Case Studies in the Political Economy of Tax Reform

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George R. Crowley. "Case Studies in the Political Economy of Tax Reform." Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, May 2016.

ABSTRACT

Faced with looming fiscal issues after the most recent financial crisis, state governments have increasingly taken steps toward tax reform. The reforms they have undertaken range from lowering tax rates to removing exemptions and credits to simplifying the tax code. The relative success and failure of reform efforts depend not only on the specific type of reform but also on the political economy surrounding the reform process, as well as on the economic climate in the state instituting reform. This study first analyzes some overall trends in state efforts to reform tax codes. Then, using case studies of five states that recently implemented reforms, this study finds some commonality in the specific features of the tax reforms as well as in the political economy surrounding the reform process. These findings motivate a discussion of the common features of successful reforms.

JEL codes: H21, H22, H71

Keywords: taxation, public finance, tax reform, tax policy, state government, budget, political economy, tax equity, tax efficiency, optimal taxation

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Release: May 2016

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In the United States, nearly every election or political debate broaches the subject of tax reform in one way or another. This is unsurprising: Taxation is, as the saying goes, one of the few certainties in life, and it affects literally every American. Further, as voters view taxation as (at best) a necessary evil, politicians stand to garner political support by making promises to reform the tax code and make its impact on the average taxpayer less cumbersome while still ensuring everyone pays a "fair share." At the same time, the tax code must generate adequate revenue to finance the services valued by voters. All told, this means the reform process will always be a pertinent issue politically but hardly one with a simple, straightforward solution.

Discussions of tax reform at the state level have become even more prominent following the 2008 financial crisis and subsequent Great Recession. Nearly every state was faced with compromised finances as the economic downturn resulted in lower tax revenues. At the same time, the increased demand for government services—both assistance programs and stimulus efforts—made spending cuts untenable. In the aftermath, many states have been forced to revisit fundamental reform of their finances in order to avoid fiscal disaster. While each state faces unique challenges, some common threads do run through all the states.

This paper analyzes five cases of state tax reform from the last decade: Utah in 2006, Rhode Island in 2010, Michigan in 2007 and 2011, Kansas in 2012, and North Carolina in 2013. The selection of these specific cases is based on several considerations. First, these cases allow an analysis of reform efforts following (or in the case of Utah, during) the Great Recession, an event that likely had a fundamental effect on the way states approach taxing and spending. In addition, these cases provide enough data to allow a detailed discussion of the conditions in each state both before the reform efforts and in their immediate aftermath. Finally, these cases demonstrate a variety of strategies for tax reform, and this variation allows for a rich discussion of possible approaches

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to reform.[1] For each case, the paper discusses the specific details of the reform, describes the economic and political environment in the state preceding the reform, and where data is available, discusses state conditions after the reform. The analysis compares the specific reform details to widely accepted best practices in tax reform—those following the criteria for good tax policy that date back to Adam Smith in 1776.[2] The task here is not only to evaluate the specific merits of each reform, but also to take stock of the specific political economy factors that most facilitate the reform process itself.

Recent state fiscal pressure notwithstanding, tax policy is always an area of importance. According to Census Bureau data from 2000–2013, the average US state raised total tax revenue equal to roughly 6 percent of its GDP, with personal and corporate income tax revenue making up roughly 40 percent and sales and gross receipts tax revenue roughly 45 percent of all tax revenue over that time. The extent to which governments rely on various taxes varies across the states. For instance, four states collect no tax revenue on personal and corporate income taxes, and other states collect only corporate income taxes. Fundamental aspects of tax design vary across states as well. For example, according to the Tax Foundation, marginal tax rates on individual income in 2014 ranged from effectively 0 percent (in those states with no income tax) to 13.3 percent, with the number of tax brackets ranging from one (in so-called flat tax states) to as many as twelve in Hawaii.[3] A similar litany of differences exists in the ways states treat

1. Certainly, analysis of additional cases of state tax reform (and indeed instances where states did *not* reform taxes), while beyond the scope of the present paper, would further strengthen the discussion of the political economy of tax reform. This paper's approach is intended as a first step toward determining the factors leading up to and the effects of state tax reform.
2. Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, ed. Edwin Cannan (New York: Modern Library Edition, Random House, 1994 [1776]).
3. Lyman Stone, "State Personal Income Tax Rates and Brackets 2014 Update" (Fiscal Fact No. 422, Tax Foundation, Washington, DC, March 2014).

corporate income taxes, sales taxes, and specific excise taxes. Clearly, there is room for experimentation in tax policy at the state level.

The choice of tax policy has economic consequences. Stephen Mark, Therese McGuire, and Leslie Papke show that higher sales and property taxes have negative effects on employment growth.[4] William McBride provides a survey of recent studies that show a negative relationship between state tax rates and economic growth.[5] For instance, using data on the United States, Christina Romer and David Romer find a negative relationship between federal revenue increases and GDP,[6] while Karel Mertens and Morten Ravn find that cuts to personal income tax rates are associated with increases in GDP.[7] In a study using international data, Norman Gemmel, Richard Kneller, and Ismael Sanz find a negative relationship between income taxes and growth,[8] and Ergete Ferede and Bev Dahlby demonstrate a similar negative relationship with corporate income taxes in Canada.[9]

Looking specifically at state policy, Michael Wasylenko shows that state tax incentives (e.g., those used to attract firms for economic development) are less important as determinants of business location than is the overall business climate, of which taxes are a vital part.[10] Dagney Faulk finds that tax breaks targeting specific firms are likely an ineffective way to attract new business investment,[11] and Howell Zee, Janet Stotsky, and Eduardo Ley raise concerns about distortions and inefficiency of a tax system based on a variety of specific, targeted tax credits.[12]

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4. Stephen T. Mark, Therese J. McGuire, and Leslie E. Papke, "The Influence of Taxes on Employment and Population Growth: Evidence from the Washington, D.C. Metropolitan Area," *National Tax Journal* 53 (March 2002): 105–23.
5. William McBride, "What Is the Evidence on Taxes and Growth?" (Special Report No. 207, Tax Foundation, Washington, DC, December 18, 2012).
6. Christina D. Romer and David H. Romer, "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks," *American Economic Review* 100 (June 2010): 763–801.
7. Karel Mertens and Morten O. Ravn, "The Dynamic Effects of Personal and Corporate Income Tax Changes in the United States," *American Economic Review* 103, no. 4 (June 2013): 1212–47.
8. Norman Gemmell, Richard Kneller, and Ismael Sanz, "The Timing and Persistence of Fiscal Policy Impacts on Growth: Evidence from OECD Countries," *Economic Journal* 121 (February 2011): F33–F58.
9. Ergete Ferede and Bev Dahlby, "The Impact of Tax Cuts on Economic Growth: Evidence from the Canadian Provinces," *National Tax Journal* 65, no. 3 (2012): 563–94.
10. Michael Wasylenko, "Taxation and Economic Development: The State of the Economic Literature," *New England Economic Review* 49 (1997): 37–52.
11. Dagney Faulk, "Do State Economic Development Incentives Create Jobs? An Analysis of State Employment Tax Credits," *National Tax Journal* 55 (2002): 263–80.
12. Howell H. Zee, Janet G. Stotsky, and Eduardo Ley, "Tax Incentives for Business Investment: A Primer for Policy Makers in Developing Countries," *World Development* 30, no. 9 (2002): 1497–516.

Turning to the literature on tax reforms specifically, Martin Feldstein shows that higher marginal rates lead to tax evasion,[13] while Anna Ivanova, Michael Keen, and Alexander Klemm find that a reform in Russia toward a flat tax increased tax compliance and revenue.[14] Anke Weber looks at how German corporate tax reforms led to changes in corporate ownership concentration.[15] Andreas Bergh and Magnus Henrekson show that lower tax rates and decreased spending are likely to be associated with economic growth,[16] and Nada Eissa finds a link between lower marginal tax rates and increased labor supply among married women.[17]

Finally, tax reform does not occur in a vacuum, and state institutions have been shown to have important effects on state policy. For example, James Poterba shows certain fiscal rules allow for faster state adjustment to crises.[18] Gary Wagner and Russell Sobel show that state policymakers use rainy day funds to bypass fiscal constraints.[19] Douglas Holtz-Eakin and John Carter and David Schap provide evidence that the gubernatorial line-item veto is not a terribly effective constraint on government,[20] and Ylin Hou and Daniel Smith provide a survey of state rules concerning balanced budgets and demonstrate the wide variation in their effective stringency.[21]

Political factors may also affect tax reform policy, in particular the political ideology of elected officials such as the governor, as well as the degree to which the executive and legislative branches in the state are controlled by the

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13. Martin Feldstein, "The Effect of Marginal Tax Rates on Taxable Income: A Panel Study of the 1986 Tax Reform Act," *Journal of Political Economy* 103, no. 3 (June 1995): 551–72.
14. Anna Ivanova, Michael Keen, and Alexander Klemm, "The Russian 'Flat Tax' Reform," *Economic Policy* 20, no. 43 (July 2005): 399–444.
15. Anke Weber, "An Empirical Analysis of the 2000 Corporate Tax Reform in Germany: Effects on Ownership and Control in Listed Companies," *International Review of Law and Economics* 29, no. 1 (2009): 57–66.
16. Andreas Bergh and Magnus Henrekson, "Government Size and Growth: A Survey and Interpretation of the Evidence," *Journal of Economic Surveys* 25, no. 5 (December 2011): 872–97.
17. Nada Eissa, "Tax Reforms and Labor Supply," in *Tax Policy and the Economy*, vol. 10, ed. James Poterba (Cambridge, MA: MIT Press, 1996).
18. James M. Poterba, "State Responses to Fiscal Crisis: The Effects of Budgetary Institutions and Politics," *Journal of Political Economy* 102, no. 4 (1994): 799–821; James M. Poterba, "Budget Institutions and Fiscal Policy in the U.S. States," American Economic Review 86, no. 2 (May 1996): 395–400.
19. Gary A. Wagner and Russell S. Sobel, "State Budget Stabilization Fund Adoption: Preparing for the Next Recession or Circumventing Fiscal Constraints?," *Public Choice* 126 (2006): 177–99.
20. Douglas Holtz-Eakin, "The Line Item Veto and Public Sector Budgets: Evidence from the States," *Journal of Public Economics* 36, no. 3 (1988): 269–92; John R. Carter and David Schap, "Line-Item Veto: Where Is Thy Sting?," *Journal of Economic Perspectives* 4, no. 2 (1990): 103–18.
21. Yilin Hou and Daniel L. Smith, "A Framework for Understanding State Balanced Budget Requirement Systems: Reexamining Distinctive Features and an Operational Definition," *Public Budgeting and Finance* 26, no. 3 (September 2006): 22–45.

same or differing political parties. Timothy Besley and Anne Case show that for Democratic governors, the presence of a binding gubernatorial term limit is associated with increases in taxes and spending, as opposed to Republicans where no such effect is observed.[22] Relatedly, Poterba shows that states with a single governing party in both the legislature and governor's office raise taxes and cut spending by greater amounts in response to crises, especially in states with fiscal constraints. Poterba proposes that this is either because unified-party states find it easier to take action or because elected officials in divided-party states feel vulnerable and reluctant to take such action.[23] John Coleman shows that unified governments produce a greater quantity of "significant enactments" of policy.[24] In contrast, Thomas Gilligan and John Matsusaka find only very weak evidence that logrolling is easier within unified legislatures,[25] and Michael Nelson finds no evidence that tax increases are more likely to occur under single-party control, but instead that coalition governments are more likely to enact broad tax increases.[26]

In sum, the literature shows that tax policy matters, efforts to reform tax policy can have real implications for economic outcomes, and other political institutions play a role as well. This paper draws on these insights to motivate its discussion of the five cases of state tax reform discussed below. The next section briefly examines some recent trends in state public finance. Section 2 explores the generally accepted principles for evaluating tax policy and reform. Section 3 presents the case studies in recent state tax reform efforts, with an emphasis on the degree to which they are based on these principles and with special attention paid to the political economy surrounding the reform efforts. The final section offers concluding discussion.

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22. Timothy Besley and Anne Case, "Does Electoral Accountability Affect Economic Policy Choices? Evidence from Gubernatorial Term Limits," *Quarterly Journal of Economics* 110, no. 3 (August 1995): 769–98.
23. Poterba, "State Responses to Fiscal Crisis."
24. John J. Coleman, "Unified Government, Divided Government, and Party Responsiveness," *American Political Science Review* 93, no. 4 (December 1999): 821–35.
25. Thomas W. Gilligan and John G. Matsusaka, "Fiscal Policy, Legislature Size, and Political Parties: Evidence from State and Local Governments in the First Half of the 20th Century," *National Tax Journal* 54 (March 2001): 57–82.
26. Michael A. Nelson, "Electoral Cycles and the Politics of State Tax Policy," *Public Finance Revie*w 28, no. 6 (November 2000): 540–60.

1. RECENT TRENDS IN STATE FISCAL POLICY

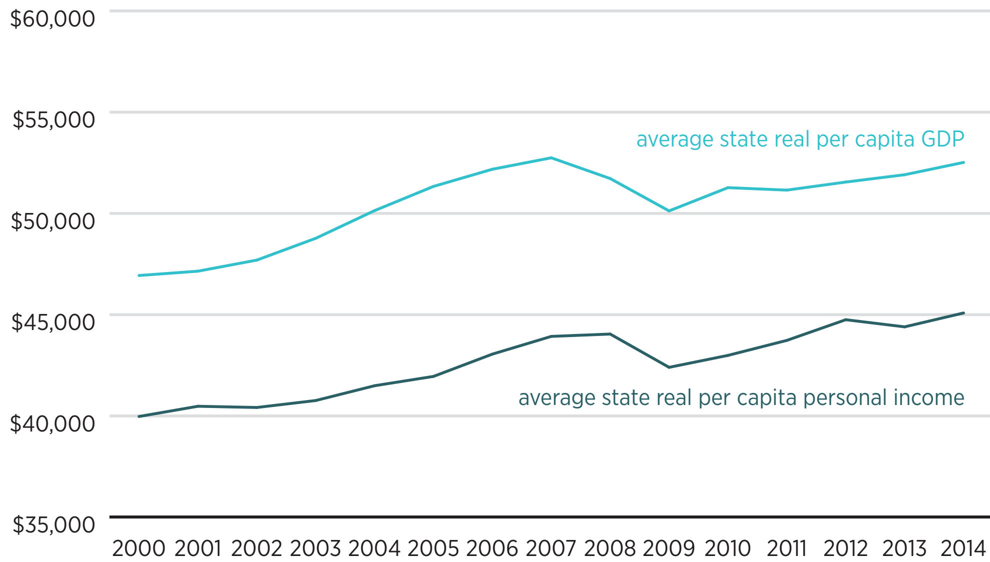
To see why tax reform has become such an important issue at the state level in recent years, one need only look at the impact on state finances of the 2008 financial crisis and the subsequent recession. The economic slowdown is quickly apparent when one looks at state GDP and personal income numbers. Figure 1 displays the average level of real per capita GDP and personal income across the 50 states over the years 2000–2014. Following a relatively stagnant period around 2000, average state GDP and personal income grew steadily until crashing as a result of the financial crisis, with per capita GDP falling from a high of approximately $52,500 to as low as $50,000—a decline of nearly 5 percent. Per capita personal income followed a similar path, falling from a high of $44,000 in 2008 to just over $42,000 a year later, a decline of nearly 4 percent. The states hardest hit saw declines in per capita GDP approaching 10 percent over that period. Recent years have seen economic growth, with average state per capita GDP returning to roughly its previous highest level and personal income surpassing its previous high.

Perhaps more telling is what happened to unemployment during the recession. Figure 2 shows the average state unemployment rate over the period 2000–2014, as well as the highest and lowest state rates for each year during that period. On average, states hovered around 4–5 percent unemployment before the financial crisis, but that average rate climbed to nearly 9 percent in 2009. More strikingly, before 2008 states with the highest rates of unemployment were at roughly 7 percent; during the recession the highest rates approached 14 percent.

Faced with declining economic conditions, states were left in the difficult position of declining tax revenues (due to decreases in economic activity) and increased demands for various services. Figure 3 showcases average real (2014 dollars) per capita tax revenue across all states during the years 2000–2014. The effects on tax revenues of the recession's decreases in economic activity are obvious. Across all states between 2008 and 2010, total tax collections per capita fell by roughly 16 percent, from more than $3,100 to roughly $2,600. Average sales/gross receipts tax revenue fell by nearly 8 percent, from an average of $1,300 per capita in 2008 to $1,200 in 2010, while total income tax collections (combined personal and corporate) fell by nearly 20 percent.[27] Very clearly, then, the economic downturn severely impacted state finances.

27. While some states do not have a general sales tax, all states collect some positive amount of revenue in the form of what the Census Bureau defines as "Sales and Gross Receipts Taxes." On the other hand, several states do not collect any personal or corporate income taxes. As such, figure 3 includes all 50 states for the sales tax data and excludes from the income tax graph those states reporting $0 revenue.

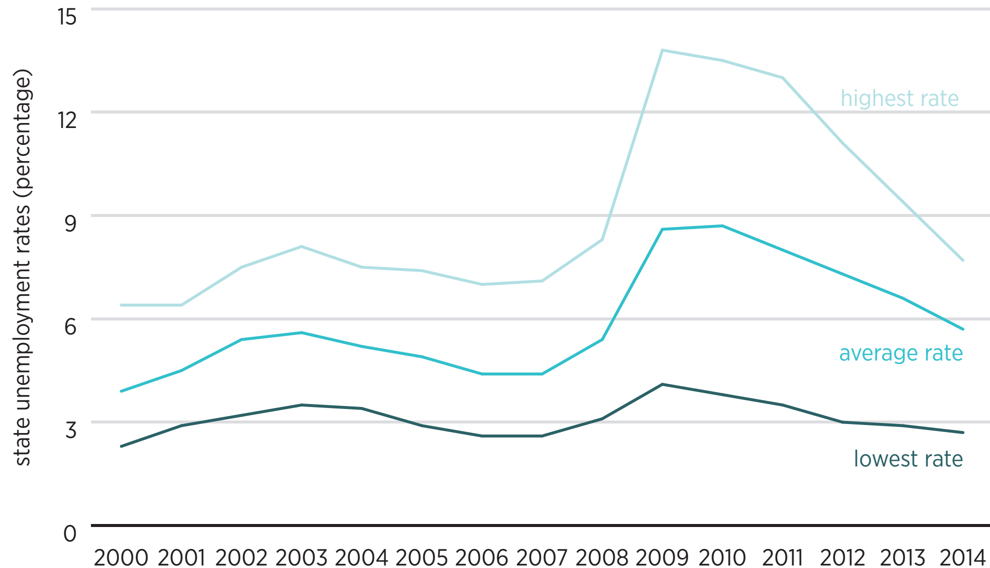
FIGURE 1. AVERAGE STATE REAL PER CAPITA GDP AND PERSONAL INCOME, 2000–2014



Source: US Bureau of Economic Analysis.

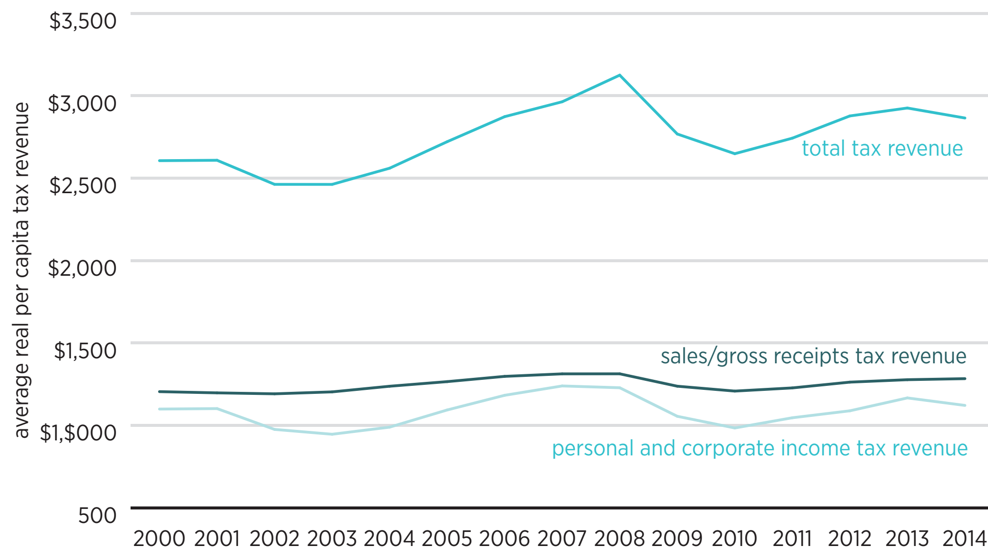
Note: Adjusted to 2014 dollars using the consumer price index.

FIGURE 2. HIGHEST, LOWEST, AND AVERAGE STATE UNEMPLOYMENT RATES, 2000–2014



Source: US Bureau of Labor Statistics.

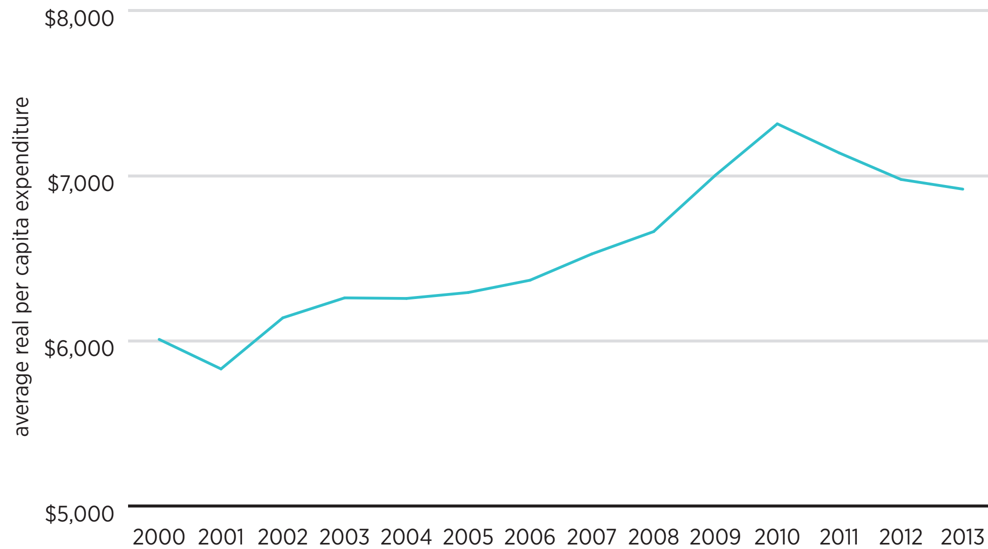
FIGURE 3. AVERAGE STATE REAL PER CAPITA TAX REVENUE, 2000–2014



Source: US Census Bureau.

Note: Adjusted to 2014 dollars using the consumer price index.

FIGURE 4. AVERAGE STATE REAL PER CAPITA EXPENDITURE, 2000–2013



Source: US Census Bureau.

Note: Adjusted to 2014 dollars using the consumer price index.

Unfortunately for the government officials attempting to keep state budgets balanced, at the same time that revenues were being gutted by the decrease in taxable economic activity as a result of the financial crisis and its aftermath, demand for government services such as various welfare and assistance programs was increasing. Further, various federal "stimulus" efforts required increases in state government spending; even though these were typically funded by intergovernmental grants in the short run, states were required to finance them out of their own source revenues after the initial federal funds were exhausted.[28] The end result was a nearly 10 percent *increase* in real per capita state spending on average across the 50 states from 2008 to 2010. Figure 4 showcases this growth. On average, states spent just over $6,500 per capita before the recession, but in 2010 the average per capita expenditure exceeded $7,300. In other words, states were facing rapidly shrinking tax revenues and rapidly increasing expenditures at the same time.

Faced with growing fiscal stresses, a number of states set out to reform their tax codes in the years following the recession. The following section outlines some of the key theoretical considerations on which tax reform efforts are centered.

2. PRINCIPLES FOR EVALUATING STATE TAX POLICY AND REFORM

The preferred normative features of sound or optimal tax policy have been the subject of research by economists since Adam Smith's *Inquiry into the Nature and Causes of the Wealth of Nations* in 1776. Smith's key principles include equity, transparency, convenience, and efficiency. These principles have largely stood the test of time. In a recent overview of state tax policy, Justin Ross outlines the current prevailing criteria for evaluating tax policy: efficiency, equity, transparency, collectability, and revenue production (the final two could collectively be considered analogous to Smith's "convenience").[29]

All non-lump-sum taxation creates market distortions in the form of deadweight loss—that is, lost consumer and producer welfare due to fewer trades taking place. Economic efficiency is concerned with minimizing these distortionary effects. The seminal work in this area follows F. P. Ramsey, who

28. Russell S. Sobel and George R. Crowley, "Do Intergovernmental Grants Create Ratchets in State and Local Taxes?," *Public Choice* 158, no. 1 (January 2014): 167–87.
29. Justin M. Ross, "A Primer on State and Local Tax Policy: Trade-Offs among Tax Instruments" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, 2014).

in 1927 laid out an approach to taxation dependent on relative elasticity—a measure of how buying and selling behavior changes in response to a change in price.[30] According to the so-called Ramsey Rule, deadweight loss is minimized (and therefore economic efficiency is maximized, at least in a second-best sense) when higher taxes are levied on those goods for which elasticities are relatively small, and low taxes are placed on goods for which elasticities are relatively large. In other words, since elasticity tells us how much buyers and sellers change their behavior in response to a price change (which taxes essentially represent), taxes are most efficient when levied in those areas where changes in price distort behavior the least.[31] Finally, regardless of relative price elasticity, lower rates will create smaller losses in economic efficiency, all else being equal.

A related concept in the efficiency effects of taxation follows from the broadness of the tax base—that is, the range of goods and services subjected to a tax. Generally speaking, the broader the tax base, the less distortionary (and therefore less inefficient) the tax will be. Like the logic underlying the Ramsey Rule, this concept follows naturally from the idea that inefficiencies related to taxation occur when taxes cause buyers and sellers to modify their behavior. If, for example, a tax were placed on vodka alone, we would expect consumers to purchase less vodka and more of other liquors that serve as substitutes. Since they purchase these other liquors only because the tax increased the relative price of vodka, the tax has fundamentally altered a market allocation—it has created an inefficient distortion in the market: namely, buyers who prefer vodka are now purchasing other, less-preferred liquors. If instead, the tax were levied on all liquors equally, the price of vodka *relative* to its nearest substitutes would remain unchanged and no such substitution would occur (though buyers would still be inclined to substitute other goods for consumption of liquor generally). Now if the base were broadened further to, say, all consumption by way of a general sales tax, the size of the distortion would be reduced even further. To summarize: taxes with broader bases are generally more efficient than those applied more narrowly because they cause smaller distortions in the behavior of buyers and sellers.

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30. F. P. Ramsey, "A Contribution to the Theory of Taxation," *Economic Journal* 37, no. 145 (March 1927): 47–61.
31. Certainly economic efficiency is but one consideration when discussing "optimal" tax policy; a major criticism of the Ramsey Rule, for instance, is that its strict application could lead to heavy taxation on food staples or medicines, things for which price elasticity of demand is relatively inelastic. Such policy is obviously undesirable on other grounds, including equity, which is discussed below.

Equity issues in taxation are generally based on the premise that those with a greater ability to pay should bear a greater burden. This focus on so-called “vertical equity” is readily observed in the progressive income tax in the United States’ federal tax code: By design, higher-earning citizens pay more in taxes as a share of their income. A lesser-known form of equity is concerned with ensuring that those with similar abilities to pay bear similar shares of taxes; this “horizontal equity” is the basis for many exemptions often found in the tax code as policymakers attempt to assess a true ability to pay. While at first it may seem that a simple measure of income could serve as a reasonable proxy for ability to pay, several factors complicate things. For instance, it is not difficult to make the case that a single man or woman earning $50,000 has more of an ability to pay than a man or woman supporting multiple children on the same $50,000 income. At the same time, since having children is a choice, one could argue that the individuals in this scenario do in fact share an equal ability to pay—one simply decided to spend a portion of his or her income on children as opposed to other goods and services. Going a step further, if both individuals had the *opportunity* to work for $50,000, but one chose instead to work part time (and therefore earned less income) in order to enjoy more leisure, the question of ability to pay becomes even more convoluted. In other words, while equity is nearly universally accepted as an important consideration for tax policy, its actual implementation is often unclear—especially in cases where the seemingly obvious measures of ability to pay (such as income) are largely, if not entirely, determined by individuals’ choices.[32]

Transparency in tax policy generally requires a degree of certainty for taxpayers insofar as everyone is well

“Taxes with broader bases are generally more efficient than those applied more narrowly because they cause smaller distortions in the behavior of buyers and sellers.”

32. In his textbook *Public Finance and Public Policy*, Jonathan Gruber goes so far as to argue that the only truly unambiguous horizontal inequities occur when tax shares for similar individuals differ due to some completely exogenous factor; his example is the hypothetical determination of tax rates based only on the flip of a coin. Gruber, *Public Finance and Public Policy*, 4th ed. (New York: Worth Publishers, 2013).

aware of which activities are subject to taxation and the degree to which they will be taxed. Relatedly, Smith's criterion of convenience requires that taxes be levied in a way that does not make their collection overly burdensome. Taxes by their very nature induce distortions in the economy because they upset equilibrium prices. Additional distortions, in the form of money and time spent complying with taxes, cause even more inefficiency. In practice, talk of certainty or convenience in taxation is often geared toward simplification of the tax code. In an extreme case where residents are subject to a single head tax, transparency is essentially absolute: everyone is completely aware of what is taxed and how much is owed. As the number of activities subject to taxation increases, or the different types of taxes increase, or as the specific rules and provisions surrounding these taxes increase, the tax code becomes increasingly complex, the level of transparency in the process becomes muddied, and compliance becomes much more difficult.

Finally, it goes without saying that the purpose of taxation is to raise revenue to finance the provision of government services. It is important that a state's tax system produce enough revenue to finance its basic expenditures—this is a concept referred to as adequacy. In terms of tax reform, ensuring adequacy often means that wholesale cuts to taxes without associated cuts to expenditures are ill-advised. If a tax system is reformed in accordance with the principles described above and the end result is a loss of revenue, the system may no longer be adequate to sustain expenditures at previous levels, thus requiring cuts to expenditures as well. An efficient but inadequate tax system will leave a government unable to pay its bills. In short, tax reform often necessitates reform of state expenditures as well.

Tax reform has become a loaded term, with nearly all political candidates, regardless of party allegiance or ideology, arguing for "reform" of one sort or another. Indeed, while the choice of specific goals for reform will necessarily be normative in nature, positive evaluation of reform involves analyzing the degree to which particular proposals are able to achieve stated ends.[33] More specifically, given the general acceptance by public economists of the principles for sound tax policy outlined above, efforts to reform a system of taxation can be evaluated as either moving closer to or further from these criteria. For instance, tax reforms designed to remove exemptions and otherwise broaden the base can be viewed as improving efficiency. On the other hand, to the extent such

33. Economists differentiate normative economics (statements of opinion or value-based judgments) from positive economics (statements of fact or testable hypotheses). In this context, a claim of "the tax system should be progressive" is normative; on the other hand, studying actual tax burdens to determine whether a specific tax system is in fact progressive would lead to a positive conclusion.

reforms increase the regressiveness of a tax system (by, say, removing exemptions for expenditures on certain basic necessities), they can be viewed as moving away from the ideal of equitable taxation based on ability to pay.

The case studies presented below evaluate recent major tax reform efforts in five states. For each case, attention is paid to the extent to which the reform moves a state's tax policy nearer the generally accepted criteria discussed above. To this end, reforms that are focused on broadening the tax base and lowering tax rates will be considered as improving efficiency, since these reforms reduce the degree to which taxes distort economic decision-making. Further, tax reforms that are geared toward improving equity can be evaluated based on the degree to which they ensure that tax burdens are related to ability to pay. Finally, steps toward simplification of the tax code—or even elimination of certain taxes entirely—will generally be viewed as improvements in transparency and convenience.

3. CASE STUDIES IN RECENT STATE TAX REFORM

With the overall trends in state fiscal policy outlined and the major theoretical considerations for tax reform established, we now turn to specific case studies from the last decade, ranging chronologically from Utah's reform in 2006 to North Carolina's recent efforts in 2013. This section outlines the specific features of each state's reform and the political economy factors surrounding it. To the extent possible, it also discusses the fiscal environment in each state following reform efforts.

Utah

Utah enacted major reforms to its tax system in 2006–2007, which became effective in 2008. The most significant change was a single flat personal income tax rate of 5 percent (based on federal adjusted gross income, or AGI) that replaced the previous structure made up of six income brackets with increasing marginal tax rates ranging from an initial 2.3 percent to 6.98 percent on income over $5,500. The reform also replaced many deductions with a credit system based partially on the federal deductions. The availability of these credits was designed such that they phase out as income rises, adding an element of progressivity to the otherwise proportional tax rate.[34]

34. Utah Legislature, "Tax Relief and Reform: What Does It Mean for Taxpayers?" (briefing paper, March 2007).

Other changes to the tax code pertained to the state sales tax. The state's general sales tax rate went from 4.75 percent to 4.65 percent. Additionally, the effective sales tax rate on food was reduced from 4.75 percent to 2.75 percent (and eventually to 1.75 percent). Certain local taxes on food were eliminated such that statewide the total combined state and local rate would not exceed 3 percent (though the reforms did leave open the possibility for certain specific local tax options to fund programs such as transportation). Importantly, certain food purchases, particularly those by low-income individuals using food stamps or similar programs, were already exempt from sales tax. In other words, the decreased sales tax rate mainly affected those earning incomes above these lowest levels.[35]

Utah's tax reform appears to align closely with the principles for taxation outlined above. The personal income tax code was significantly streamlined, from six brackets to one low, flat rate—this move alone can be justified on the grounds of both efficiency (in that the lower rate is less distortionary and leaves more income in the hands of taxpayers) and convenience (in that the single flat rate makes calculating taxes due much simpler). The removal of deductions similarly improves efficiency and convenience and helps ensure equity. Further, the phasing out of tax credits as incomes rise goes toward satisfying concerns about vertical equity that are often raised by flat tax systems. The sales tax reforms lower the rate; efforts to exempt certain food purchases, while likely justified on equity grounds, may fail to achieve this goal, since—as mentioned above—food purchased with government assistance programs was already exempt.

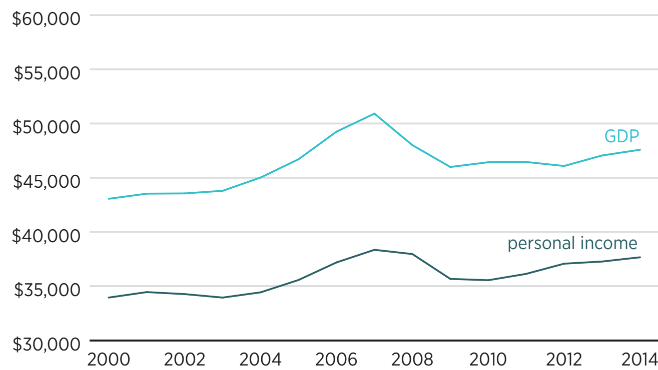
According to a brief released by the legislature at the time of the reform, the changes to the tax code were expected to result in net total (income and sales) tax reductions for 98 percent of the taxpayers and estimated reductions in revenue totaling $400 million.[36] Figure 5 depicts Utah's tax revenues from 2000 through 2014. In the years leading up to the reform, total tax collections, especially total personal and corporate income tax collections, were in decline. Total real (2014 dollars) per capita income tax collections in 2000 amounted to roughly $1,100; by 2005 they had fallen to around $1,000 per capita. In 2006 when the reforms were passed, Utah collected about $1,200 in real (2014 dollars) per capita income taxes, and just under $1,200 in real per capita sales taxes. Immediately following the reforms, income tax collections actually rose to a high of $1,300 in 2007 (a year before the reform took effect),

35. Ibid.
36. Ibid.

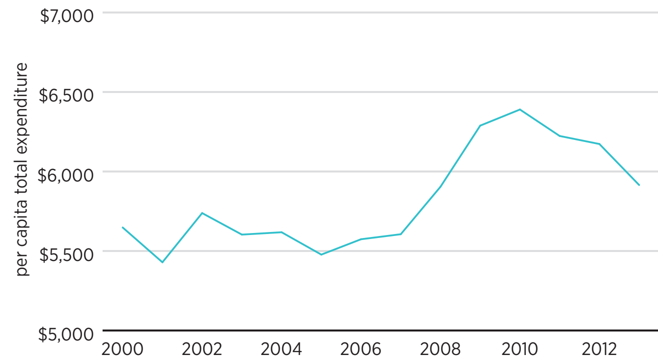
FIGURE 5. UTAH, 2000–2014

PANEL A. REAL PER CAPITA TAX REVENUE

PANEL B. REAL PER CAPITA GDP AND PERSONAL INCOME



PANEL C. REAL PER CAPITA TOTAL EXPENDITURE



Sources: US Census Bureau and Bureau of Economic Analysis.

Note: Adjusted to 2014 dollars using the consumer price index.

before declining by nearly 30 percent during the recessionary period to a low of $923 in 2010. In recent years, income tax revenues have begun to rise again. Unsurprisingly, these movements mirrored a sharp rise and fall in personal income in the state over the same period, making any definitive conclusion about the reform's effect on tax revenue (as separate from the effects of other factors, most notably the recession) difficult to reach.

While the economic downturn following 2007 complicates the analysis, comparing the periods before reform and following recovery is informative. Following the decline during the recession described above, increases in tax revenue have left real per capita total tax collections down slightly from their prereform level (with real per capita total tax revenue in 2014 standing at roughly $2,100, compared to the roughly $2,500 it had been in 2006). Further, looking at the entire interim period reveals that total per capita tax collections as a percentage of state GDP remained relatively stable, ranging from roughly 4.5 percent to 5 percent between 2006 and 2014. This could be viewed as a good thing for Utah—the state was able to improve the efficiency of its tax system in what appears to be a revenue-neutral way. It is important to note, however, that personal income was rising in the state in the prereform period as shown above, which likely factored into the relatively low impact that the reform had on revenue collection. In other words, it is unclear to what extent the reform itself would have been revenue neutral absent the strong growth in the economy in the prereform period.

Turning to the political and economic factors surrounding the reform process, before reform efforts in 2006, income tax revenues made up roughly 48 percent of all tax revenues and sales taxes roughly 46 percent. Overall economic indicators in the years leading up to the reform were relatively steady—a factor that policymakers said allowed the state the flexibility to enact reform.[37] Though real per capita personal income and real per capita GDP grew in the years following reform, this growth actually began in 2005. While both income and GDP suffered severe downturns during the recession and unemployment in the state rose to a high of 7.9 percent in 2010, recovery in the state has been rapid. After remaining relatively constant in the prereform years, real expenditures predictably grew during the recession, rising from roughly $5,600 per capita in 2006 to nearly $6,400 per capita in 2010. Since 2011, expenditure in Utah has been on a downward trajectory.

37. Olene Walker et al., "Insights and Caveats from Recent Tax Reform in Utah," *State Tax Notes*, March 24, 2008.

As noted above, institutions matter for reform. Historically, Utah has been a relatively free state economically. Using the Fraser Institute's Economic Freedom of North America (EFNA) 2014 Annual Report (which ranks states on a scale of 0–10 based on their reliance on markets as opposed to government direction of the economy), Utah's economic freedom exceeded that of the average state for each year from 1981 to 2011, with an average score of 6.9 compared to the average of 6.5 across the states.[38] At the time of reform in 2006, the state senate was 72 percent Republican and the house was 75 percent Republican. Jon Huntsman, the governor at the time, was a Republican as well,[39] meaning that Utah's government was unified at the time of reform. Utah's governor shares budget responsibility with the legislature: The state's constitutional balanced budget rule requires both that the governor submit a balanced budget and that the legislature pass it.[40] The constitutional provision also puts limits on the amount of debt taken on for deficit reduction.[41] Importantly, Utah is also home to statutory tax and expenditure limits that restrict spending to a function of the growth of population and inflation, essentially requiring that real per capita expenditure remains constant.[42] In short, Utah has an apparent history of a strictly constrained government relative to other states.

In 2008, many of the policymakers involved in Utah's tax reform authored an article for the publication *State Tax Notes* wherein they described some of the key factors in the process.[43] For instance, Utah's policymakers were keen to ensure that their reform followed principles such as fairness and efficiency, principles that run parallel to the criteria discussed above. Reform efforts actually began in the state years earlier under Governor Michael Leavitt, but the authors of this article note that tax reform had been a key part of incoming Governor Huntsman's gubernatorial campaign, and it ensured that the efforts stayed on track posttransition. Key political realities that concerned policymakers included the idea that the reform could not create obvious losers and the necessity of getting various political entities, including leaders in the state legislature and special interests such as the Chamber of Commerce, involved in crafting the reform. The architects of Utah's reform summarize several keys to their success, including managing the various political interests from the

38. Dean Stansel, José Torra, and Fred McMahon, *Economic Freedom of North America, 2014* (Fraser Institute, 2014).
39. Council of State Governments, *The Book of the States*, various editions.
40. National Conference of State Legislatures, "State Balanced Budget Provisions" (NCSL Fiscal Brief, October 2010).
41. Hou and Smith, "Framework for Understanding State Balanced Budget Requirement Systems."
42. National Conference of State Legislatures, "State Tax and Expenditure Limits—2010," 2012.
43. Walker et al., "Insights and Caveats from Recent Tax Reform in Utah."

"[Rhode Island's] relatively rapid growth in income could help explain both the relatively stable income tax collections following reform and why the climate in the state was ripe for reform to begin with—simply put, the state could afford it."

outset, enacting a reform that was truly comprehensive, and tying the reform to a key leader or "champion."[44]

Rhode Island

Rhode Island instituted a major reform of its personal income tax code in 2010. As in Utah, Rhode Island policymakers looked at both lowering the tax rate and decreasing the number of income brackets. Unlike Utah, however, Rhode Island chose to retain its bracket structure, moving from five income brackets to three and decreasing the top marginal tax rate from 9.9 percent (on income over $373,650) to 5.99 percent (on income over $125,000), based on federal AGI. Additionally, the reform eliminated Rhode Island's alternative 6 percent flat tax on personal income (with no deductions), which residents previously could elect to pay if it reduced their tax liability. While the reform increased the standard deduction (which phases out as income rises), the ability to itemize deductions was eliminated, the number of available tax credits was reduced, and the alternative minimum tax was eliminated. All told, the reform was designed to be revenue neutral, with expected revenue increases of roughly 0.03 percent.[45] Importantly, Department of Revenue simulations indicated that the top 5 percent of income earners would see tax burdens rise to the point where roughly 46 percent of all tax revenues were paid by the top end of the income distribution.[46]

As with Utah, Rhode Island's moves toward a more streamlined system—moving from five brackets to three—certainly improve the convenience and transparency of the tax code at the margin. Similarly, the rate reduction would seem to improve its efficiency by leaving more income in

44. Ibid.
45. Rhode Island Senate Fiscal Office, *Rhode Island Special Legislative Commission to Study Installation and Implications of Itemizing State Income Tax Refunds as Federal Deductions* (final report, February 5, 2014).
46. R. Kelly Sheridan, "Wait before Judging R.I. Tax Reform," *Providence Journal*, May 17, 2012.

the hands of residents and creating less of a burden on the market at least in the short run. It is possible that the projected increase in burden on high earners could have negative implications for investment and long-run economic growth in the state. Likewise, the broadening of the tax base (through the elimination of various credits and deductions) ensures fewer distortionary effects, moving toward horizontal equity. The choice to eliminate the optional flat tax is difficult to analyze: Removing what is essentially a completely separate income tax code certainly improves transparency and convenience in the process, but the flat tax itself was likely a preferred system due to its simplicity and efficiency. In other words, while the Utah case was a near certain improvement according to the criteria discussed above, Rhode Island's approach to reform appears to be a more marginal advance. Analysis by the Tax Foundation at the time of reform indicated that the plan was expected to move Rhode Island's business climate ranking from seventh worst to tenth worst.[47] According to the Tax Foundation, by 2014 Rhode Island's business climate had fallen to 46th.[48]

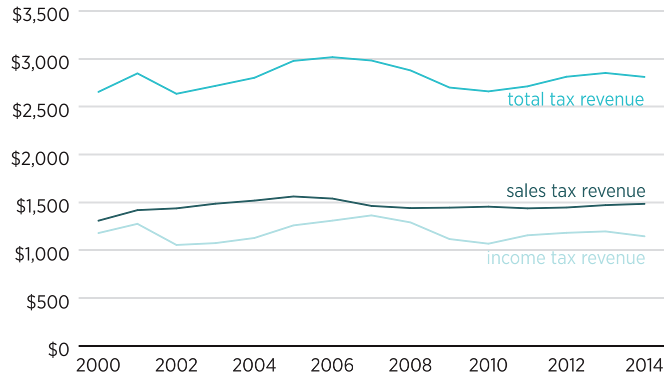
As figure 6 shows, in the years before the reform in 2010, Rhode Island's total tax revenue (in real per capita terms) was in decline after several years of growth—importantly even in the years before the recession fully took hold nationally (though it is possible its effects were felt in the state earlier than average). There is a definite increase in revenues collected in the years following the 2010 reforms, though these of course coincide with increases in GDP and per capita income during the postrecession recovery period. Per capita personal income in Rhode Island enjoyed relatively fast growth throughout the years 2000–2014, with only a minor downturn during the years following the financial crisis. This relatively rapid growth in income could help explain both the relatively stable income tax collections following reform and why the climate in the state was ripe for reform to begin with—simply put, the state could afford it. Further benefitting the fiscal situation in Rhode Island in the period following tax reform has been the relatively steep decline in state spending: Between 2010 and 2013, real per capita expenditures in the state declined from nearly $8,500 to just under $8,000, a reduction of 6.5 percent.

Once again, we turn to the political and institutional factors in place at the time of reform. Looking at data from the US Census Bureau, in 2010, income taxes accounted for roughly 40 percent of total tax revenue, and sales taxes for roughly 55 percent. When reform was passed, the state senate was

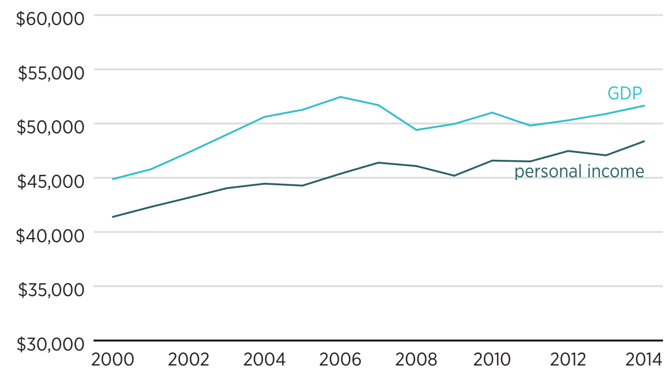
47. Tax Foundation, "Rhode Island Income Tax Reform Would Improve Business Tax Climate," May 26, 2010.
48. Scott Drenkard and Joseph Henchman, "2014 State Business Tax Climate Index" (Background Paper No. 68, Tax Foundation, Washington, DC, October 2013).

FIGURE 6. RHODE ISLAND, 2000–2014

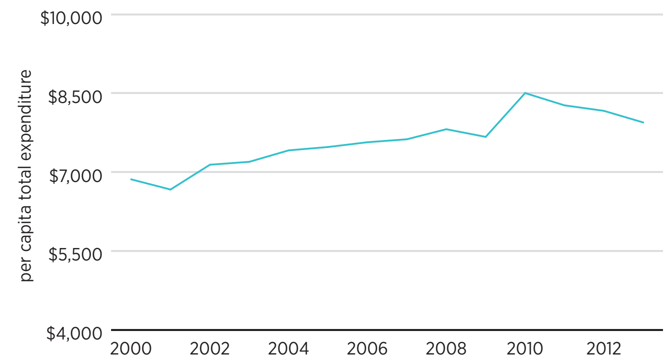
PANEL A. REAL PER CAPITA TAX REVENUE



PANEL B. REAL PER CAPITA GDP AND PERSONAL INCOME



PANEL C. REAL PER CAPITA TOTAL EXPENDITURE



Sources: US Census Bureau and Bureau of Economic Analysis.

Note: Adjusted to 2014 dollars using the consumer price index.

overwhelmingly dominated by Democrats, who held 87 percent of the seats. The house was similarly one-sided, with Democrats controlling 92 percent of the seats. The governor at the time of reform was Don Carcieri, a Republican, meaning that Rhode Island was able to achieve reform without unified executive and legislative branches.[49]

Historically, Rhode Island has been characterized by considerably less-than-average economic freedom: Since 1981, the state has had an average score of 5.2 compared to a US state average of 6.5. In Rhode Island, the governor and legislature share budget responsibility, with the balanced budget requirement stating both that the governor must submit a balanced budget and that the legislature must pass one.[50] The balanced budget rule allows that own-source revenues *and debt* must match expenditures, though a limit on debt is included.[51] Budgeting in Rhode Island is subject to an expenditure limit mandating that appropriations not exceed 98 percent of forecast revenue.[52]

Michigan

At least two major tax reform events occurred in Michigan in the past decade. In 2007, Michigan adopted the so-called Michigan Business Tax, a new system of business income taxation, which replaced the previous Single Business Tax (SBT). The SBT began as a value-added tax on business in the state and was designed to simplify the tax system. Over time, however, the SBT became quite complex and was subjected to numerous legal challenges.[53] The SBT was ultimately repealed in 2006 and replaced with a new system comprising a 4.95 percent tax on business income, a 0.8 percent gross receipt tax, and an additional 22 percent surcharge, collectively known as the Michigan Business Tax.[54] While the original intention of the 2007 tax reform was to improve the efficiency of the business tax system in the state, this new regime—and especially the 22 percent surcharge—was subjected to harsh criticism of its own.[55]

In 2011, Michigan instituted a reform primarily aimed at its corporate income tax. Notoriously hard hit by the Great Recession, Michigan designed

49. Council of State Governments, *Book of the States*.
50. National Conference of State Legislatures, "State Balanced Budget Provisions."
51. Hou and Smith, "Framework for Understanding State Balanced Budget Requirement Systems."
52. National Conference of State Legislatures, "State Balanced Budget Provisions."
53. Gregory A. Nowak, Janelle C. Punch, and Rebecca M. Pritchard, "The Rise and Fall of the Michigan Single Business Tax," *Corporate Business Taxation Monthly* (March 2007).
54. Scott Drenkard and Joseph Henchman, "2015 State Business Tax Climate Index," Tax Foundation, October 28, 2014.
55. Ken Braun, "A Good Tax Gone Bad?," *Michigan Capitol Confidential*, December 4, 2009.

the reform explicitly to "aggressively [position] the state to be economically competitive."[56] The main component of the reform was the repeal of the Michigan Business Tax.[57] This collection of taxes and surcharges was replaced with a flat 6 percent tax on corporate income, applied only to businesses organized as corporations, thus exempting an estimated 100,000 businesses previously subject to the Michigan Business Tax.[58]

The 2011 reform also eliminated various credits, deductions, and exemptions (particularly for high-income residents) and froze the personal income tax rate at 4.35 percent, to be lowered to 4.25 percent in 2013. The earned income tax credit was set at 6 percent of the federal credit, and changes were made to the treatment of pension income.[59] In short, the reforms to the personal income tax appear marginal, but they represent a move in a direction consistent with the criteria of efficiency and transparency.

Michigan's 2011 corporate tax reform seems to increase the efficiency, transparency, and convenience of its tax code; on equity grounds, however, the case could be made that the corporate tax reform—in that it exempted previously taxed businesses and applied primarily to those in the most well-off positions (namely, owners of businesses)—was not an improvement. Further, changing the definition of which types of business organizations' income is taxable could lead to distortions in the way businesses choose to organize. Critics further raise concerns that the repeal of the Michigan Business Tax represents, by definition, a tax cut for businesses and, as such, represents a relative shift of tax burden from business owners toward wage earners, especially because some of the personal income tax credits and deductions were removed.[60] However, according to the Mackinac Center (a Michigan-based think tank), the fact that the new tax regime applies only to large corporations means that most of the tax breaks inherent in the reform likely fell on small businesses.[61]

Looking at the economic climate in the state (see figure 7), it is not terribly difficult to ascertain why policymakers made reform a priority. Even before the financial crisis in 2008, Michigan's economy was already suffering a decline. According to the *Wall Street Journal*, between 2000 and 2009 Michigan had lost

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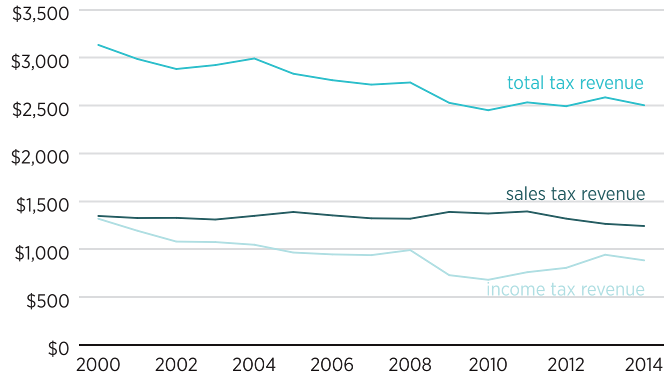
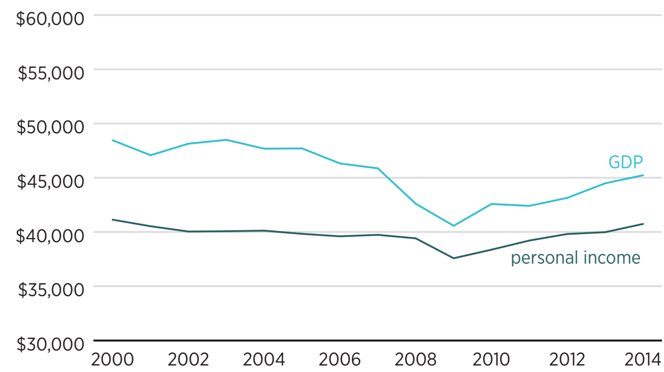
56. Michigan.gov, "Snyder Signs Tax Reform Bills to Fuel State's Turnaround," press release, May 25, 2011.
57. Drenkard and Henchman, "2015 State Business Tax Climate Index."
58. Michigan.gov, "Snyder Signs Tax Reform Bills to Fuel State's Turnaround."
59. Ibid.
60. Patricia Sorenson, "Losing Ground: A Call for Meaningful Tax Reform in Michigan," Michigan League for Public Policy, January 2013.
61. Tom Gantert, "Economists: Business Tax Reform Helping, Not Hurting, Michigan," *Michigan Capitol Confidential*, April 23, 2013.

FIGURE 7. MICHIGAN, 2000–2014

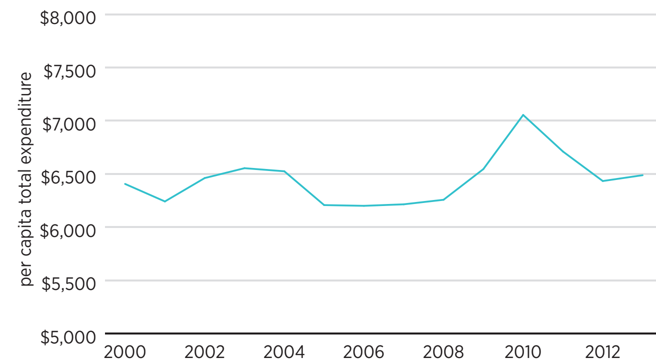
PANEL A. REAL PER CAPITA TAX REVENUE



PANEL B. REAL PER CAPITA GDP AND PERSONAL INCOME



PANEL C. REAL PER CAPITA TOTAL EXPENDITURE



Sources: US Census Bureau and Bureau of Economic Analysis.

Note: Adjusted to 2014 dollars using the consumer price index.

825,000 jobs, and by 2010 its state debt had grown to $1.4 billion.[62] From 2000 to 2007, real per capita GDP declined by roughly 5 percent and per capita personal income declined by 3 percent, though both saw marked increases beginning in 2009. Unemployment in the state had already climbed from 3.7 percent in 2000 to 7.1 percent by 2007 before hitting nearly 14 percent by the depth of the recession in 2009.[63] Understandably, total tax revenues had essentially been in decline since 2000, with real per capita total personal and corporate income tax revenues falling from $1,300 (2014 dollars) in 2000 to less than $950 by 2007. While expenditures were actually declining before the recession, shrinking tax revenue meant that real per capita debt rose from just under $2,700 (2014 dollars) in 2000 to roughly $3,200 by 2007.

Following reform in 2011, income tax revenue per capita actually rose, and total tax revenue per capita stopped declining. However, these trends appear to have preceded the reform, coinciding with increases in per capita income in the state, which had also begun before reform, thus making the specific effect of the reform difficult to untangle. According to the *Wall Street Journal*, job growth in the state stood at 4.5 percent in 2012, putting Michigan ahead of most neighboring states.[64] While this could obviously be attributed to the economic recovery (personal income rose and unemployment fell in the state since 2010), the fact that Michigan's economy was in obvious distress *before* the recession is telling. Expenditures in the state were also in decline in the postreform and postrecession years, following a steep increase from 2008–2010: Real per capita expenditure in Michigan climbed from just over $6,200 in 2008 to just over $7,000 in 2010, an increase of more than 12 percent. By 2014, expenditures had fallen to roughly $6,500 per capita, a decline of 8 percent. While other factors were clearly at play—most notably the financial pressures of the Great Recession—the relative failure of the 2007 reform could have been exacerbated by the rapid increase in spending at the state level during a period when tax revenues were in decline.

Turning to some of the institutional factors at play, during the initial reform period in 2007, Michigan's governor was Jennifer Granholm, a Democrat, and the state legislature was divided, with Democrats controlling the house and Republicans controlling the senate. At the time of reform in 2011, Michigan's governor was Rick Snyder, a Republican, and the state legislature was also held by Republicans, with 68 percent of the seats in the senate and 57

62. WSJ.com, "Michigan's Tax Referendum," *Wall Street Journal*, October 9, 2014.
63. Bureau of Labor Statistics, "Local Area Unemployment Statistics," http://www.bls.gov/lau/.
64. "Michigan's Tax Referendum," *Wall Street Journal*, October 9, 2014.

percent of the seats in the house (though in the immediately preceding years—and as late as 2010—the government was still divided with a Democratic governor and divided legislature).[65] As with Rhode Island, Michigan is typically considered a less-than-average state in terms of economic freedom. Since 1981, its score on the EFNA index averaged 5.7 (compared to the average score of 6.5 across the 50 states for the same time period).[66] Michigan's governor has full budget responsibility and is required by constitutional rule to submit a balanced budget; the legislature is also required to pass a balanced budget.[67] The constitutional rule allows revenue and debt to match expenditures, with a limit on the amount of debt used to reduce any deficit.[68] Michigan's constitution features tax and expenditure limits that cap revenue to 9.49 percent of the previous year's state income.[69]

Kansas

In perhaps the most controversial reform effort in recent memory, Kansas took significant steps to cut taxes in 2012. The plan replaced a three-bracket system (with marginal rates ranging from 3.5 percent to 6.45 percent) with two brackets: residents pay a tax rate of 3 percent on incomes up to $15,000 and 4.9 percent on dollars earned above that threshold. Further cuts are possible if revenue goals are met. Other changes included an increased standard deduction and the elimination of several tax credits. These changes were largely on a par with similar actions in other states; what was unique to the Kansas reform was an exemption for so-called "pass-through" profits—that is, profits moved from a firm to individual owners. The result allows many small businesses to avoid paying any business income taxes.[70]

At first glance, Kansas's reform appears consistent with *some* of the criteria discussed above: reductions to the tax rates, simplification of the bracket structure, and elimination of deductions and credits to improve efficiency and convenience. That said, there appear to be many issues with Kansas's approach to reform, including the decision to exempt pass-through profits from taxation, as well as a failure to ensure adequacy of revenues. On its face, the exemption of

65. Council of State Governments, *Book of the States*.
66. Author's calculations from data in Dean Stansel et al., "Economic Freedom of North America 2015" (Vancouver: Fraser Institute, 2015).
67. National Conference of State Legislatures, "State Tax and Expenditure Limits—2010."
68. Hou and Smith, "Framework for Understanding State Balanced Budget Requirement Systems."
69. National Conference of State Legislatures, "State Tax and Expenditure Limits—2010."
70. Michael Leachman and Chris Mai, "Lessons for Other States from Kansas' Massive Tax Cuts," Center on Budget and Policy Priorities, March 27, 2014.

certain revenues lowers the burden of taxation on businesses. Unfortunately, it also introduces a fundamental distortion into the market in that certain types of income are taxed while others are not (creating horizontal equity issues), which could be expected to encourage firms in Kansas to make organizational decisions primarily based on minimizing their tax burden. In short, this approach may actually *increase* the amount of inefficiency created by the tax code. Further, the exemption of these profits means Kansas has effectively lowered rates and *narrowed* the tax base, likely leading to decreased revenues.

The Kansas reform has been criticized from both sides of the political aisle: Joe Henchman of the Tax Foundation notes that the exemption of pass-through profits creates an incentive to "game the system" while Nick Johnson of the Center on Budget and Policy Priorities notes issues with both vertical equity (in that it disproportionately benefits high earners) and horizontal equity (in that the pass-through exemption creates an unfair playing field among businesses).[71] Indeed, the Kansas case has been described as a cautionary tale of sorts by officials in other states looking to reform.[72]

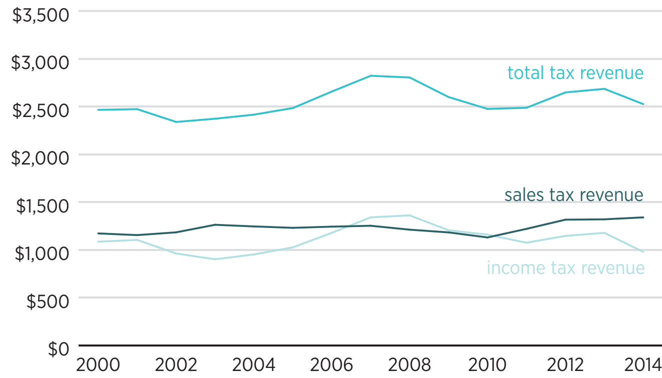
In the decade before Kansas's tax reform—especially the years leading up to the economic downturn following the financial crisis in 2008—real per capita total personal and corporate income tax collections in the state were rising (as figure 8 shows) from $900 (2014 dollars) in 2003 to a high of $1,360 in 2008. This growth mirrors similarly strong growth in overall economic indicators in the state, such as real GDP per capita and real personal income per capita. The recession brought sharp declines in both GDP and income and a marked increase in unemployment, from 4.7 percent in 2008 to 7 percent in 2010, leading to understandable declines in both income and sales tax collections in the state. Recovery was strong in Kansas, however, with all economic indicators quickly returning to their precrisis levels and tax collections rising as well. The Tax Foundation ranked Kansas as having the 20th best business climate in 2014.[73]

What's telling, however, is that in the years immediately following the reforms in 2012 (though admittedly as of this writing only two years of data were available for the postreform period) income tax collections *declined* despite strong growth in per capita GDP and per capita income and despite decreasing unemployment. In 2012, Kansas collected more than $1,100 in real

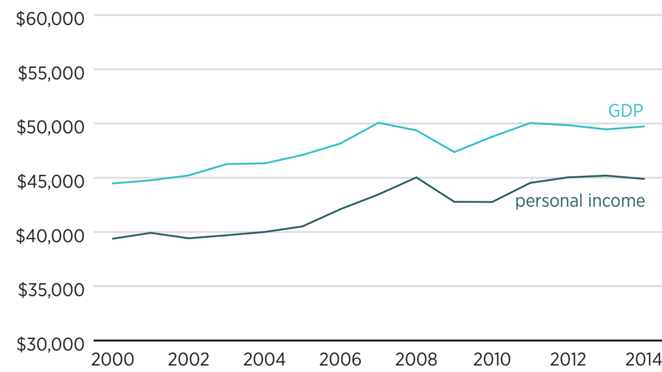
71. Joe Henchman and Nick Johnson are cited by Penelope Lemov in "What's Wrong with Kansas' Tax Reform?," *Governing the States and Localities*, April 11, 2013.
72. Rachel Bade, "GOP Learns Lessons from Sam Brownback's Tax Scare," *Politico*, December 26, 2014.
73. Drenkard and Henchman, "2014 State Business Tax Climate Index."

FIGURE 8. KANSAS, 2000–2014

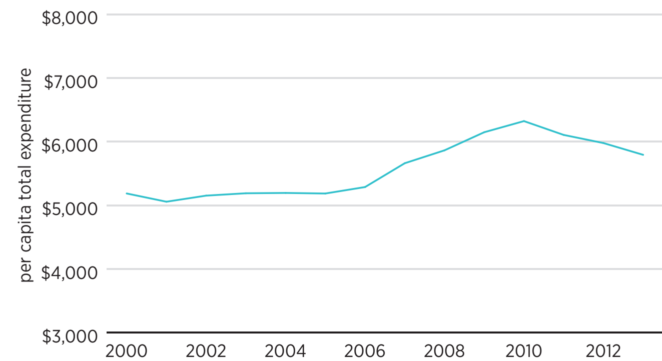
PANEL A. REAL PER CAPITA TAX REVENUE



PANEL B. REAL PER CAPITA GDP AND PERSONAL INCOME



PANEL C. REAL PER CAPITA TOTAL EXPENDITURE



Sources: US Census Bureau and Bureau of Economic Analysis.

Note: Adjusted to 2014 dollars using the consumer price index.

per capita total income tax revenue, compared to just under $1,000 in 2014—a decline of more than 10 percent. Declining revenue, especially following a tax cut as significant as that included in Kansas's reform package, is to be expected, and it is certainly not in and of itself a cause for alarm; in fact if the reduced revenue is coupled with decreased government activity in the economy, it would likely lead to increases in economic efficiency. On the other hand, if tax revenues fall and expenditures remain constant (or even rise), then deficits are inevitable. Despite the declining revenues, expenditure in Kansas has remained relatively constant, with real per capita spending declining from just over $6,000 in 2011 (the year before reform) to roughly $5,800 in 2013, still well above its prerecession level of roughly $5,200. In short, declines in income tax revenue in Kansas have not been met with similar reductions in state spending, leading to concerns about the income tax system's adequacy.

Before the reform passed, Kansas relied on the income tax for roughly 43 percent of its total tax revenue, and the sales tax for about 50 percent. When reform passed in 2012, the government was unified under a single political party. The state's legislature was held by a Republican majority: 80 percent of the seats in the senate and 56 percent of the seats in the house.[74] And Governor Sam Brownbeck, a Republican, signed the tax reform. According to the EFNA index, Kansas has an average level of economic freedom historically with a mean score of 6.5 since 1981, on a par with the average across the 50 states.[75] In Kansas, the governor has full budget responsibility, with a statutory rule requiring that he or she submit a balanced budget and a constitutional rule requiring that the legislature pass it.[76] Kansas's constitutional rule allows revenue and debt to match expenditures, with limitations on the amount of debt that can be used to reduce any deficit. Kansas has no tax and expenditure limits, perhaps allowing the apparent disconnect between declining revenues without cuts to spending in the postreform period.[77]

North Carolina

Perhaps informed by the issues in Kansas, North Carolina enacted multiple changes to its tax system in 2013 with hope that the reform "broadens the tax base, lowers income tax rates and reduces taxes for North Carolina working

74. Council of State Governments, *Book of the States*.
75. Author's calculations from data in Stansel et al., "Economic Freedom of North America, 2015."
76. National Conference of State Legislatures, "State Balanced Budget Provisions."
77. National Conference of State Legislatures, "State Tax and Expenditure Limits—2010."

families."[78] On personal income tax, the reform eliminated a three-bracket system (with marginal rates ranging from 6 percent to 7.75 percent) and replaced it with a single flat tax rate of 5.75 percent. The standard deduction was increased, the personal exemption was eliminated, and caps were placed on deductions for property tax and mortgage interest. The child tax credit was increased for the poorest residents, and social security income was exempted from taxation. The flat corporate income tax rate was to be reduced from 6.9 percent to 5 percent over two years, with further reductions scheduled to as low as 3 percent should certain revenue goals be achieved. A cap was placed on the gasoline tax, the estate tax (or so-called death tax) was repealed, and nonprofits were made exempt from sales taxes.[79] The reform also did away with various credits and exemptions (including those used for business recruitment) and eliminated the favorable tax treatment of modular homes, nutritional supplements, amusements such as movie tickets, and many other goods and services.[80]

As quoted above, the stated goal of the tax reform was to broaden the base and lower the rate—moves consistent with the ideal criteria of tax reform—and on their face, the specific changes to North Carolina's tax code appear to do that. Replacing the bracket structure with a simple flat tax increases efficiency and convenience. Eliminating various exemptions removes likely distortions. While removing progressivity from the tax rate structure could be viewed as a step back on the equity margin, attempts were made to ensure that taxes were paid in accordance with ability to pay. For instance, capping the mortgage interest deduction likely increases the tax liability for relatively rich residents. The corporate reforms appear to be similarly efficient, specifically the rate reduction and elimination of various exemptions (especially those used for business recruitment). Not all are sold on the benefits of North Carolina's reform, however. Recently, there have been calls—citing equity concerns—to reintroduce tax deductions for medical expenses for the elderly.[81] Further, the role played by special interests in crafting the reform package is clear: despite various changes to credits and deductions, a 2 percent tax discount for cigarette manufacturers remained in place even after reform.[82]

As North Carolina's tax reform is the most recent reviewed here, data availability is a serious issue when looking at any outcomes associated with

78. "Governor McCrory Signs Tax Reform into Law," governor.nc.gov, press release, 2013.
79. Ibid.
80. Mark Binker, "Breaking Down the 2013 Tax Package," WRAL.com, July 19, 2013.
81. Rob Schofield, "Editorial: Seniors, Poor Need Relief from NC Tax 'Reform,'" *NC Policy Watch*, February 17, 2015.
82. Binker, "Breaking Down the 2013 Tax Package."

that reform effort. Revenue collections for 2014 are nearly identical to what they were in 2013 in real per capita terms (see figure 9). The conditions before reform, however, perhaps help explain why reform efforts were possible in the state. North Carolina was in a state of slow recovery following the economic downturn. Specifically, real per capita personal income in the state was relatively stagnant after an initial recovery in 2012. Real per capita GDP similarly grew at a rate of only 3 percent from 2009 to 2013, following a decade of growth before the recession. By 2015, North Carolina's business climate ranked 16th of all the states', according to the Tax Foundation.[83]

North Carolina is historically an economically free state. Since 1981, it has averaged an EFNA score of 7.1 (compared to the national average of 6.5 for the same period).[84] In 2013, income tax revenue made up 52 percent of all tax revenue in the state, while sales tax revenue comprised about 41 percent. When reform was passed, North Carolina's legislature was controlled by Republicans (66 percent in the senate and 54 percent in the house), and the governor, Pat McCrory, was also a Republican.[85] In North Carolina, the governor shares budget responsibility with the legislature.[86] The state features tax and expenditure limits that restrict expenditures to at most 7 percent of state personal income.[87] The state's balanced budget rule requires both that the governor submit a balanced budget and that the legislature pass one. It allows own-source revenue and debt to match expenditure, with a rule prohibiting the carryover of deficits.[88]

4. CONCLUSIONS

Tax reform remains a pressing issue, especially in the years following the Great Recession. This paper discusses recent trends in state fiscal policy and some normative criteria for "good" tax policy and reform, and then applies these ideas to five specific instances of major state tax reform from the last decade.

While a case study approach such as this is necessarily limited in its ability to draw sweeping conclusions, some common trends are observed across the five instances of reform reviewed here. First, the most frequent concerns are about equity, especially in those states moving toward flatter tax regimes (and removing the progressivity found in bracket-based systems)

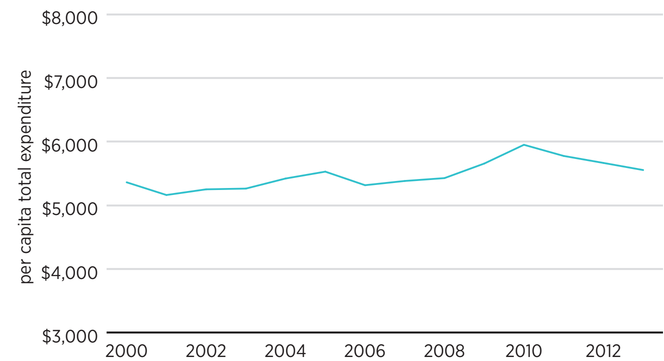
83. Drenkard and Henchman, "2015 State Business Tax Climate Index."
84. Author's calculations from data in Stansel et al., "Economic Freedom of North America, 2015."
85. Council of State Governments, *Book of the States*.
86. Ibid.
87. National Conference of State Legislatures, "State Tax and Expenditure Limits—2010."
88. Hou and Smith, "Framework for Understanding State Balanced Budget Requirement Systems."

FIGURE 9. NORTH CAROLINA, 2000–2014

PANEL A. REAL PER CAPITA TAX REVENUE

PANEL B. REAL PER CAPITA GDP AND PERSONAL INCOME

PANEL C. REAL PER CAPITA TOTAL EXPENDITURE



Sources: US Census Bureau and Bureau of Economic Analysis.

Note: Adjusted to 2014 dollars using the consumer price index.

or in those eliminating tax deductions and credits that could be justified on horizontal equity grounds. The most effective tax reforms appear to be those geared toward fundamentally lowering the rate at which economic activity is taxed while simultaneously broadening the range of activity taxed. These steps serve to improve efficiency, convenience, and transparency in the tax system. In the case of Utah, for example, moving toward a flat tax and curtailing available exemptions and deductions seems clearly in line with the accepted principles of tax reform. On the other hand, the efficacy of Kansas's approach, which cut rates but appears to have increased the distortions created by the tax code (by creating incentives for businesses to fundamentally reorganize in order to avoid taxation) is far less certain. Further, cutting taxes alone—without addressing the expenditure side of the budget—has serious negative implications for a tax system's adequacy. In the majority of the cases analyzed here, states cut expenditures in recent years; only Kansas did not match aggressive reductions in tax revenue with similar cuts to spending, and the state is now referred to as a cautionary tale.

Turning to the political economy features of each case, some overall trends and commonalities are apparent. First, as discussed above, the previous empirical literature has shown that political factors can have an impact on state policy. With the exception of Michigan, the states considered here were led by Republican governors at the time of reform, and in four of the five cases, the legislature was controlled by Republicans as well—in other words, in the majority of cases discussed here, governments that successfully passed large-scale reform were unified in terms of political party across the executive and legislative branches. In the case of Rhode Island, the legislature was unified in the hands of Democrats. In Michigan, the initial 2007 tax reform came while the state was led by a Democratic governor and the state legislature was divided; the 2011 reforms were technically implemented under a unified Republican government, though the state was still divided in the immediately preceding years. In short, while these cases feature primarily Republican governments, Michigan and Rhode Island demonstrate that this is by no means a requirement for reform.

On its face, it is perhaps unsurprising that Republican governors would champion lower taxes (which each of these reforms contained), but from a political economy standpoint, the united government, regardless of party, was likely important to the reform process (though the Michigan case demonstrates that a unified government is not necessarily essential to the reform process). In the case of Utah, for instance, policymakers were explicit in citing a need to involve political leaders of various groups in order to make

reform successful.[89] To further the point that the unified government—not the political ideology per se—was important, it is worth noting that two of the states discussed here, Rhode Island and Michigan, are historically less-than-average in rankings of economic freedom. Other institutional features seem less important. For instance, there is no obvious association between reform type or efficacy and the type of tax and expenditure limits or balanced budget rule in place, with the possible exception of Kansas, which lacks tax and expenditure limits and appears to be having issues with the adequacy of its tax system post reform.

Some trends in economic conditions leading up to reform are also apparent. In the cases of Utah and Kansas, tax revenues and personal income were rising before the reform period, likely making the idea of a tax cut politically feasible. On the other hand, in Rhode Island and Michigan, economic conditions were deteriorating before reform, perhaps creating a sense of urgency about reform. Of note is the fact that in both these states, major portions of the reform efforts dealt with the repeal of recently adopted tax policy. In Rhode Island, the recent change was the adoption of an optional flat income tax, while in Michigan the Michigan Business Tax was adopted in 2007 only to be repealed in 2011. Perhaps reform was politically feasible because these recently adopted tax regimes were blamed for declining economic performance. If so, and if results in Kansas turn out to be undesirable as predicted by many, it would be unsurprising to see additional reform in that state.

While we cannot use these commonalities to formulate complete lists of trends and factors necessary to bring on tax reform, it is likely safe to say that they do improve conditions and make reform more feasible politically. Given the likelihood of more states facing fiscal distress in coming years and inevitably needing to address calls for tax reform, additional case studies could help provide further insights into the trends discussed here.

89. Walker et al., "Insights and Caveats from Recent Tax Reform in Utah."

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