ADVANCE ARKANSAS INSTITUTE

HOW TO BRING TAX RELIEF AND TAX REFORM TO ARKANSAS

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Arkansas's outdated tax and budget policies have made us lag behind other states. Reforming our tax and budget policies will transform Arkansas into a land of opportunity.

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EXECUTIVE SUMMARY

The Arkansas Tax Reform and Relief Legislative Task Force has two missions: its job is to produce recommendations for tax reform and tax relief. Tax reform determines who pays taxes and how much in taxes they pay; it aims to make the tax code more equitable and to ensure that economic decisions are rational and efficient, rather than being based on tax avoidance. Tax reform does not necessarily reduce the sum of taxes paid. Tax relief, on the other hand, is focused on making the sum of tax payments smaller. However, it is unlikely that real progress will be made in tax policy unless and until the state's budget process is significantly revamped. This report therefore provides recommendations for both tax policy and budget policy.

Tax reform and tax relief should not aim at helping a small group or class; rather, the goal should be to benefit every Arkansas citizen. A fair and efficient tax code that advances the welfare of all Arkansans will spur our state's economy; furthermore, the tax and budget procedural recommendations described in this report will also lead to smaller and thriftier state government.

The Arkansas Tax Reform and Relief Legislative Task Force has been presented with a once-in-a-lifetime opportunity to propose reforms that would reward Arkansas citizens with the freedom to focus on what they do best – and give state policymakers the resources they need to build a more competitive economic environment. We hope that Task Force members will take advantage of this unique moment.

WHY IS ARKANSAS FALLING BEHIND OTHER STATES?

Interstate comparisons show that Arkansas's tax burden is startlingly heavy. Arkansas taxpayers are required to remit a relatively high percentage of their personal income in state and local taxes: our state has the 17th highest tax burden in the nation.[1] This tax burden reduces citizen freedom and choice, makes Arkansas less attractive to business investors, and encourages working-age citizens to migrate to neighboring states with less-burdensome taxes. Compare us to our neighbors: Oklahoma has the 40th highest per capita tax burden in the nation; Mississippi is 41st; Louisiana is 45th; Texas is 46th; Tennessee is 47th.[2] With the exception of Missouri – which has the 29th highest tax burden in the nation – we are surrounded by some of the lowest-taxed states in the Union.

STATE	RATE	TAX BURDEN RANKING
Arkansas	10.1%	17th highest
Louisiana	7.6%	45th
Missouri	9.3%	29th
Oklahoma	8.6%	40th
Tennessee	7.3%	47th
Texas	7.6%	46th

This ranking measures the total share of all citizens' income that goes to pay state and local taxes. In other words, a relatively huge percentage of the average Arkansan's income goes to support government institutions, while our surrounding neighbors bear lighter burdens. In fact, Arkansas has the highest tax burden of all states in the South and Southwest regions.

Arkansas has failed to keep up with a national trend: significant reductions in state and local tax burdens across the nation. All but four states in the Union have either reduced their overall tax burdens, or left them essentially unchanged, since 1977. Unfortunately, Arkansas has increased the tax burden on its citizens over the same period, changing its relative position among the states from "some of the least taxed at 8.6 percent to some of the more heavily taxed with a burden of 10.1 percent."[3]

Here's more perspective: let's say that we have the modest aim of wanting Arkansas to achieve merely average U.S. levels of per capita taxation, so as to match – for instance – Michigan's ranking of 25th in the nation. This modest goal – of moving Arkansas just seven spots in the ranking, from 17th to 25th place – would require an annual state and local tax cut just shy of $833 million, which translates, on average, into lower taxes of $277.21 per resident.[4] If we aim for a loftier goal – to bring Arkansas into the realm of one of the 10 least-taxed states (and nudge out Oklahoma, which currently is barely in the top 10) – that would require an overall annual tax reduction of about $1.78 billion. In other words, Arkansas citizens labor under a staggeringly high tax burden when compared to other states, and a substantial reduction in revenue will be needed just to bring us to the middle of the pack.

Perhaps if Arkansas were geographically closer to higher-tax states, such as New York (12.7 percent tax burden per capita) or Wisconsin (11.0 percent), our total tax burden of 10.1 percent would not appear quite so dire. But the reality is that Arkansas sits in an unhealthy high-tax sinkhole surrounded by low-tax competitors, which puts us at a distinct competitive disadvantage for business development and employee recruitment – and dampens the power of Arkansas citizens to make their own decisions about their own lives.

Our state's history of tax increases has made us uncompetitive with neighboring states' business environments. Furthermore, the long investment in Arkansas government services has not generated personal income growth in Arkansas – which, after 40 years of relatively large spending by state and local government, ranks near the bottom – 46th out of 50 – in per capita income.[5] Our 40-year experiment in heavy levels of state and local government spending has not improved Arkansans' financial status. It's time to follow a different path.

The bottom line is that this heavy tax burden has failed to produce dividends: it has not led to the advances in workforce enhancement or economic development that neighboring states have seen. Arkansas policymakers should let our citizens keep more of their tax dollars for themselves, so that the people can make more of their own plans, investments, and decisions. Reducing the tax obligations of the people of Arkansas is what we call “tax relief.”

ARKANSAS HAS FALLEN SHORT ON TAX RELIEF

In response to public demands for tax relief, Arkansas’s Republican-led legislature has moved ahead with multiple tax cuts. Since 2013, our state has reduced general revenue tax collections by $228 million per year.[6] By 2019, general revenues will decline another $115 million per year, thanks to the recently enacted $50 million income tax cut for lower-income earners, along with the reduction in the food tax that is tied to the elimination of $65 million in desegregation payments to certain school districts. Arkansas plans to reduce its tax intake by $343 million per year in general revenues by 2019. However, Arkansas’s appetite for special revenue taxes has increased.

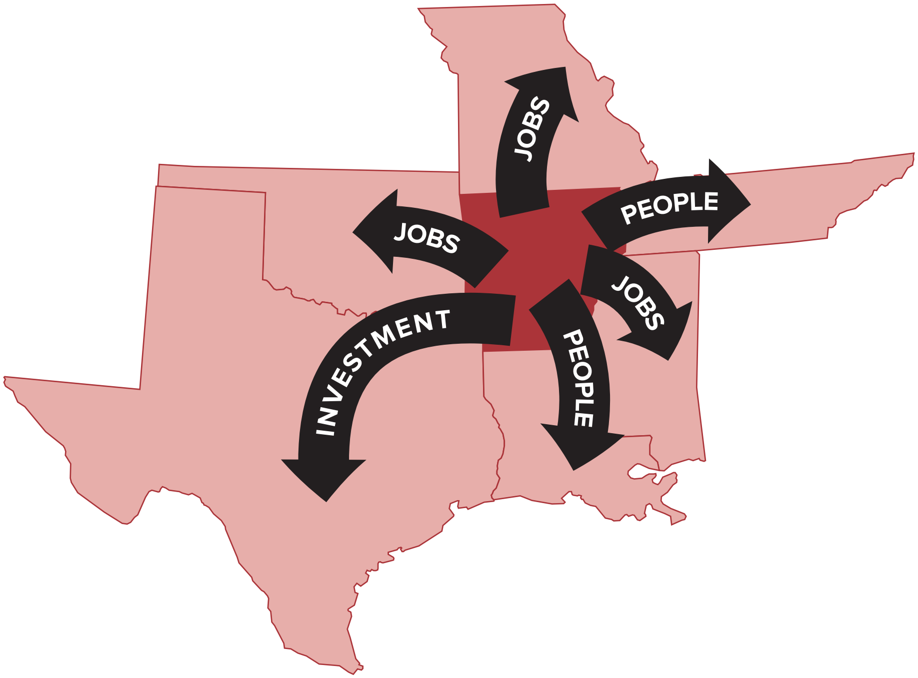
A half-cent sales tax increase for 10-year highway bonds, as approved by Arkansas voters in 2012, increased state and local government revenue by $195 million.[7] Notably, when we combine the income and food sales tax relief described in the previous paragraph with the 2012 sales tax increase for highway bonds, the net tax relief is only $148 million per year – with general revenues declining but special revenue collections increasing. (And proposed highway taxes would change that tax relief to, on net, a new $67 million tax burden.) Despite efforts to move forward with significant income and sales tax relief in the context of a moderate sales tax increase for highways, notable improvements in Arkansas’s relative tax burden ranking – especially when compared to the low-tax environments of our surrounding states – remain unrealized. The majority of Arkansas voters, if surveyed, would likely still find their taxes to be too high.

According to recent polling data, 55 percent of U.S. registered voters believe their taxes are too high.[8] The subsets of voters in that majority are well-represented in Arkansas: low-income individuals, Republicans, conservatives, and Trump voters are more likely to agree that taxes are too high, with conservatives being the most likely at 71 percent, followed by Trump voters at 70 percent. It is reasonable to conclude that cutting taxes is strongly desired by a large majority of Arkansas registered voters. The Arkansas electorate is likely to reward policymakers who enact tax relief; those policymakers should reduce Arkansas's tax burden, so that all Arkansans can point to state government action that lowered taxes.

Arkansas's neighboring states continued to push the envelope on tax reform in 2016. Without tax reforms, Arkansas will only fall further behind, given this region's competitive interstate tax environment. In 2016, Mississippi eliminated all income taxes on the first $5,000 of income, eliminated all franchise taxes, and lowered several income brackets. Tennessee also produced tax reforms: it eliminated the state estate tax and removed income taxes on interest. Tennessee's reward for these decisions was a $2 billion surplus. With competitive neighbors like these, Arkansas is well-advised to join the tax reform race.[9]

ALMOST EVERY PAYCHECK IS TAXED LESS IN OTHER STATES

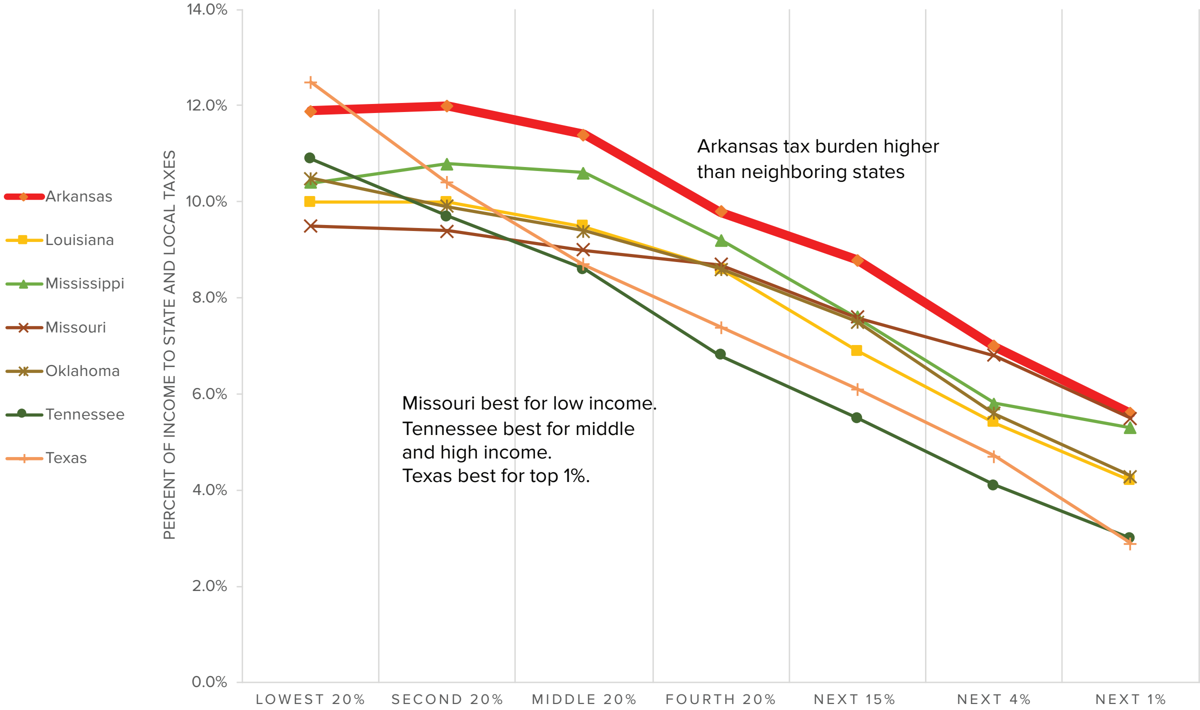
Here's a frightening fact policymakers have been doing their best to ignore: for four out of five Arkansans, the fastest route to higher take-home pay involves a moving van. Our state and local governments keep a larger percentage of personal income than every one of our neighboring states. Arkansans who seek a better tax climate have lots of options:



All our neighbor states – Missouri, Tennessee, Texas, Louisiana, Mississippi, and Oklahoma – qualify as a low-tax haven for the Arkansas worker. Just by crossing a state line, the typical Arkansas worker – whether upper-, middle-, or lower-income – would keep more of the money he or she has earned. With respect to tax policy, we can't say "Thank God for Mississippi" – our eastern neighbor provides a better bargain for just about every Arkansan who works for a living. There are a few tax loopholes and special industry deals that make a small number of well-connected Arkansas better off in this state, but the vast majority of wage-earners get a bad deal here – and they deserve a better deal from Arkansas.

The relatively high cost of government in Arkansas, as measured by tax payments, is not only a complaint of conservatives; liberal critics make the same point. One important dataset comes from the Institute of Tax and Economic Policy (ITEP), a left-leaning policy group. ITEP looked at the 2012 tax returns of all workers in the 50 states.[10] (Individually identifiable tax returns can't be seen by their researchers.) ITEP then sorted the information by income, separating the returns into seven bands or categories – from the lowest 20 percent to the top 1 percent. Every working-age taxpayer can be put in one of these seven income categories. Then ITEP calculated the percentage of income each category paid in state and local taxes. So, for instance, the bottom 20 percent of all wage-earners in Arkansas paid (on average) 11.9 percent of their income in taxes to state and local government. That's all the sales, income, and property taxes that workers in that group must pay each year.

Percentage of Income for State and Local Taxes Arkansas and Surrounding States



No group in Arkansas is safe from the heavy hand of the tax collector. With one exception, Arkansas has the highest taxes in our region. That's true for all groups, except for the bottom 20 percent – with respect to that group, we're only the second worst! (Texas places an even weightier tax burden on its poorest citizens than Arkansas.) From a purely financial perspective, workers would be better off moving to one of our surrounding states to pursue a more favorable tax climate.

At no income level do Arkansas residents escape the Arkansas tax collector, who carefully exacts a slice of every paycheck. The fact is that, in Arkansas, working harder and earning more is treated less favorably than in neighboring states. Those in neighboring states work like us and earn like us, but their state government demands less in taxes. Stay in Arkansas, and you'll keep paying a supersize Arkansas tax burden. This is the day-to-day reality of Arkansans at all income levels, who can look across the state border to see a "better place."

Many Arkansans do not have the option of leaving their family, jobs, and neighborhoods for lower taxes elsewhere. Arkansas provides more reasons to stay here than any paper could describe. But the facts on the ground suggest that lower taxes and less government spending are crucial to Arkansas's future.

Following a map to the "better place" would abandon those left behind to shoulder Arkansas's relatively high tax burden. A better path for all Arkansans, however, would be tax relief – that is, lower tax rates for everyone. History shows that Arkansans have been very generous with their tax dollars. Unfortunately, Arkansas government has failed to improve the relative income of its residents: to repeat, our state ranks 46th in the nation in per capita income. We need to ask why Arkansas spends so much – and whether the burden our state places on taxpayers is worth it.

WILL THE TAX REFORM AND RELIEF LEGISLATIVE TASK FORCE CARRY OUT ITS MANDATE?

Arkansas policymakers have heard the people's call for tax reform. During the 2017 General Assembly, several legislators signaled support for additional income tax cuts, but legislators also faced demands from the Arkansas Department of Transportation (ArDOT) for additional funds. An attempt to broaden the sales tax base by taxing internet commerce failed, largely due to legislative concerns about increased overall tax burdens. Policymakers stymied by the problem of how to balance income tax cuts with state revenue requirements created the Arkansas Tax Reform and Relief Legislative Task Force to propose solutions. Its mission: to "modernize and simplify the Arkansas tax code, create jobs for Arkansans, and ensure fairness for all individuals and entities impacted by the tax laws of the state of Arkansas."

So far, public comments by legislators have dampened expectations for additional tax cuts due to new revenue requests from ArDOT, as well as anticipated growth in Medicaid and public education funding.[11] It is unclear how aggressive members of the Task Force intend to be in the realm of tax relief. Rather, tax reform – a shuffling of revenue sources – appears to be at the core of the endeavor. Tax relief – that is, a net reduction in tax revenues – deserves to be a part of the Task Force's recommendations.

Whether the Task Force will turn out to be worthy of its name – by providing genuine tax relief – remains an open question.

THE TAX FOUNDATION'S RECOMMENDATIONS

The Task Force should build on the preliminary recommendations produced by the Tax Foundation, a nationally recognized tax policy research organization. Tax Foundation analysts visited Arkansas repeatedly in 2015 and 2016 to interview stakeholders and better understand the state's tax system; after they interviewed numerous government and business leaders, the Tax Foundation published a series of concrete, actionable recommendations in "The Arkansas Roadmap to Tax Reform"[12] – essentially consisting of proposals to reduce high marginal tax rates on personal income and to broaden the sales tax base without changing sales tax rates, an excellent starting model for the legislature.[13]

The Tax Foundation's three proposed options generally assume a "revenue-neutral" approach (a revenue-neutral approach means that tax revenues would remain unchanged);[14] these options are designed to ensure that the state's tax code encourages internal economic growth and external competitiveness with neighboring states:

Option A	**A FLAT ONE-BRACKET INCOME TAX RATE OF 4.95 PERCENT.** This option would require a ¾ vote of the legislature. This is a "revenue-neutral" proposal.
Option B	**A NEW SET OF INCOME TAX BRACKETS WITH A TOP RATE OF 5 PERCENT.** The revenue loss from decreased income tax revenue would be offset by expanding the sales tax base. Depending on the changes to the sales tax base, this option could be revenue-neutral as well. This option would require a majority-only vote of the legislature.
Option C	**A NEW SET OF INCOME TAX BRACKETS WITH A TOP RATE OF 6 PERCENT.** The revenue loss from decreased income tax revenue would be offset by expanding the sales tax base. Depending on the changes to the sales tax base, this option could be revenue-neutral as well. This option would require a majority-only vote of the legislature.

The Tax Foundation's suggestions rest on academic research demonstrating that such reforms would likely benefit Arkansas in the future: the academic literature suggests that lowering income tax rates increases economic growth and incentives to work. Indeed, because of the economic growth and larger tax base that such reforms would produce, Arkansas could experience a growth cascade that would enable enhanced funding of government services as well as further tax relief. According to the Tax Foundation:

> *Excessive taxes on income are generally less desirable than taxes on consumption because they discourage wealth creation. In a comprehensive review of international econometric tax studies, Arnold et al. (2011) found that individual income taxes are among the most detrimental to economic growth, outstripped only by corporate income taxes. The authors found that consumption and property taxes are the least harmful.*[15]

One concern with the Tax Foundation's recommendations is that Arkansas's overall sales tax burden, in terms of dollars per capita, is already high. Simply lowering the income tax while raising sales or consumption taxes might improve the business tax climate, but will not address the severe tax burden that citizens of Arkansas labor under. The Tax Foundation ranks Arkansas as having the 10th highest state and local general sales tax collections in the nation; every Arkansas citizen, on average, already pays $1407 in sales taxes every year. In fact, that $1407 figure is a larger dollar amount than notoriously high-tax states like California, New York, and Massachusetts collect per capita. The Tax Foundation already ranks Arkansas as having the 8th broadest sales tax base of any state, with 43 percent of all goods and services purchased in Arkansas already subject to tax.[16] These are sales taxes collected from Arkansans who already earn lower incomes than the U.S. average. To state the obvious, raising sales or consumption taxes makes the tax burden worse.

It is fair to argue that expanding the reach of the sales tax has some positive effects. Expanding the breadth of the sales tax base – which is to say, expanding the number or nature of the services and goods it taxes – limits economic distortions that are created when consumers make choices based on whether or not an item is taxed. Greater sales tax breadth allows for taxing more items at a lower rate, which can lead to revenue neutrality. But all taxes have negative effects, and the sales tax is no exception. Arkansas already ranks 10th heaviest in the nation with respect to per capita state and local sales tax collections, and a revenue-neutral sales tax increase would preserve Arkansas's unfortunate ranking in that area. Raising sales tax revenues through base-broadening in order to pay for income tax revenue reductions (with, for instance, a broader tax on internet sales, or by means of the ArDOT's proposed sales tax on gasoline) adds more heft to an embarrassingly heavy ranking and would further burden taxpayers – perhaps even blunting the positive effects of income tax cuts.

Two of Arkansas's neighboring states, Louisiana and Texas, have even higher per-capita state and local sales tax collections. But, on this metric, Arkansas residents are still worse off than four of our neighboring states. As described above, sales tax increases carry with them their own costs.[17]

State and Local General Sales Tax Collections Per Capita, FY2014

STATE	DOLLARS COLLECTED	RANKING
Arkansas	$ 1407	10th highest
Louisiana	$ 1491	5th
Mississippi	$ 1104	21st
Missouri	$ 918	28th
Oklahoma	$ 1186	16th
Tennessee	$ 1264	14th
Texas	$ 1455	9th

Finally, no discussion of tax reform would be complete without mentioning property taxes. Property taxes are a more stable and efficient source of revenue than income taxes; although this might present political difficulties, Arkansas policymakers who balanced increased property taxes against decreased income and sales taxes would likely see improvements in government efficiency, land use, and economic production.[18]

TAX RELIEF VS. TAX REFORM

Because of Arkansas's high overall tax burden, tax relief should be the goal. Tax relief is superior to reshuffling current tax burdens: to put it another way, tax relief is a better alternative to tax cuts in some areas that are simply counterbalanced by tax increases in others. A proper design for revenue collection is a worthwhile goal – but if it is the only accomplishment of the Task Force, then the Task Force will have failed. Letting Arkansans keep more of their hard-earned money would not only improve their well-being and grant them more control over their own lives; tax relief would also, as previously noted, encourage economic growth and job creation.

According to national polls, government spending is the number one concern among registered voters. For most of this decade, voters put the job market and economic conditions foremost; government spending has now supplanted this concern. Revenue-neutral income tax reform does not address voter concerns about government spending. In contrast, tax relief sends a clear and simple message to Arkansans that their government has their best interests at heart; it also addresses voters' top concern. Concern about government spending is broad-based; it comprises Republicans, independents, moderates, and those without a college degree. All ages, incomes, and gender groups express similar concerns. Legislators can thus speak to multiple demographic groups by pruning government spending, shrinking taxes, and improving economic conditions.[19]

A better understanding of Arkansas's tax distortions is crucial to tax reform. We hope that the Tax Reform and Relief Task Force seriously considers the Tax Foundation's suggestions for tax reform, so as to reduce Arkansas's heavy tax burden on its citizens and improve the business climate in Arkansas. However, an equally important goal of tax reform should be to let citizens make more choices about their own lives, rather than having government make choices for them.

BUDGET REFORM AS A KEYSTONE OF TAX REFORM

Tax relief necessarily creates revenue reduction, which in turn necessitates smaller government budgets. Tax relief creates significant, long-term structural change to state and local government budgets; tax relief should not trigger use of one-time, rainy-day, or long-term reserve funds if changes are coordinated with the budgeting process.

The following section discusses reform of the Arkansas budget process, which will almost certainly be necessary if policymakers want to ease Arkansas's tax burden. The state budget process arguably falls outside of the Task Force's domain, but because the success of the state budget process is so directly connected to state tax policy, the Task Force should make budget recommendations – and budget process recommendations – so as to ensure the success of its tax policy prescriptions. Improved budgeting can help legislators improve services for citizens, set appropriate priorities for infrastructure projects, and hold agencies accountable for results.

The following chart from the Arkansas Bureau of Legislative Research shows that overall general revenue collections, less refunds, have continued to increase in state fiscal years 2015 and 2016, in spite of various tax cuts. However, over time, tax collections will fall as more money is returned to Arkansas taxpayers. The policymakers in charge of the state budget will need to anticipate and incorporate the needed spending reductions.[20]

General Revenue Collections Less Refunds through SFY2016

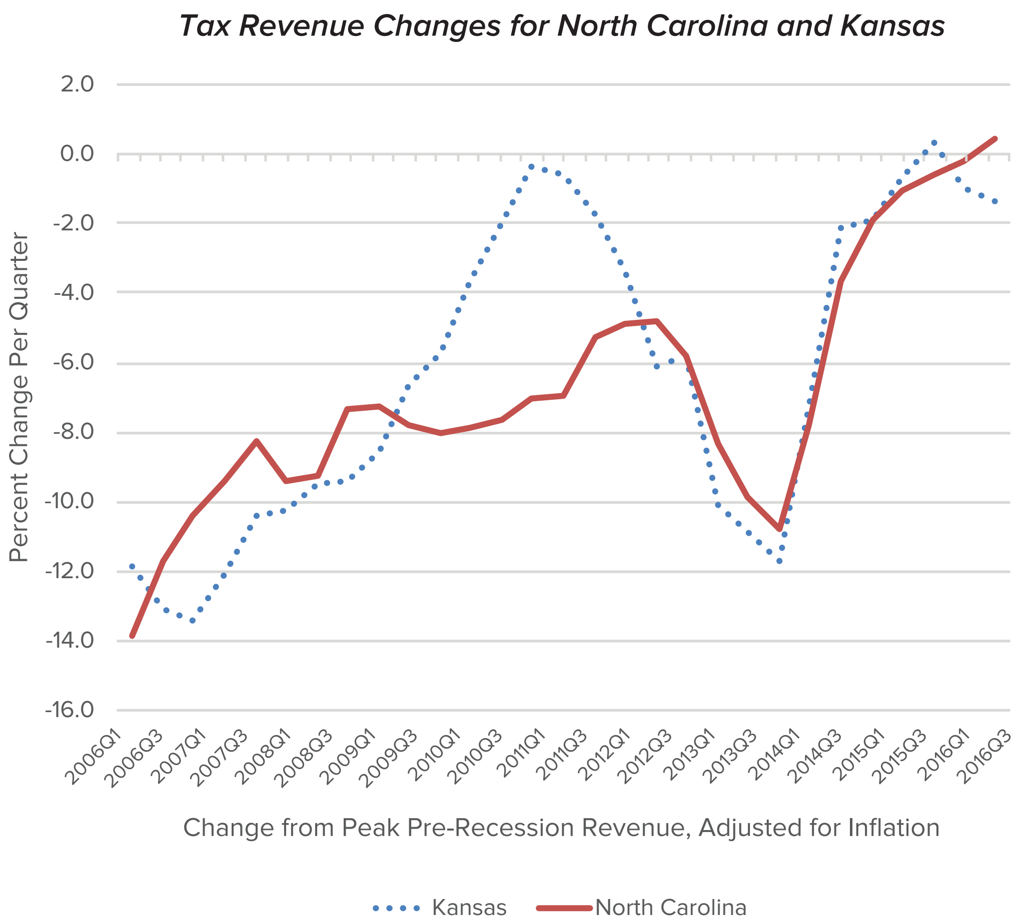
STATE FISCAL YEAR	DOLLAR AMOUNT INCREASE	PERCENT CHANGE FROM PREVIOUS YEAR
SFY 2016	$114 million	+1.94%
2015	$240 million	+4.27
2014	$1 million	+0.01
2013	$286 million	+5.36
2012	$217 million	+4.23
2011	$283 million	+5.85

FOLLOW THE RIGHT LEADER

Many of today's discussions of state tax relief include the ominous presence of Kansas in the background. Kansas's 2012 tax cuts led to severe financial difficulties, but Arkansas does not have to follow Kansas's example. Kansas policymakers failed to appreciate the impact of revenue reductions on state agency spending, and then failed to revamp state agency budgets to deal with those revenue reductions. Kansas's biennial budget of 2018-2019 is, at the time of this writing, predicted to face a $450 million yearly shortfall – in the context of required revenue of roughly $5.7 billion a year. Currently, the Kansas legislature is seeking to override the Governor's veto of proposed tax increases. The ongoing revenue shortfall is a function of an 8 percent drop in annual revenues after its tax reforms were enacted.[21]

Arkansas should learn from Kansas's experience, but also from North Carolina's. North Carolina's extraordinary tax and budget reforms of 2013 catapulted the state from sluggish to strong in the Tax Foundation's business tax climate rankings: from 41st to 11th. No other state has ever improved its rankings so rapidly in the Tax Foundation's history. Since 2013, North Carolina has cut $5.7 billion from state taxes, and has reaped the benefits of enormous economic growth[22] – thus serving as a counterexample to those who argue that state tax cuts are likely to lead to Kansas-style fiscal difficulties. Indeed, for fiscal year 2017, North Carolina is projecting a budget surplus of $581 million in its $23 billion budget – which would be the third year in a row of large budget surpluses.[23] Ultimately, the most relevant historical example here is that of Arkansas – and it seems indisputable that Arkansas's attempts at boosting its economy by larding on government spending has left our state lagging behind our neighbors.

The chart on the next page shows that Kansas and North Carolina had similar dips and recoveries in revenue collection since the Great Recession of 2008.[24] In 2013, both states instituted significant tax relief; that year, both states' revenue collections dropped 3 percent. By 2016, both states had almost fully recovered from the Great Recession. Yet North Carolina has been a national success, with budget surpluses and a radically improved business climate. The shortfalls in Kansas, in contrast, have been understood as a cautionary tale.



What was so different between the two states? It's clear that Kansas didn't suffer an unmanageable revenue shortfall. It did not face a revenue problem that was triggered by tax cuts. The different results for the two states came from other factors: better revenue forecasting, organized reductions in state spending to match tax cuts, and business tax climate improvements leading to improved job prospects all helped North Carolina succeed. Arkansas legislators should take note that North Carolina-style tax cuts (especially when combined with budget reforms) can lead to fiscal and economic success.

Even though voters have consistently sent a majority of Republican legislators to the state Capitol since 2012, there have been few noteworthy reductions in state agency spending; by and large, state agency budgets for fiscal year 2018 contain no evidence of significant program spending cuts. Rather, baseline spending remains the primary driver of budget policy. It is business as usual for some agencies to demand even higher funds – and the resultant costs are likely to be paid, once again, by using one-time funding and spending of agency fund balances. This status quo cannot be maintained if tax relief is added into the mix.

ARKANSAS'S EXPANDING STATE AND LOCAL SPENDING

Unfortunately, neither significant relief nor significant reform is likely without improvements to the biennial budget process. This is true because of the central fact of government budgeting: less revenue means less available government spending. Notably, Arkansas's government has needed more and more tax revenue over time to maintain itself. Over the years, spending has outpaced both population growth and inflation. "Arkansas state spending increased 46.25 percent between 2002 and 2015, faster than inflation (31.77 percent) and population growth (9.89 percent) over the same time period."[25]

One factor in increased spending is the *Lakeview* decision – the Arkansas Supreme Court's decision that arguably forced a great increase in state funding of education. However, state government spending increased at its greatest rate in 2009, long after the *Lakeview* decision came into effect. In fact, several of our neighboring states – such as Oklahoma, Texas, and Tennessee – have dealt with court-mandated education funding changes in a much more fiscally conservative manner. The bottom line is that Arkansas state budgets have grown at increasing rates in recent years for reasons that are largely unrelated to *Lakeview*.

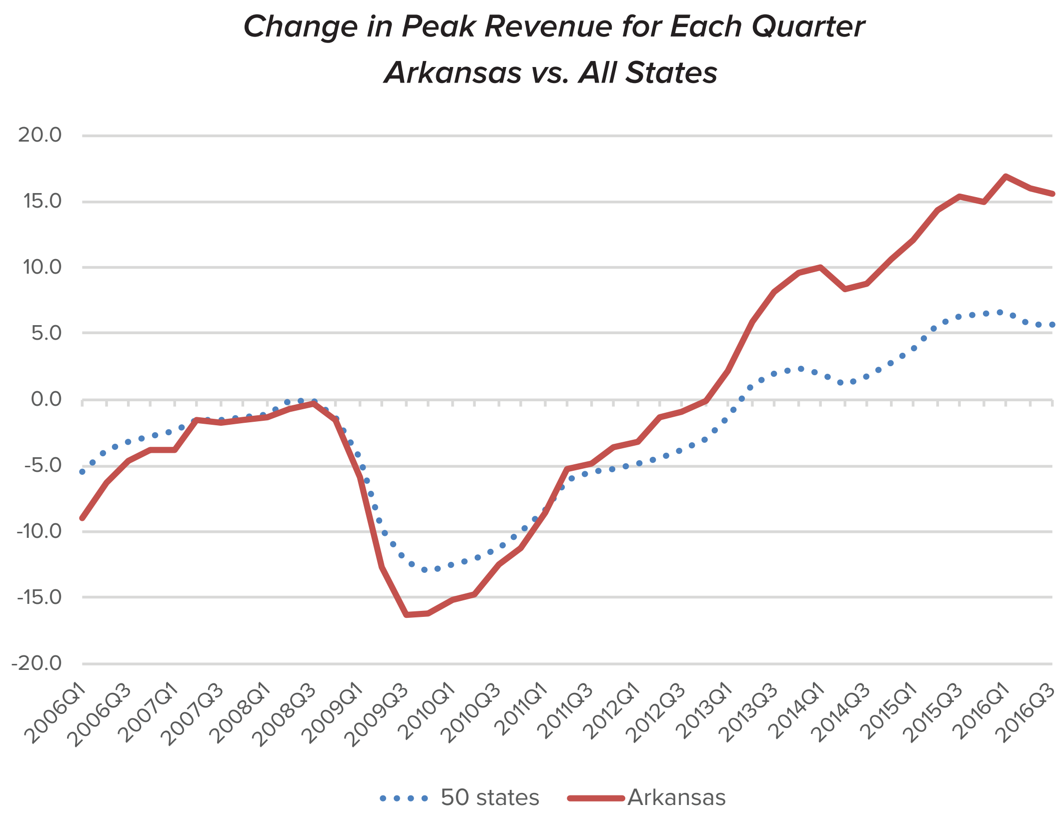
SUCCESSFUL TAX REFORM REQUIRES BUDGET REFORM

Significant tax relief can only be achieved by means of spending reductions; therefore, the Task Force should recommend systemic reforms of the budget process. Although the Task Force will presumably do its best to recommend tax reforms that are fair and efficient, overall state and local taxes will continue to weigh too heavily on Arkansas households if the Task Force focuses only on revenues. Rather, the Task Force should also focus on ways to reduce the government's dependency on revenues.

Tax relief that will empower Arkansans to make more of their own life choices requires comprehensive budget reform. Budget reform would enable the downstream benefits of tax cuts and improve public confidence in the political process. Successful budget and tax reform could, in turn, yield enormous benefits to participating legislators. Voters have a right to expect their political leaders to carefully analyze all government spending and make decisions in the best interests of their constituents. Leadership in the area of state budget reform would reflect well on the seriousness and decisiveness of elected officials.

ADVANTAGES AND DISADVANTAGES OF THE REVENUE STABILIZATION ACT

Historically, Arkansas has enjoyed unusually smooth collection of general revenues. According to the Pew Charitable Trust, Arkansas ranked 44th in the amount of unpredicted changes in tax collections – meaning that tax collections in Arkansas are much more predictable than in most states.[26] The chart below shows changes to Arkansas revenues as compared to the United States. Arkansas's relatively steady pattern of revenue collection makes for easier long-term budgeting and planning.[27] Our relatively low volatility suggests that setting aside large reserves in a rainy-day fund is unnecessary, given that unexpected shortfalls in Arkansas should be relatively small and infrequent. Notably, Arkansas revenue collection today is currently 15 percent above its peak revenue collection of 2006. That means our state's revenue collection is in much better shape than North Carolina's, which today has not even surpassed its peak revenue collection of 2008.



General revenues have been a steady source of income for state budgeting. In the last 50 years, total general revenues less refunds have declined only four times (when compared to the previous year's collections) – in 1969, 2002, 2009 and 2010.[28] (Announcements earlier this year of general revenue shortfalls are only a missed forecast – state government still collected an increasing amount of general revenue; it just wasn't as much as expected.[29]) However, agencies use the Department of Finance and Administration's (DF&A's) forecast of next year's revenues, which includes economic conditions and tax law changes. When general revenues are lower than DF&A forecasts, agencies adjust their spending plans for the remainder of the year.

The Arkansas process typically leads to full funding of agency budgets, but in anticipation of funding gaps, the Revenue Stabilization Act (RSA) manages any funding shortfalls. The RSA is a unique Arkansas statute that automatically reduces state entity funding in the event that general revenue forecasts fall short. Here's a summary of the process: the Chief Fiscal Officer of the state is required to submit the Official General Revenue Forecast and balanced budget no later than 60 days prior to the start of the regular general session, or before December 1st of a fiscal session.[30] Monthly reports of tax collections are made by DF&A to help legislators know the path of revenue collections. However, formal adjustments to the revenue forecast and agency budgets are announced as needed by the DF&A Chief Financial Officer. These forecasts also build in tax cuts that have been previously enacted by the legislature and Governor. From the agency perspective, the RSA allows great flexibility to plan around any shortfalls in state funding.

The trouble with the current process, however, is that it assumes that status quo budgeting is best. The system that has evolved typically treats last year's spending as the basis for this year's spending. Revenue and spending votes are decoupled from each other during the legislative session, but what is needed is to link them together. The defects of this approach are apparent nearly every day of each legislative session – more precisely, at the time when legislators vote on various appropriation bills listed on that day's budget calendar, even though these decisions do not typically take the big picture of all government funding into account. Even though state budget appropriations in Arkansas require a ¾ vote of the legislature, which in theory should restrict agency spending, it doesn't seem to work that way. During the session, legislators pass a dizzying array of appropriation bills nearly every day with little discussion. At the end of the session, the Revenue Stabilization Act (RSA) doles out $5 billion in general revenues among various programs; the RSA ultimately determines how much money is spent on each agency and program. One global vote on the RSA is insufficient for making budget decisions: legislators need a better procedure to manage budget priorities, especially in the context of falling revenues.

TAX PROCESS CHANGES

- Require yearly disclosure of the revenue impact of all tax expenditures.
  - This disclosure should be in a format that would allow policymakers to compare the revenue impact of any one tax expenditure to any other tax expenditure.
  - This disclosure should be in a format that would allow policymakers to understand and calculate how the elimination of any tax expenditure could be used to reduce any particular tax rate.
- Require formal review, and regular approval, of all tax expenditures.
- Incorporate the review/approval process into the regular budget process.
- Implement sunset requirements for tax expenditures.

PROPOSED TAX PROCESS CHANGES

As discussed above, the Tax Foundation has proposed three different options for tax reform in Arkansas that would encourage economic growth. Unfortunately, just changing tax rates is probably not enough: policymakers should also reform other tax provisions that distort the economic climate of the state. This may not be achievable without reforms to the process of tax policy decision-making.

More particularly, policymakers should reform what are called "tax expenditures." Speaking generally, a tax expenditure is a tax credit, tax deduction, or tax exemption. A tax expenditure can benefit a small or large number of people. Tax expenditures can shrink, distort, and damage the economy just as much as imposing a tax can. Economists on both the left and right have criticized tax expenditures: the set of tax expenditures in the tax code is like a shadow budget that gets much less scrutiny than tax rates or government spending.[31]

Consider the example of a sales tax on each can of soda: that tax would probably decrease consumer purchases. On the other hand, a tax expenditure – such as a temporary tax holiday that briefly eliminated all food taxes – might increase consumer purchases. (This kind of tax holiday is a classic instance of a sub-par policy choice, because there is substantial evidence to suggest that tax holidays do not change total consumer purchases of goods; instead, such tax holidays simply make some purchases untaxed and therefore decrease net state revenue.[32]) Tax expenditures typically attempt to encourage activities that policymakers like – such as business growth, child care, or homebuilding. However, tax expenditures will also reduce revenue needed for state government services. Tax expenditures, especially those which benefit only a small number of people, can create both changes in behavior and economic inefficiencies. (Tax expenditures can lead to desired changes, such as creating high-paying jobs in return for investment incentives. However, legislators should audit such tax expenditures for the desired outcome and total cost in lost revenues.)

Arkansas offers a variety of tax expenditures – such as tax abatements, deductions, incentives, and subsidies – to encourage particular activities. Those who receive these privileges benefit either by reduction of taxes owed or by receipt of funds from state government.

One peculiar aspect of the whole family of tax abatements, incentives, and expenditures is that these provisions get much less legislative scrutiny than tax increases. A proposed tax increase can ignite an army of opposition. A proposed tax expenditure, however, will generate less scrutiny and fewer complaints. But both will distort the economy by dampening incentives for productive behavior.

Removing tax expenditures permits rate reductions without, on net, increasing taxes. For example, the Reagan Administration, working in concert with Congress, famously eliminated tax expenditures ("loopholes") in 1986 – which paid for lower tax rates. Congress's Joint Committee on Taxation summed up the aims of Congress in enacting this reform legislation:

> *The sharp reductions in individual and corporate tax rates provided by the Act and the elimination of many tax preferences will directly remove or lessen tax considerations in labor, investment, and consumption decisions. The Act enables businesses to compete on a more equal basis, and the business success will be determined more by serving the changing needs of a dynamic economy and less by relying on subsidies provided by the tax code.* [33]

Arkansas has a large number of these incentives or revenue reductions in its state tax system. In Arkansas, tax abatement and incentives are or will soon be public information. Tax expenditures, the largest in dollar volume, are much less transparent.

Tax abatements are agreements between a government body and a single business, in which the government essentially offers tax reductions in order to purchase desired goals such as more jobs or new plant expansion. A tax abatement is a contract with only a single company, not a broad tax incentive. Beginning in FY 2017, Arkansas's reporting of tax abatements will be governed by General Accounting Standards Board (GASB) Statement 77. (The GASB is a national organization that sets standards for government accounting.) The new GASB standard is a significant improvement in the transparency of tax abatements; those tax abatements can have a marked effect on local governments. GASB 77 will help the public understand the true costs of agreed-upon economic incentives. GASB 77 standards will be developed by DF&A, but legislators should review DF&A's implementation for completeness and accuracy.

Tax incentives originate from the Arkansas Economic Development Commission (AEDC) or DF&A. Tax incentives are direct cash subsidies to a single business for meeting performance goals. Legislative Audit annually examines tax incentive outcomes and performance as found in the Arkansas Consolidated Incentives Act, 15-4-220. Legislative Audit reports have been critical of InvestArk programs for many years, because InvestArk programs did not require job creation. Act 465 of 2017 eliminated the InvestArk program, a significant advance in tax expenditure reform. Repeated, regular reviews of the InvestArk program by the legislature helped build consensus to end the program.

Tax expenditures are by far the costliest tax reduction offered by Arkansas. Tax expenditures are available to thousands of people, often as part of state income tax filing. Tax expenditures reduce the amount of revenue that would otherwise be generated, including exemptions, deductions, credits, and lower tax rates. Tax expenditures include very broad deductions as well as those narrowly targeted for certain business activities or worthy groups. DF&A publishes a limited list of such tax expenditures online, "Business Incentives and Tax Credits."[34] (Notably, DF&A's report only lists historical data for business incentive tax expenditures; it provides no projections of future revenue costs. Other states provide much broader data.)

Consolidated Incentive Act of 2003 - Payroll Rebate

ACT 182 OF 2003, as Amended
ACA § 15-4-2707
CREATE REBATE PROGRAM

PAYROLL REBATE PAYMENTS

	CREATE REBATE PAYMENTS AUTHORIZED (Calendar Yr)
2003	0
2004	0
2005	0
2006	960,851
2007	3,039,334
2008	1,955,828
2009	7,441,553
2010	13,346,749
2011	9,875,503
2012	14,328,603
2013	11,499,954
2014	9,935,999
2015	10,246,711
TOTALS	82,631,085

Most large-scale tax expenditures also reflect social priorities for the Arkansas legislature. These tax expenditures benefit certain individuals such as veterans, children, homeowners, etc. However, these socially beneficial tax expenditures also shrink state tax collection.

Tax expenditures add up quickly to a significant revenue loss for the state. Most states have annual reporting of such tax expenditures, or even a separate budget off all current items with proposed changes. A tax budget, a comprehensive picture of all tax expenditures, most importantly helps the legislature see the revenue lost to government services. Here's a snapshot of just one analysis of just one tax expenditure: the Indiana tax expenditure report's section on the child exemption.[35]

Indiana Tax Expenditure Report for Child Exemption

Totals

Tax Year	Number of Child Exemptions Claimed	Amount Claimed	Average Exemption per Return	Dynamic State Tax Reduction	Dynamic Average State Tax Reduction per Exemption
2007	971,934	$2,545,921,359	$2,619	-$83,060,438	-$85.46
2008	958,706	$2,524,007,748	$2,633	-$81,982,997	-$85.51
2009	945,752	$2,519,840,664	$2,664	-$81,109,375	-$85.76

Indiana calculates the dynamic effect of eliminating of child exemption and other deductions. What would be the overall tax effect if this exemption didn't exist? Typically, states provide tax expenditure reports which contain estimates of the size of each tax expenditure's foregone revenue. Indiana's reporting actually calculates the number of taxpayers affected by each expenditure; furthermore, it actually calculates the dynamic effect of removing the tax expenditure.

To better capture the total loss to state revenues from tax expenditures, Arkansas should strengthen its current tax expenditure report: in particular, it should expand its reporting of tax expenditures outside of economic development, and it should offer greater detail of the operation of each tax expenditure. This was the goal of Rep. Justin Gonzales's proposed HB2276 of 2017. Some observers might find the cost estimate produced by DF&A on this bill – $800,000 – to be eyebrow-raising: Minnesota, which has produced a tax expenditure report for many years, estimates its cost to be $130,000.[36] Producing an Arkansas tax expenditure report might have relatively large costs initially; however, those costs might be dwarfed by the savings that could be created by better management of state tax expenditures.

The next page contains a portion of Ohio's tax expenditure report.[37] That report projects a grand total of $9 billion a year in foregone revenue.

Ohio Tax Expenditure Report Showing All Foregone Revenue

FY 2016 – 2019
Tax Expenditure
Summary of Revenue Foregone
(in millions)

		General Revenue Fund Revenue Foregone			
		FY 2016	FY 2017	FY 2018	FY 2019
Cigarette and Other Tobacco Products Taxes					
8.01	Discount for cigarette tax stamps	$16.4	$16.1	$15.9	$15.6
8.02	Discount for timely payment of other tobacco products' excise tax	1.5	1.6	1.6	1.7
Total Cigarette and Other Tobacco Products Taxes		**$17.9**	**$17.7**	**$17.5**	**$17.3**
Alcoholic Beverage Tax					
9.01	Advanced payment credit/discount	$1.5	$1.5	$1.5	$1.5
9.02	Small brewer's credit	1.1	1.1	1.1	1.1
Tax expenditures with revenue impact below $1 million					
9.03	Sacramental wine exemption	Minimal	Minimal	Minimal	Minimal
9.04	Small wine producer's exemption	Minimal	Minimal	Minimal	Minimal
Total Alcoholic Beverage Tax		**$2.6**	**$2.6**	**$2.6**	**$2.6**
GRAND TOTAL ALL TAXES		**$8,341.5**	**$8,794.5**	**$9,115..4**	**$9,439.9**

Ohio's total budget for fiscal year 2013 was $63 billion, so the tax expenditures have a large impact on government finances. That is the level of impact tax expenditures have in Ohio; the Arkansas impact should be tracked and reviewed by the General Assembly.

Access to reliable data on tax expenditures is a necessary part of tax reform. Legislators will need to evaluate the information in such reports once created. The National Council of State Legislatures (NCSL) issued a report on best practices in state tax expenditures:[38]

1. *Tax expenditures should be an integral part of the state's budgeting process, subject to a comparable regular review and approval process as other expenditures. All tax expenditures should be reviewed regularly, with a frequency of review considering the trade-off between available resources to undertake the review and the cost of the tax expenditure.*

2. *Evaluations should be based on measurable goals and draw clear conclusions on the effectiveness of the tax expenditures.*
3. *Rigorous evaluations should determine costs and benefits of each tax expenditure, and allow policymakers to ask critical questions, including:*
    a. *To what extent did the tax expenditure affect choices made by taxpayers?*
    b. *Did the expenditure achieve its purpose?*
    c. *Who was affected by the tax expenditure?*
    d. *Did the benefits of the tax expenditure outweigh the effects of the tax increases or spending cuts needed to offset it?*
4. *The Governor and appropriate legislative committees should review the reports to determine whether tax expenditures should be continued, modified, or eliminated. This should be part of the state's normal budgeting process.*

The current structure of the General Assembly is well-suited for continued tax expenditure review: the Economic and Tax Policy Committee or the Revenue and Tax Committee could review tax expenditure reports. The Tax Reform and Tax Relief Task Force could also make recommendations for the appropriate institutional source of tax expenditure reports in future years. Furthermore, such reports should provide data about the fiscal impact of removal of those tax expenditures; in particular, they should explain how income tax rates might be lowered to take advantage of the revenue increase that the elimination of tax expenditures would create.

One of the best methods to limit tax expenditures is to require sunset clauses for each one of them. A sunset clause for a tax expenditure requires that the tax provision end after a specified period of time (for example, six years). After that time elapses, the tax expenditure ends – unless the legislature decides to renew it. The General Assembly could even pass internal rules requiring a supermajority vote threshold for renewal.

In 2009, Oregon enacted a sunset clause for all existing tax credits as well as any future tax credits.[39] As a result, tax credits do not stay in force without regular majority support from its legislature. Sunset clauses require special-interest lobbying groups (such as, for example, the Oregon Hearth, Patio and Barbeque Association) to justify their tax privilege. Regularly requiring special-interest groups to defend such measures would presumably make it more difficult for unjustifiable tax privileges to remain in force.

Lawmakers who want to increase the popularity of tax reform could combine two policies into one tax bill; they could, for instance, combine the sunsetting of tax expenditures with lower rates. Depending on the design of the bill, the General Assembly could create a revenue-neutral tax reform that lowered rates for most Arkansans. Any political pain that accompanied the elimination of tax expenditures could also be minimized by modifying the measure so as to push the establishment of both the lower rates and the sunset provisions two years (for example) into the future; if that option were chosen, advocates of lower tax rates would have an incentive to preserve them (as well as a similar incentive to preserve a cleaner tax code).

Arkansas has made great progress in improving its tax abatements and incentives. Policymakers should now seek a long-term system to report on tax expenditures, regularly review them, and add sunset clauses as necessary. Policymakers will likely find the Tax Foundation's analysis of particular tax expenditures to be of interest.[40]

PROPOSED BUDGET PROCESS CHANGES

The following suggested changes are geared towards overall legislative budgeting operations. These recommendations are not limited to the general revenue budget; instead, they focus on all budget areas. Legislators control appropriations not just for $5 billion in general revenue spending, but for a total of $23 billion in multiple areas. Budget decision-makers need new ways to manage the overall design of state government spending and to return control to the legislative branch. Although the Governor controls most executive branch agencies, appropriation is a legislative power. Through this authority, the legislature can monitor, manage, and decide on budgets in higher education, constitutional offices and agencies, and the executive branch.

The following recommendations contain suggestions about how to best understand, compare, and make global budget decisions. These suggestions are not specific program or agency recommendations. Many legislators have a basic understanding of which agency budgets need trimming, but they are frustrated by the absence of a mechanism to measure, discuss, and build consensus around the budget. If legislators accept that tax relief of the scale discussed in the first part of this paper is necessary, at least discussions of budget changes will reflect the proper scope of change needed for Arkansas.

Legislators who want to accomplish significant tax and budget reform should keep their eyes on two big-picture goals. First, policymakers should set an overall target for tax relief and corresponding revenue reduction early in the budget process. Second, policymakers should insert some or all of the following processes into budget deliberations so as to manage the difficult budget choices that would follow revenue reductions. Notably, our neighboring states have managed this budgeting process and its attendant special interest groups – and emerged with lower rates of taxation and spending.

GLOBAL BUDGET POLICY CHANGES

1. Unchain budget success from the general revenue RSA-funded budget.
2. Move the legislative review process closer to the beginning of the General Assembly.
3. Shift the focus from agency or funding sources to programs.
4. Benchmark agency programs against other states, as well as against each other.
5. Implement Tax and Expenditure Limitations.
6. Restrict the use of special revenue taxes.
7. Revamp the current capital outlay process.
8. Sell unneeded state government assets.

GLOBAL BUDGET POLICY CHANGES

1. Unchain state budget success from the general revenue RSA-funded budget.

The current balanced general revenue budget is an incomplete measure of government spending, because it ignores other operating costs controlled by the Governor and legislature. While Arkansas state government expends $23 billion per year, the annual budget cycle only focuses on less than a quarter of that figure: namely, the $5 billion or so available for general revenue spending through RSA funding.[41] Other states have a larger percentage of total spending as general revenue spending; Montana, for instance, has 40 percent of all spending as general revenue spending.

This extraordinary Arkansas focus on the general revenue budget is a subtle, but dangerous, result of the RSA. Elected officials have come to view the balanced budget and the passage of the RSA as the primary measures of budget success, even through 78 percent of state government spending takes place outside of the RSA. In legislative hearings, for instance, agencies requesting an increase in general revenue funds regularly receive careful questioning. When funding comes from other sources, however, there are typically many fewer questions. A better (although more complex) analysis would explore whether general revenue funds could be replaced with those from another source. Agencies typically don't volunteer this information, but such substitution would likely help the general revenue budget.

News articles regularly focus on monthly revenue changes to the general revenue fund while ignoring the other 78 percent of the budget. For instance, Arkansas takes "off-the-top" funds from general revenues for what we might call earmarked programs. (Non-RSA earmark programs, which totaled $403 million in 2016, include $301 million for the Educational Excellence Trust Fund as well as $66 million of desegregation payments to 3 school districts that will end in fiscal year 2018. Some of the off-the-top programs are mandatory court orders or bond payments, but other programs are statutory, discretionary programs that could be changed by the legislature.) These departures from the regular budget process (which, again, totalled $403 million in 2016) make RSA spending look smaller; they unnecessarily protect a tier of privileged programs from RSA funding changes. These earmarks also make general revenue growth look smaller, since the $5.3 billion general revenue budget is 8 percent smaller. A much better method would be to require global examination of the entire budget.

Currently, the legislature defers to the executive branch to set boundaries for much of the overall budget process. However, the Governor does not have oversight of all appropriations, only those of agencies under his supervision. The Bureau of Legislative Research and the Department of Finance and Administration could create a new, broader measure of government revenues to prevent tax receipts from being moved out of general revenues. This global budget measure would then include all agencies under legislative control, such as constitutional offices, rather than just executive agencies. The budget process should be changed so that elected officials will focus more on global revenue and global spending, rather than removing three-quarters of the budget from scrutiny as a practical matter. A smaller global budget ultimately means a lighter tax burden.

Arkansas policymakers could learn from the budget planning structures of other states. In Ohio, for example, the state budget process looks outside of the general revenue budget for a more comprehensive budget picture. There, the state has several budget bills presented by the Governor, including:

- All-funds budget (which includes all spending of general, federal, special revenue and cash funds);
- State general revenue and federal funds;
- State general revenue budget; and
- Capital outlay budget through debt issuance.[42]

Another more granular budget process occurs in the state of Washington, where the legislature hears three different budgets: Operating, Capital Outlay, and Transportation. The funding source does not determine the budget presentation in this case, and therefore Washington State does not have a general revenues budget.[43]

Washington State Budget Overview

2015-17 State Budgets
(Dollars in Billions)

Operating Budget	$78.9
Transportation Budget	$8.3
Capital Budget*	$6.6
Total	**$93.7**

*Includes Capital Re-appropriations.

This method is advantageous in that the three budgets are focused by topic, not by funding source. However, the administrative paperwork to implement such budgets at DF&A and BLR would be challenging. Both Washington and Ohio offer models the Arkansas legislature could use to initiate a conversation on new budget presentations.

Arkansas has one difficulty that some other states do not share: a dizzying number of budget bills. The state Constitution requires that all bills passed by the legislature must have only one subject. That requirement has been interpreted to mean that every appropriation must have its own bill. According to the Bureau of Legislative Research, Arkansas has the largest number of appropriation bills filed each session of any state – observers of the legislative process are well aware that there are hundreds of them every year. The only comprehensive grouping mechanisms in Arkansas budgeting are the RSA and the General Improvement Fund bills. The RSA was found constitutionally permissible in 1962 by the Arkansas Supreme Court, which found it to be a "complex accounting tool designed to ensure that the recipients of State funds receive monies only so long as cash is on hand."[44] While legal analysis is beyond the scope of this paper, legislators could pursue more targeted accounting tools for budgeting of capital projects, excess appropriation funding, and so forth.

Legislators who must make budget decisions should also require truth in labeling: each spending bill should make clear whether the proposed funding is one-time-only or ongoing spending. Such labeling would draw attention to possible funding shortfalls, and thereby prevent agencies from running out of money. For example, Tennessee's budget process provides labels for each funding change, so that legislators are well-informed about programs that are funded by recurring as compared to non-recurring funding streams. Tennessee's budget labeling also informs legislators whether programs are funded by general revenue, special revenue, or cash funds.

General Fund and Education Fund
Comparison of Appropriation Requirements and State Revenues
Fiscal Year 2016-2017

	TOTAL	RECURRING	NON-RECURRING
I. APPROPRIATION REQUIREMENTS			
General Fund Programs:			
2016 Appropriation Act - Work Program	$ 13,751,593,000	$ 13,005,758,700	$ 745,834,300
2016 Appropriation Act - Dedicated Funds	(4,207,700)	0	(4,207,700)
2017 Supplemental Appropriations - General Fund	66,858,600	0	66,858,600
2017 Supplemental Appropriations - Dedicated Funds	536,100	0	536,100
Total General Fund Requirements	$ 13,814,780,000	$ 13,005,758,700	$ 809,021,300
Less: Overappropriation	(89,838,100)	(89,838,100)	0
Net General Fund Requirements	$ 13,724,941,900	$ 12,915,920,600	$ 809,021,300
Other Programs:			
Capital Outlay Program	$ 397,636,400	$ 0	$ 397,636,400
Designated to Other Funds:			
Metro Sports Authority Debt Service	$ 3,834,700	$ 3,834,700	$ 0
Dedicated Funds - Reserves	1,000,000	1,000,000	0
Sub-Total Designated to Other Funds	$ 4,834,700	$ 4,834,700	$ 0
Facilities Revolving Fund:			
Facilities Revolving Fund - Operations	$ 13,064,800	$ 13,064,800	$ 0
Facilities Revolving Fund - Capital Outlay	71,728,700	0	71,728,700
Sub-Total Facilities Revolving Fund	$ 84,793,500	$ 13,064,800	$ 71,728,700
Total Other Programs	$ 487,264,600	$ 17,899,500	$ 469,365,100
Total Appropriation Requirements	$ 14,212,206,500	$ 12,933,820,100	$ 1,278,386,400
II. GENERAL FUND REVENUES AND RESERVES			
State Tax Revenue - Department of Revenue	$ 11,576,000,000	$ 11,054,200,000	$ 521,800,000
State Tax Revenue - Department of Revenue - 2017 Legislation	(41,425,900)	0	(41,425,900)
Franchise and Excise Taxes - One-Time Payment	134,534,000	0	134,534,000
State Tax Revenue - Other State Revenue	1,929,400,000	1,357,458,400	571,941,600
State Tax Revenue - Other State Revenue - 2017 Legislation	2,325,000	0	2,325,000
Miscellaneous Revenue	52,600,000	52,600,000	0
Tobacco MSA Revenue	143,800,000	132,100,000	11,700,000
Lottery for Education Account	342,400,000	346,607,600	(4,207,600)
Transfers, Reserves, and Other Available Funds:			
Highway Fund Transfer - Gas Inspection Act	1,100,000	1,100,000	0
Reserve for 2016-2017 Appropriations	733,500,000	0	733,500,000
Transfer to Rainy Day Fund	(100,000,000)	0	(100,000,000)
Highway Fund Transfer at June 30, 2017	(120,635,900)	0	(120,635,900)
Highway Fund Transfer at July 1, 2016	(12,000,000)	0	(12,000,000)
Debt Service Fund Transfer at June 30, 2017	83,900,000	0	83,900,000
Reserve for Future Requirements	656,400,000	0	656,400,000
Rounding	(27,700)	(27,700)	0
Sub-Total Transfers, Reserves, and Other Available Funds	$ 1,242,236,400	$ 1,072,300	$ 1,241,164,100
Total General Fund Revenues and Reserves	$ 15,381,869,500	$ 12,944,038,300	$ 2,437,831,200
III. AVAILABLE FUNDS AT JUNE 30, 2017			
Available Funds	$ 1,169,663,000	$ 10,218,200	$ 1,159,444,800
Total Available Funds	$ 1,169,663,000	$ 10,218,200	$ 1,159,444,800
Revenue Fluctuation Reserve at June 30, 2016	$ 568,000,000		
Revenue Fluctuation Reserve at June 30, 2017	$ 668,000,000		

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2. Move the legislative review process closer to the beginning of the General Assembly.

Arkansas holds public budget hearings from October to December, before each year's legislative session. This leads to a significant political problem: the looming November elections every other year discourage both Democrats and Republicans from making unpopular budget decisions. Only four other states have such early budget hearings before a January legislative session, and only four other states require the Governor to submit a budget as early as November before a January legislative session.[45] Early budget submissions sometimes make budget plans outdated by the time the new fiscal year begins in July.

The timeline of budget submissions is established by the Director of the Department of Finance and Administration in cooperation with the Legislative Council.[46] Policymakers seeking changes in this area would need to adjust the existing calendar process. However, this budget calendar crunch only takes place in odd-numbered years, during the regular session. The device of the fiscal session, which takes place in even-numbered years, was created by a 2010 amendment to the state Constitution. The fiscal session should be used by legislators to discuss and determine agency budgets more broadly; currently, review is typically confined to a few large agencies (often informally called "the Big 6"). Although legislators have historically been reluctant to extend their stay at the capital during primary season, other state legislators in states with annual sessions have managed the adjustment. Legislators should view the fiscal session as a chance to explain budget policy issues to the public, rather than only using the Arkansas Legislative Council and Audit Committees to highlight such concerns.

Speaking generally, the public will benefit from more legislative scrutiny of and engagement with Arkansas's $23 billion budget. This is not a call for extending legislative meetings; it is a call for using legislative time more appropriately. Structured and goal-oriented review of $23 billion in annual spending will benefit both the public and the elected officials which represent it, because that review is crucial to informed voting by policymakers.

3. Shift the focus from agency or funding sources to programs.

When the Arkansas budget is presented to lawmakers, it is broken down by agency and funding source. If legislators were to demand a presentation based on program or policy priorities, this would enable them to understand all state resources dedicated to specific policy goals during the budgeting process. Program goals would also take into account agencies which are not under legislative or executive control. Program goals do not have to be an actual bill topic; rather, they are an element of making decisions.

Program budgeting would allow lawmakers to get a holistic picture of which programs address general governmental goals – for instance, one general goal might be the need to provide security and protection to the public. Once these goals are defined, all related programs are grouped together, even if they are in different agencies. The budget office can then assemble data on all agencies, grants, and programs that are dedicated to such goals. For example, with respect to the goal of public security, the relevant programs would include State Police, all agency staff such as Highway Police or Game and Fish Wardens with a security role, Department of Emergency Management funding of security communications systems, and Secretary of State Capital Police. Each of these programs has a role in providing for the security of Arkansans. By grouping related programs, legislators have a better idea of the relative expense and efficiency of each.

Possible topics for consideration include the following:

- Statewide public security by Arkansas State Police, Arkansas Highway Commission, Arkansas Game and Fish Commission, and various other law enforcement entities, as described above;
- Higher education and its supporting agencies and programs;
- Career education and workforce development;
- Social benefit programs provided by the Department of Human Services, the Office of Child Support, and the Department of Workforce Services.

Other states provide their policymakers with more detailed analysis of policy goals. The Texas Legislative Budget Board, for instance, focuses on selected agencies and analyzes both cost-effectiveness and performance measures. The target agencies are notified about additional scrutiny during the summer before the session. [47] Arkansas legislators could adopt a similar method to take a deeper look at agency operations. Currently, state law empowers the Director of the Department of Finance and Administration to create such mechanisms in cooperation with the Legislative Council.[48] Legislators seeking more precise budgeting information would need to work with DFA to create and gather such data.

Policymakers who seek a more concrete example of how performance targets work would be well-advised to study Texas's approach to performance measures – although the many challenges involved in creating reliable performance measures suggest that policymakers may want to phase in such measures over several years. Here's an example of Texas's analysis that clarifies how such funds are used:[49]

Example of Texas Budget Performance Targets

Figure 1

COMMISSION ON THE ARTS

	For the Years Ending August 31, 2018	For the Years Ending August 31, 2019
Items of Appropriation:		
A. Goal: ARTS AND CULTURAL GRANTS		
Provide and Support Arts and Cultural Grants.		
A.1.1. Strategy: ARTS ORGANIZATION GRANTS	$ 3,897,533	$ 3,897,533
A.1.2. Strategy: ARTS EDUCATION GRANTS	$ 744,354	$ 744,353
A.1.3. Strategy: CULTURAL TOURISM GRANTS	$ 670,000	$ 670,000
A.1.4. Strategy: DIRECT ADMINISTRATION OF GRANTS	$ 583,622	$ 583,936
Total, Goal A: ARTS AND CULTURAL GRANTS	$ 5,895,509	$ 5,895,822

source: HB 1 by Zerwas as introduced

Figure 2

	2018	2019
Performance Measure Targets:		
A. Goal: ARTS AND CULTURAL GRANTS		
Outcome (Results/Impact):		
Percentage of Grant Dollars Provided to Minority Organizations	12%	12%
Percentage of Grant Dollars to Rural Counties	6%	6%
Percentage of Grants Funded for Arts Education	25%	25%
Number of Artists Compensated for TCA Texas Touring Roster Performances	1,500	1,500
Number of Texas Cities in Which Organizations Received TCA Grants	150	150
Number Served by Arts Respond Projects in Education	1,000,000	1,000,000
Number Served by Arts Respond Projects in Health & Human Services	100,000	100,000
Number Served by Arts Respond Projects in Public Safety & Criminal Justice	125,000	125,000
A.1.3. Strategy: CULTURAL TOURISM GRANTS		
Output (Volume):		
Number of Grants that Promote Cultural Tourism	107	107

source: HB 1 by Zerwas as introduced

The Joint Performance Review committee seems ideally situated to carry out such evaluations, or various interim committees could monitor particular agencies.

4. Benchmark agency programs against other states, as well as against each other.

Arkansas is one of only three states not to produce some sort of performance measurement of how well agencies accomplish their missions (also called "benchmarking") during its budgeting process.[50] 31 states have statutes requiring such measurement, and 24 states even audit and review the performance measures selected by their budgeting offices.

The DF&A Revenues Department, which controls our network of revenue offices, has done an excellent job in benchmarking its local office performance. DF&A measures all local revenue offices by the numbers of customers served at each branch. This measure gives DF&A management a good estimate of their capacity for expansion or reduction of services from revenue offices across the state.

Benchmarking can also be used to compare Arkansas programs to those in other states. For instance, suppose we group together all tourism-related activities, such as Department of Arkansas Heritage, Parks and Tourism, and Game and Fish. How much is the state spending in tourism-related activities compared to its neighboring states? And are there other agency programs that have been added to accomplish a different government objective, such as public safety?

Benchmarking should be executed at a program level (such as public security, for instance), but each agency should be allowed sub-goals in line with legislative policy goals. Performance measures could then be formulated at the entire agency or at the program level in order to assist local governments, legislators, and agencies to focus on priorities. In those cases in which local governments wish to maintain local control, additional costs might need to be estimated.

It should be noted that formal performance-based budgeting that hands over agency control of the budget once goals are met has not done well in Arkansas. In the Huckabee Administration, formal performance-based budgeting was attempted, but it was poorly received by legislators. Performance-based budgeting set goals for each agency. Once met, the agency could spend its funds as it pleased. In the long term, this method failed: if agreed-upon goals were met – such as crime reduction or high school graduation rate increase – the agency could then spend the rest of the money as it pleased. Legislators could not prevent (for instance) new car purchases or even new buildings.

For such reasons, this paper does not advocate performance-based budgeting: performance-based budgeting should be categorically distinguished from performance measures. Rather than allowing agencies such direct control after meeting the goals that were originally set, state legislators have typically preferred separate metrics that inform but do not control the agency budget. Performance metrics should be designed primarily to guide policymakers and agencies in meeting their goals.[51]

5. Implement Tax and Expenditure Limitations.

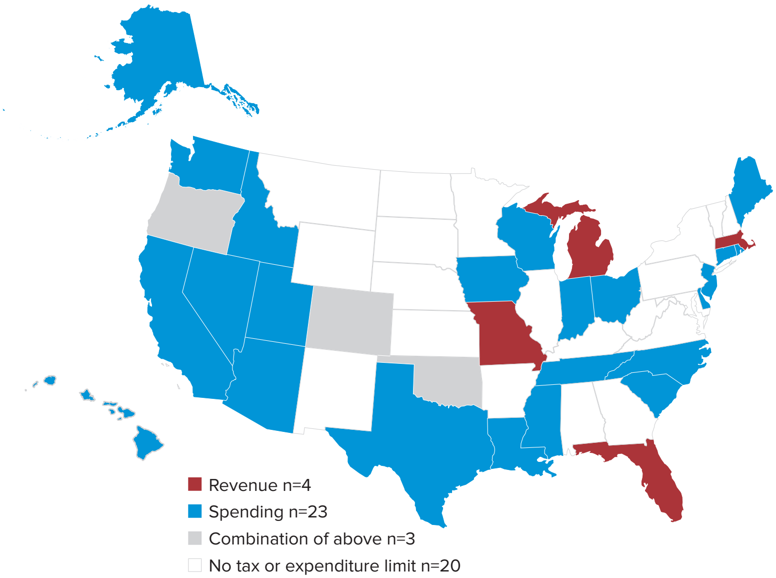
Tax and expenditure limitations (TELs) constrain how state government collects money and spends money. Arkansas could consider establishing such rules either as a statute or as a constitutional amendment. Twenty-eight states have established similar measures – nine via petitions – which indicates that this is a viable, popular option that can survive the test of the ballot box. In fact, Arkansas was an early innovator in this area by means of 1934's Amendment 19 to the state Constitution, which required a ¾ legislative supermajority to increase current taxes and to pass appropriations.[52] All six of Arkansas's neighbors have a TEL in place (some are stronger than others); four of them were voter-initiated.[53]

A new Arkansas TEL could:

- Limit overall revenue growth to population growth
- Limit unfunded mandates to local governments
- Limit overall state appropriations in selected areas
- Clarify that all new taxes and fee increases be subject to higher legislative threshold votes
- Institute a policy whereby limits could only be exceeded by popular vote
- Assign a small percentage of general revenues to subsidize a rainy-day fund

30 states have some kind of spending or tax limitation in their state budget. Some of these are statutory, while others are in the state Constitution. Many have been initiated by the public, rather than by public officials. The chart below shows such TEL enactments from the 1970s and 1990s.[54] Arkansas's efforts in this area, described above, predated the modern era of the TEL. More recently, state Rep. Bruce Westerman proposed HB 1041 of 2013, which would have limited spending growth.

State Tax and Expenditure Limits, 2010



Colorado has the most well-known TEL in the nation: its Taxpayer Bill of Rights (TABOR) not only limited revenues collected by all levels of state and local governments, but also required all tax increases to be approved in an election. Excess revenues collected must be returned to the taxpayers. In 2005, Colorado voters approved a time-out from TABOR restrictions for five years, nonetheless, the TABOR has slowed down government growth in Colorado.

Arkansas grants the Director of the Department of Finance and Administration the power to establish maximum limitations on expenditures for the year.[55] In theory, this power could be used by DFA to clamp down on agency budget requests. However, the legislature also allows state agencies to submit an original budget request unencumbered by DFA limitations. This agency power undermines the ability of DFA to limit executive agency requests.

The legislature could adopt an alternative policy: the legislature itself could require all agencies (not just those under the Governor's management) to comply with spending restrictions. (After all, it's the legislature's job to determine all appropriations in state government.) Such a policy would ensure that such limits could not be bypassed by agencies and would be broadly applied. For instance, Texas adopted a TEL as a constitutional amendment to limit spending. Each biennium, its Legislative Budget Board limits spending growth to the amount of state personal income growth. The only exceptions are those programs which are mandated by the state Constitution. This spending growth percentage is calculated in the summer, prior to agency budget development. Arkansas could create a similar TEL by statute or constitutional amendment, so that Arkansas state budgets can be constrained by calculations of spending growth.

Restrictions on state government spending through TELs typically generate strong opposition from organizations sympathetic to more government spending. The National Center on Budget and Policy Priorities, for instance, has argued that (in the words of one of its publications) "Tight Expenditure Limits Can Impede State Economies." However, Arkansas policymakers should remember that this state has been the subject of an experiment in generous taxpayer funding since 1977, especially as compared to our surrounding states. The Arkansas experience suggests a contrary thesis – namely, soaking the taxpayer over the last four decades and attempting to fuel economic growth with heightened public spending has resulted in anything but a booming state economy.

6. Restrict the use of special revenue taxes.

The original rationale for the 1945 establishment of the Revenue Stabilization Act was to divert the variety of revenue streams into general revenue. As then-Governor Ben Laney stated in his inaugural address: "Our kaleidoscopic tax laws which have been an outgrowth of patchwork legislation are a challenge to our thinking. We should find a way to channel the tax dollar into a common fund for the benefit and general welfare of our citizenry."[56] Back then, Governor Laney complained of the "hydra-headed system of over one hundred state funds." The situation has worsened: Arkansas statutes currently direct 255 special revenues into 108 different funds.

Our state Constitution makes it difficult to raise most taxes. The state Constitution's ¾ supermajority requirement for tax increases makes legislative passage difficult, unless the tax is directed towards a strongly supported goal. To direct the tax to a special, not general, funding purpose is called a special revenue. Special revenues for popular purposes can muster sufficient legislative support for passage. But the same strongly supported special revenue is also much harder to cut. Instead, the General Assembly has tax cuts within general revenues – while special revenues, either through ¾ legislative votes or ballot initiatives, grow. One example is the recent cut to general revenues that was triggered by state income tax reductions in 2017, even as the ArDOT sought new special revenue through a dedicated sales tax. Once again, Arkansas is resurrecting the "multiheaded hydra" of the past as the role of general revenues continues to diminish in the global state budget.

Suggestions to counter the problem of increasing special revenues include the following:

- Pass legislative rule changes to require that such new special revenues, tax credits, or fees be introduced earlier in the session, as is done with changes to pensions or medical scope of practice bills
- Require by statute that all special revenues support, in part, general revenues
- Sweep all cash and special revenue balances exceeding a certain amount into general revenues. (For instance, the Oil and Gas Commission and the Aviation Commission special revenue fund balances far exceed their likely near-future operating expenses, but those funds cannot be released for general revenues. Policymakers could write new norms into law requiring that specified overages – for instance, more than one year's worth of operating expenses – be swept into the general fund.)

All of these suggestions increase general revenues and reduce special revenues.

7. Revamp the current capital outlay process.

As a practical matter, the General Improvement Fund (GIF) is dead. This is a mixed blessing and an opportunity: the GIF method of creating state capital investment projects had its defects, and Arkansas desperately needs a new capital outlay method. Arkansas policymakers should treat the death of GIF as an invitation to establish new operational standards for long-term planning and prioritization of highways, buildings, levees, water districts, broadband, and IT software development. Five out of six of our neighboring states use capital outlay budgets – which rest on a separate document that lists funding and appropriations together for the legislature to consider.

Surrounding State Use of Capital Outlay Budget

STATE	CAPITAL OUTLAY BUDGET	DESCRIPTION
Arkansas	NO	General Improvement Fund was from excess revenues at end of fiscal year. In 2018 there were no funds available.
Louisana	Yes	Lousiana issues a capital outlay plan for executive agencies and highways only.
Mississippi	NO	Mississippi is like Arkansas, in that Capital Outlay was funded from excess revenues at end of fiscal year. In 2018 there were no funds available.
Missouri	Yes	Missouri issues a capital outlay plan for executive agencies only.
Oklahoma	Yes	Oklahoma has a Capital outlay budget for its executive agencies only, with a revolving fund for repairs. Due to budget shortfalls reforms needed. Oklahoma issued excellent report on needed improvements. https://www.ok.gov/DCS/Capital_Planning/
Tennessee	Yes	Tennessee presents a Capital Outlay Budget with possible bonding allowed for Highways, Higher Ed, State Buildings, Revolving Fund for Major Maintenance.
Texas	Yes	Texas presents a Capital Outlay Budget with possible bonding for State Buildings, Highways and Higher Ed

The NASBO survey of state budget management shows that Arkansas does not have either a multi-year capital budget planning process or an entity in charge of statewide capital planning.[57] The lack of any centralized review and ranking of capital projects leaves each state entity trying to fund or lobby for its own projects; with so many projects outside of executive agency management, only the legislature can prioritize the requests. Furthermore, the current capital outlay budget designation is burdened with a large number of items that are used for regular and ongoing government operations, such as cars or computer equipment over $5,000.

It is reasonable for IT or major building remodeling projects to face legislative review requirements, but eliminating smaller ongoing work requirements would allow the legislature to give more attention to difficult and significant long-term initiatives. Notably, review of highway funding by the legislature would improve transparency and accountability for these kinds of large projects.

One example of a state with a good capital budgeting process is the state of Ohio. Ohio uses bonds for its projects; its legislature also approves the capital outlay of both K-12 and higher education in its overall bonding proposal. Ohio capital outlay contrasts with Arkansas, where different government entities issue a variety of bonds. Both the University of Arkansas System and school districts have separate bonding authority for building projects. Higher Education passes a large GIF bill of possible projects, then gradually obtains financing for such projects throughout the year.

In comparison to most states, Arkansas does not do a great deal of bonding; according to the Tax Foundation, Arkansas ranks 43rd in having low dollar amounts of per capita state and local debt. Arkansas debt carries a AA rating from S&P, as do all of its neighboring states.[58] The state could consider bond issuance for capital projects through the Arkansas Development Finance Authority. Importantly, however, Arkansas's Constitution restricts the state's ability to borrow without a vote of the people.

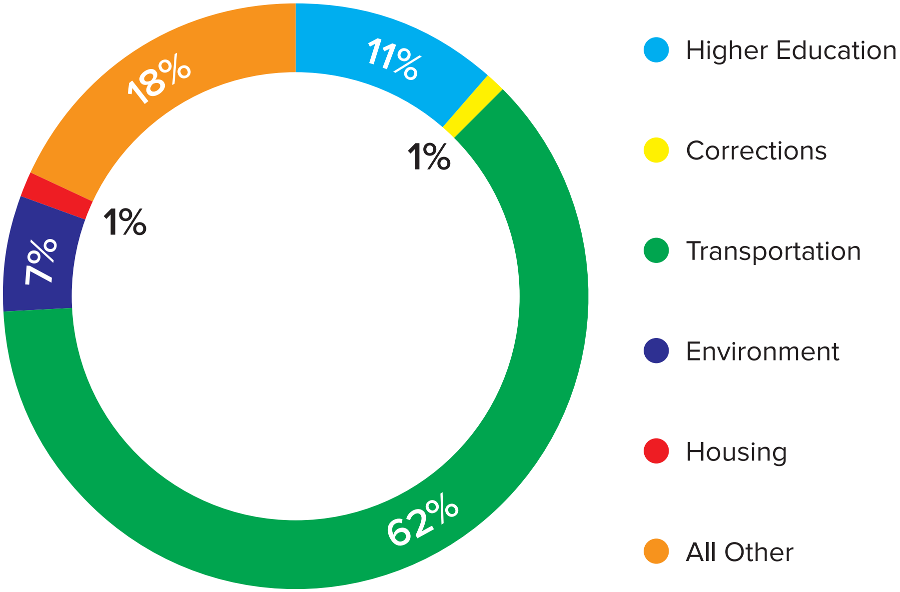
Arkansas does not have an executive division assigned to monitor capital outlay project approval, procurement, and contract monitoring. States typically have a capital outlay approval and monitoring division within the executive branch, with strong legislative oversight. Arkansas lacks this kind of unitary management. The facilities division of the Arkansas Department of Education performs a comparable role, but only for school facility improvement approval. Procurement is left to the school districts. DF&A Division of Building Authority approves contracts for construction only, but it is not involved in prioritizing projects. The Natural Resources Commission manages state capital outlay in levees and water improvement districts. Constitutionally, the Transportation Department is independent, although additional monitoring could be a component of bond or grant funding to the agency.

Reforming the current Arkansas capital outlay process should be a central focus of budget policymakers. Inattention to capital outlay issues has led to the construction of new buildings, even as older facilities deteriorate and become even more expensive to repair. Proper capital outlay would ensure that funds are spent on state priorities, not just on projects with good funding or special interest muscle.

One recent instance of poor capital outlay planning was the highway bond financing program – a 2011 special election in which roughly 6 percent of the Arkansas electorate voted. The bond program enabled the state Highway and Transportation Department to issue up to $1.3 billion in bonds – but the Department was simultaneously funding new construction ahead of regular maintenance. According to the 2014 Arkansas Infrastructure Report Card, "While Arkansas has taken steps to improve road conditions, due to the lack of available funding the State has begun putting needed projects on hold as the federal Highway Trust Fund's long-term solvency is uncertain and no state revenue sources are identified to backfill the investment needed." This 2011 building program is a good example of a poorly planned capital outlay project: rather than dedicating transportation funds to support current maintenance, the half-cent sales tax increase went instead to new capital projects – even though it could reasonably be anticipated that ArDOT would soon need funds just for its ongoing operations. Legislators should ensure that such poor planning is not repeated in the future – if necessary, with a referred constitutional amendment that gives more control over transportation policy to elected officials.

The NASBO survey of state budget management shows that Arkansas is one of only five states without a multi-year capital improvement plan.[59] A further difficulty is that the state Highway and Transportation Department is an independent constitutional agency in Arkansas. This is hard to defend from the perspective of self-government—especially because, as the chart below shows, transportation capital outlay typically towers over most other capital expenditures (this chart does not include K-12 capital outlay).

State Capital Expenditures by Program Area – Fiscal 2013



A central agency to evaluate Arkansas capital budgeting would likely assist policymakers in setting and comparing priorities. DFA typically focuses only on the Governor's executive branch activities. Currently, state capital budget reporting is determined by the Director of the Department of Finance and Administration.[60]

The lack of any centralized review and ranking of capital projects leaves each state entity trying to fund or lobby the legislature for its own projects – but with so many projects outside of executive agency management, only the legislature can prioritize the requests. Furthermore, Arkansas is one of only two states without a general standard for capital project cost estimates. Such a standard would ensure that (to speak informally) all proposals would be measured with the same yardstick – that is, a unitary standard would ensure that all projects would be compared on the same cost basis. 48 other states require at least one kind of cost estimate, such as cost per square foot, historical cost, or market-based estimates. As a result of Arkansas's capital outlay processes, submitting agencies can pick and choose which estimate is most favorable to the particular project. This also makes it much more difficult for legislators to properly compare projects.

Arkansas also lacks a formal monitoring system to track capital project progress and timelines. Nor is there a formal way to fund projects with cost overruns. Building project concerns only come to legislative attention when there are funding or appropriation shortfalls at an agency. Projects, as such, are not monitored. For instance, the lack of project monitoring on the Department of Human Service's (DHS) Eligibility and Enrollment Framework led to cost overruns and delays that greatly harmed the agency's reputation. But because of the size of DHS's budget, the agency was able to sidestep the possibility of a shortfall. What this means is that big budgets can hide big problems; furthermore, such big budgets prevent appropriate signaling to policymakers that something has gone wrong.

In a large number of states, an executive agency authority meets with the capital project team to track progress and budget overruns. In some cases, cost overruns and other variances are reported to the legislature. The tracking starts at the project's beginning; it ends with the last payment.

The National Association of State Budget Officers' "Capital Budgeting in the States: Spring 2014" provides a detailed comparison of capital budgeting in all 50 states: that report is a good starting point for the analysis of best practices and actions in other states. Legislators could seek further refinement of the capital project budgeting process through this resource. However, the primary concern for the legislature is gaining an overall, comprehensive priority list and timetable of capital projects. Furthermore, the constitutional barriers that discourage the state Highway and Transportation Department from legislative oversight place the most significant projects outside of legislative management.

In short, Arkansas has several serious deficiencies in its capital outlay process. Legislators need better ways to budget for these large, long-term projects. Better planning will lead to less money spent on projects, superior outcomes, and a clearer vision of the state's future.

8. Sell unneeded state government assets.

Arkansas's government is a massive owner of various properties, land, and state-run businesses that potentially compete with the private sector. Selling off extraneous assets and properties would allow state government to reduce its overall size, to strengthen its focus on priorities, and to remove itself from competition with the private sector – and might also generate significant revenue. For instance, the Department of Health's sale of the Home Health Service netted $24 million for the state.

The federal government has successfully used the Base Realignment and Closure (BRAC) process to create consensus in Congress when deciding which military bases to close down or consolidate. The Arkansas legislature could bind itself to a similar method – one that connects project goals to the outcome of the decision process. One hurdle is the inability of one legislature to bind the decisions of a later one, so any interim study proposals by the legislature cannot bind the next General Assembly. However, given the lengthening of legislative terms and the absence of partisan division between Arkansas's executive and legislative branch, such larger goals could be agreed upon before review.

GENERAL REVENUE BUDGET PROCESS CHANGES

1. Move more programs back into the RSA.

2. Review historical funding priorities.

3. Reduce appropriations to what is needed.

4. Eliminate preference for the surplus of general revenues.

5. Incorporate possible tax cuts prior to agency budget submissions.

PROPOSED GENERAL REVENUE RSA BUDGET CHANGES

The following suggestions focus on a relatively small sector of the state budget: namely, the $5 billion general revenue RSA budget. This section aims to assist policymakers to meet the goals of government spending reductions and to achieve tax reform objectives.

1. Move more programs back into the RSA.

The general revenue budget has become subject to enormous adjustments over time. In 1992, the first of many 'off-the-top' payments to various programs was made from this budget. Such payments represent funds that are exempt from shortfall adjustments, thus putting more strain on those agencies and programs within the scope of the Revenue Stabilization Act – while rendering other spending programs relatively immune from fiscal scrutiny. In state fiscal year 2016, discretionary off-the top payments totaled $402 million, or 8 percent of the general revenues available for distribution. These earmarked projects included Educational Excellence Funds and City/County Tourist Funds.[61]

Growth in government can be measured in several ways. The growth in RSA general revenues is relatively low: 3.24 percent per year over the last 30 years. However, other Arkansas revenues grew at much faster rates: gross general revenues grew by 3.77 percent. Taxes dedicated to specific needs (gross special revenue receipts) grew at an even faster rate: 5.37 percent over 30 years.[62] The largest special revenue category in Arkansas is that of transportation-dedicated special revenues. When federal funds and college tuition cash funds are included in the growth rates, total Arkansas state government spending grew at an astounding 6.27 percent per year for 30 years.

RSA general revenues can be adjusted or manipulated (by increasing or decreasing earmarks) so as to supply a desired RSA growth rate. Policymakers should therefore be wary of relying on the RSA general revenue statistic as an accurate measure of fiscal health. (For instance, in the state fiscal year 2019 revenue forecast, there's a temporary increase due to the end of $65 million annual desegregation payments in 2018. The desegregation payment is an earmark.) Eliminating this payment gives the RSA general revenue amount a one-time boost for fiscal year 2018.

Furthermore, RSA general revenues can be adjusted by the revenue forecast that is built into the general revenue estimate. A relatively pessimistic revenue estimate will make the rate of growth in RSA general revenues appear smaller. That pessimistic estimate will also help the state generate a surplus of funds at the end of the fiscal year – until fiscal year 2018, that surplus was used to fund legislative and executive GIF projects.

For these reasons, the RSA general revenues statistic is susceptible to manipulation; it is not a good benchmark for global budget growth or historical trends.

2. Review historical funding priorities.

The Revenue Stabilization Act allocates revenues to historical requests as priority A funding. In other words, priority A funding receives all general revenues before other tiers designated by the RSA, but new funding requests are generally assigned a low priority. However, whether programs and agencies should continue to be in priority A funding is typically not revisited in RSA. Once funding is in priority A, it is generally there for good – sometimes for decades.

Policymakers should carry out an extensive review of agencies with unchanged priority A funding. These steadily funded agencies may have decreased workloads or obsolete programs that could be eliminated. To better see if agency priorities align with those of the legislature, legislators could ask all agencies to prioritize funding as part of the budget submission. An agency could be required, for instance, to label 80 percent of its request A priority, 15 percent B priority, and 5 percent C priority. Washington State, for example, asked its agencies to budget for a 15 percent reduction in its 2015-2017 budget cycle.[637] Capital outlay should be included in the request with an assigned funding priority; that way, legislators will see prioritized agency needs in the budget submission.

Unfortunately, priority B funding does not always meet agency needs. Take the case of the Department of Human Services (DHS) as a particular example. The DHS requires a smooth flow of incoming funds as it cannot operate efficiently or budget appropriately if it has to rely on a big, uncertain chunk of cash at the end of the fiscal year. Therefore, DHS is forced to keep a reserve of funds for needed one-time expenditures. Past DHS budgets show that $90 million in GIF has been reserved and used to make up for too-late priority B funding.

3. Reduce appropriations to what is needed.

In the RSA, the state sets funding priorities by assigning each one letter grades, such as A, B, and C. However, when agencies propose their own appropriations, there is no comparable ranking of agency spending priorities. One budget-paring possibility is to require agencies to propose an internal highest-priority level of 95 percent (or some other percentage) of their base-level spending; those agencies which ultimately need to spend more could be required to achieve ALC Performance Evaluation and Expenditure Review (PEER) approval to tap additional unexpected or above-forecast appropriations. Currently, agencies apply for 100 percent of needed appropriation in their budgets. The legislature has no control over any of the agency funding in RSA. Establishing, instead, a low-priority B fund where 5 percent unallocated funds would be presented for new ALC appropriation approval would minimize undue spending by all agencies. These low-priority B funds could also come from a rainy-day fund.

Alternatively, Arkansas could ask agencies to submit as RSA priority A funding only what is necessary to continue current service levels. That would allow the legislature to place amounts for unanticipated growth in agency spending in RSA priority B. 19 states require agencies to submit current services budgeting (the amount to continue with current services to the same number of clients). That way, state budgets would have to show any changes to federal funding match, changes in number of participants, or other costs. The norm in Arkansas's current budget process is that agencies get the same dollar amount of funding every year. Current services budgeting would help determine which agencies have a reduced funding need, given declining numbers of clients. For instance, in a growing economy, Arkansas would expect to see declines in unemployment applications and higher education enrollment; tourist attractions, however, might be busier.

Currently, agencies apply for funds in excess of what is actually needed to allow for flexibility, thereby opening the door to spending that may not be critical. The use of RSA category B fund for service growth could even require ALC PEER review or approval to minimize undue spending. And legislators would have more confidence in their knowledge of state agency requests.

4. Eliminate preference for the surplus of general revenues.

The general revenue forecast has encouraged the state to aim for conservative general revenue estimates in order to generate surpluses. These surpluses not only funded the currently on-hold executive and legislative GIF,[64] but were also a crucial element used to adjust the erratic cash flow of the RSA B allocations. For example, Medicaid has $90 million in GIF set aside in the 2018 budget as well as priority B funding of $86 million – but both amounts are intended for the same $90 million in needs. The RSA allocates general revenues as the state receives its tax collections, so agencies receive their RSA funding in monthly allotments throughout the year. All of priority A RSA funding must be paid to agencies before B can be allocated. In fiscal year 2016, 98 percent of all RSA general revenues were in funding priority A, so funding priorities B and C were completely allocated in early June.

This method of allocation is sometimes at some tension with the needs of the agency: in reality, Medicaid cannot have a large amount of funding appearing erratically at the end of the year. For cash flow reasons, it will need the funding earlier and will, therefore, receive both B funding and one-time surplus funding. The current focus and reliance on surplus funds prevents appropriate forecasting for the allocation of revenue in a consistent manner.

5. Incorporate possible tax cuts prior to agency budget submissions.

Both the legislature and Governor begin budget reviews the summer before the session, usually without any pressure to reduce spending. The discussion focuses on a forecast of revenues without tax cuts and without individual agency revenue forecasts. Neither party is able to make serious budget decisions in the absence of solid revenue projections.

A more pertinent discussion would focus on building in any tax policy changes before summer budget reviews by the executive and legislative branches of state government. Both could agree on an amount and then request that agencies prepare balanced general revenue budgets accordingly, meeting funding request targets, and later avoiding bottom-up requests for additional funding. This means (for instance) that joint tax cuts would need to be selected by July, otherwise, any cuts would need to be incorporated into the Governor's balanced budget and RSA, where agencies wouldn't have the time to adjust their appropriation requests. That is to say, a tax cut after agency budgets are presented forces Arkansas to underfund agency needs, rather than to reduce appropriations.

There is nothing to stop the legislature from preparing its own budget as an alternative to the Governor's budget. In some states, this is common practice. Texas, for example, has House, Senate, and Governor's budgets.

CONCLUSION: TAX AND BUDGET REFORM WILL LEAD TO PROSPERITY IN ARKANSAS

The Arkansas Tax Reform and Relief Legislation Task Force has a historic opportunity to conduct a systematic realignment of state government; to accomplish its mission, it should consider tax cuts along with tax reforms. Legislators and the Governor now have the chance to work together to craft reforms that would support revenue reductions; policymakers have the opportunity to step on the gas so as to vastly improve the future economic growth of the state. The options that the Tax Foundation has provided demonstrate not only that alternatives to the current system exist, but that they can mean more jobs, more economic growth, and more opportunity for Arkansans. Tax relief will require budget process reform; legislators should seize the opportunity to make Arkansas's budget process more efficient. The book you hold contains practical and achievable recommendations to reform Arkansas's tax and budget process: if implemented, these recommendations will lead to lower taxes, more transparent government, less wasteful spending, and more freedom. Policymakers who act on these recommendations will make Arkansas a land of opportunity.

ENDNOTES

1. "Facts and Figures 2017: How Does Your State Compare?," Tax Foundation, Table 2.
2. *Ibid.* Taxes paid by visitors or out-of-state persons do not significantly affect Arkansas's tax burden ranking, nor does shifting state obligations to local governments.
3. "State-Local Tax Burden FY2012," Tax Foundation, January 20, 2016, p. 14.
4. The population of Arkansas in 2017 is estimated by Population.US to be 3,003,489. UALR's arkansaseconomist.com blog reported that per capita income for Arkansas in the fourth quarter of 2016 was $39,725.
5. "Facts and Figures: How Does Your State Compare?"
6. "2016 B Book," Arkansas Bureau of Legislative Research, October 2016, p. 34. Only general revenue reductions are being taken into account here, hence the figure in this text is $228 million, as compared to the original source's $300 million.
7. "Voters Approve Highway Tax," Arkansas News, November 6, 2012.
8. Fox News Poll, March 29, 2017.
9. "State Tax Cut Roundup: 2016 Legislative Session," American Legislative Exchange Council, March 2017.
10. Carl Davis et al., *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*, Institute for Taxation and Economic Policy (2015).
11. "Revenue Concerns Likely the First Issue of Arkansas Blue Ribbon Tax Panel," March 29, 2017. *Talk Business* interview with Senate Pro Tem President Jonathan Dismang: "But broadly, this session we've had discussions about funding (priorities), tax increases and our overall look at long-term income taxes and how that should work with potential additional sales tax revenues that the House failed yesterday."
12. "Arkansas Roadmap to Tax Reform," Tax Foundation, November 14, 2016.
13. Changes to property taxes are not presented as a viable option by the Tax Foundation.
14. Although the three approaches provided by the Tax Foundation could be revenue-neutral, they are not necessarily revenue-neutral: with respect to the second and third proposal, the impact on economic growth would likely be more positive, given a net revenue reduction.
15. "Arkansas Roadmap to Tax Reform," Tax Foundation, November 14, 2016, p. 38.
16. "Facts and Figures: How Does Your State Compare?," table 22.
17. *Ibid.*, table 21.
18. See generally David Brunori, *Local Tax Policy: A Federalist Perspective.*
19. Fox News Poll, May 25, 2017.
20. "2016 B Book," p. 10.
21. The Kansas Budget Blog, by former state budget director Duane Goossen.
22. Chougule, Akash, "North Carolina Wows with its Impressive Tax Cut Successes," *National Review*, December 14, 2016.
23. "North Carolina Set to Post Another Large Budget Surplus," Tax Foundation, May 8, 2017.
24. Data generated from "Fiscal 50: State Trends and Analysis" section of the pewtrusts.org website. See http://www.pewtrusts.org/en/multimedia/data-visualizations/2014/fiscal-50#ind0 .
25. "Arkansas Roadmap to Tax Reform," p. 27.

26. “Tax Revenue Volatility Poses Budget Challenges for Some States,” Pew Charitable Trust, February 2, 2017. Pew’s analysis is based on the U.S. Census Bureau’s Quarterly Summary of State and Local Government Tax Revenue, as adjusted by the Nelson A. Rockefeller Institute of Government. Data are adjusted for inflation using the U.S. Bureau of Economic Analysis’ Implicit Price Deflators for Gross Domestic Product, accessed March 20, 2017.
27. *Ibid.*
28. “2016 B Book,” General Revenue Collections Less Refunds, p. 10.
29. In April 2017, Governor Hutchinson asked agencies to budget for a $70 million general revenue shortfall in fiscal year 2017, with a $43 million shortfall anticipated now in fiscal year 2018.
30. Ark. Code Ann. § 19-4-304.
31. “A Trillion Little Subsidies: The Economic Impact of Tax Expenditures on the Federal Income Tax Code,” Mercatus Center, George Mason University. One of the authors of this report is Jeremy Horpedahl of the University of Central Arkansas. “Five Steps Towards a Better Tax Expenditure Debate”, Institute of Tax and Economic Policy. October 2012.
32. See, e.g., Drenkard, Scott and Joseph Henchman, “Sales Tax Holidays, Politically Expedient But Poor Tax Policy,” Tax Foundation Special Report No. 233, July 25, 2016.
33. Birnbaum, Jeffrey and Alan Murray, *Showdown at Gucci Gulf: Lawmakers, Lobbyists, and the Unlikely Triumph of Tax Reform*, Random House, p. 10.
34. “Business Incentives and Tax Credits Program Costs Through December 31, 2015,” Office of Tax Excise Administration, Revenue Division, Department of Finance and Administration (September 2016), p. 4.
35. “Indiana Tax Expenditure Study: Individual Income Tax Deductions, Exemptions and Credits. Tax Years 2007, 2008, and 2009,” Indiana State Budget Agency, Tax and Revenue Division (January 2013), p. 7.
36. “State of Minnesota Tax Expenditure Budget Fiscal Years 2014-2017” Minnesota Revenue, Tax Research Division, February 2016, p. 5.
37. Tax Expenditure Report, State of Ohio Executive Budget, Fiscal Years 2018-2019.
38. “Five Steps Towards a Better Tax Expenditure Debate,” Institute of Tax and Economic Policy. October 2012.
39. “Tax Code Sunsets and the Dawn of Majority Rule,” Oregon Center for Public Policy, July 2011.
40. “Arkansas Roadmap to Tax Reform.”
41. Notably, however, even within the RSA there is a category that must be funded first: education. As the Special Master’s Final Report adopted by the Arkansas Supreme Court said, “…education is the State’s first funding priority.” *Lakeview Sch. Dist. No. 25 v. Huckabee*, 370 Ark. 139, 257 S.W. 3d 879 (2007). This court decision arguably means that $2.3 billion in educational adequacy payments to school districts can’t be reduced through the RSA. The state budget draws on additional special revenues to help fund public education. However, if you assume that the educational adequacy amounts are first priority, this $5 billion figure overestimates the amount under legislative control, given that a substantial portion of it must be spent on education.
42. Suddes, Thomas, “Gov. John Kasich’s tax policies possible factor in tax revenue shortfalls,” Cleveland.com, April 15, 2017.
43. “The 2016 Citizen’s Guide to the Washington State Budget,” Senate Ways and Means Committee, State of Washington, January 26, 2016.
44. *Hooker v. Parkin*, 235 Ark. 357, S.W. 2d 534 (1962).

45. "Budget Processes in the States," National Association of State Budget Officers, Table 1, p. 8. May 28, 2015.
46. Ark. Code Ann. § 19-4-304.
47. See "Writing the State Budget" 85th Legislature, House Resource Organization State Finance Report, Texas House of Representatives, February 16, 2017.
48. Ark. Code Ann. § 19-4-302.
49. "Writing the State Budget."
50. *Ibid.*, p. 132.
51. "Investing in Results: Using Performance Data to Inform State Budgeting," National Association of State Budget Officers, July 8, 2014, provides additional information on performance budgeting.
52. Arkansas's legislative three-quarter vote threshold only applies to taxes that existed at the time of 1934's Amendment 19 – namely, "property, excise, privilege or personal taxes." Other types of taxes that were subsequently established require only a majority vote to raise.
53. "Budget Processes in the States," National Association of State Budget Officers, May 28, 2015, p. 61.
54. "State Tax and Expenditure Limits – 2010," National Conference of State Legislatures.
55. Ark. Code Ann. § 19-4-304.
56. Inaugural Address by Ben Laney before 55th General Assembly, January 1945, University of Central Arkansas Archives, Governor Ben T. Laney Collection.
57. *Ibid.*, p. 113-114.
58. "Infographic: S&P State Credit Ratings 2001-2014," *Stateline*, The Pew Charitable Trusts, June 9, 2014.
59. NASBO State Expenditure Report, Fiscal Year 2012.
60. Ark. Code Ann. § 19-4-306. This code section was last updated in 1973.
61. Chart: "State of Arkansas Fiscal Year 2016 Estimated Gross General Revenue," General Revenue Forecast of 5/8/2015, Arkansas Department of Finance & Administration.
62. "2016 B Book," Arkansas Bureau of Legislative Research, October, 2016, p. 34. Revenue numbers from BLR B-Book, 2016.
63. "A Guide to the Washington State Budget Process," Office of Financial Management, State of Washington, May 2016.
64. A GIF bill was passed in 2017, but without any associated funding. Theoretically, the GIF bill could be paid for from the rainy-day fund.

ABOUT THE AUTHOR

Marjorie Leong Greenberg has nine years of experience in public and private sector finance. She received a B.A. from Harvard University and an M.B.A. in finance from the University of Michigan; she is also a Certified Government Financial Manager and a Certified Internal Auditor. She has worked in Arkansas state government in budgeting, accounting, and purchasing for the Secretary of State and the Governor. She is currently the Director of Research and Policy at the Arkansas Health Care Association.

"The Advance Arkansas Institute's report on tax relief and budget reform is a must-read: it is a wake-up call for anyone interested in growing good-paying Arkansas jobs in an increasingly competitive environment. This report is a thoughtful, insightful, and well-timed analysis of our current situation. It is the perfect place to begin any conversation about Arkansas's future."

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