 17, 2023, <https://www.tn.gov/revenue/taxes/hall-income-tax.html#:~:text=The%20Hall%20Income%20tax%20was,or%20after%20January%201%2C%202021.>

Second, states that do not impose an income tax tend to rely heavily on other taxes. For instance, many states without an individual income tax rely on severance taxes. This effectively distributes the state's tax burden to petroleum consumers across the country. Severance tax revenues directly facilitated the repeal of Alaska's individual income tax and currently support a large portion of South Dakota, Texas, and Wyoming's state budgets.

Even in states that have strong severance tax streams, there is often at least one other tax source that offsets the revenue requirements other states rely on their individual income tax to fill. In Texas, many services are provided at the local level and funded through locally levied taxes on real property. As a result, while Texas does not have an individual or corporate income tax, it does have some of the highest property taxes in the country. South Dakota, which operates without an individual or corporate income tax, generates revenue through a broad-based sales tax which includes many goods and services other states opt not to tax. Florida and Nevada do not have robust severance tax collections but compensate for their lack of individual income tax revenue through sales taxation. A distinct advantage for the Sunshine and Silver States is the millions of tourists who visit each year. Florida and Nevada's sales tax bases are relatively narrow, but the large number of visitors paying the tax means the state can export much of its sales and use tax burden to residents of other states while keeping the rate relatively low (to the benefit of in-state residents).

Once a tax is imposed, it can be extremely challenging to eliminate because governments become reliant on that source of revenue. In this regard, states that never taxed wage and salary income have a significant advantage. Consider the challenges to income tax reform in North Dakota, a state that generates only 7 percent of its General Fund revenue from the individual income tax and where one party controls the governor's office and both chambers of the legislature (with supermajorities).

In its 2023 biennial session, the North Dakota legislature considered several bills that would have put the state on the path to eliminating its individual income tax. Despite the fact that the state collected \$3.6 billion in oil and gas tax revenue in the previous biennium, had an investment fund that generated \$871 million of revenue in the 2020-2021 biennium,¹² and was projected to have over \$3.5 billion in savings and surplus by mid-2023, policymakers in Bismarck could not agree on phasing out the individual income tax. Ultimately, competing spending priorities, questions about the impact of income tax cuts on future budgets, and the potential for volatility in severance tax revenues proved to be too much of a concern for the legislature to forgo an individual income tax. It agreed to a moderate reduction of the top marginal income tax rate instead.

Tennessee and New Hampshire set relatively quick phaseout schedules for their taxes on interest and dividend income, but the tax was responsible for only a small amount of revenue in each state. In Tennessee, during fiscal year 2015 (the last year before the Hall income tax began phasing out), the tax on interest and dividends generated \$264 million of the \$10.1 billion of General Fund revenue—only 2.6 percent.¹³ The Volunteer State phased out the Hall tax one percentage point per year, dropping from 6 percent in 2015 to 1 percent by 2020, before completely eliminating the tax in 2021.¹⁴

12 North Dakota's Legacy Fund is a constitutionally mandated savings and investment account funded by 30 percent of the taxes on petroleum produced and extracted in the state. At the end of each biennium, the account's earnings are transferred to the General Fund where they are used to fund a portion of the state's operations. See "North Dakota Legacy Fund", last updated May 31, 2023, <https://www.rio.nd.gov/legacy-fund>.

13 Tennessee Department of Finance and Administration, "2014-2015: Monthly Distribution of Estimated State Tax Revenue," referenced Jul. 17, 2023, <https://www.tn.gov/finance/fa/fa-budget-information/fa-budget-rev.html>.

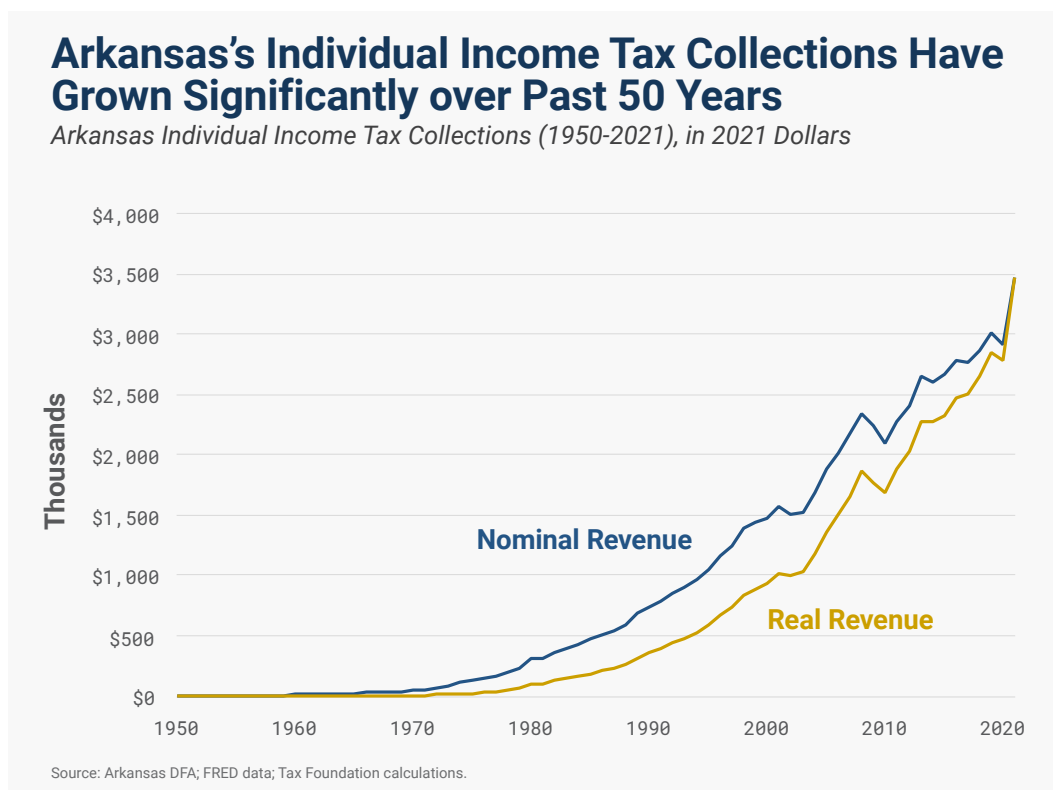
14 Katherine Loughhead, "State Individual Income Tax Rates and Brackets in 2021," Tax Foundation, Feb. 17, 2021, https://taxfoundation.org/state-income-tax-rates-2021/#_ftnref10.

New Hampshire, which is on track to eliminate its tax on interest and dividends income by 2027, began reducing its interest and dividends tax rate in 2023 with the intent of reducing it by 1 percentage point each year until fully eliminated. Similar to Tennessee, New Hampshire's interest and dividends income tax brought in relatively little revenue to the General Fund, only \$156 million of the \$3.2 billion in FY 2022—or 4.8 percent.¹⁵

By contrast, Arkansas's individual income tax was responsible for generating 44 percent of net revenue in FY 2023.¹⁶ It was relatively easy for states like Tennessee and New Hampshire to design a plan to fully eliminate their limited income taxes. It is harder to responsibly phase out an individual income tax system like Arkansas's which has been responsible for generating almost 50 percent of net General Fund revenue since 2012. Still, with state revenues growing dramatically, Arkansas lawmakers have room to work.

As Figure 2 illustrates, Arkansas's individual income tax collections have grown significantly through the years in real terms. As figure 3 shows, the state has become increasingly reliant on the individual income tax over the last five decades. In FY 2023, Arkansas's individual income tax generated \$3.9 billion of the general fund's \$8.85 billion—44 percent of net revenue—and that share has been 50 percent or more for most of the past decade.¹⁷

Figure 2.

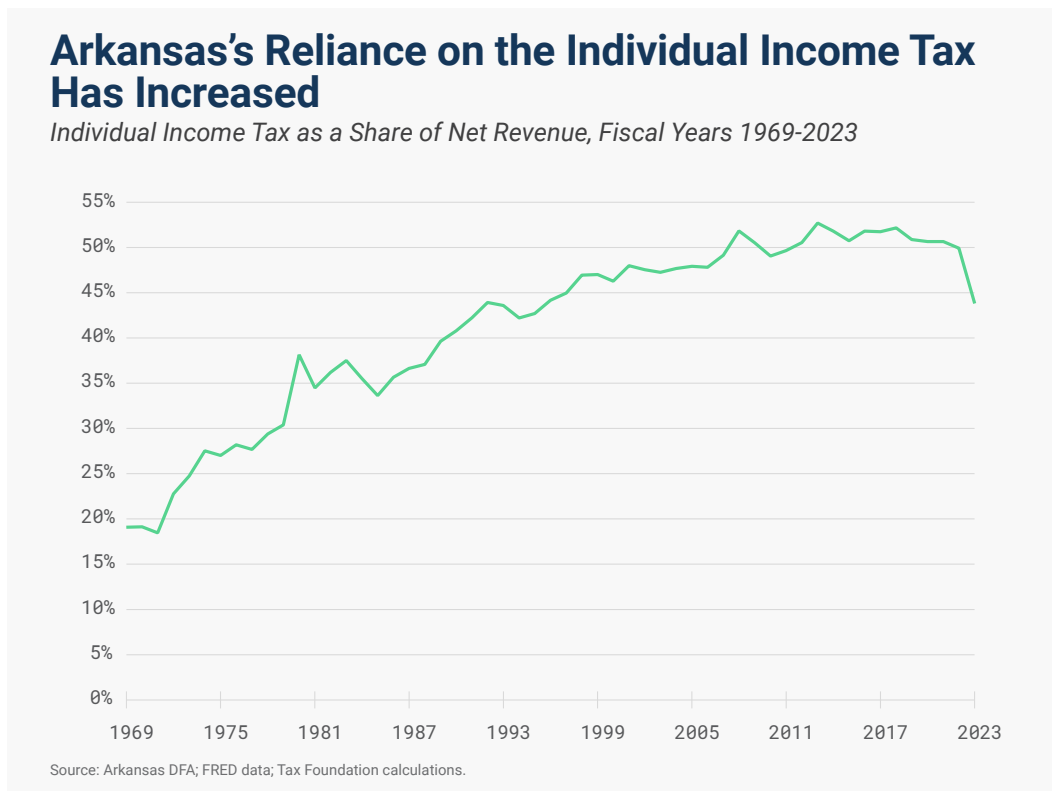


15 New Hampshire Department of Administrative Services, "FY 2022 Monthly Revenue Focus: June Preliminary Accrual," June 2022, https://www.das.nh.gov/accounting/revenue_reports.aspx.

16 Arkansas Department of Finance and Administration, "General Revenue Report for June and FY 2023 Summary," Jul. 5, 2023, <https://www.dfa.arkansas.gov/secretarys-office/monthly-general-revenue-report>.

17 Id.

Figure 3.



Given Arkansas's increased reliance on the individual income tax, special attention should be paid to what responsible and irresponsible tax reforms look like.

What Irresponsible Tax Cuts Look Like

In 2012, Kansas passed an individual income tax reform plan that exempted all pass-through income from taxation but effectively left the rest of the tax system and budget unchanged. By reducing the tax rate on pass-through income to zero, the reform package encouraged tax shifting and tax avoidance, treated business owners vastly more favorably than their employees, and substantially reduced tax collections at a time when revenues had been flatlining. This carried an annual cost of nearly \$900 million, or 15 percent of the state's general revenue budget.

The well-known fiscal crisis that resulted was only partly due to tax cuts. In the years following the 2012 reform, the Kansas Supreme Court would play a role in mandating certain education expenditures. But the true onus for hollowing out the state treasury, emptying the rainy-day fund, laying off large numbers of state employees, and damaging the state's credit rating lies with the legislature and the governor. By failing to agree to offsetting spending cuts in the budget or base-broadening provisions elsewhere in the tax code, the legislature and governor fashioned unfunded liabilities by writing checks their state literally could not cash.

Today, many critics of states' efforts to reform their individual income tax codes promptly sound the alarm and direct policymakers' attention back to the failed efforts of Kansas as a warning of what could happen in their own communities. But that need not be the reflex, provided certain criteria are met. A state is thinking like Kansas if it plans rate reductions that are projected to create a substantial deficit in the state

budget or if it enacts large-scale cuts with no real way to pay for it (e.g., offsetting spending cuts or sustained levels of economic growth that give states revenue to work with). Kansas's tax cuts came at a time when state budgets were already tight. Today, most states—including Arkansas—are collecting substantially more revenue than they've budgeted for, creating recurring surpluses that can be returned to taxpayers. Implemented responsibly, individual income tax reforms can yield many positive economic benefits for a state, and dozens of states have proven this since Kansas.¹⁸

Responsible Tax Reform Options

Option A: Hold the Budget Constant, Reduce the Individual Income Tax Rate

To generate additional room for tax cuts above and beyond what is possible through ongoing economic growth, policymakers could choose to hold the budget constant in real terms. This would involve allowing the state budget to grow at the rate of inflation and population growth (or, alternatively, with an additional increase of around 1 percent per year to compensate for population growth). Put differently, capping general fund expenditure growth would effectively freeze real spending at 2023 levels (not including the marginal increase to accommodate population growth).

This plan assumes real general revenue will grow at an average annual rate of 4.1 percent based on the average annual growth rates of individual income and sales and use tax collections between 2010 and 2019. According to the Arkansas Department of Finance and Administration (DFA), between 2010 and 2019, real individual income tax revenue grew at a rate of 5 percent per year while real sales and use tax revenue grew at 3.3 percent per year. The economic growth that lower rates facilitate will offset a portion of the revenue reduction, reflecting greater investment, productivity increases, and migration into Arkansas from other states. However, while this means that a dollar's worth of reductions on a "static basis" will result in something less than a dollar's worth of actual revenue losses on a real ("dynamic") basis, lawmakers should still understand that the positive revenue feedback from these rate reductions will not pay for themselves or come particularly close to doing so. The purpose of income tax cuts is not to increase state revenues.

Although net individual income tax collections should be expected to decrease as a result of the tax cuts, sales and use tax collections should be expected to increase. Consumption tax revenue is likely to increase as more people on the margin move to Arkansas and purchase goods and services, while established Arkansans' standard of living will likely increase due to more discretionary income in their paychecks. The expected increase in sales and use tax revenue will also be insufficient to replace the revenue forgone from income tax cuts, but it will likely offset a portion of it.

¹⁸ Jared Walczak, "Two Dozen States Show Why the Kansas Critique of Income Tax Cuts Is Mistaken," Tax Foundation, May 24, 2022, <https://taxfoundation.org/kansas-experiment-kansas-tax-cuts-critique/>.

If all surplus revenue from this plan is dedicated to individual income tax rate reduction, we project individual income tax rates could be reduced by an average of 0.2 percentage points per year (forgoing \$100 million a year from revenue growth).¹⁹ Given that constraint, it could take an estimated 7 years (FY 24-FY 31) to reduce the individual income tax rate to 3 percent, after which reductions could continue on a slow trajectory toward zero over about 22 years.

Option B: Hold the Budget Constant, Reduce the Individual and Corporate Income Tax Rates

Numerous policymakers we spoke to as we began work on this reform guide noted their preference for prioritizing individual income tax reductions over other tax reforms. However, many lawmakers also expressed caution about allowing the individual and corporate income tax rates to become too incongruous, preferring the rates stay within a few tenths of a percentage point of each other. Notably, if all resources are focused on reducing the individual income tax, the corporate income tax rate would be dramatically higher than the individual rate—or perhaps eventually, would exist in isolation. That result would violate the neutrality principle of sound tax policy and bias the state's business tax structure in favor of pass-through entities.

Our second reform option is similar to the first but with the addition of reducing the corporate income tax rate. Past tax reforms have taken deliberate steps to ensure the top corporate and individual income tax rates did not drift too far apart. The reform option modeled here keeps the corporate income tax within 0.4 percentage points of the individual income tax rate, although a smaller or larger gap could also be implemented at the legislature's discretion.

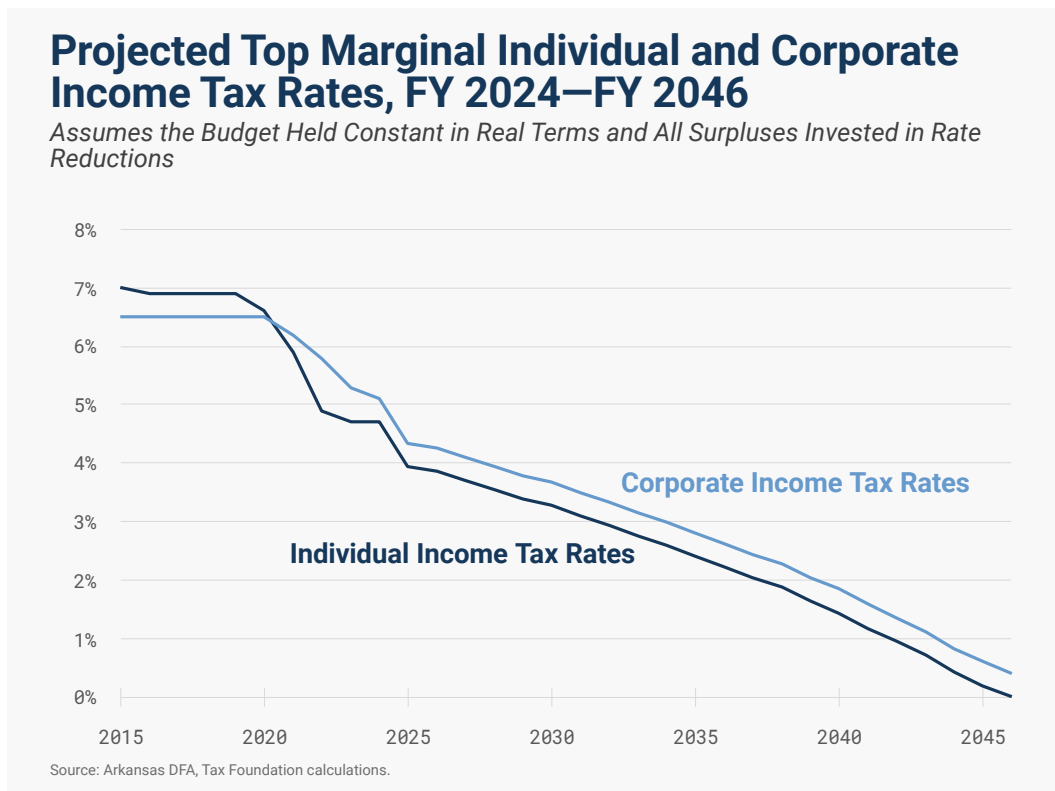
As discussed previously, policymakers should design a structurally neutral tax system that treats similarly situated individuals, businesses, and industries the same. By keeping the individual and corporate income tax rates as similar as possible, business owners are free to organize their firms as pass-through entities or corporations based on what is best for their business model, not simply to maximize tax avoidance.

This plan assumes an average annual real revenue growth rate of 4.2 percent. Since corporate income taxation is borne by employees in the form of lower wages and salaries, fewer job opportunities, and higher prices for finished goods, we assess that the tax savings will return to individuals and generate additional sales and use tax revenue. As with Option A, the feedback from the individual and corporate rate cuts should not be expected to fully offset the revenue losses from the income tax cuts.

By dedicating all surplus revenue to individual and corporate income tax rate reduction, it would take an estimated 8 years to reduce the individual income tax rate to 3 percent and 27 years to reduce the individual income tax rate to zero. Despite reducing the corporate income tax rate in tandem with the individual income tax rate, it would only take a few years longer to get to zero. Because the corporate income tax generates so little revenue for the state, decreasing the corporate income tax rate at the same pace as the individual income tax rate only costs one-quarter as much as reducing the individual income tax rate, making Option B highly attractive in comparison.

¹⁹ An average 0.2 percentage point per year rate reduction would cost an estimated \$107.2 million per year.

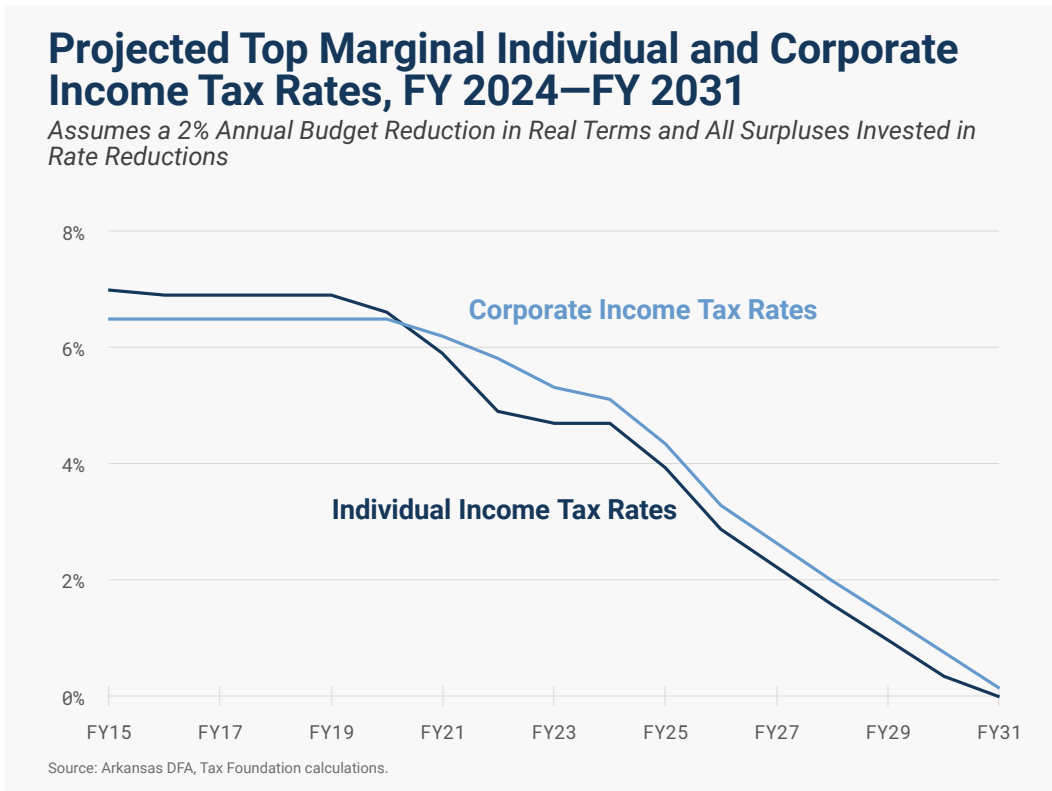
Figure 4.



If policymakers wanted to shorten the amount of time it would take to reach their target income tax rates, some level of real appropriation reduction would be necessary. For example, cutting the budget annually by 2 percent in real terms and devoting all surpluses to rate reduction could reduce the individual income tax to under 3 percent by tax year 2026. It could also cut the number of years it would take to reduce the individual income tax rate to zero. Instead of phasing the rate out by tax year 2046 (the 23-year approach in Option A), a 2 percent annual real budget reduction could put Arkansas on track to reach zero by tax year 2031. Since the corporate income tax is responsible for such a small share of the state's revenue, it could also be all but phased out by that time.

That said, cutting the state's budget to such a degree is not without risk. The future is filled with uncertainty, and while it is ultimately up to lawmakers to make the decision about what is right for their state, we believe it is in the state's interest to retain some spending capacity to respond to contingencies that may exceed the resources of Arkansas's Catastrophic Reserve Fund and various other savings funds. Importantly, if Arkansas's revenue growth exceeds our assumptions (which are conservative compared to historic revenue growth), lawmakers could accelerate rate reductions without cutting spending.

Figure 5.



Option C: Implementing a Single Set of Brackets through Revenue Cuts

Option C would merge the state’s two rate schedules into one on the basis of the lower-income rate schedule. It would effectively eliminate the three-bracket schedule for higher-income earners and eliminate the income threshold for the lower-income table’s top marginal rate. Merging the two tables would likely be a costly one-time effort. The primary benefits of this approach are its simplicity and neutrality. Not only does it eliminate the tax cliff between the tables, which currently disincentivizes productivity on the margin, but a single table greatly simplifies compliance, enforcement, and additional tax reforms. Because it does not raise rates for any taxpayers, it would not require ballot ratification or a three-quarters vote of both legislative chambers, which would be required by the Arkansas Constitution if a flat rate were achieved by raising the rate applied to any lower income range.

Table 3. Proposed Individual Income Tax Rate Schedule

Consolidates Two-Schedule System into One Schedule

2024 Tables				Proposed Single Table	
Income Level under \$87,000		Income Level above \$87,000			
Income Bracket	Tax Rate	Income Bracket	Tax Rate	Income Bracket	Tax Rate
\$0 - \$5,099	0.0%	\$0 - \$4,400	2.0%	\$0 - \$5,099	0.0%
\$5,100 - \$10,299	2.0%	\$4,401 - \$8,800	4.0%	\$5,100 - \$10,299	2.0%
\$10,300 - \$14,699	3.0%	\$8,801+	4.4%	\$10,300 - \$14,699	3.0%
\$14,700 - \$24,299	3.4%			\$14,700 - \$24,299	3.4%
\$24,300 - \$87,000	4.4%			>\$24,300	4.4%

Source: AR Code § 26-51-201; Tax Foundation.

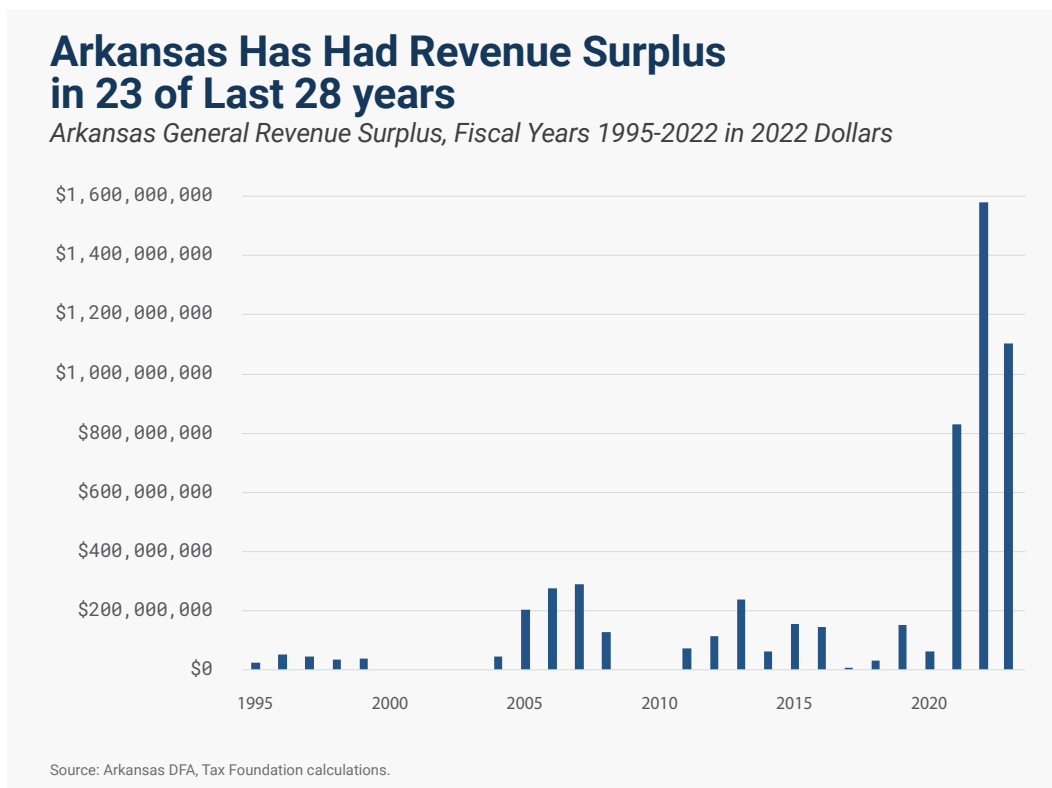
It is important to note that the tax cut schedules in Options A and B rely on a consistent general revenue surplus year over year. While the state has realized a revenue surplus nearly every year since fiscal year 1995, and there's broad consensus that states' revenue baselines are higher now than they have been in the past—a combination of broader tax bases, higher domestic investment due to the Tax Cuts and Jobs Act, and remote sales tax collection authority, among other things—states will never be immune from recessions. If unforeseen expenses arise or if a recession results in lower-than-expected tax collections, these plans would likely need to be paused so as not to risk creating unfunded state liabilities. Lawmakers could use tax triggers to pause rate reductions automatically under these circumstances.

Considerations Regarding Scheduled Reductions

A scheduled rate reduction approach (e.g., 0.2 percentage point reduction per year) is appealing because of its simplicity, the clear timeline on which rate reductions will occur, and the potential to rapidly reduce the rate to zero. But there are also challenges to this approach.

The unreliability of future surpluses poses viability challenges for a straight-line phaseout. One of the reasons Arkansas has realized consistent revenue surpluses over the last three decades is because lawmakers have consistently set individual income tax rates at a level that generated more revenue than the legislature needed or was willing to appropriate. Since policymakers have started decreasing rates and done so for the longest period in state history, observers should not take future surpluses for granted, especially as inflation slows and federal COVID relief funds recede.

Figure 6.



In FY 2021, Arkansas had a budget surplus of nearly \$830 million in real 2022 dollars, the largest surplus in state history. That overage nearly doubled by the end of FY 2022 when the budget surplus surged to almost \$1.6 billion. Another \$1.16 billion surplus was reported at the close of FY 2023, which helped facilitate the most recent round of rate reductions. But while those surpluses have been historic, they have also been anomalous.

Between FY 1995 and FY 2022, Arkansas has realized a revenue surplus in 23 of the 28 years. The average surplus during that period was \$164.5 million, in 2022 dollars. Excluding the FY 2021-FY 2022 outlier surpluses, the average surplus between 1995 and 2020 was only \$84.6 million. For this reason, a straight-line phaseout of the individual income tax may be difficult to achieve in the short or mid term.

A further challenge to the straight-line phaseout involves the cost estimate of annual rate reductions. The \$50 million DFA estimate for a 0.1 percentage point rate reduction in 2023 is likely a best-case scenario for future cuts. As rate reductions begin to affect those in the intermediate and lower tax brackets, the cost per tenth of a point will likely increase.²⁰

Tax Triggers Can Facilitate Responsible, Long-Term Reforms

Tax triggers involve setting a revenue target or other fiscal condition that, when met, results in a permanent tax policy change. Historically, the Arkansas legislature has preferred to adopt tax rate reductions on an ad hoc basis rather than adopt a longer-term approach where changes are implemented through conditions-based tax triggers. The exception to that rule was SB 1, adopted during the Second Extraordinary Session of 2021, which included a schedule of individual and corporate rate reductions contingent on no funds being transferred out of the State's Catastrophic Reserve Fund.²¹ That was a type of negative tax trigger, where if the transfer of funds did *not* happen the rate would be reduced. Positive tax triggers are more common and involve revenue collections reaching a pre-determined benchmark before rates are reduced.

Waiting to see how much surplus accrues before cutting the rate is a system that has worked well for Arkansas in the past. It was responsible for the majority of the 2.2 percentage point individual income tax rate reduction that occurred between 2015 and 2023 and is a reasonable way to cut taxes when no major changes occur to state programs. However, Arkansas may not be able to count on the continued rate of revenue growth. As rates are pared back and criminal justice and education funding expanded, revenue and spending will begin to reach an equilibrium.

In the future, the legislature could continue its ad hoc approach to tax reform, but this can create new difficulties and space for competing priorities. The relatively passive, wait-and-see approach is fiscally responsible in the sense that it ensures funding the duly authorized functions of government. However, allowing economically harmful tax policies to persist longer than necessary because there is no organized effort to reform an inefficient system provides little relief for residents whose economic mobility and standard of living are impeded by outdated tax policies. This is especially true in states with markedly inefficient tax systems (e.g., those in the bottom 10 of the *State Business Tax Climate Index*, including Arkansas).

20 This accounts for the difference in the cost of the straight-line phaseout at \$50 million per 0.1 percentage point (\$2.35 billion) and the total revenue generated by the individual income tax in 2023 (\$3.9 billion).

21 S.B. 1, 93rd Gen. Assy., Second Spec. Sess. (Ark., 2021), <https://www.arkleg.state.ar.us/Bills/Detail?id=SB1&ddBienniumSession=2021%2F2021S2>.

The absence of a deliberate, long-term reform plan can also result in sound, broad-based tax policy reforms competing for resources with incentives, credits, and other targeted relief efforts that treat the symptoms of uncompetitive tax policies but not the underlying causes. There are obvious incentives for policymakers to exempt various groups or interests from the tax base, but doing so results in a narrower portion of the population bearing a heavier tax burden, if the same level of services is to be maintained.

Rather than all Arkansans benefiting from a lower income tax rate, the adoption of special credits and incentives is essentially the government choosing which residents will be winners and which will be losers. Between 2017 and 2021, the state has paid over \$551 million in business incentives and tax credits for everything from coal mining to recycling equipment.²² Perhaps some credits and incentives have had a positive effect, but it is difficult to verify which ones, how much, and for whom because none of these tax expenditures have been studied to determine their actual economic benefit.

What can be said with greater certainty is that the vast majority of tax credits would not be necessary if the state's tax code was more competitive. Lawmakers often authorize these incentives under the banner of job creation and economic development, but the truth is that if a state needs to offer such packages, it is most likely covering for an undesirable business tax climate. A far more effective approach is the systematic improvement of the state's tax climate for the promotion of long-term competitiveness. If individual income tax cuts are the legislative and executive priority, the implementation of revenue triggers can reinforce that position automatically.

Some policymakers are averse to revenue triggers and believe they bind future legislatures, but revenue triggers need not pressure future governments. A well-designed trigger should limit the volatility and unpredictability associated with changes to the tax code, but if enough legislators felt the need, the triggers could be revised, paused, or rescinded. And, by design, they are more flexible than scheduled rate reductions.

An ideal tax trigger design would establish a revenue benchmark that allows the General Fund to grow commensurate with inflation and population growth. Once the benchmark is defined, if revenue collections exceed that threshold (with the inflation and population adjustment) and are certified by the competent authority, then the individual income tax rate would be automatically reduced. The tax trigger could be designed to decrease the rate by a certain value (e.g., 0.2 percentage points), or the rate could be set to a level that would decrease future revenue collections by an amount equal to the current surplus.

It may be tempting to establish a benchmark using the official revenue estimate rather than actual prior-year revenues, but this approach is risky. If a revenue estimate is mistaken, or if the baseline is lower than usual due to an economic downturn, the state may inadvertently find itself with unfunded liabilities due to premature tax cuts.

²² Arkansas Department of Finance and Administration Revenue Division, "Business Incentives and Tax Credits Program Costs Through December 31, 2021," August 2022, <https://www.dfa.arkansas.gov/images/uploads/exciseTaxOffice/BusinessIncentivesandTaxCreditsCostreport.pdf>.

Options Afforded by Sales Tax Reform

Another way Arkansas could responsibly afford cuts to the individual income tax is through select reforms to its sales and use tax system. Revenue offsets of this type are often criticized as simply substituting one tax for another—a zero-sum game where an individual saves one dollar in income tax in exchange for paying an extra dollar of sales tax. But because income and sales taxes have different economic effects, and because base-broadening provisions have a different impact than rate adjustments, modernizing the sales tax to pay down income tax rate reductions can be a net gain for Arkansans.

Income taxes consume a percentage of one's pay and necessarily limit how much a person is able to save for the future, but a well-designed sales tax only taxes an individual when they purchase a good or service for final consumption. Taxing only what people consume can thus increase the individual's saving rate relative to the alternative under an income tax system. This option is embraced by many of the states that do not levy an individual income tax.

Sales taxes are often criticized as a regressive form of taxation—one that taxes lower-income earners at a higher effective rate than higher-income earners. There is some truth to that claim, but much of this is because higher-income individuals spend more of their incomes on services, which policymakers have broadly exempted from sales tax in the state. The inclusion of a broad array of consumer services in the sales tax base would mitigate the regressivity of the sales tax while also facilitating the reduction of the state's sales tax rate, which, when combined with the average local option sales tax, is one of the highest in the country. Expanding the sales tax base facilitates a lower sales tax rate, enhances sales tax revenue, and enables individual income tax rate reductions. Far from being a one-for-one swap, offsetting income tax collections by modernizing the sales tax system is a net gain for Arkansans and the state's economy.

Sales Tax Modernization

While broadening the sales tax base presents political challenges, as consumers might view the process as a tax increase, they can improve both the neutrality and the stability of the overall tax system when paired with income or sales tax rate reductions. A broader sales tax base is more neutral than determining the sales tax base politically. And it is also more stable, as the more goods and services are included in the base, the less revenue is subject to swings due to any one category of consumption changing year-to-year.

To give a clear example of base broadening, consider the partial exemption of food and food ingredients, or what we commonly call groceries. Given that this partial exemption was only recently enacted into law, it may seem unlikely that this exemption will be reversed. That makes it even more important that we fully recognize the other tax reform options that are precluded by this exemption.

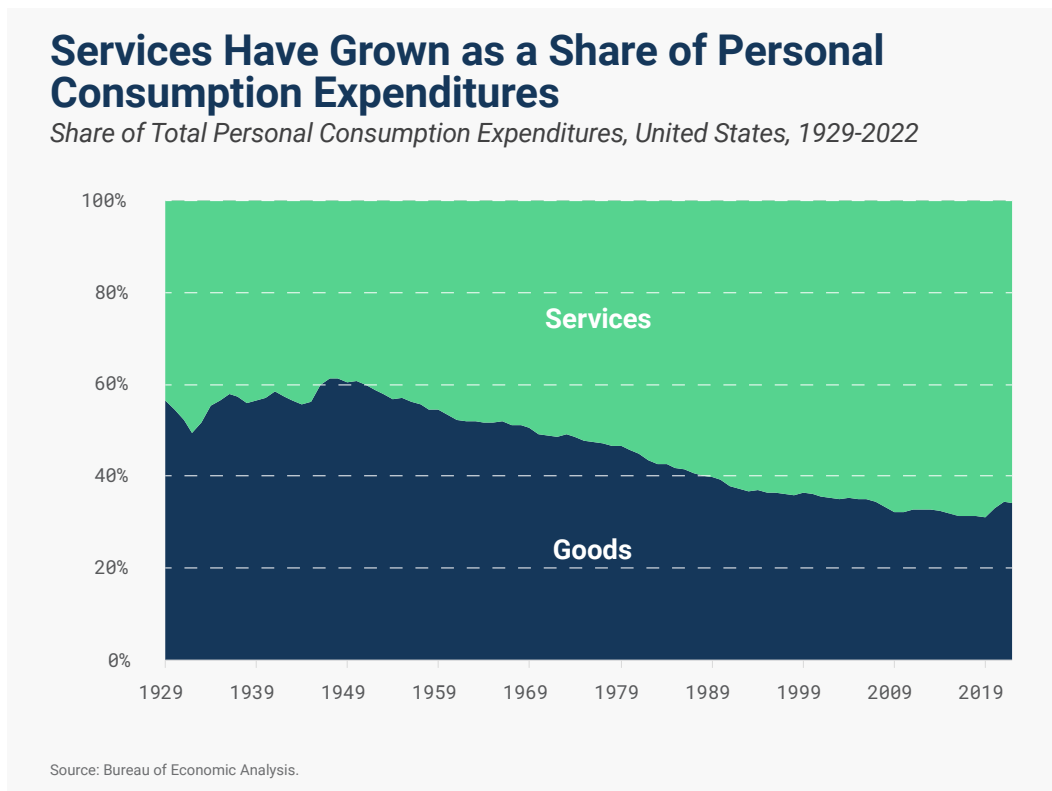
The exemption is partial in two ways. At the state level, groceries are still subject to the 0.125 percent Conservation Tax Fund sales tax that funds the Game and Fish Commission and the Department of Parks, Heritage, and Tourism. Cities and counties with local option sales taxes also still include groceries in their sales tax bases, pointing to another issue with the current exemption: different tax bases at the state and local levels.

According to the Department of Finance and Administration, in fiscal year 2023, the partial exemption for groceries meant that \$400 million in tax revenue was not being collected by the state.²³ If applied to reducing the sales tax, which is among the highest in the nation when including local rates, that \$400 million could reduce the state sales tax rate from the current 6.5 percent to around 5.8 percent. If applied to reducing the income tax, the top rate could be reduced from 4.7 percent to under 4 percent. Either of these rate reductions would be significant, and if applied to the income tax, it could greatly accelerate the tax reform options we have outlined in this chapter.

The grocery exemption is just one among many goods and services that could potentially be included in the sales tax base. The same DFA report referenced above listed 120 different sales tax exemptions that are currently in law. Few of them are as large as the grocery partial exemption, and many are exemptions for business purchases, which are justified under a correctly sized sales tax base (which should only include *final* consumption). While removing any one exemption is politically challenging, a package of exemption reforms may be more politically palatable, especially if it can reduce the rates in major ways.

The sales tax base issue is even bigger than the DFA report suggests. The 120 exemptions it lists are only those that are specifically provided for in law. Consumer services is another category of consumption broadly exempted, and this is no small problem. According to the latest data from the Bureau of Economic Analysis, Arkansans dedicated 62 percent of their consumption spending to services, with the remainder going to goods. By broadly exempting services (with a few exemptions), Arkansas is not taxing over half of the potential sales tax base.

Figure 7.



The erosion of the sales tax base due to shifting consumer spending patterns is a long-standing issue. When sales taxes were first introduced in U.S. states in the 1930s, over half of consumer spending was on goods. Figure 8 shows the gradual but significant changes in consumer spending patterns over the past century.

Today in the U.S., around two-thirds of consumer spending is on services. When Arkansas adopted its first permanent sales tax in 1935, just 43 percent of consumer spending was on services. Since goods are easier to track, and they constituted the majority of spending, Arkansas and other states made goods the primary sales tax base. As that sales tax base has shrunk, states have needed to raise tax rates to maintain similar total revenue numbers.

The Federation of Tax Administrators (FTA) regularly surveys states about what is included in their sales tax base. The most recent survey from 2017 asks states about 176 potential services that could be taxed, though many of these are business services.²⁴ For example, in the category of personal services, the FTA asks about 20 different services.

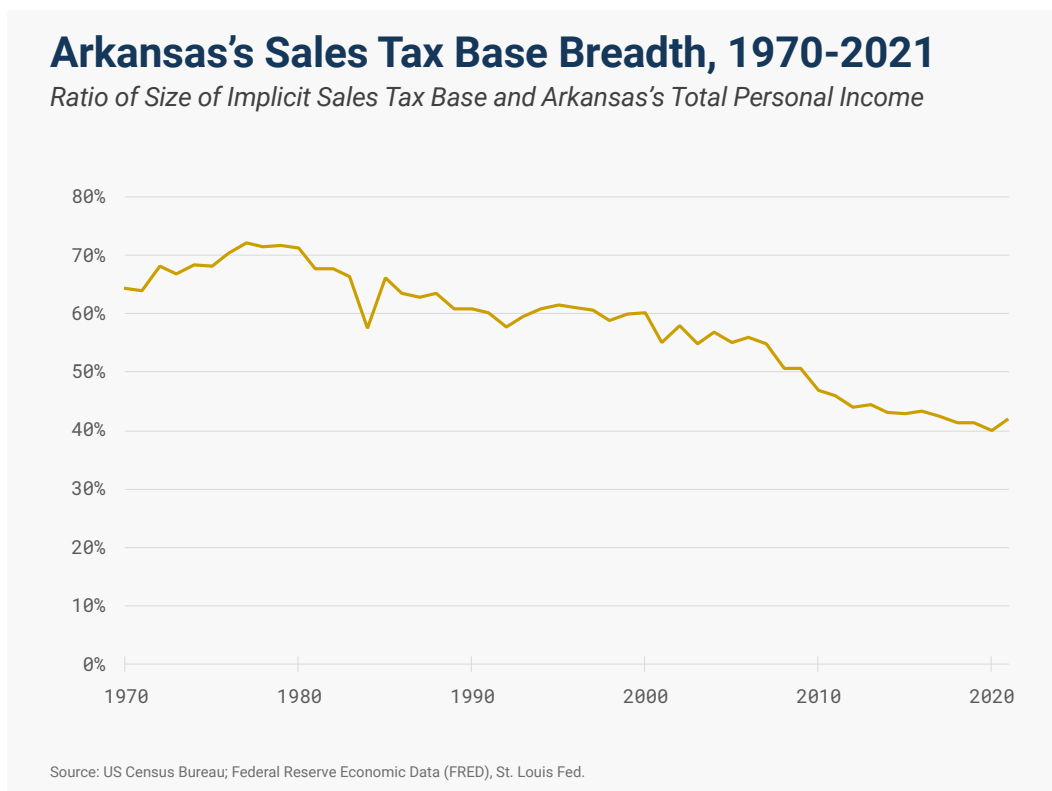
Arkansas currently only includes seven of those services in its tax base, while some states include 19 or 20 of those services (Delaware, Hawaii, New Mexico, South Dakota, and Washington). Examples of personal services that Arkansas currently does not tax, but other states do, include barber shops and beauty parlors, dating services, altering and repairing garments, massage services, personal instruction (such as dance and golf), and tax return preparation. All of these services are taxed by at least five states, and some are taxed by as many as 20 states.

24 Federation of Tax Administrators, "Survey of Services Taxation, 2017," <https://taxadmin.memberclicks.net/sales-taxation-of-services>.

The list of 20 personal services in the FTA report is just a portion of the services that could potentially be taxed in a much broader sales tax base. Other services included in the report are often for personal consumption as well. For example, a variety of computer and online services in Arkansas are exempt, though in 2018 the purchase of online books, music, and movies were included in the tax base for the first time. This change demonstrates two things. First, base broadening is sometimes politically possible, as it clearly was for these services. Second, the distinction between goods and services is often blurrier than we may think. A book is a book, whether you buy it at a physical bookstore or download it from the internet. Taxing one kind of book but not another book is non-neutral, and some might say unfair. In this case, the legislature recognized that arbitrary distinction, but the principle could be applied much more broadly by including many more services in the sales tax base.

When compared with other states overall, Arkansas has a fairly broad sales tax base, with the 11th-broadest base measured as a ratio of state personal income.²⁵ However, that relatively high ranking comes with caveats. First, the base only covers about 40 percent of personal income, thus excluding over half of the potential base. Second, the ratio has declined dramatically from 72 percent as recently as 1977. That decline is shown in Figure 9. And finally, the sales tax base is artificially large because Arkansas taxes many business services, which ideally would not be included to avoid tax pyramiding. This taxing of business-to-business services, along with the high sales tax rate, contributes to Arkansas's poor ranking on the sales tax component of the *State Business Tax Climate Index*, with a ranking of 45th for the sales tax.

Figure 8.



25 Janelle Fritts, "Facts and Figures 2023: How Does Your State Compare?," Tax Foundation, March 2023, Table 21: State Sales Tax Breadth, <https://taxfoundation.org/data/all/state/2023-state-tax-data/>.

Broadening the sales tax base presents numerous political challenges, but the economic benefits are potentially large, including a faster reduction in the individual income tax rate. There is one final benefit to note: broadening the sales tax base at the state level would also increase sales tax revenue for cities and counties with local option sales tax. Once again, any increased revenue could be viewed by citizens as a tax increase, but there is the potential to further lower local sales tax rates, which currently average almost 3 percent combining city and county taxes in Arkansas. State income taxes and local sales tax rates could both be reduced through a well-designed base-broadening process.

Individual Income Tax Reform's Impact on Tax Competitiveness

Option A: If Arkansas reduced its individual income tax rate to 3 percent under the dual tax schedule design, the competitiveness of the state's individual income tax system would improve from 35th to 25th, holding other states and tax changes constant. Arkansas's overall tax competitiveness would improve from 39th to 37th.

Option B: If Arkansas reduced its individual and corporate income tax rates to 3 and 3.4 percent, respectively, under the current tax schedule designs, the competitiveness of the state's individual income tax system would improve from 35th to 25th; the corporate income tax system's competitiveness would improve from 29th to 19th; and the competitiveness of the state's overall tax structure would improve from 39th to 36th.

Option C: If Arkansas consolidated its dual tax tables into a single schedule and the top marginal rate remained unchanged, that threshold would kick in at \$24,300. The design change alone would improve the competitiveness of the state's individual income tax system from 35th to 26th, while overall competitiveness would improve from 39th to 37th. If it coupled the consolidation with a rate reduction to 3 percent (where the top two marginal tax brackets were eliminated and the new top marginal rate would kick in at \$10,300), the competitiveness of the state's individual income tax system would improve from 35th to 19th, while overall competitiveness would improve from 39th to 36th.

Phaseout to Zero: If policymakers phased out the individual income tax to zero, Arkansas's individual income tax system would be tied for the most competitive in the country and its overall tax competitiveness would rank 5th in the country, holding other states and tax changes constant.

Summary of Individual Income Tax Reforms

It will ultimately be up to Arkansans and their elected representatives to determine what the tax structure looks like in years ahead, but “getting to zero” will likely require strict fiscal discipline and difficult choices within the state’s budget. As policymakers continue to debate those ideas, they should remain clear-sighted about the trade-offs.

As a rule, tax cuts do not pay for themselves. That is not to suggest there is no dynamic feedback. Income tax reduction or elimination would certainly affect total personal income throughout the state such that some new sales tax and property tax revenues would accrue. However, the entire cost of the rate cut will not be made up through new consumption and property tax collections. Consequently, to avoid generating unfunded liabilities and repeating the mistakes of Kansas in 2012, the state must seek additional revenue from less economically damaging types of taxation or impose constraints on the budget. Rate reductions can be responsibly funded through existing levels of growth, but these are likely to prove inadequate to fund full elimination—at least in any constrained timeframe.

Income tax reduction can be an effective treatment for economic ailments, but it is a means to an end—not an end in itself. The ultimate goal is economic growth and prosperity, so how a tax is paid for—what revenue offsets or what spending reductions are agreed to—remains an important consideration.

Eliminating the individual income tax is an ambitious policy goal and one that could bring significant economic benefit to Arkansas. But policymakers should be clear-sighted and careful not to pursue income tax elimination for the wrong reasons. It may be easier for Arkansas to carve out its competitive advantage by driving the top individual and corporate rates down to 3 percent, maintaining its nation-leading low property tax rate, and modernizing the sales and use tax system by expanding the base and lowering the rate.

Business Taxes

Introduction

Arkansas has markedly improved its tax treatment of small businesses and corporations since 2016, but there are still numerous opportunities for the state to further modernize its tax treatment of businesses.

As of July 1, 2022, Arkansas's overall corporate income tax system ranked 29th on Tax Foundation's *State Business Tax Climate Index*.²⁶ A large component of that score is determined by the corporate income tax rate (5.1 percent and 12th lowest in the U.S. in 2023, improving to 4.8 percent in 2024), but there are also less well-known structural elements that play an outsized role in the state's tax competitiveness. This should be good news for policymakers because structural reform costs less and may enjoy broader ideological support while also improving economic competitiveness—essentially, providing more “bang for the buck.”

In addition to corporate income tax rate reductions, policymakers should consider reforms to the expensing of capital investment and net operating loss provisions in the corporate income tax code as well as the inventory and franchise taxes in the property tax code.

The Corporate Income Tax

Corporate income taxes are taxes on business profits earned by C corporations. The corporate income tax directly increases the cost of making investments in capital, like machinery and equipment, which businesses and workers use to be more productive. When businesses and workers are more productive, the economy grows. So, by increasing the cost of making investments, the corporate income tax discourages investment and productivity growth, creating one of the largest negative impacts on economic growth compared to other taxes.

An argument sometimes made against cutting corporate income tax rates is that wealthy corporate owners will pocket the savings and average workers will be passed by, but this argument fundamentally misunderstands the incidence of corporate taxation. Despite what the name might suggest, corporate income taxes are borne in large part by the labor factor of production—those employed by the company and those consuming what is produced. Corporations are able to shift a significant amount of the corporate tax burden to workers in the form of lower wages, fewer job opportunities, and higher costs of finished goods. But the same is also true for tax savings.

²⁶ Janelle Fritts and Jared Walczak, “2023 State Business Tax Climate Index,” Tax Foundation, Oct. 25, 2022, <https://www.taxfoundation.org/2023-state-business-tax-climate-index/>.

When taxes are cut, corporations tend to pass on the savings to labor. The reason is that businesses are nearly always in competition with each other—competition for market share and competition for experienced, efficient workers. The competition for employees is especially intense in tight labor markets like those of 2023 when there were nearly three open jobs in the state for every unemployed Arkansan.²⁷ Corporations have little incentive to hold onto tax savings if they could invest it in greater productivity and increase their long-term revenues. So, while perhaps surprising, cutting corporate taxes can collectively benefit average Arkansans as much as, if not more than, Arkansas’s capital owners.

Arkansas’s Corporate Income Tax History and Rates

Arkansas enacted its corporate income tax in 1929, but prior to 2021, the marginal rates had never been reduced. What is more, the rates and brackets in effect at the end of 2020 had been unchanged since 1991. At 6.5 percent, Arkansas used to have one of the highest corporate income tax rates in the South. Prior to 2021, it also had one of the most oddly structured corporate income tax schedules in the country: a graduated six-bracket system with five rates ranging from 1 to 6 percent for corporations with taxable income up to \$100,000 but a flat rate of 6.5 percent for all corporations with taxable income in excess of \$100,000.

Beginning in 2021, the top corporate income tax rate was reduced to 6.2 percent. In 2022, the sixth and highest marginal bracket was eliminated, and the fifth bracket (applicable to taxable income over \$25,000) was reduced from 6 percent to 5.9 percent. As a result of legislation passed in the August 2022 special session, the top corporate income tax rate was reduced to 5.3 percent on January 1, 2023. At the end of the 2023 legislative session, the rate was lowered again to 5.1 percent, retroactive to the beginning of the year, and in special session, a further rate reduction to 4.8 percent (with a bracket consolidation) was adopted for 2024.

Table 4. Arkansas’s Corporate Income Tax Schedule

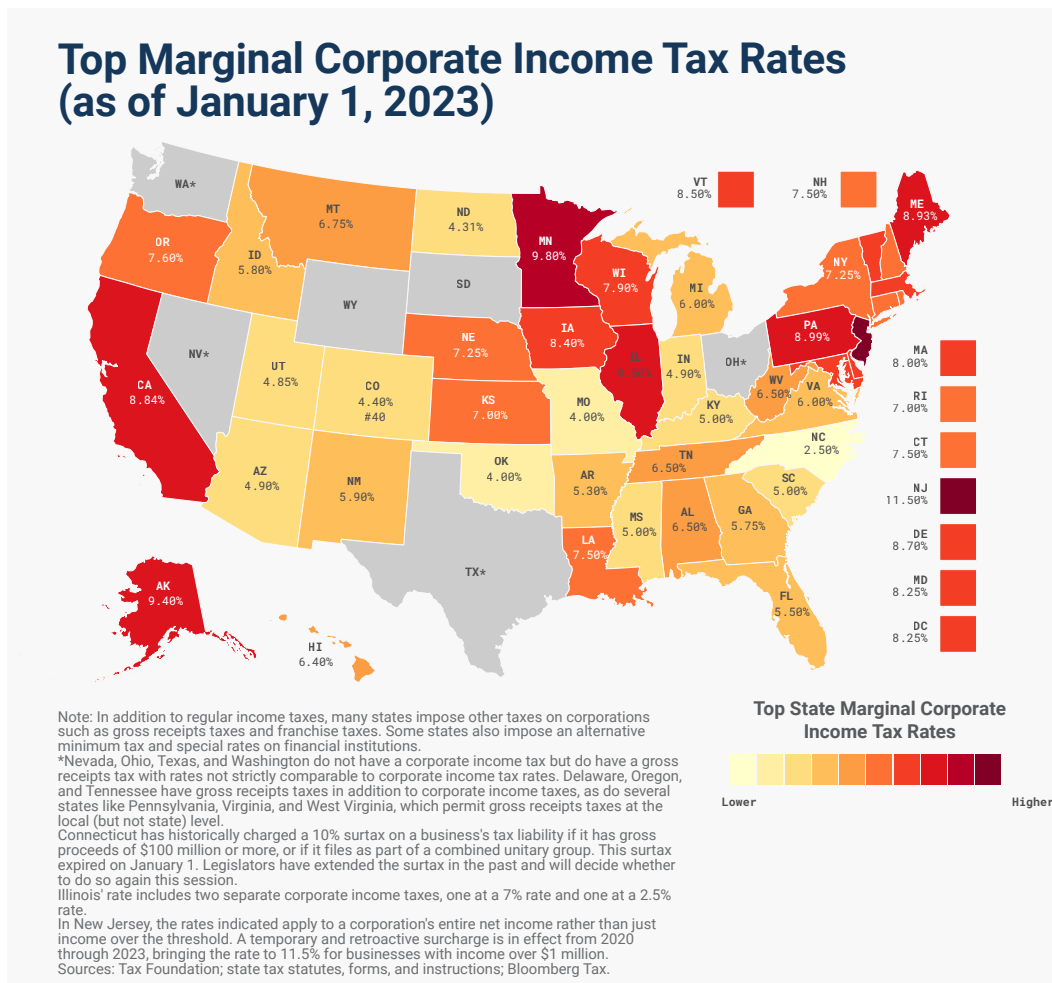
Rates and Brackets, Tax Years 2023 and 2024

Taxable Income	2023 Rate	2024 Rate
\$0–\$3,000	1%	1%
\$3,001–\$6,000	2%	2%
\$6,001–\$11,000	3%	3%
\$11,001–\$25,000	5%	4.8%
>\$25,000	5.1%	4.8%

Source: Arkansas Code § 26-51-205(a)(4).

²⁷ See U.S. Bureau of Labor Statistics, “State Job Openings and Labor Turnover,” Jul. 26, 2023, <https://www.bls.gov/news.release/jltst.toc.htm>; and “Economy at a Glance: Arkansas Unemployment,” accessed Aug. 10, 2023, <https://www.bls.gov/eag/eag.ar.htm>.

Figure 9.



Economic Importance of Corporate Income Tax Rate Reduction

The corporate income tax is one of the state’s more economically damaging taxes because of its negative effect on capital growth and the fact that the incidence is heavily borne by employees. Additionally, the tax has historically only generated an average of 8.3 percent of the state’s general revenue. Those drawbacks make the corporate income tax a prime candidate for reduction and ultimate elimination.

Dollar for dollar, a phaseout of the corporate income tax would generate one of the highest returns for the state’s economy. If lawmakers choose to prioritize other policy reforms, they should at least ensure that the corporate income tax rate is not allowed to lag far behind the individual income tax rate. When this occurs, the business tax system becomes biased against corporations in favor of pass-through entities paying taxes through the individual income tax system. The neutrality principle of sound tax policy calls for a state’s tax code to treat like-businesses and industries the same. Economic efficiency is maximized when market forces and business models determine how a business should be organized rather than the tax system.

Impact on Competitiveness

Holding other states and other aspects of Arkansas's corporate income tax system constant, reducing the corporate income tax rate to 4 percent would improve the competitiveness of the State's corporate income tax system from 29th to 23rd on the *State Business Tax Climate Index*. Eliminating the top two brackets so that the new top marginal rate becomes 3 percent and kicks in at \$6,000 (an effectively flat tax rate) would improve the competitiveness of the corporate system to 17th, holding all other states constant.

But rates are not the only things that matter—far from it.

Full Expensing

Overview and Treatment by Other States

Full expensing, also known as 100 percent bonus depreciation, is a corporate tax provision that allows C corporations to deduct the full amount of qualifying capital investment from taxable income in the year the investment was made. These provisions play an outsize role in increasing business investment and creating better job and earnings opportunities for workers and are superior to traditional capital depreciation policies in terms of setting the conditions for economic growth.

Prior to the 2017 Tax Cuts and Jobs Act (TCJA), federal and state governments, including Arkansas, allowed businesses to deduct the cost of capital investments according to the Modified Accelerated Cost Recovery System (MACRS). Depending on the type of property, the MACRS schedule allowed firms to deduct investment costs over a 3-, 5-, 7-, 10-, 20-, 27.5-, or 39-year period.

After the enactment of the TCJA, businesses were permitted to fully expense—at the federal level—the cost of their short-lived capital investments in the year the investments were made. Many states also included a full expensing provision in their tax codes when they conformed to the post-TCJA Internal Revenue Code. By 2022, 17 states offered 100 percent bonus depreciation. Arkansas, however, continues to maintain the traditional MACRS depreciation system.

This decision to limit depreciation of capital investment puts the Natural State at a disadvantage relative to states that offer bonus depreciation since Arkansas businesses must still deduct the cost of capital investment over multiple years or decades.²⁸ This treatment is different from the consideration given to other business expenditures like wages and supplies, which can be expensed in the year they were made. Limiting businesses' ability to deduct certain types of expenses results in firms that made capital investments having taxable income that is higher than their actual net income. Not only are Arkansas corporations obligated to pay an artificially high tax bill under the current system, but they can never fully deduct the real cost of those investments.

Since investments are depreciated on future tax returns in nominal dollars, real tax savings are reduced both by inflation (which erodes the purchasing power of money) and by the time value of money (where

28 As codified in A.C.A. § 26-51-428, Arkansas conforms to IRC § 168(a)-(j), which establishes MACRS.

the cost of forgone opportunities always makes it better to have a dollar today than a dollar next year). This constrains corporations to recoup only a portion of their original investment. On the margin, that structure disincentivizes firms from making the type of capital investments that increase productivity and benefit workers. Instead, it incentivizes companies to shift those funds to uses that generate greater returns, perhaps even out of state.

Full expensing provisions boost long-run productivity, economic output, and incomes primarily because investments that were not profitable under long-term depreciation rules become profitable under full expensing. When capital formation is hindered, workers are impeded from reaching their full earning potential. Greater capital investment, on the other hand, correlates with both greater worker productivity and higher wages.

In an increasingly mobile economy, states that make in-state investment more attractive will have an advantage over their peers. In an economy characterized by high inflation and supply chain shortages, states also need to be aware of provisions in their tax codes that exacerbate the effect of inflation or create a feedback loop that contributes to even more inflation. States that subject capital to lengthy and incomplete cost recovery drive up the cost of investment and lead to malinvestment. They put a thumb on the scale in favor of expenses that can be written off immediately, such as labor, advertising, or supplies. They discourage the sort of long-term capital investment that can boost productivity, expand production, and have a necessary complementarity with labor. Making full expensing permanent can also help curb inflation by setting conditions for businesses to address the production side of the problem where too much money is chasing too few goods.

Recommendation

On January 1, 2023, the federal bonus depreciation provision began to phase out from 100 percent to 80 percent. Unless Congress intervenes, the bonus depreciation rate will continue to decrease by 20 percentage points per year until it reaches zero in 2028. Consequently, every state that conforms to IRC § 168(k) and does not enact a permanent full expensing provision at the state level will see an effective tax increase on short-lived capital investment. Mississippi and Oklahoma are the only states (as of 2023) with permanent full expensing provisions—a particularly notable improvement in Mississippi, which had not provided any bonus depreciation previously. Arkansas can distinguish itself nationally while staying competitive with its modernizing neighbors by enacting its own permanent full expensing provision that will set conditions for increased capital investment and productivity in the state.

Impact on Competitiveness

If Arkansas added a permanent full expensing provision to its corporate income tax system, while other states' provisions phase out due to federal conformity, the competitiveness of the state's corporate income tax system would improve from 29th to 24th, holding other provisions constant.

Franchise Tax

Overview and Treatment by Other States

Unlike corporate income taxes, which are levied on a business's net income (profit), state franchise taxes (also known as capital stock taxes) are imposed on a business's net worth (accumulated wealth). As such, the tax tends to penalize investment and requires businesses to pay regardless of whether they make a profit in a given year—or ever.

Fifteen states, including Arkansas, levy franchise taxes, but they are not always limited to C corporations. Different states have different laws regarding the types of businesses that fall under a capital stock tax. Regardless of which entities are subject to the tax, the primary problem is that franchise taxes disincentivize capital formation and business asset accumulation in a state. This comes at the benefit of very little revenue, only \$39 million in FY 2022.

Exact formulas and methodologies vary from state to state, but franchise taxes are usually levied on a firm's net assets. At 0.3 percent, Arkansas imposes the highest tax rate on these assets, while Wyoming imposes the lowest at 0.02 percent. Among the states that levy a capital stock tax, half place a cap on the maximum liability a business may be required to pay, but Arkansas does not have a limit. Among the seven states with a cap, Georgia's is the lowest at \$5,000, while New York's is the highest at \$5 million.

Franchise taxes are also a nuisance tax—an entirely separate tax with which businesses must comply, even if they only owe \$150 (the minimum). And for some business models that involve multiple LLCs, the \$150-per-LLC fee can add up, even if the business itself is quite small.

Not only does Arkansas find itself at a disadvantage nationally by imposing a franchise tax, but it is also at a growing regional disadvantage.²⁹ Of its six neighbors, three states (Missouri, Oklahoma, and Texas) do not impose a franchise tax. Missouri and Texas have long foregone a franchise tax, but Oklahoma joined the list in 2023.³⁰ A fourth neighbor, Mississippi, will phase its capital stock tax out by 2028. Additionally, in the 2023 legislative session, the Louisiana legislature passed a bill to phase out the state's capital stock tax. While it was ultimately vetoed for fiscal reasons, the governor approved of the bill conceptually and suggested another attempt at repeal in future years.³¹

Recommendation

Arkansas would be well-served by the phaseout or repeal of the franchise tax. Doing so would put Arkansas in line with the 35 other states that do not levy, or are in the process of eliminating, a franchise tax—including four out of six neighboring states. At less than \$40 million, eliminating the franchise tax is an affordable way for policymakers to improve Arkansas's marginal tax competitiveness while modernizing the state's tax code.

29 Connecticut is on course to eliminate its capital stock tax by 2024. For more details on how states across the country deal with capital stock taxes, see Janelle Fritts, "Does Your State Levy a Capital Stock Tax," Tax Foundation, Mar. 21, 2023, <https://www.taxfoundation.org/state-capital-stock-taxes-franchise-taxes-2023/>.

30 Manish Bhatt, "Oklahoma Adopts Franchise Tax Repeal, Eliminates Marriage Penalty," Tax Foundation, Jun. 7, 2023, <https://www.taxfoundation.org/blog/oklahoma-franchise-tax-repeal-marriage-penalty/>.

31 Wesley Muller, "Gov. Edwards Rejects Phase-out of Louisiana's Corporate Franchise Tax," *Louisiana Illuminator*, Jun. 28, 2023, <https://www.lailluminator.com/2023/06/28/gov-edwards-rejects-phase-out-of-louisianas-corporate-franchise-tax/>.

Figure 10.

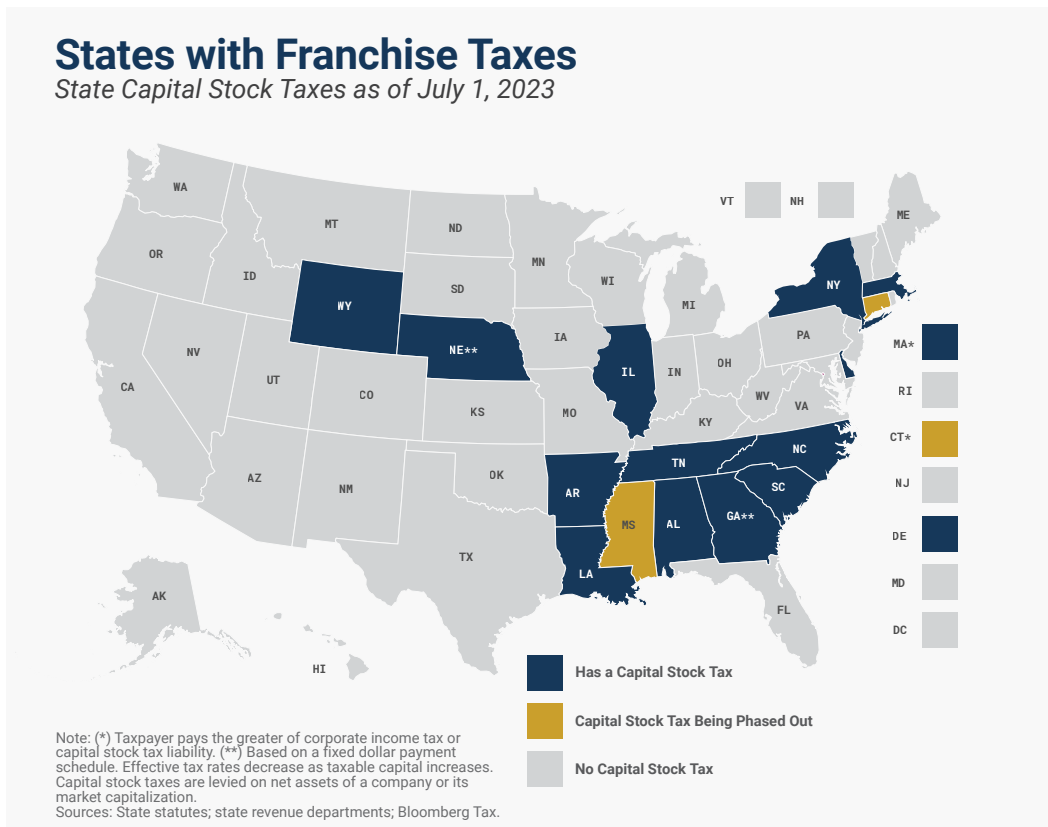


Table 5. Capital Stock Tax Rates

Arkansas and Select Competitors (As of July 1, 2023)

State	Top Tax Rate	Max Payment
Arkansas (a)	0.3%	Unlimited
Louisiana (b)	0.275%	Unlimited
Mississippi (c)	0.125%	Unlimited
Missouri	N/A	N/A
North Carolina	0.15%	Unlimited
Tennessee	0.25%	Unlimited
Texas	N/A	N/A

(a) Highest CST rate of any state

(b) First \$300,000 of taxable capital is exempt from tax

(c) Tax will be fully phased out by January 1, 2028

Source: Bloomberg Tax and state statutes.

Impact on Competitiveness

Holding all other states and tax changes constant, if Arkansas repealed its franchise tax, then the state's overall tax competitiveness would improve from 40th to 38th, with a substantial improvement in the property tax component since Arkansas is otherwise on similar footing with many other states.

Inventory Taxes

Overview and Treatment by Other States

Another tax that is harmful to the viability of businesses and to economic diversification is the tax Arkansas allows localities to levy on the value of a business's inventory. The inventory tax is collected annually as part of the business's local property tax obligation, and notwithstanding the revenue that accrues to municipal and county governments, the inventory tax creates an unnecessary drag on the economy for several reasons.

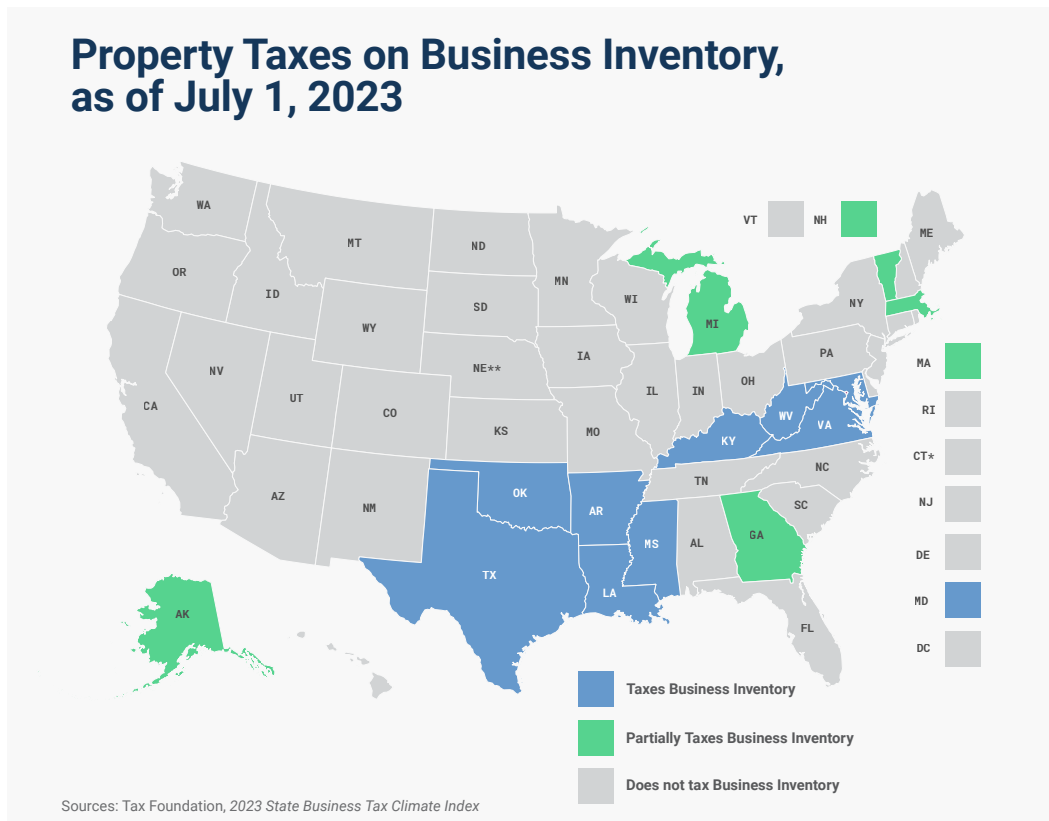
First, inventory taxes are levied regardless of a business's profitability. This disincentivizes entrepreneurship in industries that require expensive amounts of inventory to be kept on hand, since many new start-ups lose money in their early years. The inventory tax's disregard for profitability can also hamper those businesses struggling to stay afloat during economic contractions.

Second, inventory taxes are nonneutral in their application. Businesses that require larger inventories, like retailers and manufacturers, end up paying more in taxes than firms that do not rely on expensive inventories yet are similar in terms of profitability, size, or net worth. This contrasting treatment decreases economic diversity on the margin. All else equal, the tax burden of owning a car dealership, which requires an expensive inventory stock, is higher under the inventory tax than that of a hotel, even if the comprehensive property value or public service requirements of the firms are the same. Both business owners and consumers pay the price.

Third, inventory taxes can contribute to tax pyramiding and a lack of transparency in pricing. For production processes that occur in Arkansas, inventory taxes can increase the cost of doing business, especially if firms source components from in-state suppliers. If manufacturers throughout the production processes source business inputs from other in-state suppliers subject to the inventory tax, at least part of the price they pay for that business input is the inventory tax passed on by the component supplier. This process repeats itself throughout the production process until the final good is sold to the consumer who, by that point, is paying sales tax on the price of the finished good *and* successive iterations of the inventory tax that have been passed on, at least in part, during the production process.

Not only do inventory taxes conceal the true cost of the good and lead to the inefficient allocation of resources, but they also make Arkansas businesses less competitive. It means goods produced in Arkansas like tires from Texarkana, furnaces from Stuttgart, and airplanes assembled in Little Rock have an extra input cost unrelated to production. Not only does this render Arkansas producers less competitive, but it also disincentivizes new firms from locating in the state and increases the cost of goods for consumers.

Figure 11.



While most Arkansans are not in the market for a private jet, many will likely find themselves in the market for a new or used car, truck, or camper. These, and all other goods held in an Arkansas business' inventory, cost more because a significant portion (if not all) of the inventory tax ends up being passed on to consumers.

The inventory tax will not show up on a customer's receipt, because firms end up treating the tax as an added cost of doing business and pass the tax to the consumer directly, but opaquely, through the price of the good. How much of the tax ends up being borne by the consumer depends on the availability of substitutes and the consumer's willingness to pay. If consumer demand remains the same but no suitable substitute for the product is available, the producer will be able to pass along the full cost of the inventory tax to the consumer. If, as in many cases, there is some substitute available or the consumer's willingness to purchase the good diminishes, producers will end up lowering the retail price to remain competitive thereby bearing a share of the inventory tax burden themselves.

The inventory tax is also burdensome in the sense that it is “taxpayer active,” meaning taxpayers must determine their tax liability themselves. This increases the cost of complying with the tax. Since the tax is an *ad valorem* tax, or a tax on the fair market value of the item, merchants must track the value of the items in their inventory throughout the year so that by January 1 of each year they can report the average value of their inventory from the preceding year.³² The average value of the previous year’s inventory is then multiplied by the personal property tax millage of the local taxing district to determine the inventory tax. The tax is then remitted with the firm’s real property tax payment. The process is even more involved for manufacturers³³ and motor vehicle dealers.³⁴

Recommendation

Since inventory taxes are a type of property tax, local governments receive the majority of revenue from such taxes. This adds a layer of complexity to any plans of limiting or repealing such taxes, as an immediate repeal could strain local government finances.

Nevertheless, the fact that Arkansas is one of only nine states to fully tax business inventory brings into stark relief the disincentive to establishing an inventory-centric business in Arkansas.³⁵ (The tax is, however, relatively common regionally.) A phaseout or repeal of the inventory tax would improve Arkansas’s tax competitiveness nationally and relative to the majority of its neighbors as Louisiana, Mississippi, Oklahoma, and Texas all impose a tax on inventory.

Impact on Competitiveness

Eliminating the inventory tax would have a marked impact on the competitiveness of Arkansas’s property tax system. Holding other states and tax changes constant, repealing the inventory tax would improve the competitiveness of the property tax system from 27th to 13th in the nation. That change would also improve the state’s overall tax competitiveness from 40th to 39th.

Net Operating Loss Provisions

Overview

When a C corporation determines its federal taxable income for income tax purposes, it starts by deducting business expenses (like supplies, wages, and rent), asset depreciation, and other costs from its gross revenue. If the difference between revenue and all applicable deductions is positive, then the company earned a profit, and that corporate income is subject to tax. If the company has more deductions than revenue, then the firm operated at a loss and has no income to tax.

³² A.C.A. § 26-26-1201.

³³ According to A.C.A. § 26-26-1205, each manufacturer “shall make out and deliver to the county assessor a sworn statement of the amount of his or her other personal property subject to taxation, also including in his or her statement the average value, estimated as provided in § 26-26-1203, of all articles purchased, received, or otherwise held for the purpose of being used, in whole or in part, in any process or operation of manufacturing, combining, rectifying, or refining which from time to time he or she shall have on hand during the year next previous to the time of making the statement...”

³⁴ According to A.C.A. § 26-26-1207, “The assessment of motor vehicle inventories of motor vehicle dealers shall be determined by calculating the monthly average of the number of sales of new and used motor vehicles by the dealer and multiplying the average by the unit inventory value.”

³⁵ The nine states that fully tax business inventory are: Arkansas, Kentucky, Louisiana, Maryland, Mississippi, Oklahoma, Texas, Virginia, and West Virginia. Five states (Alaska, Georgia, Massachusetts, Michigan, and Vermont) levy a partial tax on business inventory.

For almost every business, large or small, new or old, success is realized in fits and starts. It is common for nascent firms not to earn profits in the early years of their existence.³⁶ But unprofitability in the short run is no guarantee a business will fail in the long term, just as profitability in the short term is no guarantee of long-term success. Some innovators require more runway than others, but that should not in itself be reason for grounding. Determining viability is best left to the marketplace where investors, businesses, and consumers efficiently allocate resources. This is where net operating loss (NOL) provisions can help.

Of all the forces that impact a company's operations and decision-making processes, the tax code should be the least disruptive. NOL provisions allow businesses to use losses in one year to offset taxable income in another year. This treatment ensures that taxes are on long-term profitability and reduces the tax code's adverse impact on economic growth. Well-designed NOL provisions increase the tax code's neutrality by ensuring that entrepreneurs are not unnecessarily punished for taking risks while also providing the latitude for innovation.

Federal Treatment of NOL Provisions

NOL provisions have been part of the federal tax code in varying degrees since 1918.³⁷ Under federal law, corporations are permitted to apply past or current losses to future tax liability (carryforwards) with the caveat that the loss may not decrease any future year's tax liability by more than 80 percent. Businesses previously were allowed to apply losses to tax liabilities from the two previous years (carrybacks) and receive a refund for the difference. The advantage of that arrangement was the liquidity it provided a business that operated at a loss. Essentially, the business was able to smooth its income across good years and bad years. Carrybacks were eliminated under the Tax Cuts and Jobs Act (TCJA) of 2017, and the 80 percent cap was introduced, in exchange for eliminating the 20-year limit on the number of years losses could be carried forward.³⁸ While lifting the 20-year limit helps some businesses, overall, the change was intended as a revenue-raiser, paying for other provisions of the TCJA, including the corporate tax rate reduction.

36 The average American would likely be surprised to learn how many landmark companies failed to generate a profit even years after inception.

In 1971, FedEx was founded as the world's first overnight shipping group. Despite initial enthusiasm surrounding its service, the company proceeded to lose millions of dollars in its first five years of operations due to unforeseen increases in fuel prices. Maggie Zhang, "The Founder Of FedEx Saved The Company From Bankruptcy With His Blackjack Winnings," *Business Insider*, Jul. 16, 2014, <https://www.businessinsider.com/fedex-saved-from-bankruptcy-with-blackjack-winnings-2014-7>.

Amazon became a publicly traded company in 1997 but lost \$2.8 billion over the next four years. Saul Hansell, "TECHNOLOGY; A Surprise From Amazon: Its First Profit," *The New York Times*, Jan. 23, 2002, <https://www.nytimes.com/2002/01/23/business/technology-a-surprise-from-amazon-its-first-profit.html>.

Uber also revolutionized service in its industry. However, despite its popular appeal and massive revenues, Uber did not earn an operating profit until the second quarter of 2023. In the first quarter (January-March) of 2023, Uber completed 2.1 billion trips. See Uber Investor, "Uber Announces Results for First Quarter 2023," May 2, 2023, <https://investor.uber.com/news-events/news/press-release-details/2023/Uber-Announces-Results-for-First-Quarter-2023/default.aspx>. Uber did not earn an operating profit until the second quarter of 2023. Preetika Rana, "Uber's Business is Finally Making Money After Years of Losses," *The Wall Street Journal*, Aug. 1, 2023, <https://www.wsj.com/articles/uber-q2-earnings-report-2023-453c335a>.

Other entrepreneurial endeavors share these start-up woes: Turner Broadcasting System (which founded CNN), ESPN, Tesla, Netflix, Airbnb, and Peloton all operated or are operating with significant losses several years after their founding.

It is not just technology companies that record regular operating losses. Industries where revenues are highly dependent on fluctuations in the business cycle, like hotels, restaurants, and leisure services, can close the year with losses despite making all the right decisions. The same is true for companies in research-intensive industries. Pharmaceutical companies, for instance, may spend years investing hundreds of millions of dollars developing and testing a new drug before completing a viable product approved for public use. Energy companies, likewise, spend significant sums exploring potential energy reserves and developing new extraction or storage technologies.

Firms focused on commodity industries are also prone to annual losses. Agribusinesses fall prey to droughts and disease. Mining explorations may not pan out. Oil and natural gas fields may turn up dry or prove too costly to extract at the market price.

37 Mark P. Keightley, "The Tax Treatment and Economics of Net Operating Losses," Congressional Research Service, updated Oct. 19, 2020, <https://crsreports.congress.gov/product/pdf/R/R46377>.

38 Prior to the Tax Cuts and Jobs Act, losses were allowed to be carried forward for up to 20 years.

State Treatment of NOL Provisions

When states determine how to treat operating losses, they often use federal taxable income as the starting point. As of 2022, 17 states³⁹ and the District of Columbia conform to federal NOL provisions.⁴⁰ By conforming to the federal code, states mimic (1) the annual loss deduction cap (losses carried forward may not reduce current tax liability by more than 80 percent), (2) the unlimited number of years to which losses can be carried forward, and (3) the prohibition against carrying losses back to offset previous years' tax liabilities.

Thirteen states do not conform to the federal provisions, because they limit carryforward years to 20 and impose no cap on loss deduction.⁴¹ In these states, businesses may use losses to offset up to 100 percent of the year's tax liability for 20 years provided they have enough losses to carry forward.

Twelve states, however, restrict carryforwards below the 20-year threshold. Five states—Alabama, Minnesota, North Carolina, Oregon, and Tennessee—permit losses to be carried forward for up to 15 years. Illinois allows unlimited losses for 12 years.

As of tax year 2021, Arkansas allows NOLs to be carried forward for 10 years.⁴² Michigan, Montana, New Hampshire, and Vermont also limit carryforwards to 10 years while Rhode Island imposes a five-year cap.

Additionally, two states set limits to the amount of loss a company can carry forward. Pennsylvania limits a firm's total carryforward amount to 40 percent of the given loss, deductible over a maximum of 20 years. New Hampshire limits the carryforward amount to \$10 million, deductible over a maximum of 10 years. All told, this makes 13 states with NOL provisions substantially inferior to those offered by the IRC. Weak NOL provisions effectively put companies with profitability highly correlated to the business cycle at a disadvantage relative to those in other industries.

Five states, to their credit, continue to allow carrybacks, despite the removal of that component from the federal code. Idaho permits up to \$100,000 of losses to be carried back up to two years. Mississippi and Missouri allow unlimited losses to offset up to two previous years of tax liability. New York also allows unlimited losses to be carried back but extends the application to any tax liability in the previous three years. Montana also uses a three-year carryback rule, but it only allows \$500,000 of losses to be applied over that time.

Since profitability is not a factor in gross receipts taxation, NOL provisions do not exist in states like Texas, which impose a gross receipts tax (called the "margin tax") in lieu of a corporate income tax.

39 These states are Alaska, Colorado, Delaware, Florida, Georgia, Hawaii, Kansas, Kentucky, Maine, Maryland, New Mexico, Oklahoma, South Carolina, South Dakota, Utah, Virginia, and West Virginia.

40 Janelle Fritts and Jared Walczak, "2023 State Business Tax Climate Index," Tax Foundation, Oct. 25, 2022, <https://www.taxfoundation.org/2023-state-business-tax-climate-index/>.

41 These states are Arizona, Connecticut, Idaho, Indiana, Iowa, Massachusetts, Mississippi, Missouri, Nebraska, New Jersey, New York, North Dakota, and Wisconsin.

42 This is an increase over the eight-year cap Arkansas imposed for tax year 2020 and the five-year cap for losses occurring between 1987 and 2020. Prior to 1987, Arkansas imposed a three-year carryforward limit.

Table 6. Net Operating Loss Carryforwards and Carrybacks for Pass-Through Entities

Arkansas and Select Competitors (As of July 1, 2023)

Individual	Federal Conformity	Carryforward/back Years	Carryforward/back Caps
Arkansas	No	10/0	Unlimited
Florida		No Individual Income Tax	
Louisiana	No	Unlimited/0	72% of taxable income
Mississippi	No	20/2	Unlimited
Missouri	No	20/2	Unlimited
North Carolina	No	15/0	Unlimited
Oklahoma	Yes	Unlimited/0	80% of taxable income
Tennessee		No Individual Income Tax	
Texas		No Individual Income Tax	

Source: Bloomberg Tax; state tax statutes and instructions.

Table 7. Net Operating Loss Carryforwards and Carrybacks for Corporations

Arkansas and Select Competitors (As of July 1, 2023)

Corporate	Federal Conformity	Carryforward/back Years	Carryforward/back Caps
Arkansas	No	10/0	Unlimited
Florida	Yes	Unlimited/0	80% of taxable income
Louisiana	No	Unlimited/0	72% of taxable income
Mississippi	No	20/2	Unlimited
Missouri	No	20/2	Unlimited
North Carolina	No	15/0	Unlimited
Oklahoma	Yes	Unlimited/0	80% of taxable income
Tennessee	No	15/0	Unlimited
Texas		No Corporate Income Tax (GRT)	

Source: Bloomberg Tax; state tax statutes and instructions.

Why NOL Provisions Are Pro-Growth Policy

Smoothing business income over time is a better reflection of a company's profitability. Imagine a company that loses \$1.5 million this tax year but makes \$1 million next year. Without NOL provisions, this business would not be taxed this year, but would have \$1 million in taxable income next year even though the company is still down \$500,000 over a two-year period.

Structuring the tax code to focus on long-term average income is pro-growth because it affords businesses the opportunity to forgo taxation in the short term to promote longevity and facilitate future growth. Shifting the focus to long-term net income gives businesses the benefit of the doubt, permits productive risk-taking, and removes government from the equation of businesses' success.

The Stabilizing Effect of NOL Provisions

A system plagued by uncertainty complicates decision-making and sidelines investment. As employers and shareholders hedge against cost increases and other changes that could harm profitability and market demand, employment opportunities wane and wages plateau. The opposite is also true: stability encourages spending and investment by setting conditions for predictable employment. People are more likely to circulate money through the economy if they believe their employment situation is stable. The greater the uncertainty, the more likely individuals are to save their money—as we have seen during the pandemic.⁴³ Minimizing uncertainty through stable policies is also an important prerequisite to maximizing meaningful employment.⁴⁴ In short, stability in tax policy is one of the more important ways a government can promote better economic expansion.

In practice, stability looks like a predictable tax code that allows businesses to make long-term investments and achieve hiring goals by leveraging well-structured NOL provisions. Governments can promote stability in the marketplace and in the tax base by delaying the receipt of corporate tax revenue from firms that operate at a loss in a particular year. By doing this, businesses are given the leeway to succeed or fail on their merits. Likewise, employees are not forced out of work prematurely because an employer is forced to make a trade-off between payroll and tax compliance.

For employers, retention is preferable to layoffs, risking employees turning to competitors, or hiring untrained workers. Employees prefer retention for purposes of income and insurance stability, skill-to-job match, and self-worth. Taking a long-term approach to net income promotes economic stability and is beneficial for all parties involved.

The Smoothing Effect of NOL Provisions

In addition to mitigating elements of risk, well-structured NOL provisions can help businesses bridge economic downturns. Hospitality and other industries whose profits depend on disposable income or business travelers often do best during periods of economic growth. However, when the economy contracts and people have fewer dollars to spend on discretionary items and travel, these industries' profits also recede. Without NOL provisions (both carryforwards and carrybacks), more businesses in the hospitality space may have had to shut down in the past two years.

Long-term predictability is important for businesses whose profitability is positively correlated with the business cycle. Decision-makers who do not know when the next recession will occur or how long it will

43 Rick Babson, "Study shows surge in savings during the pandemic," Federal Reserve Bank of Kansas City, Apr. 29, 2021, <https://www.kansascityfed.org/ten/2021-spring-ten-magazine/study-shows-surge-in-savings-during-the-pandemic/>.

44 This is also known as full employment. If an economy has reached full employment, output (gross domestic product, or GDP) is maximized as a result of the unemployment rate reaching the lowest level it can achieve without prompting inflation related to widespread wage spikes and labor competition. This is also known as the non-accelerating inflation rate of unemployment (NAIRU).

last are helped by knowing that heavier tax burdens during booms can be averaged out during busts.

Long-term stability helps business owners, but it helps employees even more. By factoring NOL provisions into long-term hiring and investment plans, businesses are able to retain workers for a longer period. The smoothing effect of NOL provisions can make the difference between a business laying off workers or keeping them on the payroll. This is good for families, neighborhoods, and communities. It is also better for government to smooth tax receipts over the long run than to watch the tax base erode due to bankruptcies or layoffs.

When a business fails during a recession, it often takes significant time for another to replace it. It takes even longer for employment levels to return to normal. Consider the last two recessions, the COVID-19 recession and the Great Recession—the two largest since the Great Depression. According to the Bureau of Labor Statistics, it took approximately six months for private sector establishments (number of businesses) to return to their pre-COVID-19 pandemic level.⁴⁵ Private sector employment levels lagged much further behind. As of October 2021, the United States economy was still 1.7 million jobs below its pre-pandemic high in February 2020.⁴⁶ Similarly, the replacement of all private sector establishments lost during the Great Recession, which officially ended in June 2009,⁴⁷ did not occur until the final months of 2013.⁴⁸

Additionally, 7.9 million net private sector jobs were lost during the Great Recession. Employment levels did not return to pre-recession levels until the second quarter of 2014.⁴⁹ Barriers to entry, including start-up costs, risk tolerance, and market volatility, are a few reasons for this. Of course, not every bankruptcy will lead to massive destabilization, but the examples illustrate how important a stable environment is for businesses and workers. When jobs and capital are lost, it can take an extraordinary amount of effort to bring them back.

Table 8. Effective Tax Rates without NOL Provisions

Convenience Store		
Year	Profit or Loss	5% Tax
1	\$50,000	\$2,500
2	\$50,000	\$2,500
3	\$50,000	\$2,500
4	\$50,000	\$2,500
5	\$50,000	\$2,500
6	\$50,000	\$2,500
7	\$50,000	\$2,500
8	\$50,000	\$2,500
9	\$50,000	\$2,500
10	\$50,000	\$2,500
Total	\$500,000	\$25,000
Effective Tax Rate		5%
Jewelry Store		
Year	Profit or Loss	5% Tax
1	\$50,000	\$2,500
2	-\$25,000	\$0
3	\$100,000	\$3,750
4	\$150,000	\$7,500
5	\$150,000	\$7,500
6	\$100,000	\$5,000
7	-\$100,000	\$0
8	-\$75,000	\$0
9	\$50,000	\$2,500
10	\$100,000	\$5,000
Total	\$500,000	\$35,000
Effective Tax Rate		7%
Hardware Store		
Year	Profit or Loss	5% Tax
1	-\$200,000	\$0
2	-\$100,000	\$0
3	\$0	\$0
4	\$150,000	\$7,500
5	\$150,000	\$7,500
6	\$150,000	\$7,500
7	\$50,000	\$2,500
8	\$50,000	\$2,500
9	\$100,000	\$5,000
10	\$150,000	\$7,500
Total	\$500,000	\$40,000
Effective Tax Rate		8%

Source: Author's calculations.

45 The second quarter of 2020 saw net loss of 276,000 private business establishments. Net gains were recorded in the third and fourth quarters of 2020 with 170,000 and 115,000 establishments added, respectively. An additional 146,000 private establishments were added in the first quarter of 2021. See Bureau of Labor Statistics, "Number of private sector establishments by direction of employment change, seasonally adjusted," last updated Oct. 27, 2021, https://www.bls.gov/web/cewbd/table5_1.txt

46 Bureau of Labor Statistics, "Employment Situation Summary," last updated Nov. 5, 2021, https://www.bls.gov/news.release/archives/empst_11052021.htm.

47 National Bureau of Economic Research, "US Business Cycle Expansions and Contractions," last updated Jul. 19, 2021, <https://www.nber.org/research/data/us-business-cycle-expansions-and-contractions>.

48 Approximately 204,000 establishments were lost during the Great Recession, although additional losses occurred outside the official dates determined by the NBER. See Bureau of Labor Statistics, "Number of private sector establishments."

49 See Bureau of Labor Statistics, "Private sector gross job gains and job losses, seasonally adjusted," last updated Oct. 27, 2021, https://www.bls.gov/web/cewbd/table1_1.txt.

NOL Provisions Encourage a Diverse Tax Base by Leveling the Playing Field

NOL provisions are also important to ensure fair tax codes and a diverse tax base. Consider the following example of three businesses: a convenience store, a jewelry store, and a hardware store. Each has a different business model, but all earn the same income over 10 years. All stores operate in the same city and in a state that taxes business income at 5 percent and, hypothetically, does not have an NOL provision in its tax code. For simplicity's sake, our three examples are pass-through businesses, which benefit from business loss provisions within the individual income tax.

The convenience store is well established. The convenience store owner earns consistent, if somewhat small, profits throughout all periods of the business cycle. After 10 years, he has earned \$500,000 in profits, and his effective tax rate is 5 percent.

The jewelry store is also well established. The owner earns large profits during periods of economic growth, but he struggles to break even during economic recessions. After 10 years, the owner has earned \$500,000 in profits, and his effective tax rate is 7 percent.

The hardware store is a relatively young establishment. The owner lost money her first two years in business but managed to break even the third year. The store does best during periods of economic growth when new homes are being constructed. As home building slows during recessions, the store does most of its business with homeowners looking to renovate or maintain their existing homes. Consequently, the store is still profitable during economic contractions, albeit less so than during expansions. After 10 years, the owner has earned \$500,000 in profits and her effective tax rate is 8 percent.⁵⁰

Start-ups and industries with profits highly correlated to the business cycle are often harmed by the absence of NOL provisions. That is depicted in the example above. Despite earning the same profit over the course of 10 years, the jewelry and hardware store owners have effective tax rates that are 2 and 3 percentage points higher, respectively, than the convenience store owner. Moreover, the absence of NOL provisions risks stopping businesses in their tracks before they get a chance to be profitable. The hardware store has a tax liability of \$7,500 in year 4 when it is still \$150,000 from breaking even.

Entrepreneurs consider the tax code when they evaluate starting a business, and many of their decisions are made on the margin. Some people may start their company because they are particularly skilled in a given trade or they want to strike out on their own. Many others make decisions based on cost-benefit analyses. An entrepreneur may prefer to own a hardware store. Perhaps that's what his grandfather did, and it gives him a greater sense of satisfaction. But, if hardware store start-up costs are high and the business model generates higher effective tax rates, he may opt to invest his start-up funds in a convenience store with less overhead and lower effective tax rates. Alternatively, he may even decide the reward is too small to invest anything and instead remain employed by someone else. Moreover, innovators competing for start-up capital, or those who cannot secure outside venture capital, may find a tax code with inadequate NOL provisions particularly onerous.

⁵⁰ This example was inspired by Carol Portman, "Net Operating Losses in Illinois and Around the Country: Matching Taxes to the Business Cycle," Taxpayers' Federation of Illinois, October 2021, <https://www.illinoistax.org/index.php/net-operating-losses-in-illinois-and-around-the-country-matching-taxes-to-the-business-cycle-carol-portman/>.

Sidelining investment is suboptimal for two reasons. First, it limits the economy. If an entrepreneur decides to sit on her start-up funds instead of, say, investing them in a new hardware store, the broader community suffers. New jobs are forgone; contractors and homeowners miss out on a convenient supplier of building materials; and the owner's upward mobility is restrained.

The second reason sidelining investment is inefficient is because it narrows the tax base, which can result in a need to increase the tax rate. Absent new businesses, the objects or entities available for taxation are limited. This effectively concentrates the tax burden on fewer taxpayers.

A broad and diverse tax base is important because invariably certain industries or businesses will fall on hard times. If governments become dependent on a few industries or commodities for funding, revenue streams and services run the risk of disruption when inevitable recessions occur or when goods and services become obsolete. As an example, several localities are struggling to replace funding from taxing cable companies as consumers increasingly cut the cord.⁵¹ Diverse tax bases are more likely to weather economic storms and changes to consumer behavior without producing the kind of revenue volatility that could disrupt government services and public goods.

The final drawback to a narrow tax base is the risk of a high tax rate. Essential government services must be funded. To fund these services, tax rates on the limited number of taxpayers are necessarily higher than they would be in a jurisdiction with a broad, diverse tax base.

A tax system with robust NOL provisions is a neutral, fairer tax system. Neutrality is one of the foremost principles of a sound tax code. Without NOL provisions, the tax code can intentionally or unintentionally favor one industry or class of business over another. Beyond the concerns of horizontal inequity, industry-biased tax codes are also not in the best interest of governments. Governments are best served by diverse, resilient tax bases facilitated through low barriers to entry and equal treatment.

NOL provisions encourage growth and stability by mitigating risk to vulnerable businesses and by contributing to similar businesses being treated equally by the tax code. In this way, they adhere to the policy principle of neutrality. By maintaining a neutral tax code—choosing neither winners nor losers—governments also promote the efficient allocation of resources. The market allocates resources to areas of optimal use when entrepreneurs succeed or fail on their merits—rather than as a result of a non-neutral tax code.

Entrepreneurs are disincentivized from starting a business like the hardware or jewelry stores in the example above if they know they will have to pay more in taxes. While a government may earn more in the short term from limiting or excluding loss carryforwards, that short-run benefit comes with the trade-off of long-term instability.

⁵¹ Ulrik Boesen, "Cutting the Cord from Cable Has States Courting New Revenue Streams," Tax Foundation, Jul. 19, 2021, <https://www.taxfoundation.org/streaming-services-tax/>.

Contrast the impact of a NOL provision on the same three businesses from the previous example.

Table 9. Effective Tax Rates with NOL Provisions

Convenience Store					
Year	Profit or Loss	Available NOLs	Taxable Income	NOL Carryforward	5% Tax
1	\$50,000	\$0	\$0	\$0	\$2,500
2	\$50,000	\$0	\$0	\$0	\$2,500
3	\$50,000	\$0	\$0	\$0	\$2,500
4	\$50,000	\$0	\$0	\$0	\$2,500
5	\$50,000	\$0	\$0	\$0	\$2,500
6	\$50,000	\$0	\$0	\$0	\$2,500
7	\$50,000	\$0	\$0	\$0	\$2,500
8	\$50,000	\$0	\$0	\$0	\$2,500
9	\$50,000	\$0	\$0	\$0	\$2,500
10	\$50,000	\$0	\$0	\$0	\$2,500
Total	\$500,000				\$25,000
Effective Tax Rate					5%

Jewelry Store					
Year	Profit or Loss	Available NOLs	Taxable Income	NOL Carryforward	Tax (5%)
1	\$50,000	\$0	\$50,000	\$0	\$2,500
2	-\$25,000	\$0	-\$25,000	-\$25,000	\$0
3	\$100,000	-\$25,000	\$75,000	\$0	\$3,750
4	\$150,000	\$0	\$150,000	\$0	\$7,500
5	\$150,000	\$0	\$150,000	\$0	\$7,500
6	\$100,000	\$0	\$100,000	\$0	\$5,000
7	-\$100,000	-\$100,000	-\$100,000	-\$100,000	\$0
8	-\$75,000	-\$175,000	-\$175,000	-\$175,000	\$0
9	\$50,000	-\$175,000	-\$125,000	-\$125,000	\$0
10	\$100,000	-\$125,000	-\$25,000	-\$25,000	\$0
Total	\$500,000				\$26,250
Effective Tax Rate					5.25%

Hardware Store					
Year	Profit or Loss	Available NOLs	Taxable Income	NOL Carryforward	Tax (5%)
1	-\$200,000	\$0	-\$200,000	-\$200,000	\$0
2	-\$100,000	-\$200,000	-\$300,000	-\$300,000	\$0
3	\$0	-\$300,000	-\$300,000	-\$300,000	\$0
4	\$150,000	-\$300,000	-\$150,000	-\$150,000	\$0
5	\$150,000	-\$150,000	\$0	\$0	\$0
6	\$150,000	\$0	\$150,000	\$0	\$7,500
7	\$50,000	\$0	\$50,000	\$0	\$2,500
8	\$50,000	\$0	\$50,000	\$0	\$2,500
9	\$100,000	\$0	\$100,000	\$0	\$5,000
10	\$150,000	\$0	\$150,000	\$0	\$7,500
Total	\$500,000				\$25,000
Effective Tax Rate					5%

Source: Author's calculations.

Impact on Competitiveness

Expanding the state's NOL provision by uncapping the carryforward period and the amount of operating losses that can be carried forward is a reform that could be nearly as impactful as reducing the corporate income tax rate. Holding other states' tax changes constant, Arkansas's corporate income tax competitiveness could improve from 29th to 17th just by uncapping NOL provisions.

If Arkansas made all of the recommended improvements to the corporate income tax code specified above (flatten the corporate income tax rate schedule to three brackets with a top marginal rate of 3 percent, enact full expensing, and uncap NOL provisions) the state's overall corporate income tax competitiveness would skyrocket from 29th to 4th in the country. In turn, Arkansas's overall tax competitiveness would improve from 40th to 35th under those reforms.

If both inventory and franchise tax repeal were adopted together, Arkansas's property tax system would become the 4th most competitive property tax system in the country. The state's overall tax competitiveness would improve to 37th.

If policymakers in Little Rock enacted all the business tax reforms addressed in this chapter, Arkansas's corporate and property tax systems would each rank 4th in the nation while the state's overall tax competitiveness would improve from 40th to 26th.

Table 10. State Business Tax Climate Index Summary of Reforms

Business Tax Reforms in Corporate and Property Tax Systems

Reform Recommendations	Index Ranking		Neighboring States' Tax Competitiveness (2023)						
	Overall	System	LA	MO	MS	OK	TN	TX	
Corporate Reform Options									
CIT Rate Reduction-3%	40 to 38	29 to 17	Overall	39	11	30	23	14	13
Enact Full Expensing	40 to 39	29 to 24	Corporate	32	3	13	4	45	47
Uncap NOL Provision	40 to 38	29 to 17	Property	23	7	37	30	33	38
Options 1, 2, & 3	40 to 35	29 to 4							
Property Reform Options									
Franchise Tax Repeal	40 to 38	27 to 9							
Inventory Tax Repeal	40 to 39	27 to 13							
Options 5 & 6	40 to 37	27 to 4							
Corporate and Property Reforms									
Options 4 & 7	40 to 26	4 to 4							

Source: Janelle Fritts and Jared Walczak, *2023 State Business Tax Climate Index*, Tax Foundation, Oct. 25, 2022, <https://taxfoundation.org/research/all/state/2023-state-business-tax-climate-index/>.

Conclusion

Arkansas lawmakers have clearly demonstrated an appetite for continued tax reform, potentially encompassing the ultimate elimination of the state's individual income tax. This goal is commendable, and is within reach, but it must be approached with care. Responsible, triggered rate reductions, potentially paired with offsetting revenues (for instance, from sales tax modernization) can help lawmakers achieve this aim in time.

During this process, however, policymakers should not lose sight of the many other areas in which the state's tax code could benefit from reform. Efforts in recent years have dramatically improved the competitiveness of the state's individual and corporate income tax rates, but overall tax competitiveness is still dragged down by archaic taxes that penalize investment and make it harder to start a business, and by stingy provisions that drive up costs for low-margin or struggling firms. Structural reforms with modest revenue implications can help make Arkansas far more attractive to job creators.

Decades ago, Arkansas swapped nicknames, dropping "Land of Opportunity" for "the Natural State." While the former may no longer be the state's nickname, it very much deserves to be policymakers' ambition. Responsible pro-growth reforms to Arkansas's tax code can help ensure that the Natural State is indeed a Land of Opportunity.

About the Tax Foundation

The Tax Foundation is the nation's leading tax policy research organization. Since 1937, our research, analysis, and experts have informed smarter tax policy at the federal, state, and global levels. Our Center for State Tax Policy uses research to foster competition among the states and advises policymakers on how to improve their tax systems.

Authors

Timothy Vermeer

Former Senior Policy Analyst

Jared Walczak

Vice President of State Projects

About the Arkansas Center for Research in Economics

The Arkansas Center for Research in Economics (ACRE) is an Arkansas-focused research center housed in the College of Business at the University of Central Arkansas. ACRE scholars and policy analysts use academic research and original analysis to educate the public on important issues of public policy in Arkansas. Our research focuses on barriers to employment, taxes and spending, targeted incentives, education, and government transparency. ACRE promotes solutions that respect the personal and economic freedoms of individuals because protecting and expanding these freedoms has a proven record of improving the lives of people around the world and here at home.

Authors

Jeremy Horpedahl, Ph.D.

Director of the Arkansas Center for Research in Economics,
Associate Professor of Economics at the University of Central Arkansas

The authors would like to acknowledge ACRE Policy Analyst Joseph Johns for his contribution to this project.

Many changes have been made to the Arkansas tax system since 2016, and lawmakers have clearly demonstrated an appetite for continued tax reform. But what should come next?

This publication picks up where our previous book left off, offering a roadmap for continued reform.

It shines a spotlight on work left undone, proposes next steps where some efforts have already been made, and helps lawmakers explore the trade-offs involved in some of the new ideas—including the potential phaseout of the individual income tax—that have entered the tax conversation in Little Rock.

Arkansas may have swapped nicknames, dropping “Land of Opportunity” for “the Natural State,” but the former very much deserves to be policymakers’ ambition. Responsible pro-growth reforms to Arkansas’s tax code can help ensure that the Natural State is indeed a Land of Opportunity.



TAX FOUNDATION



**ARKANSAS CENTER FOR
RESEARCH IN ECONOMICS**

UNIVERSITY OF CENTRAL ARKANSAS

©2023 Tax Foundation

Tax Foundation
1325 G Street, N.W. Suite 950
Washington, D.C. 20005
202-464-6200

taxfoundation.org

