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State Tax Cut Roundup

2018 Legislative Session

ALEC American Legislative Exchange Council
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State Tax Cut Roundup – 2018 Legislative Session

Executive Summary – Tax Reform in the States

The 2018 state legislative sessions ended with 16 states enacting substantial tax relief for their citizens that was sufficient to qualify for *State Tax Cut Roundup.* Reducing effective tax rates in response to broader tax bases resulting from federal tax conformity was a common theme. Of the 16 states that substantially reduced taxes in 2018, a full 14 did so as a part of conforming state tax codes to the new federal code following the passage of the federal Tax Cuts and Jobs Act (TCJA). The annual *Rich States, Poor States: ALEC-Laffer State Economic Competitiveness Index* illustrates how certain tax and fiscal policies lead states to prosper and others to fall behind.[i] Fortunately, state legislators are heeding this message. Six states cut taxes unrelated to federal tax conformity, saving taxpayers more than $600 million in tax liability in 2019 alone.

This edition of *State Tax Cut Roundup* highlights 16 states that cut taxes – the second-most behind the 2013 edition which saw 18 states cut taxes. State-level budget surpluses arising from federal tax conformity were the primary driver behind state-level tax reductions in 2018. TCJA's corporate and personal income tax reforms spurred an increase in spending, investment, and repatriation of business assets formerly held abroad. States were able to capitalize on nationwide economic growth and state revenues grew as income, sales and business activity increased in response to tax reform. State revenues also grew as a result of changes made to the federal code. Following passage of the TCJA, the federal tax code became broader as a result of repealing the personal exemption and capping and repealing tax deductions.

Largely for simplicity purposes, the vast majority of the states with income taxes conform some or nearly all of their tax codes to mirror the federal code – with the exception of Arkansas, Mississippi, New Jersey, and Pennsylvania who rely entirely on their own state definitions.[ii] States must choose between what is known as "rolling" and "static" conformity. Rolling conformity states automatically conform their tax codes to the federal code as changes are made at the federal level, while static conformity requires states to take legislative action to conform to federal changes. Changes in the federal tax base led to revenue increases which were countered by tax rate reductions at the federal level. Absent state-level tax reductions, a large majority of states conforming to federal changes would similarly increase state revenue and create an effective tax increase at the state level. The federal government counteracted the effective tax increase from a broader base by cutting personal income tax rates, corporate income tax rates, nearly doubling the standard deduction, and doubling the child tax credit. In all, simplifying the tax code through repealing and capping tax deductions is estimated to save $3-5 billion in tax compliance costs and 80 percent of individual filers are expected to see a reduced tax burden.[iii] The potential revenue increase from conformity was so large, many states expected an increase in revenue exceeding $500 million annually. Many state legislatures recognized the economic consequences a sudden tax increase would have on their state economy and used the opportunity to cut taxes to hold taxpayers harmless. States that conformed and cut taxes often saw no decrease in revenue compared to 2017, giving states the policy outcomes from a tax cut without the normal need to curtail spending. Of the 41 states with a broad-based income tax, 19 decided to conform to federal tax changes and cut taxes in calendar year 2018. The 2019 legislative session will likely see even more embrace tax reform, as 5 states opened the new year with conformity questions unresolved and many more chose to conform to the federal tax code without making their own state tax reforms.[iv]

Overall, the economic evidence strongly suggests states with lower tax burdens and more economic freedom regularly outperform their higher tax and more restrictive counterparts.[v] Creating a tax and fiscal policy climate conducive to economic growth should be a top priority for every state. Hopefully, the example set by these reforms and their economic results over time will persuade other states to pursue pro-growth tax reform in their coming legislative sessions.

To be listed in *State Tax Cut Roundup*, a state must meet all the following criteria, which have remained consistent throughout the previous five editions of this report:

• Substantially cut taxes at the state level

• Vote(s) occurred during the 2018 legislative session

• Tax cuts must result in a net decrease in taxes

• Tax cuts must apply broadly and neutrally, or otherwise move the state closer to the *ALEC Principles of Taxation*

Best of the Best

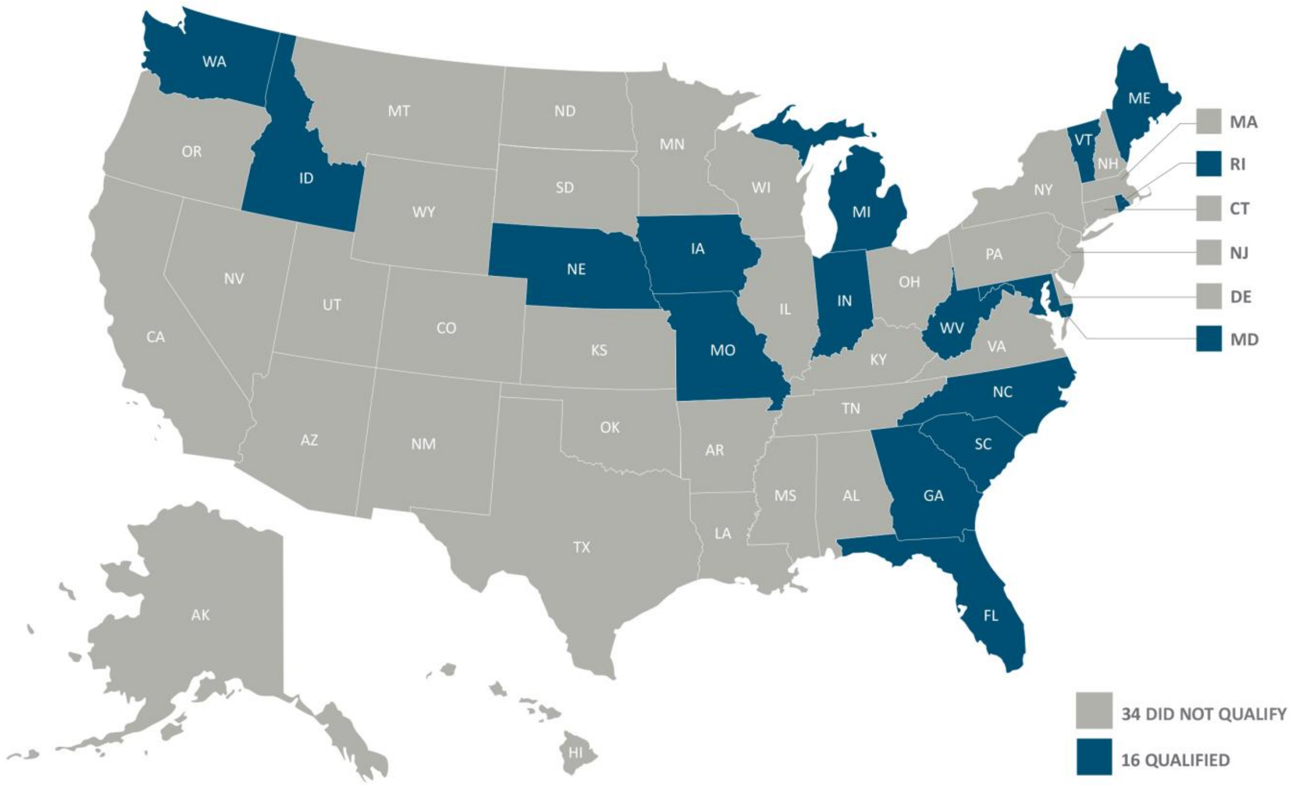
Missouri, Iowa, and Nebraska deserve special mention for enacting exemplary pro-growth tax reforms.

Nebraska enacted the most significant new tax cut of 2018, cutting $326 million, or $166.32 per capita, in 2019 tax burden alone. Rather than keeping a projected revenue surplus following federal tax conformity, Nebraska preserved and expanded the personal exemption, increased the state standard deduction by $250 and $500 for single and joint filers, respectively, and tied the personal income tax brackets to inflation using CPI-U rather than chained CPI-U. This puts Nebraska's inflation adjustments on a higher slope than chained CPI-U, meaning Nebraska's tax savings will grow year after year.

Iowa also passed significant tax cuts for the first time since 2013. As a part of federal tax conformity, the Iowa Legislature reduced personal and corporate income tax rates for every bracket, passed provisions for bracket consolidation contingent on revenue targets, and voted to eliminate the state's Alternative Minimum Tax (AMT) by 2021. A sharply progressive income tax structure gave Iowa some of the highest income tax rates in the country.[vi] By cutting $100.1 million in 2019 and $642 million annually by 2024, Iowa can more effectively compete for jobs and residents in the competitive Midwest region.

Last but not least, Missouri passed the largest tax cut in state history through federal tax conformity and subsequent rate reductions. As one of his last acts as governor, former Gov. Eric Greitens signed a corporate income tax cut that lowers the rate from 6.25 percent to 4 percent by tax year 2020. Upon full enactment, Missouri businesses will save $99.4 million annually. As one of his first acts as governor, Gov. Mike Parson signed personal income tax cuts designed to boost take-home pay for all Missourians. By reducing the top income tax rate from 5.9 percent to 5.4 percent, and lower upon meeting revenue triggers, Missouri's personal income tax cuts will save taxpayers an estimated $206.62 million is FY 2019. Combined with base broadening provisions related to federal tax conformity, Missouri's tax reform amounts to a net tax cut of $5.8 million annually once fully enacted. These crucial tax reforms will help Missouri compete for jobs and residents against neighboring states with higher income tax rates, such as Iowa, Kentucky, and Arkansas.[vii]

FIGURE 1 | STATES THAT QUALIFIED FOR STATE TAX CUT ROUNDUP DURING THE 2018 LEGISLATIVE SESSION



Trends in State Tax Reform

The Tax Cuts and Jobs Act of 2017 created a once-in-a-generation opportunity for state tax reform. When the federal government makes changes to the Internal Revenue Code (IRC), states have the option to "conform" to those changes. When Congress repealed the personal exemption and capped deductions, the federal tax base became broader and revenues increased. While the federal government offset these increases by cutting tax rates, state conformity carries no automatic tax cuts and actually leads to an effective tax increase at the state level by similarly broadening state tax bases. Federal tax reform and conformity gave states the opportunity to provide significant tax relief – without making cuts to government services. By the end of 2018, 19 states had seized the opportunity to cut taxes after conforming to federal tax changes.[viii] However, only 15 of these states are included in this report. Kentucky, New York, and Utah are not included in this edition of Tax Cut Roundup, because they raised taxes elsewhere and counteracted every cent of tax cuts passed through conformity. Looking back, 2018 was a record-setting year for *State Tax Cut Roundup*. Florida set a record for the most consecutive *State Tax Cut Roundup* appearances. Between 2012 and 2018, Florida has been featured six times– in every year of this publication. Rhode Island made its fourth appearance, the most among Northeastern states. As the Northeast falls behind the rest of the country in terms of population, employment, and GDP growth, Rhode Island's embrace of commonsense, even if minor, tax reform should give Northeastern free market and limited government policymakers a glimmer of hope.

Tax Cuts by State

Florida

2018 Rich States, Poor States Economic Outlook Rank: 6

Florida continued its trend of annual tax cuts by tackling the infamous commercial rents tax. S.B. 620 lowered the commercial rents tax rate from 5.8 to 5.7 percent, saving businesses $27.4 million in fiscal year 2019 alone.[ix] Florida is currently the only state with a tax on commercial rents. This tax increases the price of leasing, lowers real estate profits, and adds one more hurdle to small business success.[x] If Florida can continue to cut commercial rent tax rates, small businesses will have a brighter future in the Sunshine State.

Florida broke a new record this year by qualifying for *State Tax Cut Roundup* for all six editions of this publication. No other state has demonstrated such a commitment to tax relief over recent years. In fact, during his successful run for the U.S. Senate, former Gov. Rick Scott announced $10 billion in taxes had been returned to hard-working Floridians since he assumed office in 2011.[xi]

Additionally, during the 2018 election, voters overwhelmingly approved Amendment 5, which requires a two-thirds vote in both legislative chambers to pass a tax increase.[xii] With some of the most stringent restrictions on tax increases in the country, Florida's past and future tax cut successes are well protected.

Georgia

2018 Rich States, Poor States Economic Outlook Rank: 11

Marking its first appearance in *State Tax Cut Roundup*, Georgia used the issue of federal tax conformity to significantly cut personal and corporate income tax burdens. Bordered by two no-income-tax states and low-tax North Carolina, Georgia was in need of serious policy changes in order to keep up with states like Florida and Tennessee.[xiii] Georgia lawmakers were wise to lower the state's tax burden to try and attract capital. By cutting the corporate and top personal income tax rates from 6 to 5.75 percent with potential for further cuts to 5.5 percent in 2020, and doubling the standard deduction to $4,600 and $6,000 for single and joint filers, respectively, Georgia made important first steps to stay competitive with surrounding states.[xiv] Even with the 2018 tax cuts in Georgia, South Carolina is the only neighboring state with a higher top personal income tax rate.[xv]

Idaho

2018 Rich States, Poor States Economic Outlook Rank: 2

In response to federal tax conformity, Gov. Butch Otter signed HB 463, which reduced personal and corporate income tax rates, doubled the standard deduction, and created a state child tax credit on top of the federal child credit. House Majority Leader Mike Moyle hailed the tax reform package as "the largest tax cut in Idaho history."[xvi] Despite concerns from tax reform opponents, Idaho was able to fund scheduled spending increases to education while maintaining full state reserve accounts.[xvii]

Starting in fiscal year 2019, each of Idaho's seven tax brackets are reduced by 0.475 percentage points, reducing Idaho's top rate from 7.4 percent to 6.925 percent. The corporate income tax was also lowered by 0.475 percentage points to

6.925 percent.[xviii] HB 463 doubled the state standard deduction to $4,600 and $6,000 for single and joint filers, respectively. HB 463 initially created a child tax credit of $130, but HB 675, passed in March, increased this to $205 per qualifying dependent. Altogether, Idaho's tax reform will save taxpayers $129.5 million in 2019 alone.[xix]

Indiana

2018 Rich States, Poor States Economic Outlook Rank: 3

The Hoosier State is one of the biggest success stories in the history of *Rich States, Poor States*, as the state's economic competitiveness has skyrocketed from 24 in 2012 to a current rank of 3rd.[xx] Several tax reform packages in recent years have moved the state in the right direction, including when the Indiana Legislature phased in a reduction of the state personal income tax, the corporate income tax, and eliminated the estate tax.

In 2018, the Indiana Legislature passed HB 1316 to address conformity questions. Notably, the state has opted to not conform to several federal definitions which may have resulted in unintended tax increases for Indianans had no action been taken. The state decoupled from the net interest deduction cap, global intangible low-taxed income provisions, and from the new net operating loss rules. Additionally, HB 1316 retains the state's personal exemption, changes the inflation measure used to calculate the earned income tax credit, and expands the 529 education savings plan credit.[xxi]

The Indiana Legislature continues to prioritize hardworking taxpayers and job creators. Rather than pocket a massive revenue increase due to federal changes, the state took intentional steps to prevent tax increases on its citizens. By passing HB 1316, the Indiana Legislature declined to collect an estimated $129 million in tax conformity windfall and returned $73 million to taxpayers in 2019 alone.[xxii, xxiii]

Iowa

2018 Rich States, Poor States Economic Outlook Rank: 29

Gov. Kim Reynolds signed SF 2417 into law on May 30, 2018, stating "I signed this bill for every Iowan who works hard to earn a paycheck and deserves to keep more of it." SF 2417 conformed Iowa's tax code to federal changes made due to the federal Tax Cuts and Jobs Act and returned much of the projected revenue increase to taxpayers by cutting taxes. Without passing tax relief along with conformity, Iowans would have seen an increase in tax liability at the state level.[xxiv] The state's personal income tax will be simplified and lowered in a two-step process. Iowa' s personal income tax code currently has nine tax brackets. The top sticker rate of 8.98 percent kicked in for all taxpayers starting at $71,910 of income. Beginning in 2019, the rate for every bracket will be reduced, with the top rate dropping from 8.98 percent to 8.53 percent. Subject to revenue triggers, by 2023 the top individual income tax rate will be reduced to 6.5 percent with four brackets instead of nine. Several other changes would also take effect by 2023, including the elimination of both the alternative minimum tax and the ability to deduct federal income taxes from taxable state income.

In addition to having one of the nation's highest personal income tax rates, Iowa's top corporate income tax rate of 12 percent is among the highest in the nation. Under the new tax law, in 2021 the top corporate tax rate will be reduced to 9.8 percent, and both federal deductibility and the corporate alternative minimum tax will be repealed. Enacting a corporate income tax rate reduction would be a large step in making Iowa more economically competitive. Altogether, the Iowa Department of Revenue estimated Iowa's recent tax reform saves taxpayers $100.1 million in 2019, increasing to $642.2 annually by 2024, contingent on revenue triggers.[xxv]

Tax changes made effective in 2019 are already providing significant tax relief for Iowans. If the state can meet the revenue triggers to initiate further tax reform, taxpayers in the Hawkeye State can look forward to keeping even more money in their pockets.

Maine

2018 Rich States, Poor States Economic Outlook Rank: 42

Marking the Pine Tree State's second *State Tax Cut Roundup* appearance in a row, the Maine Legislature and former Gov. Paul LePage took the opportunity of federal tax conformity to improve tax code competitiveness and save residents money on state taxes.

First, Maine reestablished a state personal exemption on the first $4,150 of income. Maine also coupled the state standard deduction to the federal definition, giving Maine one of the highest standard deductions in the country– $12,000 for single filers and $24,000 for joint filers.[xxvi] Combined with cutting the state corporate income tax rate from 8.93 to 8.33 percent, Maine taxpayers can expect to save $22.6 million during the 2019 fiscal year.[xxvii]

Maine's *Rich States, Poor States* economic performance and economic outlook ranks are 41st and 42nd, respectively, indicating that Maine's economy has been stagnant and is expected to remain so.[xxviii] Maine's experience is typical of states in the Northeast, where seven out of nine U.S. Census-defined Northeast states perform in the bottom half of states in economic performance and eight out of nine perform in the bottom half in economic outlook.[xxix] Maine's current tax regime is also typical of the Northeast – high personal income tax burdens where progressive tax structures punish job creators. Maine will need to rethink its tax structure to create long term prosperity – and decreasing its personal and corporate income tax burdens is a good place to start.

Maryland

2018 Rich States, Poor States Economic Outlook Rank: 32

The Old Line State picked up the baton of federal tax reform during the 2018 legislative session and passed tax reform as a part of federal tax conformity. Maryland increased the state standard deduction by $250 and $500 for single and joint filers, respectively, saving taxpayers $56.6 million in fiscal year 2019 alone.[xxx] More importantly, Maryland decided to preserve the state personal exemption. If Maryland conformed in full to federal tax changes and repealed the state personal exemption, Marylanders would see an effective tax increase of $730 million at the state level in fiscal year 2019.[xxxi]

Maryland also increased the estate tax exemption from $4 million to $5 million.[xxxii] Estate and inheritance taxes, often called "death taxes," are some of the most injurious forms of taxation currently practiced by states. Death taxes demand that families surrender a portion of what their loved ones have left behind for them. Sixteen states currently levy a death tax, but as recently as 2001, every state collected inheritance or estate taxes. States gradually repealed their death taxes over the past 18 years, because, in addition to being incredibly unfair, they raise remarkably little revenue –

comprising only 1.4 percent of collections among states with death taxes in 2016.[xxxiii] Furthermore, they are highly volatile sources of revenue for states.

Michigan

2018 Rich States, Poor States Economic Outlook Rank: 18

The Michigan Legislature passed the first significant tax reform package since 2014 as a part of federal tax conformity. Since the federal Tax Cuts and Jobs Act repealed the federal personal exemption on taxable income, full conformity would mean states that link to the federal code in this area would repeal some or all of their personal exemption for state taxes. If the Michigan Legislature made no tax changes in conjunction with full conformity, taxpayers would no longer be able to exempt $4,000 from their taxable income, resulting in a massive tax increase. Rather than pocketing the additional revenue, the legislature decided to preserve and expand the state personal exemption, allowing taxpayers to exempt more revenue in future years.[xxxiv]

SB 748 allows Michigan taxpayers to claim a personal exemption on state income taxes and expands the personal exemption from $4,000 in 2017 to $4,050 in 2018, $4,400 in 2019, $4,750 in 2020, and finally $4,900 by 2021. Preserving and expanding the personal exemption is projected to save taxpayers $75 million in Tax Year 2019 alone. Once the personal exemption increases to $4,900 in 2021, taxpayers are projected to save $176.3 million annually and the change in law will have saved taxpayers $405 million cumulatively between 2018 and 2021 tax years.[xxxv]

Michigan tacked towards a more free market approach by passing corporate income tax reform in 2012, right-to-work legislation in 2013, and business personal property tax reform in 2014.[xxxvi, xxxvii, xxxviii] Consequently, Michigan has seen a stark increase in their *Rich States, Poor States* economic outlook ranking since a low point of 34th in 2009.[xxxix]

Missouri

2018 Rich States, Poor States Economic Outlook Rank: 23

Missouri passed tax reform in two waves in 2018. Former Gov. Eric Greitens signed SB 884 reducing corporate income tax rates. Following Gov. Greitens' departure, Gov. Mike Parson signed HB 2540, which reduced personal income tax rates and conformed Missouri's tax code to federal tax reforms.[xl]

SB 884 reduced corporate income tax rates from 6.25 percent to 4 percent starting in tax years after January 1st, 2020. The corporate income tax rate reduction is expected to save Missourians $49.7 million in fiscal year 2020 with savings increasing to $99.4 million by 2021.[xli] HB 2540 reduced the top personal income tax rate from 5.9 percent on income

over $9,000 to 5.4 percent on income over $8,000. As part of a previous budget package passed in 2014, income tax rates are set to decrease by 0.1 percent every year contingent on revenue triggers. Assuming all revenue triggers are met, Missouri's top tax rate will fall to 5.1 percent by 2022. The personal income tax reform is not projected to reduce overall tax liability for Missourians immediately, but by 2021, Missourians will start paying substantially less in income taxes. [xlii]

Tax reform does not have a long history in Missouri, as the first reform package since 1921 passed by veto override just in 2014.[xliii] Even taking into account the 2014 reforms, Missouri is not a low-tax-rate state. The Show-Me State's personal income tax and corporate income tax rates rank amongst the middle states according to magnitude of tax burden and Missouri's sales tax regime is among the most labyrinthine with nearly 2300 unique taxing authorities.[xliv, xlv, xlvi] Missouri has a long way to go to make their state tax system simpler, fairer, and less extractive, but SB 884 and HB 2540 are substantial steps in the right direction.

Nebraska

2018 Rich States, Poor States Economic Outlook Rank: 28

Nebraska passed one of the largest tax cuts per capita during the 2018 legislative session as a part of federal tax conformity legislation. Through commonsense tax reforms, Nebraska's tax code will now be less onerous and fairer.

L.B. 1090 increased the standard deduction by $200 for single filers and $500 for joint filers to $6,750 and $13,500, respectively. L.B. 1090 also preserved the state personal exemption that would have expired when Nebraska conformed to federal tax changes. [xlvii]

In addition, Nebraska linked their income tax brackets to inflation determined by the Consumer Price Index – All Urban Consumers (CPI-U), rather than the Chained Consumer Price Index- All Urban Consumers (C-CPI-U) used by the federal government to determine inflation. The CPI-U results in higher measures of inflation and pushes more income into lower tax brackets than the C-CPI-U. While this is a complex tax policy change, moving to the CPI-U will save taxpayers a significant sum of money across tax years as the CPI-U measure of inflation grows faster than the C-CPI-U reducing tax liability increasingly over time.[xlviii]

Altogether, Nebraska's tax reform package is projected to save taxpayers $326 million in FY 2019. While the personal exemption and standard deduction increases certainly save taxpayers a lot on their own, tax savings grow by $32 million between FY 2019-2020 and FY 2020, highlighting the effect of moving from C-CPI-U to CPI-U.[xlix] As savings grow over time, this change in Nebraska's tax policy highlights how complicated and seemingly irrelevant tax policy details can have significant benefits for years to come.

North Carolina

2018 Rich States, Poor States Economic Outlook Rank: 7

North Carolina passed significant tax reform for the fourth year in a row in 2018, putting the Tar Heel State just behind Arizona and Florida in consecutive *State Tax Cut Roundup* appearances.[l] North Carolina's landmark tax cut of 2017 continued its path towards full enactment as scheduled rate reductions became law and the General Assembly passed further tax reform as a part of federal tax conformity in 2018.

North Carolina's 2017 tax reform reduced the corporate income tax rate from 3 to 2.5 percent and the state's flat personal income tax rate from 5.499 to 5.25 percent, but the rate reductions would not take effect until after January 1, 2019, making the 2017 tax reform a delayed enactment.[li] Ordinarily, *State Tax Cut Roundup* does not cover rate reductions that took place as delayed enactments or phase-ins, as they are passive tax cuts that were not voted upon in the past legislative session. However, the General Assembly preserved scheduled tax rate reductions by overriding Gov. Roy Cooper's veto on the FY 2019 budget. While the personal and corporate income tax rate reductions were not initially voted upon in 2018, the veto override passed in 2018 to preserve tax cuts demonstrates a devotion to meaningful tax reform in the General Assembly.[lii]

North Carolina decided to return much of the unforeseen tax conformity surplus back to taxpayers by increasing the standard deduction from $17,500 to $20,000 for joint filers and $8,750 to $10,000 for single filers.[liii] This increase brings North Carolina's standard deduction close to the federal amount of $24,000 and $12,000 for joint and single filers, respectively.[liv]

Rhode Island

2018 Rich States, Poor States Economic Outlook Rank: 39

Continuing a strong trend of appearances in *State Tax Cut Roundup*, Rhode Island marks its fourth appearance in this publication's six editions. As a part of federal tax conformity, Rhode Island passed legislation to preserve and expand the state personal exemption. If Rhode Island conformed in full to the Tax Cuts and Jobs Act of 2017 without any additional tax legislation, Ocean State taxpayers would no longer be able to exempt $3,900 from their income for the purposes of paying state taxes. Following passage of HB 7200, taxpayers can now exempt $4,000 from their tax liability despite the repeal of the federal personal exemption.[lv]

While no fiscal note exists detailing how much preserving the personal exemption saves Rhode Island taxpayers in 2019, past personal exemption claims provide a predictive window. Given 2014 income data, Rhode Island taxpayers would save $118.2 million with a $3,900 personal exemption assuming a 3.75 percent tax rate - a rate much lower than Rhode Island's top marginal personal income tax rate of 5.99 percent.[lvi, lvii] Considering Rhode Island's top marginal personal income tax rate is higher than the assumed rate, the personal exemption is now $4,000, and Rhode Islanders' real wages are growing, it is likely that preserving the personal exemption saves taxpayers more than $118.2 million in 2019 and will likely save taxpayers even more in future years.[lviii]

South Carolina

2018 Rich States, Poor States Economic Outlook Rank: 33

After slipping several spots in the latest edition of ALEC's *Rich States, Poor States* annual economic competitiveness index, the Palmetto State took a step in the right direction with HB 5341, which aligns the state's tax code with federal tax changes made last year by Congress.[lix] Among other things, this legislation adds a state tax deduction for dependents with an additional deduction for each child under 6 years of age. It also increases the standard deduction to mirror federal law, and indexes individual state income tax brackets to inflation. According to the South Carolina Revenue and Fiscal Affairs Office, the majority of South Carolina taxpayers will see a decrease or no change in their state tax liability.[lx]

South Carolina has not qualified for *State Tax Cut Roundup* since the publication started tracking tax cuts by state in 2013. Considering that no-income-tax Tennessee and Florida and very-low-income-tax North Carolina have been national tax cut success stories, South Carolina will likely need to do much more to keep up with its neighbors to the north and south and continue attracting people, businesses, and capital. Last year, ALEC awarded Gov. Henry McMaster for giving one of the very best, pro-taxpayer State of the State addresses in the nation in terms of his economic policy proposals.[lxi] He called for $2.2 billion in individual income tax relief over the next five years and lamented the fact South Carolina has one of the highest marginal income tax rates in the Southeast. Should Gov. McMaster and the South Carolina Legislature follow through with these proposals, the state will continue its positive trajectory.

Vermont

2018 Rich States, Poor States Economic Outlook Rank: 49

The Vermont Legislature passed a budget this year conforming Vermont's tax code to federal changes arising from federal tax reform and made significant changes to the state's personal income tax. Without passing tax reform, many in the Green Mountain State were looking at higher tax burdens following state tax conformity. To counteract an increase in tax liability, the legislature preserved Vermont's personal exemption on the first $4,150 of income and created a standard deduction of $6,000 and $12,000 for single and married filers, respectively. The budget also reduced each of Vermont's six personal income tax brackets by 0.2 percentage points and collapsed the top two brackets into one rate of 8.75 percent. Vermont's income tax reforms are projected to save taxpayers $29.24 million in FY 2019 alone.[lxii]

The ALEC 2018 *Rich States, Poor States* report places Vermont 38th in economic performance and 49th in economic outlook. Vermont's dismal performance is indicated by a net outmigration of 13,338 people from 2007 to 2016 and an employment increase of only 1.58 percent over the same period. Part of the reason for Vermont's malaise is tax policy. Vermont has the second highest property tax burden in the country, the second most progressive income tax structure, and levies an estate tax.[lxiii] Every bad tax policy practiced by Vermont is a disincentive for high earners to move to the state and bring economic opportunity with them. Given the hostility to job creators present in Vermont's tax code, the state will likely continue its economic decline. The income tax reforms made in the budget are a great first step towards changing Vermont's trajectory.

Washington

2018 Rich States, Poor States Economic Outlook Rank: 37

In March, Gov. Jay Inslee signed SB 6614 lowering property tax rates from $2.70 to $2.40 per $1,000 of assessed value, effective only for the year 2019. SB 6614 is projected to save Washingtonians over $206 million in property tax burden next year.[lxiv]

Lowering property taxes during the 2018 legislative session comes after the Washington Legislature voted to increase property taxes by $0.80 per $1,000 of assessed value in 2017. This increase was a legislative fix to satisfy requirements made by the Washington Supreme Court that the legislature increase education funding. SB 6614 rolls back 40 percent of the 2017 tax increase.[lxv]

No-income-tax Washington currently has one of the strongest economies in the country. ALEC's *Rich States, Poor States* annual report finds that the state's GDP grew by more than 50 percent between 2006 and 2016. High employment growth and a booming economy incentivized 313,700 people to move to Washington since 2007.[lxvi] One major result of Washington's booming economy is the astronomical rise in housing prices. According to the U.S. Department of Housing and Urban Development (HUD), the median house price in Washington is $350,000, the fifth-highest of any state.

Washington also has the third-highest homelessness rate in the nation at 29 homeless persons per 100,000 residents. In fact, HUD has highlighted a direct relationship between housing prices and homelessness.[lxvii] Property taxes, in effect, increase the price of housing by making it more expensive to own and by forcing landlords to increase rent to cover high taxes. High property taxes in Washington exacerbate sky-high housing prices and contribute to the homelessness problem. SB 6614 is an important first step towards decreasing the property tax burden, though it remains to be seen whether the legislature will make the property tax cut permanent.

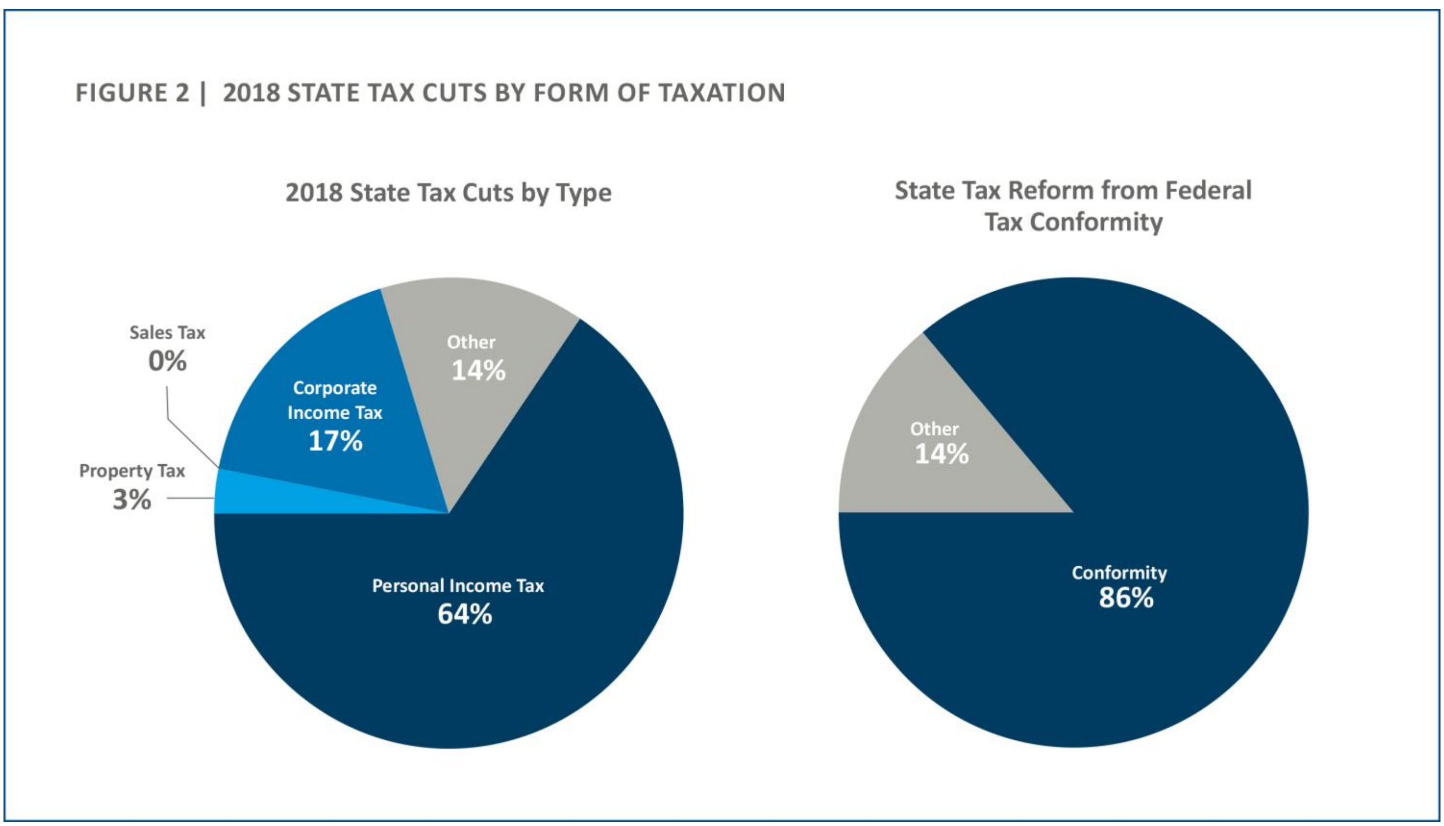
West Virginia

2018 Rich States, Poor States Economic Outlook Rank: 30

West Virginia marks its first appearance in *State Tax Cut Roundup* by preserving the personal exemption as a part of federal tax conformity.[lxviii] If West Virginia lawmakers would have simply conformed to the changes in the federal tax code, Mountain State taxpayers would no longer be able to exempt a portion of their income from state taxes. Thanks to the state legislature, taxpayers can still exempt $2,000 from their income for state tax purposes.[lxix] Had the state legislature decided to fully conform to federal tax changes without any effective tax rate reductions, it is likely

West Virginia taxpayers would owe the state millions in additional taxes. Conforming to the federal tax code and preserving the personal exemption simplifies tax compliance for West Virginians and saves taxpayers from a massive tax increase.

Tax Cuts by Type



Of the 16 states that qualified this year, 14 chose to reduce or reform their personal and corporate income taxes – that is cheerful news for taxpayers. A large volume of academic literature – 23 out of 26 peer-reviewed studies since 1986 – demonstrates that all taxes harm economic growth. Of the studies that differentiate between various forms of taxation, personal and corporate income taxes are the most harmful to long-term economic growth.[lxx] In fact, Organization for Economic Cooperation and Development (OECD) scholars found a 1 percent decrease in income tax burden lead to an expected 0.25 to 1 percent increase in GDP per capita between 1971 and 2004.[lxxi] By reducing reliance on income taxes, these 15 states have helped secure long-term economic prosperity for their state. Washington decided to reform

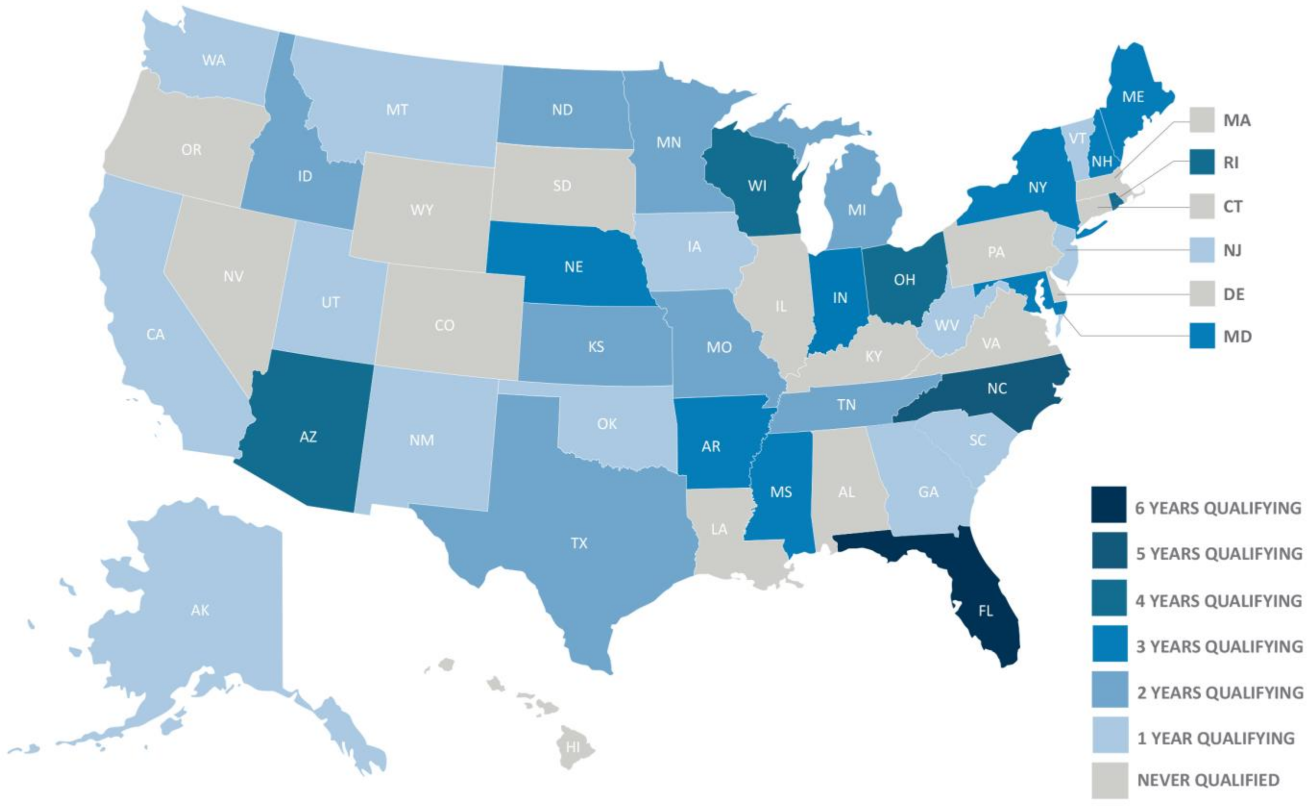
property taxes and saved taxpayers over $206 million in 2019 alone. North Carolina deserves special recognition for previously legislated tax cuts that will take effect starting January 1, 2019. Despite political forces pushing North Carolina to abandon scheduled tax cuts, the legislature overrode Gov. Cooper's veto and successfully preserved hard-fought tax reform.

The figure above details tax cuts by the type of tax reduced in the 2018 legislative sessions. Note the total exceeds the number of qualifying states – 16 – due to the fact several of those states reduced more than one specific tax.

The figure below details the frequency of appearances in *State Tax Cut Roundup* by state since 2013. Recording how many times a state cut taxes since 2013 gives information on which states keep tax reform on their legislative agendas over many years versus which state tax reforms are only temporary policy whims. Including tax reforms made during 2018 legislative sessions, Florida is the state most devoted to commonsense tax policy geared towards generating long-term growth. North Carolina is not far behind with five State Tax Cut Roundup appearances compared to Florida's six consecutive appearances. Arizona, Ohio, Rhode Island, and Wisconsin are tied for third-most appearances in State Tax Cut Roundup with four appearances each.

States Qualifying for *State Tax Cut Roundup* During the 2013-2018 Legislative Sessions

FIGURE 3 | STATES THAT MADE TAX CUTS DURING THE 2013 – 2018 LEGISLATIVE SESSIONS



Implications of State Taxes for Economic Growth

State governments have core tasks that demand funding, and the manner in which legislatures fund these core functions of government can carry serious implications for economic competitiveness. Legislators are presented with a plethora of tax policy tools that carry an equally expansive catalog of consequences. When considering how to fund government services, it is important for fiscal analysis to go beyond simply how much money a certain tax will raise. Predictability of revenue and anticipating behavioral change in response to a tax increase are equally important questions. Tax cuts have similarly crucial considerations–how much revenue will be lost, how will the budget be balanced, and how much will the economy grow? Cutting the most pernicious, burdensome, and extractive taxes will have a much different effect on the budget and the economy than cutting less distortionary taxes. Every tax raises revenue in a different manner with diverging consequences for economic health. Organization for Economic Co-Operation and Development (OECD) scholars found taxes on income and capital are far more distortionary and harmful to economic growth than consumption taxes such as sales and property taxes.[lxxii, lxxiii] Comparing economic growth between the states, it is no surprise those states relying primarily on income taxes substantially underperform their lower or no-income-tax counterparts.

Looking at the table below, the nine states with the highest top income tax rates see GDP growth, personal income growth, employment growth, and population growth well below the national average. The nine states without an income tax saw 97 percent higher population growth, 31 percent higher employment growth, and 9 percent higher personal income growth than the states with the highest income tax rates. The outstanding economic performance of states that avoid income taxes compared to states with the highest income taxes indicates how taxing earning, production, and investment discourages economic growth.

Basic economics dictates that income taxes discourage work, savings and investment by taxing the next dollar earned. A second order effect of income taxation is how high-income-tax states encourage taxpayers to leave for states with lower income tax burdens. States without an income tax grew by more than twice the rate states with the highest top income tax rates grew. ALEC's annual *Rich States, Poor States* report details how adjusted gross income (AGI) flows between states.[lxxiv] The impact of taxation on decisions to relocate is even more pronounced when observing how capital flows from states with the highest personal income tax rates to states with low- or no-income taxes.

TABLE 1 | NINE ZERO INCOME TAX STATES VS. NINE HIGHEST EARNED INCOME TAX (PIT) RATE STATES

	As of 1/1/2018	10-Year Growth				
		2007-2017				2005-2015
State	Top Marginal Earned PIT Rate†	Population	Employment	Personal Income	Gross State Product	State & Local Tax Revenue‡
Avg. of 9 Zero Earned Income Tax Rate States*	0%	11%	7%	39%	30%	36%
50-State Avg.*	6%	7%	5%	36%	32%	43%
Avg. of 9 Highest Earned Income Tax Rate States*	10%	6%	5%	36%	34%	48%

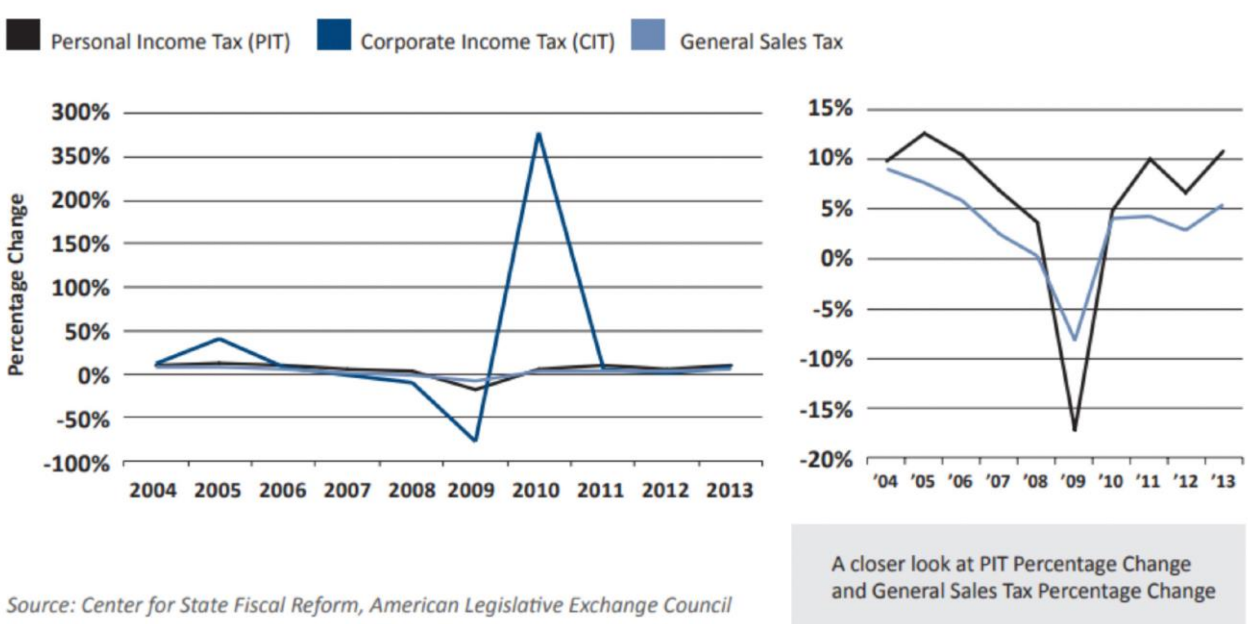
Source: Laffer Associates

The effects of corporate income taxes on state revenue streams are similar to the effects of personal income taxes but are even more counterintuitive. Corporate income taxes are notorious for encouraging tax avoidance and they raise negligible amounts of revenue compared to other sources of revenue. Strategies such a relocating business headquarters and transferring assets to lower tax states make taxing capital a risky endeavor for states. Among other factors, tax avoidance has always made the corporate income tax a relatively unreliable source of revenue. State corporate income tax revenue equaled merely 0.5 percent of nationwide gross state product (GSP) in 1986, falling even lower to 0.33 percent of state GSP in 2013.[lxxv] The Tax Foundation notes that corporate income taxes comprised only 3.7 percent of state revenue in 2014.[lxxvi] Low tax revenue collections and successful tax avoidance on the part of corporations indicates that firms can easily change behavior which leads to little benefit for state treasuries. Businesses changing behavior depending on state tax rates also indicate that states compete around business tax policy. By cutting or eliminating the corporate income tax, states can vastly increase the competitiveness of their tax code relative to other states at little cost to state revenues. In fact, eliminating the corporate income tax provides a second tax reform opportunity to ditch the practice of picking winners and losers through corporate income tax preferences and instead focus on making tax codes fairer and simpler, further increasing the competitiveness of state economies.

Reliance on personal and corporate income tax revenue can spell disaster for state budgets. Corporate income taxes are the most difficult tax revenue source to forecast followed by personal income tax revenue, as detailed by Figure 4 on the next page.[lxxvii] Pew Charitable Trusts found that state revenue forecasts are increasingly inaccurate as errors are driven by increased revenue volatility from corporate income, capital gains, and non-withheld personal income.[lxxviii] Increasingly inaccurate revenue forecasts imply that states are more likely to experience a revenue shortfall, triggering mid-fiscal year budget adjustments that are costly in terms of dollars and man-hours. States can avoid the lurking problem of revenue shortfalls by decreasing reliance on volatile sources of revenue and switching to more reliable revenue streams, such as retail sales taxes.[lxxix]

This past year, states overwhelmingly prioritized cutting taxes that harm state economies the most. Nearly 80 percent of tax cuts in 2018 went after either personal or corporate income taxes. Not only will these tax cuts help state economies by boosting economic prosperity, but they make states more competitive relative to each other.

FIGURE 4 | STATE TAX AND REVENUE VOLATILITY



Source: Center for State Fiscal Reform, American Legislative Exchange Council

Conclusion

The federal Tax Cuts and Jobs Act of 2017 has provided a once-in-a-generation opportunity for state policymakers. With unbudgeted and ongoing revenue increases, due to the linkage of state and federal tax bases, lawmakers cut taxes with little or no impact on previous revenue projections. In 2018, of the 16 states that qualified for this report, 14 states jumped at the opportunity while two others cut taxes despite not having a personal income tax. In all, by cutting personal and corporate income taxes, states cut more than $1.7 billion in measurable 2019 tax burden for their residents. The 2019 legislative sessions provide states another chance to be responsible with taxpayers' hard-earned dollars and we expect many additional states will be added for next year's edition of this publication.

Appendix: ALEC Principles of Taxation

The proper function of taxation is to raise money for core functions of government, not to direct the behavior of citizens ¬or close budget gaps created by overspending. This is true regardless of whether government is big or small and this is true for lawmakers at all levels of government. Taxation will always impose some level of burden on an economy's performance, but that harm can be minimized if policymakers resist the temptation to use the tax code for social engineering, class warfare and other extraneous purposes. A principled tax system is an ideal way to advance a state's economic interests and promote prosperity for its residents. The fundamental principles presented here provide guidance for a neutral and effective tax system; one that raises needed revenue for core functions of government, while minimizing the burden on citizens.

Simplicity:

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

Transparency:

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

Economic Neutrality:

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

Equity and Fairness:

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

Complimentary:

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

Reliability:

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

Pro-Growth:

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

The ALEC Principles of Taxation have been adopted by the ALEC Task Force on Tax and Fiscal Policy.

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