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Help from Our Friends: What States Can Learn from Tax Reform Experiences across the Country

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Key Findings

- State tax reform is a difficult process, but states like Utah, Indiana, and North Carolina, and the District of Columbia, illustrate that reform can be successful when it happens in a diligent and thoughtful way. Other states can learn much from these experiences.
- All four of these jurisdictions lowered tax rates, broadened tax bases, and simplified their tax structures, improving their competitiveness.
- Tax reform does not need to be a one-year effort. Indiana, for instance, instituted its reforms over a five-year time frame.
- The use of tax triggers helped North Carolina and the District of Columbia ensure that they had sufficient revenues to pay for government services.
- Kansas, however, illustrates an unsuccessful example of tax reform. Dramatically cutting a state's revenue source, without offsetting spending or tax changes, puts the state's fiscal health in jeopardy. These problems were exacerbated by Kansas's special pass-through exemption, which narrowed the state's tax base.

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Introduction

Reforming and modernizing a state tax code is a herculean task, but states considering reform are not alone. They can learn from the lessons of other states. A number of states have developed and passed tax reforms in the last several years. This paper looks in depth at five recent state/jurisdiction tax reform efforts in: Utah, Indiana, North Carolina, the District of Columbia, and Kansas. The first four are generally considered to be successful examples of tax reform. While each approached the important questions differently, these four all broadened tax bases, lowered tax rates, and simplified their tax structures. North Carolina and Utah completed theirs in one large tax package, with smaller modifications later. Indiana completed a series of smaller reforms over a number of years, while the District of Columbia used a series of tax triggers to accomplish their goals.

Kansas is the unique state in this grouping, and instead, illustrates an unsuccessful example of state tax reform. Base broadening is an essential part of tax reform. Kansas's exempted a large part of income from its tax base, leading to tax avoidance.

Utah's Reforms Before (And During) The Great Recession

In 2006 and 2007, Utah enacted a major reform of its tax code, first in a special legislative session in late 2006 and then in the 2007 general session a few months later. The major achievement of this tax reform was the creation of a flat-rate tax system for the individual income tax, which was passed in a 2006 special session. In the general session in 2007, Utah enacted several more tax changes, including a small decrease in the overall state sales tax rate, and a larger decrease in the sales tax on groceries.

Unlike North Carolina (discussed later in this paper), Utah began its tax reform efforts from a position of strength in its tax system. It already ranked well (18th) in the 2006 edition of the Tax Foundation's *State Business Tax Climate Index*.[1] Today, in the 2018 edition of the *Index*, Utah has moved up even further, with the eighth best overall score and the 11th best score for the individual income tax. And that eighth best overall score is actually the highest score among states that have all three major tax types.[2] Utah started from a strong position, but its 2006-2007 reforms moved the state up to have one of the best business tax climates in the country.

Prior to the 2006-2007 reforms, Utah had a progressive income tax with six brackets. The brackets ranged from 2.3 percent up to 7 percent, and this specific set of brackets had been in place since 1997, though Utah had a multi-bracket income tax since its enactment in 1931.[3] The top rate of 7 percent applied to married couples with taxable income above $8,627 per year (or $4,314 for single filers). The standard deduction and personal exemption are both tied to the federal standard deduction and personal exemption in Utah, and reforms converted these deductions into credits.

1 Jonathan Williams, "Utah's New Flat Tax," Tax Foundation, September 22, 2006, https://taxfoundation.org/utahs-new-flat-tax/.

2 Jared Walczak, Scott Drenkard, and Joseph Bishop-Henchman, "2018 State Business Tax Climate Index," Tax Foundation, October 17, 2017, https://taxfoundation.org/state-business-tax-climate-index-2018/.

3 Utah State Tax Commission, Economic & Statistical Unit, "History of the Utah Tax Structure," November 2016, 160, http://tax.utah.gov/esu/history/history.pdf.

The big change was to move Utah from a six-bracket, progressive tax system to a flat-rate income tax of 5 percent. The initial reform passed in the 2006 special session created a dual-track system, where filers could either continue filing under the old progressive system, or the new flat rate. The flat rate was initially set at 5.35 percent, though this rate and the dual-track system only existed for tax year 2007. In 2007, the legislature lowered the rate to 5 percent and eliminated the six-bracket system, leaving only the flat rate system for all taxpayers.

Prior to the reform, a married couple would not be paying a 5 percent marginal rate until they were above $5,177 in taxable income (the rate was 5.2 percent), so some taxpayers would have seen a net tax increase under this reform. To partially offset this tax increase, Utah made two changes to the sales tax rates, as well as one change to income tax credits. For the sales tax, first the general sales tax rate was lowered slightly from 4.75 percent to 4.65 percent. The tax rate on food was also lowered to 1.75 percent in two steps.[4]

In the income tax, Utah added new income tax credits to help make whole those taxpayers who would see their rates increase under a flat-rate income tax. Instead of taking the standard deduction and personal exemption to arrive at taxable income, the new tax system applied these as credits (equal to 6 percent of the total) after the tax is calculated.[5] The credits are nonrefundable, and start to phase out above $24,000 for married-filing-joint returns (this is adjusted for inflation, so it is almost $28,000 today).[6] Thus, high-income taxpayers will pay exactly 5 percent of their income in taxes, whereas low-income taxpayers will pay less than 5 percent (zero at some income levels), retaining some progressivity even within a flat-rate system.

These changes to the tax code did result in a net cut to state revenue. The individual income tax changes resulted in a roughly $190 million revenue reduction, and the sales tax changes reduced state revenues by about $160 million (most of that coming from the sales tax reduction on groceries).[7]

Utah also had the unusual experience of its tax changes going into effect right as the Great Recession hit state budgets. But because Utah carried out its reforms in a prudent manner, they did not suffer additional adverse effects from the recession (other than the effects all states felt). By lowering rates, broadening the base, and making sure the overall package was roughly revenue-neutral, Utah demonstrated that good tax reform can work even in a rough business cycle.

4 Utah Legislature, Office of Legislative Research and General Counsel, "Tax Relief & Reform: What Does It Mean for Taxpayers?" briefing paper, March 2007.

5 Taxpayers can also use federal itemized deductions as their credit (less any state income tax included in itemized deductions). The personal exemption credit is set at 75 percent of the federal level.

6 Utah Legislature "Tax Relief & Reform: What Does It Mean for Taxpayers?".

7 Ibid.

Indiana's Consistent Path to Reform

Unlike Utah and North Carolina, which tackled the majority of their reforms in one legislative session, Indiana approached reform in smaller pieces. The state passed small reforms in multiple sessions, which, in combination, represent a far-reaching reform of the Hoosier State's tax code. By lowering individual and corporate tax rates, reforming the state's tangible personal property tax, and repealing its inheritance tax, the Hoosier State now ranks ninth in the *State Business Tax Climate Index*,[8] the second-highest rank of a state with every major tax type (following only Utah).[9]

Indiana's first step towards tax reform began in 2011. In that year, the state launched a bold strategy, lowering the state's corporate income tax rate from 8.5 percent to 6.5 percent by 2015. The rate would fall by 0.5 percent each fiscal year, slowly lowering the tax burden for Hoosier businesses.[10]

TABLE 1.

Indiana's Original Corporate Income Tax Phasedown

Fiscal Year	Rate
2012	8.0%
2013	7.5%
2014	7.0%
2015	6.5%

Note: Indiana's corporate income tax reductions were made on July 1 of each year.

The corporate rate reduction was financed in part by eliminating a tax credit for municipal bonds from other states. Indiana was unique in that it allowed credits for non-Indiana bonds. The state also eliminated net operating loss carrybacks after the 2011 tax year.

In 2013, the first year of then-Governor Mike Pence's (R) term, the state continued its tax reform. This tax package made several key reforms. First, it set the individual income tax on a set phasedown, to match the state's corporate income tax. When fully phased in, Indiana would have the second lowest individual income tax, behind only Pennsylvania, of any state that taxes individual income in the country.[11] The 2013 tax package also accelerated the elimination of the state's inheritance tax. The tax, originally slated for elimination in 2022, was repealed immediately.[12] Finally, the plan retained the corporate income tax phasedown created in 2011.

8 Walczak, Drenkard, and Bishop-Henchman, "2018 State Business Tax Climate Index."

9 States ranking above Indiana, except for Utah, are missing one or more of the major taxes. For instance, Wyoming, ranked first, does not have an individual or corporate income tax, due to the state's heavy reliance on severance taxes.

10 Joseph Bishop-Henchman, "Indiana Approves Tax Changes, Including Corporate Tax Rate Reduction," Tax Foundation, May 2, 2011, https://taxfoundation.org/indiana-approves-tax-changes-including-corporate-tax-rate-reduction.

11 In the interim, North Dakota cut its individual income tax rate. In 2017, Indiana had the third lowest individual income tax rate of states that tax individual income.

12 Joseph Bishop-Henchman, "Indiana Approves Income Tax Reductions," Tax Foundation, May 14, 2013, https://taxfoundation.org/indiana-approves-income-tax-reduction.

TABLE 2,

Indiana's Individual Income Tax Phasedown

Year	Rate
2013	3.40%
2014	3.40%
2015	3.30%
2016	3.30%
2017	3.23%

Indiana continued its trend of tax reform in 2014, with further reductions in the state's corporate income tax. By 2022, the state's corporate income tax rate will be 4.9 percent, an impressive reduction from the state's 8.5 percent rate in 2011.

TABLE 3.

Indiana's Further Corporate Income Tax Phasedown

Fiscal Year	Rate
2012	8.50%
2013	8.00%
2014	7.50%
2015	7.00%
2016	6.50%
2017	6.25%
2018	6.00%
2019	5.75%
2020	5.50%
2021	5.25%
2022	4.90%

Note: Indiana's corporate income tax reductions were made on July 1 of each year.

The state also made noteworthy changes to its local tangible personal property taxes in 2014.[13] Tangible personal property taxes are local property taxes on inventory, machinery, and other capital investments of businesses. Indiana recognized the need to reduce and eliminate these taxes, but was concerned how to proceed given the local governments' reliance on the tax revenue. The state came up with a creative solution: local governments were granted significant authority to reduce these taxes. Local governments could first decide to exempt the small amounts, less than $20,000, in tangible personal property value. Locals were also permitted to exempt new property purchases.[14]

13 Scott Drenkard, "Indiana's 2014 Tax Package Continues State's Pattern of Year-Over-Year Improvements," Tax Foundation FF no. 425, April 7, 2014, https://taxfoundation.org/indiana-s-2014-tax-package-continues-state-s-pattern-year-over-year-improvements.

14 Scott Drenkard, "Indiana's 2014 Tax Package Continues State's Pattern of Year-Over-Year Improvements," Tax Foundation, April 7, 2014, https://taxfoundation.org/indiana-s-2014-tax-package-continues-state-s-pattern-year-over-year-improvements.

Never content on tax issues, the Hoosier state pushed forward again in 2015,[15] eliminating its throwback rule for corporate income taxes. Throwback rules are complicated provisions that require businesses to add untaxed income, known as "nowhere income," from other states into another state's tax base. Multiple states try to claim this untaxed income, requiring firms to engage in a tangled web of calculations to determine their taxable income. Eliminating this rule further simplified the state's corporate income tax.

The state also furthered its tangible personal property reforms from 2014. While 2014's reform allowed localities the option to exempt up to $20,000 in tangible personal property, in 2015, the state automatically exempted the amount statewide.[16]

The state also created a taxpayer rebate program in 2011. If the state's rainy-day fund exceeded 10 percent (later revised to 12.5 percent) of the state's budget spending, the excess would be automatically refunded. Half the money would help to lower the unfunded liability within the teacher's pension program, while the other half would be refunded to Hoosier residents via an income tax credit. Hoosiers saw a $111 tax refund in 2012, when the state had a $2.5 billion surplus.[17] The state continued to run surpluses, but future legislatures dedicated more of the surplus to education.[18]

At the same time that all these reforms took place, the state also launched a nation-leading tax incentive review process.[19] All tax incentives must be reviewed on a five-year basis by the state's Legislative Services Agency (LSA). And even more important, when cost-benefit analysis of the incentives proved the provisions were ineffective, the state has seen fit to repeal them.[20] In 2015, LSA's research showed a program providing a tax deduction for solar-powered roof vents was not fruitful. According to the report, "The link between the solar-powered roof vent/fan deduction and taxpayers' expenditures…is questionable and appears to be very weak, if at all present."[21] Eliminating these incentives allowed the state to finance other tax reforms.

Finally, in 2017, Indiana raised its gasoline tax as part of a package to create a long-term transportation funding plan. The 10 cents-per gallon increase is expected to generate $1.2 billion annually and help fund a number of construction projects around the state.[22] Approximately $850 million would finance state construction projects, with $350 million going to local infrastructure projects. This followed a transportation study committee identifying $1 billion a year in funding projects.[23] While raising a gas tax is often unpopular, aligning user fees, like a gas tax, with the associated spending projects, like road construction, is a sound financing approach for states. Recent

15 Ben Bristor and Scott Drenkard, "Indiana Tackles Throwback Rule and Personal Property Tax," Tax Foundation, June 30, 2015, https://taxfoundation.org/indiana-tackles-throwback-rule-and-personal-property-tax/.

16 Ibid.

17 Kevin Rader, "Indiana Announces Taxpayer Refunds," WTHR-TV, November 21, 2012, https://www.wthr.com/article/indiana-announces-taxpayer-refunds.

18 Tony Cook, "Automatic tax refund from the state? Don't expect one," *The Indianapolis Star*, July 3, 2015, https://www.indystar.com/story/news/politics/2015/07/03/automatic-tax-refund-state-expect-one/29675755/.

19 The Pew Charitable Trusts, "Indiana: Tax incentive evaluation ratings," May 3, 2017, http://www.pewtrusts.org/en/research-and-analysis/fact-sheets/2017/05/state-tax-incentive-evaluation-ratings-indiana.

20 Indiana General Assembly, "House Enrolled Act No. 1142," 2015, https://iga.in.gov/legislative/2015/bills/house/1142#document-2e46b813.

21 Indiana Generaly Assembly, Indiana Legislative Services Agency, "Indiana Tax Incentive Review," November 2014, 17, https://iga.in.gov/legislative/2014/publications/tax_incentive_review/#document-0b08377d.

22 Kasey Chronis, "Gas tax hike of 10 cents per gallon takes effect in Indiana," WNDU-TV, http://www.wndu.com/content/news/New-laws-budget-items-take-effect-in-Indiana-and-Michigan-on-Saturday-431727563.html.

23 Joseph Bishop-Henchman, "Indiana Gas Tax Proposal: Existing User Taxes & Fees Cover Less than Half of Road Costs," Tax Foundation, January 11, 2017, https://taxfoundation.org/indiana-gas-tax-proposal-existing-user-taxes-fees-cover-less-half-road-costs/.

polling further suggests that ensuring dedication of gas taxes in Indiana to road maintenance and construction has increased the popularity of what may appear on its face to be an unpopular tax hike.[24]

Indiana has launched an aggressive campaign in the last six years to overhaul and reform its state's code. Almost every year, since 2011, the state has passed tax reforms to improve the competitiveness of the state, including lowering its individual and corporate income tax rates, reforming tangible personal property taxes, and reforming corporate tax base rules. Indiana's actions represent a responsible step forward, particularly for states concerned about enacting too many changes at one time.

North Carolina's 2013 Tax Reforms

North Carolina's tax code had long been uncompetitive before their recent tax reform. The state's tax code was among the bottom 10 of states on the Tax Foundation's *State Business Tax Climate Index*, ranking 46th in 2011, 45th in 2012, and 44th in 2013, the final score before their first comprehensive tax reform.[25]

The list of issues with the state's tax code was long. The state had the highest individual income tax rate in the Southeast at 7.75 percent, with a progressive rate structure with low rate kick-ins. Income above $12,750 was taxed at 7 percent.

Business taxes were also high in North Carolina. The corporate income tax in the Tar Heel State was the highest in the Southeast at 6.9 percent, and the state was plagued by a narrow corporate tax base. From 2003 to 2009, North Carolina provided more than $6.7 billion in economic development incentives, such as tax credits, abatements, and special incentive packages, but the success of these packages was lackluster.[26] North Carolina was one of only 20 states with a franchise tax,[27] a tax on business assets, with the high rate of 0.15 percent of assets.

In 2013, the state undertook comprehensive tax reform, seeking to improve the state's tax climate. The North Carolina legislature passed a dramatic, comprehensive overhaul of the state's tax code. The plan broadened, flattened, and lowered the individual income tax, lowered a number of business taxes, and expanded the sales tax base, among other changes.

The first major change was a modification to the state's individual income tax. The state consolidated its three income tax brackets, with a top rate of 7.75 percent, into a flat income tax with a top rate of 5.8 percent. It also included a further phasedown of rates to reach 5.75 percent in 2015.

24 Brian Slodysko, "Poll: Majority approve of Indiana's 10-cent fuel tax increase," Associated Press in *South Bend* (Indiana) *Tribune*, October 23, 2017, https://www.southbendtribune.com/news/local/poll-majority-approve-of-indiana-s--cent-fuel-tax/article_1f59837f-523d-5213-8fd2-6c9079470d36.html.

25 *North Carolina Illustrated: A Visual Guide to Tax Reform*, Tax Foundation, November 2015, https://taxfoundation.org/north-carolina-illustrated/.

26 Joseph Bishop-Henchman and Scott Drenkard, *North Carolina Tax Reform Options: A Guide to Fair, Simple, Pro-Growth Reform*, Tax Foundation, January 23, 2013, https://taxfoundation.org/north-carolina-tax-reform-options-guide-fair-simple-pro-growth-reform.

27 Several states have repealed their franchise tax since North Carolina began reform. Currently, 17 states have a franchise tax.

TABLE 4.

North Carolina Individual Income Tax Rates, Before and After Reform

2013		2014		2015		2016	
6%	$0-$12,750	5.80%	$0	5.75%	$0	5.75%	$0
7%	$12,750-$60,000						
7.75%	$60,000+						

To mitigate concerns about regressivity in this change, the state coupled its rate changes to changes with its tax base. The state increased its standard deduction from $6,000 for married filers to $15,000, while repealing its personal exemption of $2,000.[28] Combined, North Carolinians would see the first $15,000 of their income being exempt from taxation, compared to $8,000 prior to reform. The state also increased the amount of its child tax credit for lower-income households. The credit increased from $100 to $125, but the increase was limited to married filers below $40,000 in income.[29]

At the same time, the state limited a number of its individual tax expenditures to finance these tax changes. The total number of individual income tax expenditures fell from 40 to 17, and even for the retained expenditures, many were limited.[30] The total itemized deduction for mortgage interest and property taxes paid was capped at $20,000.[31] The adoption tax credit decreased from 50 percent of the federal credit to 30 percent of the federal credit.

North Carolina also lowered its corporate income tax as part of its tax reform package from 6.9 percent to 6 percent in 2014 and 5 percent in 2015. Additionally, the state created a unique tax trigger to further lower the corporate rate if the state's revenue hit specific targets. If revenues exceeded $20.2 billion in 2015, the corporate income tax rate would fall again to 4 percent in 2016, with another cut to 3 percent in 2017 if 2016 revenues exceeded $20.975 billion. In both cases, the state achieved the revenue target, lowering corporate income tax rates.[32]

TABLE 5.

North Carolina Corporate Income Tax Rates, Before and After Reform

2013		2014		2015		2016		2017	
6.90%	$0	6%	$0	5%	$0	4%	$0	3%	$0

28 Tax Foundation, "North Carolina Illustrated: A Visual Guide to Tax Reform," November 5, 2015, https://taxfoundation.org/north-carolina-illustrated/.

29 Ibid.

30 North Carolina Department of Revenue, "North Carolina Biennial Tax Expenditure Report - 2011," https://www.dor.state.nc.us/publications/nc_tax_expenditure_report_11.pdf, and North Carolina Department of Revenue, "North Carolina Biennial Tax Expenditure Report - 2013," https://www.dor.state.nc.us/publications/nc_tax_expenditure_report_13.pdf.

31 North Carolina State Law 2013-316 §1.1.(d).

32 Jared Walczak, "Designing Tax Triggers: Lessons from the States," Tax Foundation, September 7, 2016, https://taxfoundation.org/designing-tax-triggers-lessons-states/.

Similar to the individual income tax, the state eliminated several corporate tax expenditures. The state's generous film credit was allowed to expire, and was subsequently replaced with a grant program. Credits for low-income housing, historic rehabilitation, and recycling oyster shells, among others, were allowed to expire.[33]

Finally, the state made large changes to its sales tax structure as part of its tax reform package. North Carolina had two sales tax holidays. The first exempted clothing, school supplies, and computers, among other items, in early August each year for back-to-school purchases. The second, in November, exempted ENERGY STAR® home appliances, such as refrigerators, from the sales tax. The state eliminated both sales tax holidays as part of its tax reform package.

The state expanded its sales tax base to include several new purchases as well, though to a lesser degree than in several of the original proposals.[34] For instance, bread and other bakery items sold at a bakery were no longer exempt from the sales tax. North Carolina also began charging sales tax on admission charges to entertainment events, such as live performances, movies, festivals, and museums.[35] Finally, the state expanded its sales tax base to more fully tax manufactured and mobile homes.[36]

North Carolina's tax reform was groundbreaking, becoming the first state to pass comprehensive tax reform in one legislative session since Utah in the mid-2000s. By broadening their tax bases, the state was able to dramatically lower their individual and corporate income tax rates, lowering tax burdens for individuals. Compliance costs were also lowered with the larger standard deduction. And finally, North Carolina's strategic use of a tax trigger ensured that the state had sufficient revenues to meet its spending needs. North Carolina's 2013 tax reforms are an excellent example of what is possible for a state to accomplish with tax reform.

North Carolina's 2015 Tax Reforms

Following passage of its comprehensive tax reform package in 2013, North Carolina made further modifications and reforms during its 2015 legislative session. These changes advanced upon principles of its 2013 reform. The state made further cuts to its individual income tax, lowering the rate from 5.75 to 5.499 percent in 2017. North Carolina also slightly increased their standard deduction from $15,000 to $15,500 for married filers. Finally, the state kept its corporate income tax rate trigger in place, which allowed rates to decrease to 4 percent in 2016 and 3 percent in 2017.

The state also expanded its sales tax base to include service contracts, such as services for "repair, maintenance, and installation" services,[37] and used the additional revenues to ensure equity among its

33 North Carolina Department of Revenue, "North Carolina Biennial Tax Expenditure Report 2013," and North Carolina Department of Revenue, "North Carolina Biennial Tax Expenditure Report - 2015," https://www.dor.state.nc.us/publications/nc_tax_expenditure_report_15.pdf.

34 Liz Malm and Scott Drenkard, "North Carolina Considers Impressive Tax Reform Options," Tax Foundation, June 7, 2013, https://taxfoundation.org/north-carolina-considers-impressive-tax-reform-options/.

35 N.C.S.L. 2013-316, §5(b) and (c).

36 Tax Foundation, "North Carolina Illustrated: A Visual Guide to Tax Reform."

37 North Carolina State Law 2015-6§105-164.3(33d).

local governments for their spending priorities.[38]

North Carolina's 2017 Tax Reforms

In 2017, the state legislature continued to push forward with state tax reforms, even after the party in the governor's mansion flipped with the election of Democratic Governor Roy Cooper. The Republican-controlled legislature passed multiple tax reforms within its budget, and subsequently overrode the governor's veto of the changes.[39]

The state's individual income tax rate is scheduled to be reduced again in 2019, from 5.499 percent to 5.25 percent. At the same time, the state's standard deduction will increase from $17,500 to $20,000 for married filers.[40]

Businesses will also see additional tax cuts under the budget agreement. The corporate income tax will fall from 3 percent to 2.5 percent, also in 2019.[41] At the same time, the franchise tax will be lowered for S corporations. Instead of 0.15 percent on all assets, S corps will pay a flat $200 on their first $1 million in capital value. Assets in excess of $1 million will be subject to the 0.15 percent rate.[42]

TABLE 6.

Summary of North Carolina Tax Changes from 2013 to 2019

	2013 (Before Reform)	2019 (Fully Phased in)
Individual Income Tax Rate:	$0-$12,750: 6%	$0: 5.25%
	$12,750-$60,000: 7%	
	$60,000+: 7.75%	
Standard Deduction (Married Filers)	$6,000	$20,000
Corporate Income Tax Rate:	$0: 6.9%	$0: 2.5%

38 Scott Drenkard, "North Carolina Budget Compromise Delivers Further Tax Reform," Tax Foundation, September 17, 2015, https://taxfoundation.org/north-carolina-budget-compromise-delivers-further-tax-reform/.

39 Colin Campbell, "NC House overrides budget veto, making the spending plan law," *The* (Raleigh, N.C.) *News & Observer*, June 28, 2017, http://www.newsobserver.com/news/politics-government/state-politics/article158589669.html.

40 Nicole Kaeding, "North Carolina Continues its Successful Tax Reforms," Tax Foundation, October 27, 2017, https://taxfoundation.org/north-carolina-continues-tax-reforms/.

41 Ibid.

42 Ibid.

District of Columbia

In 2014, the District of Columbia passed a tax reform package that lowered individual income tax rates and business tax rates, increased the standard deduction and personal exemption amounts, and expanded the Earned Income Tax Credit for childless workers. Some of the changes took place right away, while many of the changes used a tax trigger, so they were not implemented until enough new tax revenue was available.[43] As of January 2018, all the changes that required tax triggers have been enacted.[44] In addition to the tax triggers, the tax changes were partially paid for by expanding the sales tax base to several personal services.

Many of the changes D.C. enacted came directly from the recommendations of a Tax Revision Commission, which held a series of meetings and public hearings over a 16-month period in 2012 and 2013.[45] Some of the Commission's recommendations addressed ways that D.C. could be more competitive with neighboring Virginia and Maryland. For example, the District's business franchise tax rate (a form of a corporate income tax) was 9.975 percent prior to the reforms, while Maryland's was 8.25 percent and Virginia's was even lower at 6 percent. The Commission recommended lowering the rate to match Maryland, and the reform package put this change in place; much of the reduction was done in steps triggered by tax revenue surpluses.

The individual income tax was changed in two major ways. First the "zero bracket," the amount of income you can earn without owing any tax, was greatly expanded. This was done by increasing both the standard deduction and personal exemptions to match the amounts in the federal tax code. For example, a married couple with two children now had $27,800 of untaxed income, whereas before it was only $10,800.[46] Second, a new 6.5 percent tax bracket was added, lowering the rate for households between $40,000 and $60,000 of income (it had been 8.5 percent, which still applied to those over $60,000). As with the changes to the business tax, these two changes to the individual income tax were done in steps through tax triggers.

While the tax reform package as a whole reduced revenue by about $67 million, there was one major change that increased revenue: the expansion of the sales tax base to certain personal services. The services included in the base expansion were recommended by the Tax Revision Commission as well. The list of services included: construction contractors and other construction-related services, storage of household goods and mini-storage, water for consumption at home, barber and beautician services, carpet and upholstery cleaning, health clubs and tanning studios, car washes, and bowling alleys and billiards parlors. As would be expected, businesses in these industries opposed the idea of being included in the sales tax base, and health clubs even tried to name this a "yoga tax." But despite the orchestrated fanfare, the sales tax base expansion was included in the final tax package.

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43 The District of Columbia used a unique tax trigger approach to manage its revenue availability during tax reform. They divided all their recommendations into 26 concrete steps. The first nine were implemented immediately, with the remaining 17 being added as revenues allowed. For a full list, see Joseph Bishop-Henchman, "D.C. to Enact Remaining Tax Cuts After Projection of Large Recurring Surplus," Tax Foundation, February 28, 2017, https://taxfoundation.org/dc-enact-tax-cuts-large-surplus.

44 Jared Walczak, "State Tax Changes That Took Effect on January 1, 2018," Tax Foundation, January 2, 2018, https://taxfoundation.org/state-tax-changes-took-effect-january-1-2018/.

45 D.C. Tax Revision Commission, "Final Report of the D.C. Tax Revision Commission," May 2014, http://www.dctaxrevisioncommission.org/final-report.

46 These figures will change under the new federal tax code, as changed by the Tax Cuts and Jobs Act. The District of Columbia conforms to the federal standard deduction and personal exemption.

The tax reform package in D.C. demonstrates a number of important tax reform principles in action. First, lowering rates by broadening the tax base can be done effectively, even when narrow interests object to being included in the base. Second, when structured correctly, tax triggers are a prudent means of implementing tax cuts, as we saw in North Carolina. Finally, tax cuts don't necessarily have to diminish the progressivity of the overall tax code, as evidenced by the expanded zero bracket and earned income tax credit.

Kansas's Missteps in Tax Reform

Unlike the states mentioned earlier in this paper, Kansas represents a case study in how not to approach state-level tax reform. Kansas passed large tax rate cuts, without accompanying base broadening, creating a large hole in the state's budget. At the same time, the state completely exempted one type of income from the income tax, leading to tax avoidance.

In 2012, Governor Sam Brownback (R) proposed an aggressive tax package. It would have lowered the state's individual income tax, with the top rate falling from 6.45 percent to 4.9 percent, while increasing the state's standard deduction.[47] A number of other deductions, such as mortgage interest, would be eliminated too. At the same time, nonwage income from pass-through businesses would be exempt. Overall, the plan would have been revenue-neutral.[48]

However, the package actually passed by the legislature differed significantly from the original plan proposed by Governor Brownback. After several months of debate among the governor, House, and Senate, the House grew frustrated and sent the unresolved plan to the governor's desk.[49] Many of the identified pay-fors in the governor's plan were removed from the final package, representing a large net tax cut for the state. The governor decided to go ahead and sign the plan, and promised to sign a compromise bill to supplant it when the House and Senate ironed out the details. But negotiations balked, and the state was left with a tax cut with estimated annual costs of $803 million by 2014.[50]

The plan was also problematic for its complete exemption of nonwage income for pass-through businesses. Pass-through businesses, such as sole proprietorships and LLCs, are taxed through the individual income tax rather than the corporate tax. Owners of these businesses pay themselves a wage, but any additional income is taxed on Schedule C of their income tax return. Kansas's tax plan dictated that all nonwage income would be exempt from taxation, creating an incentive for tax avoidance.[51]

47 Joseph Bishop-Henchman, "Kansas Governor Proposes Significant Income Tax Reform, Reducing Rate from 6.45% to 4.9%," Tax Foundation, January 19, 2012, https://taxfoundation.org/kansas-governor-proposes-significant-income-tax-reform-reducing-rate-645-49/.

48 Ibid.

49 Mark Robyn, "Not in Kansas Anymore: Income Taxes on Pass-Through Businesses Eliminated," Tax Foundation, May 29, 2012, https://taxfoundation.org/not-kansas-anymore-income-taxes-pass-through-businesses-eliminated/.

50 Mark Robyn, "Legislators Maneuver in Kansas' Income Tax Reform Debate," Tax Foundation, May 11, 2012, https://taxfoundation.org/legislators-maneuver-kansas-income-tax-reform-debate/.

51 Mark Robyn, "Not in Kansas Anymore: Income Taxes on Pass-Through Businesses Eliminated."

Reports of abuse of this provision quickly circulated within the state. Bill Self, head coach of the Kansas University men's basketball team, had the majority of his income paid to an LLC in the state to help avoid Kansas income taxes.[52] A study by several academic economists highlighted the tax avoidance caused by the provision. First, filers with pass-through income increased the amount of their nonwage income, to take advantage of the tax change. Second, they found "no evidence of increases in investment." According to the authors, their research found "income shifting rather than real economic activity."[53] State estimates put the total loss of revenue from this provision at $200 million to $300 million a year.[54]

In 2013, Kansas considered ways to again pass the base broadeners needed to finance its 2012 tax cuts. Again, "legislators stripped out the base broadening and kept the tax cuts," arguing that "starving the beast" was the preferred approach.[55] Many in the legislature refused to confront the issues they created the year before. Large tax cuts without revenue or spending offsets create large budget holes, impacting the provision of government services. The final package passed in 2013 did end up raising revenues, but it was still a large net tax cut. After all the changes, the state still passed an almost $500 million tax cut for 2014, with the amounts increased further in later years. (By 2018, the cut was expected to be over $900 million in annual revenue.[56] For comparison, Kansas's general revenue budget was $6 billion.)

At the same time, the state continued to miss a number of its revenue projections, partly due to weak agricultural prices and partly due to the pass-through exemption. These missed projections added to the budget crunch, as the state continued to struggle for revenue to pay for spending programs.[57]

As a result, the state faced a large budget crunch. Kansas had to drain its rainy-day fund, and issue furloughs for state employees, among other efforts.[58] Finally, in 2015, the state began a series of tax increases to finance the previous cuts. The sales tax rate was increased, and a number of deductions were eliminated, among other changes.[59] Kansas passed another round of tax increases, including repeal of the state's pass-through exemption, in 2017, over Governor Brownback's veto, to help close the budget gap.[60]

52 Dan Margolies and Sam Zeff, "Thanks to Tax Cuts, Bill Self, Highest Paid State Employee, Owes Little in Kansas Income Taxes," KCUR-FM, May 16, 2016, http://kcur.org/post/thanks-tax-cuts-bill-self-highest-paid-state-employee-owes-little-kansas-income-taxes#stream/0.

53 Jason DeBacker, Bradley T. Heim, Shanthi P. Ramnath, and Justin M. Ross, "The Impact of State Taxes on Pass-Through Businesses: Evidence from the 2012 Kansas Income Tax Reform," September 1, 2017, p. 2, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2958353.

54 Scott Drenkard and Joseph Bishop-Henchman, "Testimony: Reexamining Kansas' Pass-through Carve Out," Tax Foundation, January 19, 2017, https://taxfoundation.org/testimony-reexamining-kansas-pass-through-carve-out/.

55 Liz Malm and Joseph Bishop-Henchman, "Kansas May Face Budget Problems as Senate Again Strips Tax Reform Out of Tax Cut Bill," Tax Foundation, March 15, 2013, https://taxfoundation.org/kansas-may-face-budget-problems-senate-again-strips-tax-reform-out-tax-cut-bill/.

56 Joseph Bishop-Henchman and Scott Drenkard, "Kansas 2013 Tax Reform Improves on Last Year's Efforts," Tax Foundation, June 18, 2013, https://taxfoundation.org/kansas-2013-tax-reform-improves-last-years-efforts/.

57 Joseph Bishop-Henchman, "Kansas May Drop Pass-Through Exclusion After Revenue Projections Miss Mark Again," Tax Foundation, April 30, 2015, https://taxfoundation.org/kansas-may-drop-pass-through-exclusion-after-revenue-projections-miss-mark-again/.

58 Joseph Bishop-Henchman, "Kansas Approves Tax Increase Package, Likely Will be Back for More," Tax Foundation, June 12, 2015, https://taxfoundation.org/kansas-approves-tax-increase-package-likely-will-be-back-more/.

59 Ibid.

60 Joseph Bishop-Henchman, "Kansas Pass-Through Carveout Repealed After Legislature Overrides Gov. Brownback's Veto," Tax Foundation, June 6, 2017, https://taxfoundation.org/brownback-pledges-veto-kansas-tax-bill/.

While the state's individual income tax in 2018 will still be lower than it was before tax reform efforts began in 2012, Kansas's story over the last five years illustrates the risks of cutting taxes without regards to sound tax policy or a state's spending priorities. By providing a wholesale exemption to pass-through income, the state encouraged individuals to simply reclassify their income. It was not an economic growth driver as some proponents promised. Additionally, the state's reckless slashing of revenues, without accompanying spending changes, risked the fiscal solvency of the state. By 2017, Kansas was one of only four states without budget reserves.[61]

Tax reform is difficult, and Kansas's experience illustrates how states should not approach these difficult questions.

Concluding Insights from State Legislators Who Were There

In December 2017, the Arkansas Tax Relief and Reform Task Force invited legislators from Indiana, North Carolina, Oklahoma, and Kansas to share their thoughts and experiences on tax reform. Throughout the conversation, five key themes emerged.[62]

First, tax reform is a process. Representative John Szoka (R) of North Carolina described tax reform as an "evolution, not a revolution." Second, cutting revenue cannot be the single goal. Representative Steven Johnson (R) from Kansas discussed how Kansas's 10 percent revenue cut put the state at risk. Third, spending must be considered simultaneously. North Carolina Representative Bill Brawley (R) discussed that state's new highway prioritization system, while Speaker Tim Moore (R) noted that North Carolina also reformed its education and unemployment insurance programs. Balanced budget requirements mean that states must consider spending changes as part of tax reform. Fourth, tax trigger designs are critical. As discussed previously, North Carolina's tax trigger was a critical part of its tax reform efforts. Oklahoma Tax Commissioner Clark Jolley (R) spent a large part of his presentation discussing his state's challenging tax trigger.

But most importantly, all the presenters echoed that tax reform is worth the effort. Eliminating tax expenditures and handling trade-offs isn't politically easy, but in the end, the presenters reiterated that tax reform was worth the effort. Senator Brandt Hershman (R) of Indiana outlined the various accolades Indiana continues to receive for reforming its tax code, and how those changes are translating into greater economic opportunity for Hoosiers.

There are important lessons to learn from other state experiences with tax reform. While Kansas's troubled experience teaches us that reforms must be thoughtful and diligent, comprehensive reforms in Utah, Indiana, North Carolina, and the District of Columbia illustrate that smart, sensible tax reform is possible, and can dramatically improve a state's competitiveness.

61 Ibid.

62 Nicole Kaeding, "Arkansas Tax Reform: Lessons from Other Legislators," Tax Foundation Blog, December 6, 2017, https://taxfoundation.org/arkansas-tax-reform-lessons-legislators/.