

POLITICAL ECONOMY

IN THE CAROLINAS

STATE TAX POLICY AND GROWTH: A RESEARCH NOTE

Notes & Commentary by:
Peter M. Frank
Wingate University

I. INTRODUCTION

Coming out of the Great Recession, many state governments experienced significant budgetary problems. In almost every state, the financial position mirrored somewhat the federal government's large budget shortfalls that led to unsustainable deficits. Unlike the federal government, most state governments cannot borrow or create new money at a seemingly unending pace. Thus, sometimes major tax and spending policy changes became inevitable for state governments. Since many state policy changes were implemented in the past three to four years, evidence has been mounting as to both the positive and negative effects of tax-policy changes on economic growth at the state level. Ideally, there would be a simple story to tell with forty or more sample cases in which state lawmakers negotiated various policy changes and economists evaluated the results; yet all public policy analysis examining the various levers state governments use to manipulate revenue outcomes is highly complex.

Throughout the United States, tax policy varies considerably from states with progressive income tax rates that mimic the federal statute's rate structure to states without income tax altogether. States have some federally imposed limitations, yet for the most part their revenue-generating policies are independent of both other states' and the tax policy established in Washington. While this creates ample opportunities for studying varying policy regimes, it also results in the difficult task of identifying the optimal strategies for state fiscal health.

State tax-policy changes are targeted at changing the incentives for doing business in a state, and thus

generating economic growth, or targeted at addressing continued budgetary problems. Often, these objectives go hand in hand, as states mainly change tax policy to enhance growth with the further objective of then creating a more stable fiscal outlook. The distinction is far from trivial, though, as recent research demonstrates, in that how a state approaches both tax and spending changes is a key driver of economic outcomes. Evidence discussed below establishes a distinction between two states, Kansas and North Carolina, which indicates that when tax cuts are balanced with responsible fiscal changes in spending economic growth ensues.

II. RESEARCH ON STATE TAX POLICY

Tax policy, both in intention and desired outcomes, results in competing goals, and legislatures consist of policy makers that have strong biases toward one goal versus another. Think tanks and other organizations also get caught up in analyzing the impact of tax policy based on their perception of the most important goal. Yet these goals will always be in tension. There will always be trade-offs faced by policy makers in maximizing tax revenue versus improving equity, or easing collection versus increasing economic efficiency. Understanding these trade-offs is an important part of analyzing the effectiveness of any changes in policy. Any research on state tax policy must consider the competing goals. The five most important criteria to balance when comparing the costs and benefits of a state tax plan are economic efficiency, equity, transparency, collectability, and revenue production (Millsap and Gonzalez 2016).

What complicates this research is the increasing complexity, in most cases, of the state tax structures, and the varying categories of taxes states use to generate revenue. Economists focus on income, property, and consumption taxes, but there are myriad ways taxes are structured (Millsap and

Gonzalez 2016).

Sifting through the varying goals of tax policy and reconciling those with outcomes poses a challenge for researchers and can result in contradictory conclusions in studying a given policy change. The economic theory of tax changes is an essential part of understanding the impact of such changes. With tax changes, individuals are faced with both a substitution effect and an income effect. The substitution effect faced by the state workforce concerns the choice to work more (or less) because of the lower (or higher) income tax imposed on the worker. Individuals will trade leisure for more work if the cost to working more (i.e., the marginal tax) is lower. Also, an income effect changes individual workers' demand for goods by changing their income (i.e., a lower tax rate results in higher real income). The often difficult question is to what extent the substitution effect and the income effect interact. Does the worker decide to work more or consume more (and have time to consume more) when a state lowers the overall tax burden for the individual? Some argue that these effects are small and thus that tax cuts do not have the intended impact on growth (McArdle 2017), while others claim the impact is complicated because tax cuts tend to be at least partly self-financing (i.e., the substitution effect has a more significant impact than the income effect) (Mankiw and Weinzierl 2006).

Much of the recent research on the use of state tax cuts examines the impact on economic growth when making changes to the state income tax. The question not often asked is, what are the primary intended outcomes of a tax-policy change? Most public statements by policy makers show they are seeking to close budget shortfalls or spur economic growth. What is often preventing these outcomes from being realized is the failure to consider all of the costs of any policy change. In reality, tax policy is just one piece, and possibly a

small piece, affecting a state's overall fiscal health. When examining the costs and benefits of tax policy, it is misguided to neglect the other policies that potentially impact economic growth such as education policy and transfer programs.

Conflicting research demonstrates the difficulty in isolating the effects of tax changes. In certain cases, research advocates an increase in tax rates because of the short-term consequences of increasing rates rather than cutting spending (Bivens 2017). On the other hand, research also indicates that states that enacted tax cuts experienced significant growth and outperformed states with the highest overall tax burden (Williams and Young 2017). The key in analyzing these contradictory accounts is attempting to understand both the intended outcomes and the vast differences in state tax regimes. Personal income tax (PIT) change along with commercial income tax (CIT) change often garners the most-significant attention. Yet states have a broad range of taxation options for generating revenue, and it remains very difficult to isolate the effect of certain policy changes while holding other changes constant. Since some states have no income tax on individuals, when comparing these states with those that cut PIT researchers must control for the direct and indirect effects of other policies.

Another example of this challenge is found in research that analyzes the overall climate for doing business in a state. Policy makers point to business climate as a key metric for economic growth, and CIT rates are one piece influencing whether start-ups or expansion of existing firms, help grow a state's economy. The Tax Foundation has created an extensive index for assessing the business tax climate in all fifty states. The focus of this index is not only to examine the rates of CIT, but also to understand the overall structure of state tax systems. For example, states without a PIT would expect to have a higher tax rate on businesses or

possibly a higher property tax rate to make up the necessary revenue. A state that has a higher income tax rate (either individual or corporate) would be expected to allow for a lower property tax (other things equal). Regardless of the equity considerations concerning types of taxes (income, property, or sales), states should maintain a tax system that balances the overall streams of revenue generation. Florida, for example, ranks very high (meaning the best climate for working and doing business) because the state legislature is able to maintain a zero tax on individual income and very modest rates on businesses and personal property. Connecticut, on the other hand, while praised by some researchers as a model for states facing budget deficits, ranks very low (forty-third out of fifty) because of its high PIT and the second-highest property tax rate in the nation (Walczak, Drenkard, and Henchman 2017).

A vital aspect of tax-policy change is examining whether tax cuts are financed by deficit spending or offset by changes in overall spending. Economic intuition indicates that in the short run, income tax cuts will reduce revenue and thus necessitate a change in spending or a change in how spending is financed. Two key questions arise: (1) Will the revenue shortfall occur temporarily and be offset by a change in growth? (2) What will determine whether tax cuts will impact growth at all? These are important, and slightly different, questions economists ask before weighing the evidence as to when and how tax-policy changes (notably increases or decreases in income tax) lead to economic growth and fiscal health. Again, recent research at the state level indicates that tax cuts financed by spending cuts, in the short run, are more likely to result in economic growth. For tax policy to have a positive effect on growth, it should create an incentive to save and invest, have only a small (positive) income effect, reduce distortions (across sectors, and across different types of income

and types of consumption), and increase the budget deficit minimally (Gale and Samwick 2014). Such cuts do not automatically lead to growth, though. As with fiscal decisions that accompany a tax cut, the industrial mix of a state's economy is also a contributing factor. In a review of research from the 1990s, of six states that cut taxes three had faster output growth, and several tax-cutting states in the 2000s had similar growth rates to the overall US economy (Gale, Krupkin, and Rueben 2015).

Much research addresses some outcomes of tax-policy changes, yet often the broader goals of tax cuts are ignored (by both policy makers and researchers). Plenty of critics provide evidence that tax cuts at the state level fail to translate into growth (Leachman and Mazerov 2015), yet evidence ranking each state based on the overall tax regime demonstrates that economic and fiscal health are tightly linked with overall tax policy (Laffer, Moore, and Williams 2017). Examining these rankings connects lower income tax states to greater overall economic health, particularly in terms of income growth and economic opportunities for residents.

III. EVIDENCE FROM TWO STATE TAX REGIMES

Kansas has faced ongoing challenges with the budget deficit since cutting taxes in 2012 (effective January 2013). Governor Sam Brownback pushed for the tax cuts, hoping they would provide a “shot of adrenaline into the heart of the Kansas economy” and stagnant growth would cease. However, the tax cuts turned out to precede a sluggish economy with continued fiscal instability for the state government. As a result, the Kansas legislature reversed the tax cuts in June 2017. On the other hand, the North Carolina economy is thriving after its 2013 tax-policy reforms (effective January 2014) and the state continues to cut taxes yearly. Nevertheless, North Carolina's success has

received little acknowledgement from critics of tax-cut policies while the Kansas case has been analyzed meticulously. This contrast poses a challenge in trying to identify why tax cuts hurt the Kansas economy and provided a boost for North Carolina.

Both Kansas and North Carolina were inspired by Arthur Laffer's theory that tax cuts boost economic growth (Beachum 2017). In 2012, before the tax cuts, Kansas had a top marginal PIT rate of 6.45 percent, a top marginal CIT rate of 7 percent, and an unemployment rate of 6.1 percent (Williams and Wilterdink 2017). Before enacting tax cuts, North Carolina had three tax brackets for PIT at 6 percent, 7 percent, and 7.75 percent, and a CIT rate at 6.90 percent.

The first difference between the two tax reforms is the broad legislative approach. In Kansas, the reform included a reduction of the top marginal PIT rate to 4.9 percent (–24 percent), a reduction of the middle-bracket rate from 6.25 percent to 4.9 percent (–22 percent), and a reduction of the low-income PIT rate from 3.5 percent to 3.0 percent (–14 percent), with an exemption for pass-through businesses (Williams and Wilterdink 2017). In North Carolina, the tax reform introduced a flat-tax system by reducing PIT rates to 5.8 percent (–3.3 percent, –17 percent, and –25 percent per bracket respectively), and it reduced the CIT rate from 6.90 percent to 6 percent (–19 percent). Additionally, the North Carolina reform expanded the CIT tax base by letting credits expire, while also expanding the sales-tax base. The North Carolina policy also eliminated more than half of the tax expenditures by broadening the PIT base (“North Carolina Illustrated: A Visual Guide to Tax Reform” 2015).

Both Kansas and North Carolina used a long-term phase-in to continue reducing rates throughout the years following the original tax cuts, though Kansas reversed them in 2017.

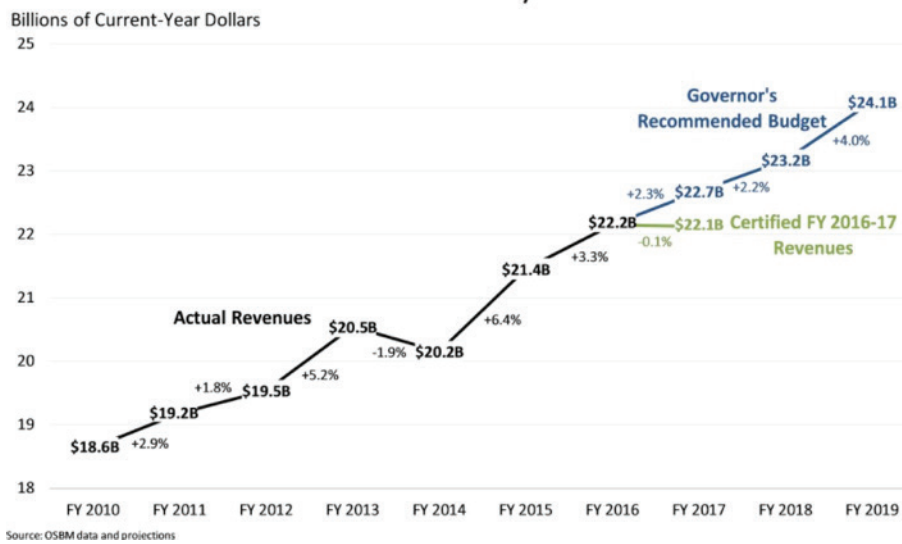
Currently, the CIT rate in North Carolina is a flat 3 percent (lowest among the forty-four states that levy a CIT), and in Kansas the rate is 4 percent for companies with income under \$50,000 and 7 percent for income greater than \$50,000. According to the Center on Budget and Policy Priorities, when fully implemented the tax cuts cost Kansas State \$460 million (7.3 percent of the 2017 fiscal year revenue) and North Carolina State \$1.3 billion (5.9 percent of the 2017 fiscal year revenue) (Leachman and Mazerov 2015). Also, five of eleven states that phased in tax cuts, including North Carolina, produced multiyear expenditure estimates covering the full duration of the phase-in (Figueroa, Leachman, and Mazarov 2017). Kansas is among the states that did not produce such estimates, which caused structural problems for the state budget. Moreover, North Carolina was more prepared for the potential revenue fluctuations because the state had rainy day funds, while Kansas created such funds only in 2016 (Pew Charitable Trusts 2017). North Carolina was more strategic in preparing for the impact of the tax reform, by also making modest changes in other tax policy such as

expanding sales tax collections.

The graphic below demonstrates North Carolina's revenue history. Revenues to the North Carolina State coffers increased after 2010 before decreasing in 2014 (tax cuts became effective in 2014). However, revenues began to rise again in late 2014. North Carolina has experienced relatively stable total revenue collections over the years since 2010.

On the other hand, Kansas tax revenues have dropped since the tax cuts and have been slower to bounce back. After a slight increase in 2013, PIT revenue dropped significantly in 2014 and has remained much lower than it was prior to the tax cuts. The CIT did not have the same drop-off in 2013, yet it did fall in 2016, which further hindered the state budget during the most recently completed fiscal year. The two states' tax and revenue paths further illustrate the divergent impact of tax cuts depending on the policy implementation and the various other, simultaneous legislative decisions. In North Carolina, the income tax cuts were quickly countered by changes in revenue sources and potential incentive changes that led to an

General Fund Revenue: Recent History & Forecast



increase in revenue to the state (only after a very short-lived decrease in tax receipts).

IV. CONCLUSION

As indicated above, most of the commentary on tax policy at the state level (and often at all levels of government) rarely focuses on the broad goals for tax collection and subsequent spending. It is often assumed that the goal for state legislators is to maximize tax revenue and then allocate spending according to the demands for public goods within a particular state. There will always be more demands on a state budget than funds available. Even in times of surplus, a state will typically pay down debt or find a neglected budget category to increase spending. A closer analysis of overall state spending, and the broad goals of state fiscal policy, is a crucial component of any tax policy regime especially considering the monopoly power states have on the provision of public goods.

REFERENCES

- Beachum, L. 2017. "Big Tax Cuts for the Rich, Less for the Poor." Center for Public Integrity.
- Bivens, J. 2017. "Recommendations for States Facing Budget Shortfalls: Focus on Connecticut." Economic Policy Institute.
- Figueroa, E., M. Leachman, and M. Mazerov. 2017. "Phasing In State Tax Cuts Doesn't Make Them Fiscally Responsible." Center on Budget and Policy Priorities.
- Gale, W. G., A. Krupkin, and K. Rueben. 2015. "The Growth Mirage: State Tax Cuts Do Not Automatically Lead to Economic Growth." Tax Policy Center.
- Gale, W. G., and A. A. Samwick. 2014. "Effects of Income Tax Changes on Economic Growth." Economic Studies at Brookings.
- Laffer, A. B., S. Moore, and J. Williams. 2017. "Rich States, Poor States." 10th ed. American Legislative Exchange Council.
- Leachman, M., and M. Mazerov. 2015. "State Personal Income Tax Cuts: Still a Poor Strategy for Economic Growth." Center on Budget and Policy Priorities.
- Mankiw, N. G., and M. Weinzierl. 2006. "Dynamic Scoring: A Back-of-the-Envelope Guide." *Journal of Public Economics* 90(8-9): 1415-33.
- McArdle, M. 2017. "Republicans Keep Repeating the Same Tax Mistake." Bloomberg.
- Millsap, A., and O. Gonzalez. 2016. "Economic Perspectives: State and Local Tax Policy." Mercatus Center.
- Pew Charitable Trusts. 2017. "State Rainy Day Funds in 2017."
- Walczak, J., S. Drenkard, and J. Henchman. 2017. "2017 State Business Tax Climate Index." Tax Foundation.
- Williams, J., and B. Wilterdink. 2017. "Lessons from Kansas: A Behind the Scenes Look at America's Most Discussed Tax Reform Effort." American Legislative Exchange Council.
- Williams, J., and E. Young. 2017. "State Tax Cut Roundup: 2016 Legislative Session." American Legislative Exchange Council.