Bloomberg BNA

Daily Tax Report™: State

Tax Policy

The relationship between tax cuts and economic growth has been the subject of much discussion and debate at the state and federal level. A number of states have reduced taxes to spur economic growth. In this article the Brookings Institution's William G. Gale and Aaron Krupkin, and the Urban Institute's Kim Rueben, discuss the economics of tax cuts and the experience in Kansas.

Tax Policy Outside of the Emerald City



BY WILLIAM G. GALE, AARON KRUPKIN, AND KIM RUEBEN

In the aftermath of the Great Recession, numerous states cut taxes with the hope of spurring economic growth. The expected gains, however, have rarely come to fruition. Instead of leading states to the promised land of robust growth, the tax cuts have undermined state revenues, weakened public services, and in some cases, resulted in lower credit ratings. This pattern was recently highlighted in Kansas, where, in the face of a significant tax-cut-induced budget shortfall, lawmakers partially rolled back the sizable tax cuts they had enacted in 2012. The states' experiences offer several lessons for other states and the federal government: tax cuts do not guarantee economic growth; special tax rates for business activity mainly generate more tax-sheltering behavior and less revenue; and people are more willing to pay higher taxes when they can see the link between revenues and the societal benefits that government provides.

William G. Gale is the Arjay and Frances Miller Chair in Federal Economic Policy and a senior fellow in the Economic Studies Program at the Brookings Institution. Aaron Krupkin is a senior research analyst with the Urban-Brookings Tax Policy Center. Kim Rueben is a senior fellow at the Urban-Brookings Tax Policy Center and directs the Urban Institute's State and Local Finance Initiative.

Background

Over the past 40 years, many conservative politicians have argued that the cure for what ails the economy is lower taxes and, more specifically, lower income tax rates on high-income households. Beginning with Arthur Laffer's famous napkin, the theoretical concept

 ISSN 1534-1550

that reducing top income tax rates would boost economic growth and revenue has been touted as fact in some circles. In the extreme versions that thrived early in the Reagan administration, advocates, or ''supply siders,'' argued that federal tax rates were so high, and the response to tax cuts was so large, that tax-cut packages that reduced income tax rates would increase economic growth enough to pay for themselves.

Although there is scant evidence that cuts in top federal income tax rates have actually boosted growth rates at all, much less enough to be self-financing, the movement for lower income tax rates spread to state governments long ago. Failure of supply-side economics at the federal level does not necessarily imply failure at the state level, however. For one thing, lower taxes might lure existing businesses and jobs from other states, even if they do not yield a national increase in jobs. But the stakes are higher for the states. The federal government can finance revenue shortfalls by borrowing from the public, but states are far more constrained, by both skeptical private credit markets and constitutional balanced budget rules in 49 states that require current spending equal revenues. The failure of supply-side economics to work at the state level could force significant budget shortfalls and punishing cuts in spending.

The Kansas Experience

This is basically what happened in Kansas. In 2012, a Republican legislature and governor reduced the top income tax rate from 6.45 percent to 4.9 percent. For income from some businesses – including partnerships, LLCs, S-corporations, and sole proprietorships – Kansas didn't just lower the rate, it cut it to zero. In 2013, Kansas passed another tax cut, which would have reduced the top rate for wage income by another percentage point by 2018.

All of this was supposed to boost economic activity in general and business activity in particular. But after the tax cut passed, economic growth in Kansas lagged behind neighboring states and the nation as a whole, and the resulting anemic level of revenues led to ballooning shortfalls, causing significant cutbacks in vital programs such as Medicaid, education, Temporary Assistance for Needy Families, court funding, and infrastructure.

Faced with a choice between cutting spending further or undoing some of the previous tax cuts, the legislature, in part spurred by the courts, just chose the latter. It voted to raise the top tax rate on wage income to 5.7 percent and end the special treatment of business income. The tax increases are projected to raise $1.2 billion over the coming two years, which will help close a budget shortfall of almost $900 million. They will also allow the state to pay for the State Supreme Court-mandated increase in school funding.

Other States' Experiences

Of course, Kansas was not the only state to lower tax rates over the last few years with the hopes of spurring economic growth. Unsurprisingly, most of these states did not enjoy massive gains as a result. For example, policy makers in Oklahoma reduced state income tax rates multiple times. Even though the cuts included triggers to try and mitigate a deficit, because of how they were designed and because of falling oil prices, the tax cuts have resulted in a state budget crisis that forced the state to significantly cut education spending. The Oklahoma legislature is now considering tax increases to close the gap.

In 2013 and 2015, Ohio enacted a significant business tax break, lowering the rate to 0 percent on pass-through income under $250,000 and 3 percent on pass-through income above the threshold. However, the state is now experiencing lower than expected revenues and a sizable budget shortfall. Job growth in Ohio continues to trail the national average as well.

Similar stories have played out in other states such as Louisiana and Wisconsin.

Lessons for the Future

These tax cuts, and the Kansas tax cuts in particular, were some of the cleanest experiments the country has ever had in measuring the effects of tax cuts on economic growth. The policies were largely a failure. Other states should be paying attention.

First, tax cuts do not guarantee economic growth. The Kansas experiment is a stunning rebuke of supply-side rhetoric put forth by tax-cut advocates like Arthur Laffer and Stephen Moore, who promised big economic gains. This is especially important for states given their need to balance their budgets. Even with economic growth, the decrease in tax rates is more likely to lead to revenue declines, as the direct decline in revenues is likely to outweigh any increases from economic activity. If tax cuts do not produce growth, the results are even more dire. A state would be left with lower revenues than anticipated, and it would be forced to cut spending, raise other taxes (usually sales taxes or fees), or implicitly (and often unconstitutionally) borrow from other accounts to eliminate the shortfall. Ironically, these spending cuts are often proposed in areas such as education or safety net programs, which have been shown to produce positive impacts on growth and economic wellbeing.

Second, the Kansas experience shows that special tax rates for businesses mainly generate more tax-sheltering behavior and less revenue instead of a real increase in business activity. A recent study discovered that Kansans found it advantageous to convert labor income into business income for tax purposes, even with a tax differential of less than 5 percentage points. They could do it easily, for example, by reclassifying the same activities as consulting for their prior employer, even without an increase in actual business activity. As a result, it would not be wise for other states to enact significant spreads between the top tax rate on wages and the top tax rate on pass-through income.

Third, the Kansas experience could provide states with a lesson in understanding their taxpayers' preferences, which is critical for effective messaging and political viability of fiscal policies. In particular, the Kansas saga is consistent with the view that people are more willing to pay higher taxes when they can see the link between tax revenues and the societal benefits that government provides. After experiencing the significant cuts to public spending, Kansans voted to oust many of the most conservative GOP legislators in the 2016 elections. In a May poll in Kansas, a bedrock Republican state, 59 percent of those surveyed preferred to solve the state's budget problems with either tax increases or

   ISSN 1534-1550

a combination of tax increases and spending cuts (rather than just through spending cuts).

The evidence seems clear that cutting tax rates is not a solution to hard budget choices and does not necessarily lead to economic growth. It does, however, lead to revenue declines, and while some politicians may find it convenient to embrace Laffer-style thinking, reality has an inconvenient way of interjecting itself into the conversation. Alas, there is no free lunch in tax policy.