Remarks on problems to be addressed during 2013 state tax reform debates

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December 19, 2012

Introduction

I'll start by talking about four major problems with state tax systems that any good tax reform package should address, and I'll try to use some examples of how these issues have been approached in the states.

For those of you that have seen the briefing materials for this call, you'll see a little bit of discussion about these topics in the policy brief we shared.

Adequacy

The first major problem is related to revenue, or the adequacy of a tax system. Basically, are taxes raising enough money to fund the schools, roads, and everything else that residents are willing to pay for?

The biggest story here is closely tied to the economy. The states have definitely been seeing *some* revenue growth these last few years, but unless you're in the middle of a natural resource boom like North Dakota's, that growth has been much slower than in the past. Overall, state revenues aren't even back to where they were before the recession—they're actually 5 percent lower now than they were in 2008, once you adjust for inflation

The biggest way states have responded to this revenue shortfall has been with large cuts in state budgets. With the federal stimulus money mostly gone last year, the states relied on spending cuts to close three-quarters of their total budget shortfalls. Altogether, since the recession began, state budgets have been cut by more than $290 billion dollars.

So with all that in mind, the first question that you need to ask about any tax reform proposal is how it will impact the state's budget—will it help state revenues rebound and restore some of the services that have been cut, or will it require even more cutbacks in the services we have today?

A lot of lawmakers have taken the last few years of revenue growth—however weak—as a sign that tax cuts are suddenly affordable. So take Oklahoma for example, where the top income tax rate was recently cut—and where lawmakers are still trying to pile on an even more expensive tax cut on top of that. But per-student spending in Oklahoma is still down 20 percent since the recession began. They're basically taking the revenue hole created by the Great Recession and digging it even deeper.

Sustainability

Moving on, the second issue that tax reform should address is sustainability. This is one of the harder issues to get lawmakers interested in, which is why it's so important that the rest of us take it very seriously. A sustainable tax system doesn't just produce enough revenue to fund the government between now and the next election, it also does that over the long-term, so that we can continue to have good schools and safe roads even as the cost of providing those things inevitably grows over time.

The perfect example of an <u>un</u>sustainable tax is the cigarette tax. It's levied as a flat dollar amount per pack that doesn't grow with inflation, and the population of people paying that tax is quickly shrinking as smoking becomes less and less popular.

Fortunately, we're not trying to fund our entire government with anything as blatantly unsustainable as the cigarette tax, but the taxes we do rely on most—like the sales tax and the income tax—often have big holes in them that keep them from growing at a reasonable rate over time.

So for example with the sales tax, we see online shopping absolutely booming—it's projected to grow 45 percent in just the next 4 years. But we also see a lot of states failing to use all the tools at their disposal to ensure their sales tax covers these purchases.

An even bigger problem relates to how sales tax laws have huge blind spots when it comes to intangible services. Sales taxes usually apply to toothpaste, furniture, and all the same tangible things people were purchasing half a century ago when the laws were written, but sales taxes don't even recognize the existence of intangible services, from haircuts to car repairs, that Americans spend more and more of their money on today.

Corporate taxes face very similar problems—they apply to business models from a century ago. And many state personal income taxes have enormous carve-outs for some of the fastest growing components of personal income, from retirement income to capital gains.

So when you're looking at any "tax reform" idea, it's always important to ask about its effect not just for the current year's budget, but on the state's long-term outlook as well. Especially since the long-term outlook for state taxes is already not very good in a lot of cases.

If you want an example of a state that's totally ignored the importance of sustainability—and there are a lot—you can look to Arizona. A lot of lawmakers there wanted to enact a new tax cut, but there's already an expensive cut in the state sales tax rate going into effect next summer. To get around this, those lawmakers decided to very slowly phase-in a new tax cut for capital gains income over the course of many years. Using this tactic meant that the lawmakers who voted for this plan get to take credit for cutting taxes today, while not having to deal with the revenue consequences of that decision until much later.

Fairness

Another issue that's central to any tax reform debate is fairness. Matt already mentioned some of our research showing that virtually every state tax system in the country is upside-down, requiring the poorest families to spend more of their household budgets on taxes than any other group. And this is one of the most serious problems with state tax systems—it means that state taxes can push some families into poverty, while requiring far less of the upper-income taxpayers whose income has been growing fastest recently.

Let's just dive into a couple examples of how fairness can come up in state tax debates. In Indiana, the Governor-elect has proposed what he calls an "across the board" tax cut. But that doesn't actually tell you very much about the plan's actual effect on tax fairness.

The question that needed to be asked—and the one we decided to answer using our computer model—was how the benefits of the plan would actually shake out among Indiana residents with varying ability to afford their tax bills.

Specifically, what the Governor has proposed is cutting the state's only major progressive tax—the personal income tax. And our analysis showed that this "across the board" plan would be tilted heavily in favor of the state's highest-income residents. More than a quarter of the benefits would go to just the richest 5 percent of taxpayers, while about one in three of the state's poorest residents would see no tax cut at all. That's despite the fact that Indiana's poor face some of the highest overall taxes in the country. And yet somehow the plan has been labeled as benefiting Indiana residents "across the board."

Oklahoma is another example of where the labels used to describe big tax ideas can obscure important fairness issues. Almost all of the debate last year was framed around how to quote-unquote "cut taxes." But using our tax model we asked whether everyone would really see a tax cut under the plans being discussed, and we showed that many of the plans under discussion would actually raise taxes on up to *half* of all Oklahoma households, including many of the poor. And it was this realization that led to last year's tax debate falling apart in Oklahoma, and to lawmakers having to wait until this upcoming session to come back and try again.

Simplicity

Fourth, I want to talk for just a minute about the importance of simplicity in state tax codes. I don't think you'll find a lot of disagreement around the idea that state tax systems are too complicated. But a lot of times this is used as an argument for flattening the income tax rates, as if the extra bit of arithmetic required by a graduated rate structure is what's forced so many Americans to hire an accountant to do their taxes. This is really just a distraction. The real complication comes about because of the slew of special breaks and tax shelters built into the code.

And the question you need to ask when evaluating claims about the simplicity benefits of any tax plan is whether it's actually going to make tax filing any easier.

We're at a point now where every type of income you earn can be subject to totally different tax rules. So your earnings are treated differently depending on whether they're wages, or capital gains, or interest, or dividends, or pension income, or business income, or whatever else you can possibly think of. A lot of this has come from lawmakers trying to accomplish every objective imaginable through special tax breaks—from promoting homeownership to even encouraging bird hunting.

Any true tax reform has to reduce this complication by broadening the tax base and wiping out the tax breaks that are least effective in achieving their goals. This doesn't mean every tax break has to be eliminated—basic exemptions and credits that prevent working poor families from being taxed deeper into poverty are a couple examples that are worth keeping. But for every break like that, there are a dozen more that are expensive, unproven, and often unnecessary. And the only time those tend to get eliminated is as part of big tax reform discussions.

Economic Myths

So those are the four major issues that need to be discussed as part of any tax reform debate: adequacy, sustainability, fairness, and simplicity.

But I'd be remiss if I didn't mention a fifth issue that's often touted as a justification for cutting taxes under the guise of reform. And that's the supposed economic benefits of lower taxes. We saw this as a central theme of the tax debates in Kansas, Oklahoma, and Tennessee last year. And we're expecting much of the same from North Carolina, Indiana, and lots of other states this year, as Meg's going to explain in a second.

The basic idea here is that lower taxes are allegedly a huge incentive to work and invest, and that refusing to levy an income tax in particular acts like a magnet that draws entrepreneurs away from Silicon Valley and toward no-tax states like South Dakota and Wyoming. To support this claim, we've seen a lot of "research" from ALEC and other conservative groups, and in particular an economist named Arthur Laffer that asserts, basically, that none of the economic success experienced by states like Alaska can be traced to their natural resource endowment, and it's all actually a result of their decision not to levy an income tax.

Of course, this is absurd. There are indeed a handful of states with unique advantages in terms of tourism or natural resources that have found unusual ways to pay for their governments. But this doesn't mean that ditching your income tax and paying for it with worse schools and crumbling roads is a path to prosperity.

Unfortunately, a lot of—frankly—very simplistic analyses that purport to show exactly the opposite have been released in recent months, and we've made it a point to explain the flaws with those analyses whenever we can. You can find some of our work doing exactly that on our website.

But before you go rushing to our site, let me turn it over now to our state policy director, Meg Wiehe. She's going to talk more about the specific tax battles we're expecting to get started in just the next few weeks, and point out some trends we're seeing in terms of similar ideas being discussed in a lot of different states.