

CASE STUDIES IN THE POLITICAL ECONOMY OF TAX REFORM

The Great Recession of 2007–2009 not only caused the tax bases of many states to shrink, but also created a growing demand for government services, which caused state spending to increase by nearly 10 percent on average between 2008 and 2010. Naturally, this created significant fiscal stresses for many states, making state-level tax reform politically feasible in several places.

A new study for the Mercatus Center at George Mason University examines recent trends in state fiscal policy and details how well these efforts conform to widely accepted “best practices” in tax reform. It examines the tax and the expenditure patterns of five states and finds that, while there is no one correct way to enact economically beneficial tax reform, it is possible to discern some clear trends.

To read the study in its entirety and learn more about its author, Troy University economics professor George R. Crowley, see [“Case Studies in the Political Economy of Tax Reform.”](#)

WHAT CONSTITUTES SOUND TAX POLICY?

While the academic literature shows slight disagreements over the best practices for tax policy, most economists agree that sound tax policy must be based on five principles: efficiency, equity, transparency, convenience, and adequacy. A tax regime is *efficient* to the extent that it does not lead buyers and sellers to modify their behavior in order to take advantage of beneficial tax treatment. Taxes with broader bases tend to be more efficient than taxes that seek to benefit narrow interests. Taxes are *horizontally equitable* when people with similar earnings pay a similar share of taxes; they are *vertically equitable* when people with higher earnings pay more than people with lower earnings.

Taxes are *transparent* when it is easy for taxpayers to discern how much they owe. They are *convenient* when compliance is not unnecessarily costly. Simplifying the tax code increases both transparency and convenience. Finally, it is important that a state raise enough revenue to finance its expenditures—that is to say, the tax system must be *adequate*.

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CASE STUDIES IN RECENT TAX REFORM

The following five case studies of states that introduced significant tax reform following the Great Recession examine how well each reform effort conforms to the criteria of successful tax reform.

Tax Reform in Utah

In 2006–2007, Utah replaced its six income brackets with a 5 percent flat tax on personal income. It also replaced many deductions with tax credits and lowered its sales tax.

- The flat tax resulted in lower rates for most people, and the elimination of deductions created a broader tax base. This simplification of the tax regime not only improved the efficiency of the tax system but also made it more convenient for taxpayers.
- Phasing out tax credits as incomes rose ensured some degree of equity.

Tax Reform in Rhode Island

In 2010, Rhode Island collapsed its five tax brackets down to three and decreased the top marginal tax rate. It also eliminated the alternative minimum tax (a flat tax) and the ability to itemize deductions, and significantly curtailed the number of available tax credits.

- Collapsing the number of brackets has made the tax code more transparent and more convenient for taxpayers, and the rate reduction would seem to improve its efficiency.
- However, though eliminating various credits and deductions indicates a move toward greater equity, the choice to eliminate the alternative flat tax removed a more simple and efficient tax option for some people.

Tax Reform in Michigan

Michigan has witnessed two major reform events over the past decade. In 2007, the state replaced its complicated Single Business Tax with what was supposed to be a simpler tax on business activity: the Michigan Business Tax. The Michigan Business Tax was repealed in 2011 and replaced with a flat, 6 percent tax on corporate income, to be applied only to businesses organized as corporations.

- The Michigan Business Tax was neither efficient nor equitable, imposing a 4.95 percent tax on business income, a 0.8 percent gross receipt tax, and a 22 percent surcharge. The 2011 reform increased the efficiency, transparency, and convenience of Michigan's tax code.
- However, the fact that many previously taxed businesses were exempt from the new flat tax created certain inequities in the system, and the change in the definition of which types of business organizations' income is taxable may lead to distortions in the way businesses choose to organize.

Tax Reform in Kansas

In 2012, Kansas instituted what came to be regarded as a very controversial set of reforms. The existing set of three individual tax brackets was replaced with a two-bracket system: 3 percent on incomes up to \$15,000 and 4.9 percent on incomes above that threshold. The standard deduction was also increased and many tax credits were eliminated.

- However, Kansas also made the decision to exempt “pass-through” profits from corporate taxation; that is, business income that is taxed on individual business owners’ tax returns. While this lowers the tax burden on businesses, it creates distortions in the way business owners choose to classify their operations. Moreover, it is inequitable because it disproportionately benefits high earners and creates an unfair playing field among businesses.
- Still, the reform did simplify the bracket structure, and the elimination of deductions and credits surely improved both efficiency and convenience. However, the adequacy of the tax system has been a concern, largely owing to the exemption of pass-through profits that effectively *narrowed* the tax base.

Tax Reform in North Carolina

North Carolina enacted multiple changes to its tax code in 2013. It replaced the existing three-bracket system with a single flat tax rate of 5.75 percent, eliminated the personal exemption, increased the standard deduction, and placed caps on the property tax and the mortgage interest deduction. It also increased the child tax credit and exempted Social Security income from taxation. It reduced its flat corporate income tax from 6.9 percent to 5 percent over two years and did away with various credits and exemptions.

- Replacing the bracket structure with a flat tax certainly increased the system’s efficiency and convenience, and removing exemptions reduced distortions. Though movement toward a flat tax eliminates the progressivity of a tax system, North Carolina tried to ensure the system was equitable by, for example, capping the mortgage interest deduction and increasing the child tax credit.
- However, the state has been charged with allowing special interests to play a nontrivial role in crafting its reform package. For example, despite changes to many of the state’s credits and deductions, a 2 percent tax discount for cigarette manufacturers remains in effect.

COMMON TRENDS

While it is impossible to draw sweeping generalizations from the experiences of these five states, some common trends can nonetheless be discerned.

- The most effective tax reforms seem to be those that both lower the rates of taxation and simultaneously broaden the scope of activities that are taxed. Such reforms improve the efficiency, convenience, and transparency of a tax system.
- Equity is a common concern for would-be reformers, particularly in states moving to a flat-tax regime and thereby potentially reducing the progressivity of their tax systems. Some states, such as North Carolina, have tried to overcome this problem by curtailing tax credits and deductions for high earners while maintaining them for low earners.
- While unified government (when the legislative and executive branches are controlled by one political party) appears to be an important factor in facilitating tax reforms, the case of Michigan shows that it is not essential to the reform process.