INSTITUTE FOR REFORMING GOVERNMENT

Growing Economic Prosperity – Lessons from Tax Reforms in the States

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Introduction

Perhaps no other issue in the history of American public policy has attracted such vociferous debate and ideological warfare as tax policy. Although speaking to a Conservative Party gathering in England in 1983, the remarks of British Prime Minister Margaret Thatcher encapsulate the perspective of many tax reformers in the United States:

> *Let us never forget this fundamental truth: the State has no source of money other than money which people earn themselves. If the State wishes to spend more it can do so only by borrowing your savings or by taxing you more. It is no good thinking that someone else will pay—that "someone else" is you. There is no such thing as public money; there is only taxpayers' money.*[i]

States have been at the forefront of tax experimentation in our nation. Even before the federal government enacted the individual income tax in 1913, two states had made it law; Wisconsin in 1911 and Mississippi in 1912. Most Western states adopted the tax in the 1930s in response to the Depression-era decline in property tax revenues,[ii] and Alaska is the only state, in 1980, to repeal its income tax.[iii] By the same token, it has been states that have often led the way in tax reductions and reforms.

This report looks at examples of state-led tax reforms and offers them as examples to state leaders as they consider changes to state tax laws. These examples, illustrate the four principles of successful tax policy as proposed by the nonpartisan Tax Foundation: simplicity, transparency, neutrality, and stability.[ivv]

Recommendations

Below are four recommendations that are a result of the policy analysis in this report. These recommendations reflect the mission of the Institute for Reforming Government which seeks to simplify government at every level by offering policy solutions to thought leaders in American government in the areas of tax reform, government inefficiency, and burdensome regulations. We believe by working toward implementing these types of pro-growth policies state governments will see higher economic growth and job creation that benefits working families.

1. Enact taxpayer controls that put more decision making directly into the hands of taxpayers to approve spending or other policy changes, before lawmakers are able to increase taxes. This would help:
    - Provide much greater transparency to taxpayers.
    - Restrain government spending and keep governing bodies in check by the people who elected them.
    - Increase economic growth leading to taxpayers keeping more of their hard-earned money.
    - Limit tax increases by having parameters set by taxpayers, not lawmakers.
2. Ease the taxpayer's burden of compliance by making tax laws simpler through fewer tax brackets and reduced steps in calculating the total tax bill. This would help:
    - Give taxpayers more opportunity to save their own

hard-earned dollars through lower taxes and simpler tax laws.

3. Reduce tax rates on personal income and business income. This would help:
    - Contribute to bottom-up and top-down economic growth, which benefits everyone.
    - Inspire job creation and create more stability for working families.
4. Broaden the tax base. This would help:
    - Lower tax rates so that Americans can keep more of what they earn.
    - Contribute to growth and builds revenue.
    - Level the playing field among businesses and job creators while facilitating the collection of tax revenue.
    - Minimize preferential treatment in the tax code.

The report provides substantive support for these recommendations and illustrates the need for tax reform around the country.

Steadfast Leadership in Wisconsin

People in many states have suffered from decades of high taxes and flagrant government spending. These systemic, failed policies usually are not righted overnight or with a single piece of legislation. Instead, they call for principled leadership that is doggedly committed to policy solutions that ease the burden of government on families and unleash economic opportunities and growth.

At the end of 2010, Wisconsin had lost 134,000 jobs, mostly from manufacturing, over the previous four years.[vi] The state faced a $3.6 billion budget shortfall, up from $3.2 billion eight years earlier. It was fueled by state government's insatiable appetite for spending that outpaced the tax revenues coming in, despite income taxes being hiked by $2 billion and property taxes by $1.5 billion under the previous administration.[vii] As a percentage of personal income, property taxes in Wisconsin had been one of the 10 highest in the nation for almost 30 years.[viii] In fact, Wisconsin was referred to as "the California of the Midwest" and, in FY 2010, ranked just behind California as one of the top five states with the highest state and local tax burden.[ix]

The Badger State, the first state in 1911 to enact an income tax even before the federal income tax, began to dig itself out of the tax and spend hole in 2011, when Governor Scott Walker and the legislature ushered in reform-centered policy efforts. In addition to "giv[ing] state and local governments the tools to balance the budget through reasonable benefit contributions,"[x] through landmark legislation known as 2011 Wisconsin Act 10, state leaders listened to the taxpayers and "saved public employers more than $3 billion, including $2.35 billion in pension costs."[xi] Specifically, the battered manufacturing and agricultural jobs were boosted through a tax credit to those job creators. When fully implemented in 2016, the Manufacturing and Agriculture Credit was responsible for 42,000 new jobs over the previous three years.[xii] In 2013, Governor Walker signed Act 20 that cut personal income tax rates in every bracket and reduced the number of brackets from five to four. Also, 2013 Wisconsin Act 20 jettisoned 17 tax deductions or credits and provided taxpayer savings of $650 million in two years.[xiii]

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With a state revenue surplus in 2014 of almost $1 billion, Governor Walker continued to return those savings back to the taxpayers. Property taxes for the typical homeowner were slashed by $406 million, on top of the $75 million reduction the year prior, resulting in more than a 4 percent cut.[xiv] More relief was achieved in 2015[xv] as Governor Walker proposed

"increas[ing] funding for the school levy tax credit… to reduce property taxes..."[xvi] Then in 2017, Wisconsin eliminated the state-assessed property tax, known as the Forestry Mill tax. It also repealed the state's Alternative Minimum Tax (AMT), an uncommon tax provision in state tax law that affected many middle-class taxpayers in Wisconsin.[xvii]

Wisconsin's steady commitment to real reform built upon the previous successes year after year, and, after eight years, yielded results dramatically different than those in 2010. Heavy tax burdens and lost job opportunities were replaced with economic prosperity and a better quality of life. Over the eight years of the Walker administration, tax cuts accumulated to $8 billion, giving the average Wisconsin household a savings of $3,478.[xviii] Property taxes on a typical home were slashed by $3.6 billion to a rate lower than they were in 2010, while home values rose. The unemployment rate in June 2019 was at a historic low of 2.9 percent, one of the lowest in the nation.[xix] Real GDP grew at twice the rate from 2010 to 2017 (10.3 percent) compared to 2001 to 2010 (4.9 percent), catapulting Wisconsin from 35th in the nation to 11thfor the fastest growth.[xx]

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Bold Reforms in North Carolina

Widely hailed as "one of the most meaningful state tax reforms in the last twenty years,"[xxi] North Carolina enacted legislation in 2013 that fundamentally restructured the state's tax system overnight. Most of the reforms became effective during the next tax year and were not subject to a phase-in period, although the state continued to reduce tax rates following this large, initial wave of reforms. The 2013 package broadened the tax base, cut and flattened taxes for individuals and businesses, simplified the tax system, and made tax policy more neutral. These reforms, led by Governor Pat McCrory and the legislative majorities, illustrate how quickly bold, smart reforms can lead to growth and prosperity.

Prior to the 2013 tax reform package, North Carolina was among the most uncompetitive tax codes in the nation. It levied the highest individual income tax bracket in the Southeast at 7.75 percent, and taxed income above $12,750 at 7.0 percent.[xxii] According to a report by the Tax Foundation, North Carolina ranked 20th in the country for total state and local tax burden and higher than all but one of its competitor states for FY 2012. Then, an average North Carolina taxpayer paid state or local governments $3,659 in taxes.[xxiii] The tax climate for job producers was even poorer. The state had the highest corporate income tax rate in the Southeast of 6.9 percent and ranked between 44 and 46 in the Tax Foundation annual *State Business Tax Climate Index*. The corporate tax base was narrow and did not reflect the state's decreased manufacturing job base and increase in professional and service-related jobs. It was one of 20 states that maintained a franchise tax, which taxed business assets with the highest bracket of 0.15 percent of the value of assets.[xxiv]

In 2010, Republicans flipped control of the North Carolina House and Senate from the Democrats with veto-proof majorities.[xxv] Currently a U.S. Senator, Thom Tillis was elected Speaker of the House and joined Republican majorities in the Senate to press for tax reform. Governor McCrory worked with the legislature to broker a deal to craft a single, flat tax for all taxpayers.[xxvi] The House approved the bill by a 77-38 vote, and the Senate approved it 32-17.[xxvii]

The 2013 legislation ushered in sweeping reforms that moved the state towards a more consumption-based tax model. The most notable of these reforms included the following:

- Consolidated the state's three individual income tax brackets into one, flat tax with the top rate reduced by 25 percent for incomes over $60,000 from 7.75

percent to 5.8 percent in 2014 and another phasedown to 5.75 percent in 2015. The lowest bracket for those earning $0 to $12,750 fell from the pre-2013 rate of 6 percent.

- Increased the standard deduction from $6,000 to $15,000 for married taxpayers and repealed the personal exemption of $2,000. To further its mitigation of a regressive effect, the state increased the child tax credit for lower income households from $100 to $125 for married taxpayers earning below $40,000.
- Lowered its corporate income tax from 6.9 percent to 6 percent in 2014 and 5 percent in 2015. The legislation also implemented a tax trigger for future years. Although not enshrined in the constitution like Colorado's Taxpayers Bill of Rights, the tax cut was contingent upon state revenue levels and provided a reduction to 4 percent in 2016 if revenues exceeded $20.2 billion in 2015 and to 3 percent in 2017 if revenues were more than $20.975 billion in 2016. The state exceeded both revenue targets, triggering the reduction of corporate income tax.
- Allowed several tax credits to expire including credits for recycling oyster shells.
- Broadened the state sales tax structure. First, the reforms eliminated the state's two sales tax holidays, one for back-to-school purchases, and another for home appliances with the ENERGY STAR® certification. Both had been codified as permanent tax holidays years before.[xxviii] Additionally, the state included formerly exempt or lower rate items in the base sales tax, including service contracts, electricity, piped natural gas, amusements, entertainment, manufactured homes, mobile homes, and bread sold at a bakery.[xxix]

The 2013 reform package cut taxes more than $500 million in the first two years, but the legislature and Governor McCrory continued to press for pro-growth policies. After allowing the 2013 tax reforms to take effect in 2014, the state passed additional legislation in 2015 to reduce the personal income flat tax from 5.75 percent to 5.499 percent, effective in 2017, and eliminate the bank privilege tax, which imposed a $30 tax for every $1 million in assets.[xxx] In 2017, the legislature, without a willing partner in the governor's mansion, overrode Governor Roy Cooper's veto and enacted a budget with tax cuts in addition to those scheduled for phase-in from previous legislation. Yet again, the personal income tax rate was lowered. This time the rate decreased from 5.499 percent to 5.25 percent, and the single, corporate tax rate reduced from 3 percent to 2.5 percent; both reductions effective in 2019. The state's standard deduction also increased again by $2,500 for married, joint filers, from $17,500 to $20,000.[xxxi] The 2018 legislative session marked the fourth consecutive year of tax reforms when state lawmakers returned to taxpayers the state's unexpected tax conformity surplus realized from the federal tax reform legislation of 2017. They increased the standard deduction again; to $20,000 for joint filers and $10,000 for single filers.[xxxii]

Since instituting tax reforms, North Carolina has experienced incredible economic growth. In the first two years following the passage of the 2013 reforms, North Carolina led the nation in GDP growth, posting a record 13.4 percent increase.[xxxiii] The rate of economic growth continued to accelerate between the first quarter of 2017 and the first quarter of 2018, when the state ranked in the top 20 with the highest increase in GDP.[xxxiv]

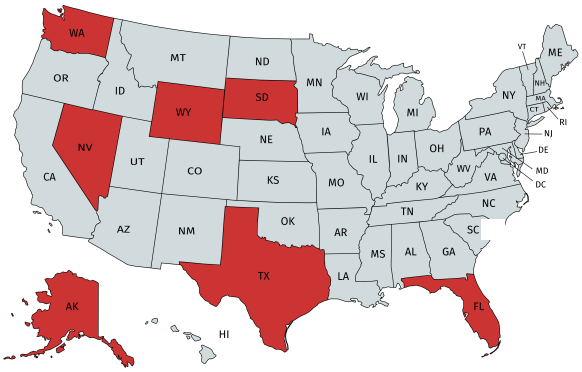
The state was ranked by *Forbes* as the third best state for business in 2014, and then the second best state for business in 2015.[xxxv] It has leaped over 30 spots in the Tax Foundation's *State Business Tax Climate Index* in just a few years—from 44th to 12th.[xxxvi] Even before the reforms became effective, national publications pointed to them as further reason for retirees to move to the Tar Heel State, noting the abolishment of the death tax and the flattened rate for personal income.[xxxvii] Job growth since 2014 also has been above the national average,

and, according to the John Locke Foundation, North Carolina is outperforming other southeastern state economies as a whole.

The Summit - No Individual Income Tax

Many tax reform champions claim the absence of a personal income tax as their nirvana. Seven states charge no individual income taxes: Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming. Additionally, two states only tax income from interest and dividends: New Hampshire and Tennessee.[xxxviii] Legislation passed in Tennessee in 2016 gradually decreases the income tax on investment income until the tax is completely repealed on January 1, 2021.[xxxix]

States Without Tax on Personal Income



States with no personal income tax have many advantages over those that levy the tax. Workers and families often will make the choice of where to live based on the state's personal income tax rate, and those states that levy none have a distinct advantage over those that do. This can give those states better footing to compete with other states for jobs, workers and businesses – which will understandably often choose to follow the workforce.[xl] A number of states, particularly high-tax states, struggle to keep people from leaving for states with a lower tax burden.

A repeal of the personal income tax can be fiscally and politically difficult. Many elected officials are hesitant to repeal the personal income tax, expressing concerns that doing so would eliminate what is typically a significant source of state revenue, and by extension, make it more difficult for the state to fund programs and services. Without an appropriate revenue replacement, it can be very difficult, if not impossible, for a state to replace the lost revenue or cut spending accordingly.

Alaska is the only state to eliminate its personal income tax. After being established in 1949 at 10 percent, to rise to a high of 16 percent by the 1960s, the individual income tax was repealed in 1980.[xli] Alaska was able to repeal its personal income tax because of the billions of dollars in new revenue that flooded the state with the oil boom.[xlii]

In November 2019, Texans will vote on whether to enshrine the absence of a personal income tax in the state constitution. If the constitutional referendum passes, the personal income tax could then come to the Lone Star State only by a two-thirds vote of each legislative chamber and a majority vote of Texans.[xliii]

The Kansas Tax Experiment

In 2012, Kansas enacted a sweeping tax reform package to cut the top individual income tax rate from 6.45 percent to 4.9 percent and increased the standard deduction while eliminating other deductions. The plan that actually passed and signed into law, however, did not include many of the revenue off-sets because of disagreements within the legislature. The tax reform package essentially, therefore, produced only a tax cut, with an estimated annual cost of $803 million by 2014. Although the governor hoped to pass compromise legislation to deal with some of the unresolved issues, the legislature was unable to reach an agreement.

The tax cut package signed into law also created an incentive for individuals to avoid taxes through the use of pass-through businesses, by exempting nonwage income for these businesses from taxation.[xliv] While the state saw anemic employment and economic growth, the number of individuals reporting business income skyrocketed, likely due to zero taxes on pass-through businesses.[xlv] The state also saw a

decline in agricultural prices, which further exacerbated the state's revenue woes.[xlvi] Within two years of the tax cuts, job growth in Kansas lagged not only the national average but its neighboring states as well.[xlvii]

Kansas' tax reform efforts ultimately failed because the plan lacked revenue offsets and did nothing to broaden the tax base. These problems with the original reforms led to a significant budget crunch and financial distress. The state since has passed several tax increases to reverse the results of the original, legislative action in 2012.[xlviii]

Colorado's Taxpayers Bill of Rights

Colorado's Taxpayer's Bill of Rights (TABOR) illustrates the importance of enshrining tax policy in the state constitution and out of easy reach by legislative ideologies that are less favorable to pro-growth policies. Passed in 1992 with 54 percent of the statewide vote,[xlix] TABOR limits the state and local governments from raising certain taxes without voter approval and prohibits government from spending tax revenues unless they are outpaced by a growing population or inflation rate. Any natural growth of revenues is rebated to taxpayers.

It remains the only law of its kind in the nation as part of the state constitution but has been under constant attack by the "tax and spend lobby." The TABOR limit is equal to either the prior fiscal year's revenue limit grown by inflation and population growth, or the current fiscal year's revenue, whichever is less. An amendment passed by voters in 2000 guaranteed a minimum amount of funding for education, requiring per-pupil funding levels to keep pace with inflation. In 2005, Colorado voters again modified TABOR, suspending the revenue limit until 2010 and modifying the revenue limit going forward. Known as Referendum C, this modification was designed to allow the state to keep excess revenue during an economic recovery when revenues may increase year-over-year but are flat or down over a multi-year period. The Referendum C cap is based on the highest amount of revenue collected in the five years preceding FY 2011, multiplied by the TABOR growth rate, and, in succeeding years, equals the prior year's cap times the TABOR growth rate.[l]

The Colorado TABOR does not implement a sustained reduction of tax rates but allows the state legislature to choose "any reasonable method of refunds […], including temporary tax credits or rate reductions."[li] Since TABOR's adoption in 1992, the legislature has enacted 21 various refund mechanisms but, after repealing 18 of them over the years, currently allows for three vehicles for refund: (1) a property tax exemption reimbursement to local governments, (2) a temporary individual and corporate income tax rate reduction from 4.63 percent to 4.5 percent, and (3) a six-tiered sales tax refund. Each is used sequentially until the excess revenues are depleted.[lii]

In TABOR's first 25 years, revenues exceeded the cap in eight of those years resulting in a total refund obligation of almost $3.5 billion to taxpayers. After revenues failed to exceed the cap for nine consecutive fiscal years, FY 2014-15 resulted in a refund the following year of $169.7 million,[liii] and, after another two year hiatus, FY 2017-18 provided a refund of $39.8 million.[liv] The state projects that the most recent fiscal year that ended June 30, 2019, will provide a total refund of $574.7 million through not only the property tax exemption reimbursement to local governments but also the income tax reduction and sales tax refund. [lv]

Efforts to curtail TABOR over the last quarter of a century continue today with full vigor. In its 2019 session, the Colorado General Assembly referred a referendum measure to this November's ballot that would further neuter TABOR. Known as Prop CC, it would authorize the state to spend excess revenues on education and infrastructure projects rather than return them to taxpayers.[lvi] Even if this year's initiative fails, a larger threat looms for the 2020 ballot thanks to the state's supreme court ruling in June that allows Proposed Initiative 3 to proceed. If it collects the required signatures, the referendum would ask the voters for a complete repeal of TABOR from the constitution.[lvii]

Proponents of TABOR argue that the amendment has kept government spending in check in Colorado and led to economic growth in the state that was above the national average.[lviii] They also argue that the limits on government spending have kept Colorado from experiencing some of the financial difficulties of other states, including California. For example, the proportion of state spending to Coloradans' personal income has dropped from 6.7 percent in FY 1992-94 to 3.9 percent in FY 2011-12.[lix] Former Colorado Governor Bill Owens (R) continues to support TABOR, saying that it keeps government growing at the same pace as the private sector unless voters allow it to grow more.

In 2016, the Independence Institute released a report on the impact of TABOR after 20 years. They found that TABOR had slowed government taxes and spending in the state, which were increasing at nearly double the rate of inflation prior to TABOR's enactment. They also found that private job growth in the first decade of TABOR's existence (prior to any reforms) private sector job growth was much greater than public sector job growth. The paper also found that if TABOR had not been enacted and the government had continued growing at the same rate as in 1983-92, the average state resident would have paid $442 more in taxes in 2012. On average, the individual Coloradan has saved over $6,000 since TABOR's enactment, and a family of four has saved more than $24,000.[lx]

Truth in Taxation in Utah

In 1985, the Utah state legislature passed HB 388, the Tax Increase Disclosure Act, known commonly as "Truth in Taxation," which requires local governments in the state to go through a certain process in order to change their property tax rates. The legislation also changed the property tax from a rate-based tax to a revenue-based tax. The process lays out a certain timeline for the completion of certain steps in order to raise property taxes. The goal of the law was to make a local increase in property taxes more transparent.

The process essentially follows these steps:[lxi]

- A notification must be sent for a public meeting.
- When the public meeting is held, the agenda must include the proposed tax increase as a separate agenda item, and also detail the purpose for the tax increase, as well as the dollar amount of the increase and the percentage of the increase.
- Local property owners (those that would be subject to the tax) must receive a mailed notice of the proposed tax increase.
- Public notifications of the increase and a notice of a public hearing must be published twice in the largest local newspapers.
- After the newspaper ads have been published, public hearings are held.

While there is not a formal vote on the tax increase, residents are encouraged to comment on the proposed tax increase during the public meeting and hearings.[lxii]

Property tax revenues largely funds school districts, but also is one of the primary funding sources for city and county operations, including law enforcement, parks and recreation, transportation, animal control, libraries, and other services.

A report by the Utah Foundation found that the Truth in Taxation law has kept property tax revenues from increasing as quickly as Utah property values. The report also found that the state's property tax burden has been one of the most stable in the country, averaging between $24.14 and $29.45 per $1,000 of personal income over the period of 1993 to 2015.

Additionally, in the ten years prior to the passage of the law, revenues from property tax collections increased 12 percent every year; since 1985, revenues have only increased by 4 percent. The Utah Foundation report also found that property tax revenues have continued to outpace the revenue growth needed to account for inflation and the state's population growth.

Finally, the report concluded that Truth in Taxation has struck a good balance between preventing government revenue windfalls while giving local government the flexibility to make changes to their property tax rates based on current needs.[lxiii]

There has been some criticism of the Truth in Taxation law. Some argue that the process has made it so difficult for local governments to incrementally raise property taxes over several years that they are now resorting to much larger tax increases to "catch up." For example, in 2018, there were 53 cities, towns, school districts, water districts, and special districts that were looking to raise property taxes, including a proposed 114.9 percent increase in Tooele City. Others say that local officials did not want to face the public with a proposed tax increase, so they avoided raising property taxes so as to avoid the multiple public hearings as required by the law.[lxiv]

Revisions to the Truth in Taxation law may be on the horizon. The Tax Restructuring and Equalization Task Force, which is a legislative task force, comprised of five state senators and five representatives, currently are touring the state to gather input on overhauling the state's tax system.[lxv] During the meetings, the mayor of Salt Lake County asked the Task Force to allow localities to make inflationary adjustments to property taxes without requiring them to go through the Truth in Taxation Process.[lxvi] Town hall meetings are expected to end this summer, and the Task Force is expected to make final recommendations to leadership in the legislature in September, potentially setting up a Special Session in the fall.[lxvii]

Conclusion

Reforming state tax policy involves intricate, well-reasoned analysis that also demands keen political and communication skills. These examples included in this report should give encouragement to leaders in states that are looking to lessen the tax burden and spur economic growth. The correct approach to reform is dependent upon the unique tax bases, budget priorities, and fiscal structure in each state. Successful tax reform is not simply about reducing tax rates. It must consider how lower tax rates will broaden the tax base by attracting more families, jobs, and new businesses that, in turn, will provide revenues to pay for necessary government services.

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[v] "Simplicity: Tax codes should be easy for taxpayers to comply with and for governments to administer and enforce. Transparency: Tax policies should clearly and plainly define what taxpayers must pay and when they must pay it. Disguising tax burdens in complex structures should be avoided. Additionally, any changes to the tax code should be made with careful consideration, input, and open hearings. Neutrality: Taxes should neither encourage nor discourage personal or business decisions. The purpose of taxes is to raise needed revenue, not to favor or punish specific industries, activities, and products. Minimizing tax preferences broadens the tax base, so that the government can raise sufficient revenue with lower rates. Stability: Taxpayers deserve consistency and predictability in the tax code. Governments should avoid enacting temporary tax laws, including tax holidays, amnesties, and retroactive changes." *Ibid.*

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