State Tax Cut Roundup

2013 Legislative Session

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LIMITED GOVERNMENT • FREE MARKETS • FEDERALISM

CENTER FOR STATE FISCAL REFORM

TAX AND BUDGET SOLUTIONS FOR ECONOMIC GROWTH

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The ALEC Center for State Fiscal Reform strives to educate those who share a commitment to our principles and shared goals. We also strive to educate our legislative members on how to achieve greater economic prosperity by outlining which policies work and which ones fail. This is done by personalized research, policy briefings in the states, and by releasing nonpartisan policy publications for distribution such as *Rich States, Poor States, Tax Myths Debunked, Keeping the Promise: State Solutions for Government Pension Reform,* and the *State Budget Reform Toolkit*.

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Reform for Economic Growth

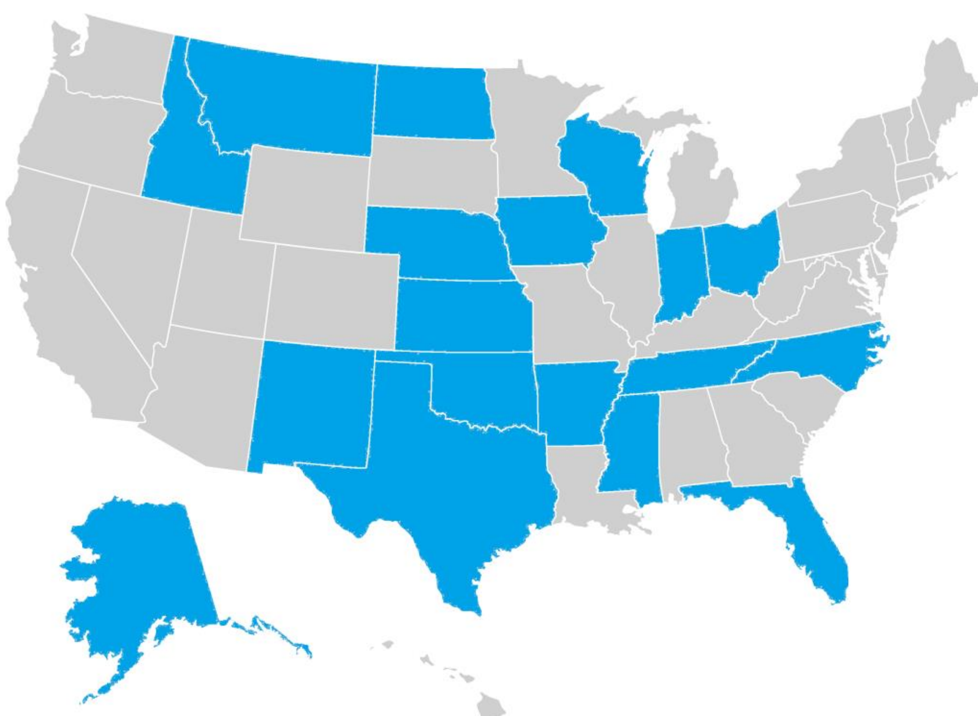
For the majority of state legislatures, the 2013 legislative session has come to an end. This session featured many states looking to reform their tax codes and become more economically competitive. Overall, 18 states made pro-growth tax changes this session. However, not all tax changes are improvements. Evidence found in the 6th edition of *Rich States, Poor States* offers a research-based guideline to states wishing to reform their tax codes in a way that will increase economic growth. In general, states with lower tax and regulatory burdens, as well as those that encourage entrepreneurship, consistently perform better economically than their high-tax counterparts.

Sound fiscal policy and pro-growth tax reform may seem difficult to accomplish, but it is far from impossible. Just this past session, a significant number of states worked to pass pro-growth reforms that will improve their state's competitiveness and help propel economic growth. Below is a list of states that have accomplished responsible and pro-growth changes in the past legislative session.

To be listed in the ALEC Tax Cut Roundup, a state must meet the following criteria:

- Substantially cut taxes at the state level
- Vote(s) occurred in the 2013 legislative session
- Results in a net decrease in taxes over the legislative session
- Applies broadly and neutrally, or otherwise conforms the state closer to ALEC's Principles of Sound Tax Policy

States That Made Significant Tax Cuts in the 2013 Legislative Session



Principles of Sound Tax Policy[1]

The proper function of taxation is to raise money for core functions of government, not to direct the behavior of citizens or close budget gaps created by overspending. This is true regardless of whether government is big or small, and this is true for lawmakers at all levels of government.

Taxation will always impose some level of burden on an economy's performance, but that harm can be minimized if policymakers resist the temptation to use the tax code for social engineering, class warfare and other extraneous purposes. A principled tax system is an ideal way to advance a state's economic interests and promote prosperity for its residents.

The fundamental principles presented here provide guidance for a neutral and effective tax system; one that raises needed revenue for core functions of government, while minimizing the burden on citizens.

Simplicity:

The tax code should be easy for the average citizen to understand, and it should minimize the cost of complying with tax laws. Tax complexity adds cost to the taxpayer, but does not increase public revenue. For governments, the tax system should be easy to administer, and should help promote efficient, low-cost administration.

Transparency:

Tax systems should be accountable to citizens. Taxes and tax policy should be visible and not hidden from taxpayers. Changes in tax policy should be highly publicized and open to public debate.

Economic Neutrality:

The purpose of the tax system is to raise needed revenue for core functions of government, not control the lives of citizens or micromanage the economy. The tax system should exert minimal impact on the spending and decisions of individuals and businesses. An effective tax system should be broad-based, utilize a low overall tax rate with few loopholes, and avoid multiple layers of taxation through tax pyramiding.

Equity and Fairness:

The government should not use the tax system to pick winners and losers in society, or unfairly shift the tax burden onto one class of citizens. The tax system should not be used to punish success or to "soak the rich," engage in discriminatory or multiple taxation, nor should it be used to bestow special favors on any particular group of taxpayers.

Complimentary:

The tax code should help maintain a healthy relationship between the state and local governments. The state should always be mindful of how its tax decisions affect local governments so they are not working against each other – with the taxpayer caught in the middle.

Reliability:

A high-quality tax system should be stable, providing certainty in taxation and in revenue flows. It should provide certainty of financial planning for individuals and businesses.

Pro-Growth:

A low tax burden can be a tool for a state's private sector economic development by retaining and attracting productive business activity. A high-quality revenue system will be responsive to competition from other states. Effective competitiveness is best achieved through economically neutral tax policies.

Tax Cuts by State

The *Rich States, Poor States* Economic Outlook Ranking is a forward-looking measure based on a state's standing in the equally weighted average of 15 important state policy variables. These variables include tax policy, regulatory policy, and labor policy. Data reflects state and local rates and revenues and any effect of federal deductibility. (1=Best, 50=Worst)[2]

Alaska

Rich States, Poor States 2013 Economic Outlook Ranking: 21

This past session marked significant oil tax reform in Alaska. The More Alaska Production Act created a 35 percent tax base for oil production, removed most progressive rate increases, and linked tax credits directly to oil production.[3] With this new, simpler tax structure, Alaska will have a greater competitive economic edge. Furthermore, since approximately 90 percent of the state's general fund comes from oil production revenue, new business expansion will be a great help to the state's economy.[4]

Aside from oil tax reform, Alaska also addressed tax reform for small businesses. The measure reformed the corporate income tax brackets by adjusting them to account for inflation. Small businesses earning $222,000 or less will have a tax cut, and businesses with income below the $25,000 mark will see no income tax at all. This measure is another step towards a more competitive business climate in Alaska.

Arkansas

Rich States, Poor States 2013 Economic Outlook Ranking: 24

The Arkansas General Assembly passed legislation that reduced the personal income tax rate on every income bracket by 0.1 percentage point. In addition to its income tax cuts, the state also reduced the capital gains tax rate by allowing for a deduction totaling $2,200 and lowering the taxable portion of capital gains from 70 percent to 50 percent.[5] Additionally, manufacturers located in Arkansas will be getting a tax cut in the form of a new deduction for equipment. This is estimated to save manufacturers nearly $25 million annually and represents an attempt to exempt business inputs from taxation. Exempting business inputs from taxation prevents additional layers of taxes from being added on at every level of production, a practice economists refer to as "tax pyramiding." Customers should only pay the final sales tax once on the actual cost of the consumer item.

Florida

Rich States, Poor States 2013 Economic Outlook Ranking: 9

Good tax policy got a boost in the Sunshine State this session, which passed a measure that would exempt all manufacturing equipment from sales and use taxes starting in April 2014.[6] A study done by the Council on State Taxation (COST) has demonstrated that by eliminating the tax burden on business inputs, consumers only pay the true sales tax cost once, at the point of sale, rather than paying hidden costs that result from taxing pyramiding when goods in the chain of production are taxed in addition to the final consumer product.[7]

With nearly 60 percent of small businesses being manufacturers and supplying close to 371,000 people with jobs in the state, this tax measure will help stimulate and incentivize the production of equipment and hiring of workers in this industry while reducing the overall cost of goods for consumers.[8]

Idaho

Rich States, Poor States 2013 Economic Outlook Ranking: 7

The 2013 legislative session gave a boost to small businesses in the state of Idaho. Small businesses are exempt from the personal property tax up to the first $100,000. Nearly 90 percent of small businesses will benefit from this tax exemption. This personal property tax cut on businesses will provide roughly $20 million in tax relief for in-state businesses and improve the state's overall tax climate for those thinking about opening up a small business in Idaho.[9]

Indiana

Rich States, Poor States 2013 Economic Outlook Ranking: 14

Governor Pence and the Indiana Legislature earned a victory for Indiana taxpayers this session when the legislature passed a tax cut package that will make the state more economically competitive. The plan includes a reduction of the state income tax phased in over four years reducing it to 3.23 percent from its current 3.4 percent. The plan also continues phasing in corporate income tax cuts and fully eliminates the state's economically damaging "death tax."[10] With Right-to-Work laws and a more competitive tax code, the message is clear: Indiana is open for business.

Iowa

Rich States, Poor States 2013 Economic Outlook Ranking: 25

Iowa made a historic property tax cut for all classifications of property. This new legislation will give Iowa families $4.4 billion in property tax relief over the next decade. All classes of property will see tax cuts by having their tax bill assessed at 90 percent of property value rather than the property's full value, with agricultural and residential home owners saving close to $500 million annually by the end of the tenth year.

In addition to property tax cuts, the bill also included $90 million in annual deductions and relief for the state's income tax, including a credit when the taxpayer trust fund exceeds $30 million, and limited how much property taxes could increase year-to-year.[11] Iowa also doubled the state's Earned Income Tax Credit.[12]

Kansas

Rich States, Poor States 2013 Economic Outlook Ranking: 11

Last year Kansas made history with its tax cuts, especially for small businesses. This legislative session fine-tuned those previous changes to include a pathway to reduce the Kansas personal income tax rates even further.[13]

The legislature allowed a sales tax increase to partially expire, setting the overall rate at 6.15 percent, down from 6.3 percent. In addition, cuts to the personal income tax will phase in over several years to lower the rate to 2.3 percent on the first $30,000 of income and 3.9 percent on income over that.[14] Overall, the extremely pro- growth reforms in Kansas will help the state become even more economically competitive.

Mississippi

Rich States, Poor States 2013 Economic Outlook Ranking: 10

The Mississippi legislature took a major step towards creating a more sound business tax base by exempting manufacturers from paying a 1.5 percent sales tax on energy. Taxing business energy consumption leads to tax pyramiding, or the compounding of the tax burden as products make their way through the chain of production. Sound tax policy requires that all business inputs be exempted from taxation. Given this, Mississippi's reform is a small, but important, step in the right direction.[15]

Montana

Rich States, Poor States 2013 Economic Outlook Ranking: 42

Montana also considered tax reform this session. The state adopted a measure to exempt the first $100,000 of personal property from the business and equipment tax. It also reduces the tax rate to 1.5 percent on the first $6 million of taxable value, and 3 percent on the value above $6 million.[16] This is a step towards pro-growth tax reform in Montana.

Nebraska

Rich States, Poor States 2013 Economic Outlook Ranking: 37

Nebraska seemed like it was off to a monumental start when Governor Dave Heineman explored the idea of eliminating the personal income tax. Instead, Nebraska chose to create a commission to further study options for fundamental tax reform.

However, a series of small but important tax cuts were implemented this legislative session. Nebraska eliminated the Alternative Minimum Tax (AMT), allowed business losses to be carried over 20 years rather than five, allowed contributions to a college savings plan to be tax deductible, and expanded a capital gains tax exclusion for companies that establish a program for employee stock options.[17] [18] [19]

New Mexico

Rich States, Poor States 2013 Economic Outlook Ranking: 33

In a successful attempt to make New Mexico a more competitive state and attract more businesses, Governor Susana Martinez worked with the legislature to enact a significant and bipartisan corporate income tax cut. For years, New Mexico levied the highest corporate income tax rate in the Southwest region (except for California) and struggled to remain economically competitive with its neighbors. However, that changed in the 2013 legislative session, which saw the corporate income tax reduced from 7.6 percent to 5.9 percent.[20]

While there were other credits, deductions, and changes to the corporate income tax, the actual rate reduction was the centerpiece of reform and is a significant step in the right direction for New Mexico.

North Carolina

Rich States, Poor States 2013 Economic Outlook Ranking: 22

In mid-July, after months of debate and deliberation, North Carolina passed monumental tax reform. The bill had broad, far-reaching effects that immediately improved the state's competitiveness and put it on the track for higher economic growth. In general, the plan consisted of the following:

- Replaced 3-tiered personal income tax structure with a modified flat tax.
- Lowered the top marginal rate of the personal income tax (from 7.75 percent down to 5.8 percent in 2014, and then 5.75 percent in 2015)
- Reduced the personal income tax across all income brackets
- Lowered the corporate income tax rate (from 6.9 percent down to 6 percent in 2014, 5 percent in 2015, and the possibility of falling to 4 percent in 2016 and to 3 percent in 2017, depending on whether revenue growth targets are achieved)
- Eliminated the state's death tax;
- Broadened the sales tax base
- Eliminated multiple gross receipts franchise taxes, privilege taxes, and preferential sales tax rates.

In all, the reform bill cuts taxes more than $500 million in the first two years alone, and more than $650 million a year by the 2017-2018 fiscal year.[21] Without question, the reforms are among the most significant tax relief any state has passed in the last decade.

North Dakota

Rich States, Poor States 2013 Economic Outlook Ranking: 2

North Dakota surprised its residents this session with a bill that gave them $850 million in relief for property taxes. The $850 million was part of a much larger $1.1 billion dollar package designed to reduce taxes. The measure provides residents with $200 million in tax relief by creating state-funded tax credits that will be used for property tax reductions.[22] Tax relief is an appropriate and perhaps overdue use of the state's surplus revenue created from its energy boom and rapid economic development.

Ohio

Rich States, Poor States 2013 Economic Outlook Ranking: 26

The Ohio legislature has room to claim the largest year-to-year tax cut of the 2013 legislative session with a cut of $2.7 billion over three years.[23] Personal income tax payers see the greatest benefit, as a 10 percent across-the-board income tax rate cut will phase in over the next three years.[24] Small businesses filing as pass-through entities will now be able to deduct 50 percent of the first $250,000 in taxable income each year.

On the other hand, businesses with more than $1 million taxable gross receipts will bear more of the state's commercial activities tax burden. The sales tax rate was also raised to 5.75 percent, and expanded to additional services.[25]

Of interest, Gov. Kasich used his line-item veto power to eliminate a provision that would have required out-of-state retailers, with no physical presence in Ohio, to collect sales taxes on digital sales.[26]

Oklahoma

Rich States, Poor States 2013 Economic Outlook Ranking: 19

In terms of economic competition with neighbors, few states have it as tough as Oklahoma. Texas is booming with no income tax and Kansas made major reforms that essentially eliminated the income tax for small businesses, with plans to fully phase it out in the future. Governor Fallin has repeatedly mentioned concerns about becoming "an income tax sandwich" by being located in-between Kansas and Texas.

However, legislators in Oklahoma are taking steps to make sure that doesn't happen. In the 2013 legislative session, Oklahoma legislators voted to reduce the personal income tax from 5.25 percent to 5 percent starting January 1, 2015. There is also a provision to lower the income tax further to 4.85 percent in 2016 if certain revenue targets are met.[27] While the reduction is modest, it is a step in the right direction and there are many calling to speed up a "march to zero" in light of the serious steps taken by Oklahoma's neighbors to become more economically competitive.

Tennessee

Rich States, Poor States 2013 Economic Outlook Ranking: 18

Tennessee Governor Bill Haslam signed into law a new bill that will reduce the state's sales tax on groceries from 5.25 percent to 5 percent.[28] While that is certainly a good step towards a lower sales tax burden, the far better approach would have been to simply lower the entire sales tax rate rather than enact preferential rates on certain purchases.

Texas

Rich States, Poor States 2013 Economic Outlook Ranking: 12

This legislative session, the Lone Star State further solidified its reputation as an excellent state in which to do business. A measure reforming the economically damaging Texas margins tax was approved. Governor Perry had asked the legislature to tackle the issue and the result was a tax cut of more than $1 billion to Texas businesses. The measure included adding a $1 million deduction for Texas businesses and lowered the rates on all businesses, regardless of size.

This reform, paired with the fact that Texas does not levy a personal income tax, signifies a re-dedication to the pro-growth tax and fiscal policies that have made Texas the economic powerhouse that it is today.[29]

Wisconsin

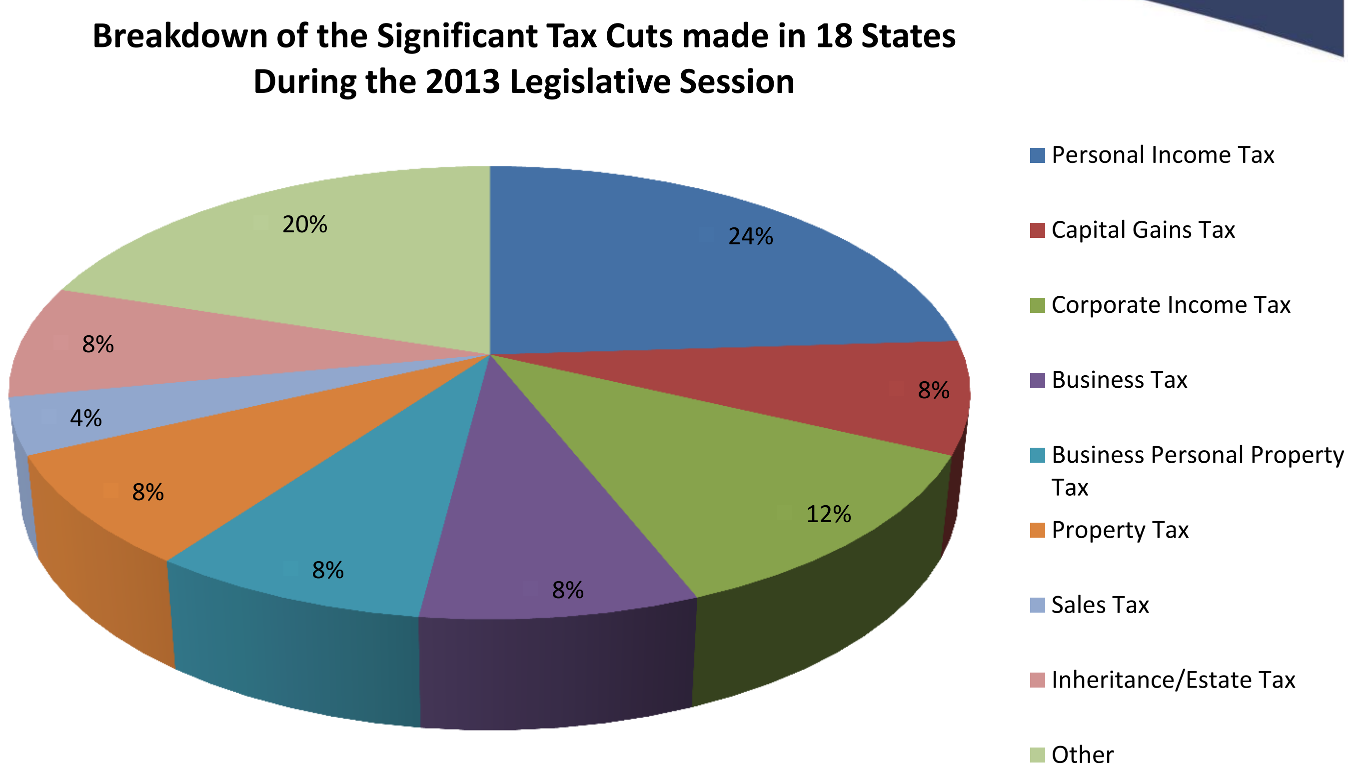
Rich States, Poor States 2013 Economic Outlook Ranking: 15

The 2013-2015 biennial budget in Wisconsin contained a helpful surprise for taxpayers – cuts to tax rates for every income bracket. Wisconsin's complex system of five personal income tax brackets was reduced to four, with the lowest income earners receiving a 4 percent tax cut, and couples making more than $315,000 also sending less to Madison with a new top personal income tax rate of 7.65 percent. Middle-income families will pay 4 to 7 percent less in the newly merged brackets. The enacted budget also eliminates 17 tax deductions and brings depreciation and capital loss standards to federal standards. The total income tax cut comes out to a taxpayer savings of $650 million over two years.[30]

Which Taxes Did States Cut?

Some states merely tweaked their tax codes and may have only cut one particular type of tax. Other states, however, used the 2013 legislative session to enact fundamental tax reform.

Of the 18 states that cut taxes this year, there were approximately 25 meaningful cuts in specific tax categories. The chart below outlines how many instances a particular type of tax was reduced in the 2013 legislative session. Almost one quarter of the 25 tax cuts were to the personal income tax, followed by reductions to various state specific taxes and reductions to the corporate income tax. Sales tax reductions were the least enacted form of tax cuts in 2013.



Taxes and Economic Growth

Mainstream economists, small business owners, and taxpayers across the country know that taxes have an adverse impact on commerce and economic development. Taxes create a barrier between work and reward and decrease the incentive to add value. While tax revenues are necessary to provide for core functions of government, excessive rates hamper the potential for economic growth both at the national and state levels.

In the American Legislative Exchange Council Report *Tax Myths Debunked*, authors Dr. Randall Pozdena and Dr. Eric Fruits discuss a recent study from Professor Christina Romer (along with her husband David Romer), President Obama's former head of his Council of Economic Advisors. Their report has provided some of the strongest and most current evidence on the relationship between federal taxes and economic growth. The report finds the following conclusions:[31]

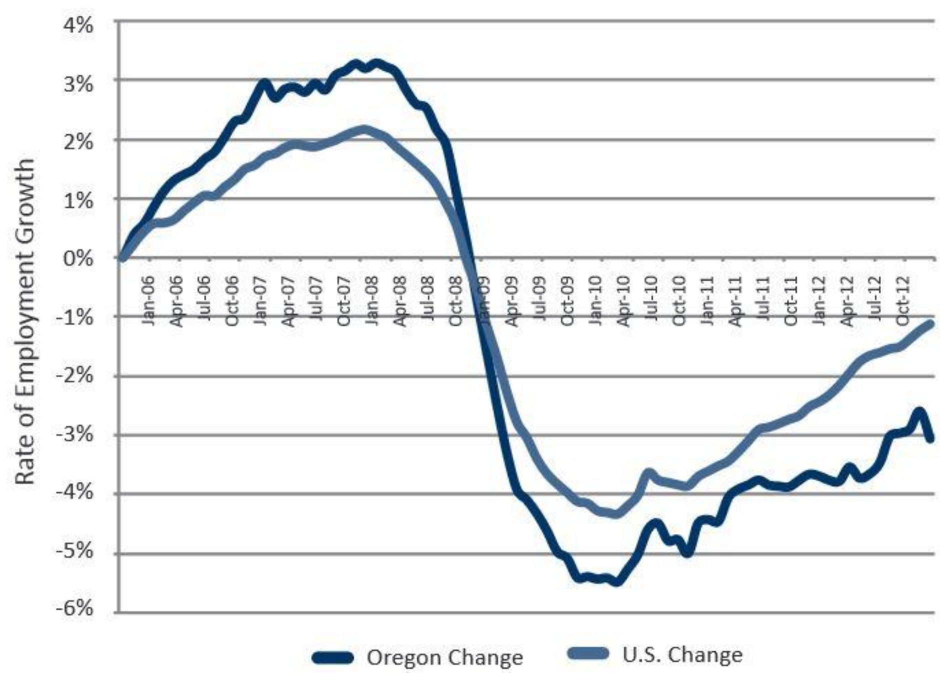
- Each 1 percent increase in taxation lowers real GDP by 2 to 3 percent.
- These damaging effects on the economy are persistent and are not diminished by offsetting changes in prices
- Investment falls sharply in response to tax increases. It is very likely that this strong retreat of investment is part of the reason the declines in output are so large and persistent.

Similar results can be found on the state level. Drs. Fruits and Pozdena also discuss the effects of a sharp tax increase in Oregon and its effect on state employment.

"In 2008 Oregon raised its highest marginal tax rates on both personal and corporate income to the first and second highest rates in the country. The net effect was to slow employment growth in Oregon significantly relative to U.S. employment growth on the back side of the 2007 recession."[32]

Oregon's Income Tax Hikes Slowed its Employment Growth Rate Between January 2006 and October 2012

(source: *Tax Myths Debunked*)



The conclusions of these reports are in line with the academic consensus. Dr. William McBride of the Tax Foundation recently performed a literature review of relevant studies on the relationship between taxes and economic growth. In his review, McBride finds the following:[33]

- Out of 26 peer-reviewed academic studies on the issue since 1983, only three failed to find a negative impact of taxes on economic growth.
- The three that did not find a negative impact found no impact at all, certainly not a positive one.

The results of these economic studies confirm that when capital is removed from the private (and most productive) economy and redirected to the government, the potential for economic growth diminishes; at least relative to what could have been. The evidence is clear: lower tax burdens result in higher income growth, more job creation, and often increases revenue collection.

Conclusion

With the federal government locked in seemingly endless gridlock, it is up to the states to jumpstart their own economies and allow private sector entrepreneurs to be the drivers of economic growth. It is encouraging to see so many pro-growth proposals from just the last legislative session. But, there is much more work to do. Even the states that are doing well have the potential to be doing better once they decide to reform the tax and fiscal policies that are holding them back. While we acknowledge that there are many factors that help determine a state's economic growth, based on the evidence, tax and fiscal policies are among the most important.

It is also important to remember that states do not decide policies in a vacuum. The decisions that one state makes will affect other states whether they like it or not. Conversely, when states make pro-growth policy decisions, other states are challenged to become more competitive. As states learn lessons on what to do (or not to do) from each other, people, jobs, and capital will move accordingly. As this reality sinks in, the expectation for pro-growth tax reform in the states during the 2014 legislative session will be even higher.

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