To: **North Dakota Interim Taxation Committee**
From: **Jonathan Williams, ALEC Chief Economist, and Vice President, Center for State Fiscal Reform**
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American Legislative Exchange Council
Date: **09/06/2018**
Re: **The evidence on state income taxes and economic competitiveness**

Thank you, Chairman and distinguished members of the committee for the invitation to speak today. We appreciate the opportunity to present non-partisan research and analysis on income taxes and economic competitiveness in the states.

As you may know, ALEC is the nation's largest non-partisan voluntary membership organization of state legislators. Comprised of nearly one-quarter of the country's state legislators and stakeholders from across the policy spectrum, ALEC members represent more than 60 million Americans and provide jobs to more than 30 million people in the United States. We believe all Americans deserve an efficient, effective and accountable government that puts the people in control.

Today, we will provide a review of the economic literature on various forms of taxation and their impact on growth. Then, we will examine the growth differentials between the nine states without income taxes and those with the highest income taxes to see what they can tell us about how income taxes affect economic wellbeing. Finally, we will look at regional competition, what it means for North Dakota, and provide details from particularly notable tax reforms recently achieved by Tennessee and North Carolina.

A review of the academic evidence on taxes and economic growth

A large volume of academic literature makes it clear that all taxes negatively affect economic growth. A Tax Foundation survey of 26 peer-reviewed studies since 1983 found that 23 indicated a negative relationship between taxes and economic growth, while the other three found no relationship at all.

However, not all taxes are created equal, and some stunt economic growth more than others. Scholars at the Organization for Economic Cooperation and Development, or OECD, using a panel of data from 21 nations, found that corporate and personal income taxes are far more distortionary and harmful to economic growth than taxes on consumption, like sales or property taxes. They controlled for various factors, including measures of physical and human capital accumulation, population growth, and time and country-specific effects. Researchers also controlled for the overall tax burden in each country as a share of GDP. This allowed them to isolate the effect of different types of taxes based on the share of tax revenue that comes from each

source. Their results indicated that a 1 percent shift of tax revenues from income taxes (both personal and corporate) to consumption and property taxes would increase GDP per capita by between 0.25 percent and 1 percent in the long-run.

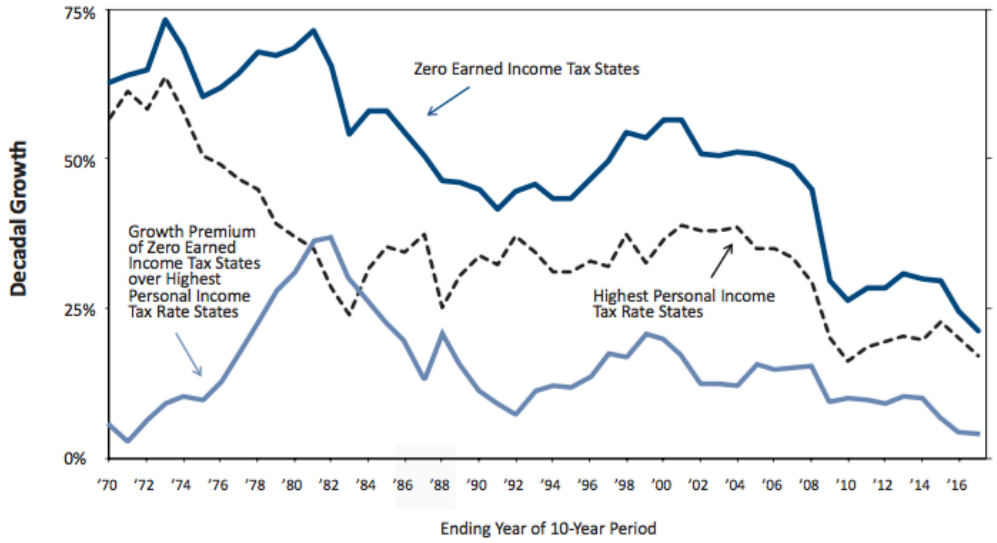
Another important finding of this study was that progressivity of personal income taxes substantially reduces economic growth when compared to flat-rate tax systems. The OECD authors found even more support for their results by looking at industry and firm-level measures of investment and productivity growth. They found that corporate taxes, both in terms of the rate and depreciation allowances, reduce growth of investments and productivity. They write: "a reduction in the top marginal personal tax rate is found to raise productivity in industries with potentially high rates of enterprise creation."

Annually, we produce the national economic study, *Rich States, Poor States: ALEC-Laffer State Economic Competitiveness Index*. Together with co-authors (Reagan economic advisor, Dr. Arthur Laffer and Stephen Moore), we analyze how economic competitiveness drives income, population and job growth across the states. *Rich States, Poor States* adds to a growing body of evidence that taxes matter, and some taxes matter more than others. For many years, our research has warned against an over-reliance on income taxes – on both personal and business income. For instance, we analyzed the nine states without an individual income tax versus the nine states with the highest individual income taxes over the past decade. From 2006 to 2016, the population in states with no income tax grew 111 percent faster than their high tax counterparts (11.9 percent vs. 5.6 percent) on an equally-weighted basis. In aggregate, population grew by 15.2 percent in the no income tax states vs. 6.7 percent in their high tax counterparts.

According to the Bureau of Labor Statistics and the St. Louis Fed, over the past 10 years (March 2007-March 2017), private sector job growth in the states with no income tax increased 28 percent faster than the states with the highest income taxes (6.9 percent growth vs. 5.4 percent growth) on an equally-weighted basis. In aggregate, private sector jobs increased by 12.2 percent in the no income tax states compared with 7.9 percent growth in the high-income tax states.

Obviously other factors, including right-to-work status, regulatory environment, and makeup of state economies clearly matter for these statistics; but these general trends are reflected decade after decade for the past 50 years. The graph below highlights the economic growth premium of states with no income tax when compared to those with the highest personal income tax rates.

10-Year Real Personal Income Growth Rates: No-Income-Tax-States and Highest-Income-Tax-States (Annual personal income deflated with GDP implicit price deflator, 1970 to 2016)



Source: Bureau of Economic Analysis, Laffer Associates

Data from the 11 states that adopted a personal income tax between 1961 and 1991 are also illustrative. These states include West Virginia (1961), Indiana (1963), Michigan (1967), Nebraska (1968), Illinois (1969), Maine (1969), Rhode Island (1971), Pennsylvania (1971), Ohio (1972), New Jersey (1976), and Connecticut (1991). In the years following adoption of the tax, in every one of these states, population, employment, personal income, gross state product, and state and local tax revenues all declined relative to the rest of the nation. And with no-income-tax states South Dakota and Wyoming both within your region, it becomes even more important that North Dakota continue to innovate its tax policies to remain competitive.

The reasons why income-based taxes are economically damaging to states range from the adverse economic effects of the taxes, to purely public finance objections, such as the volatile nature of income tax revenues.

Income taxes and revenue volatility

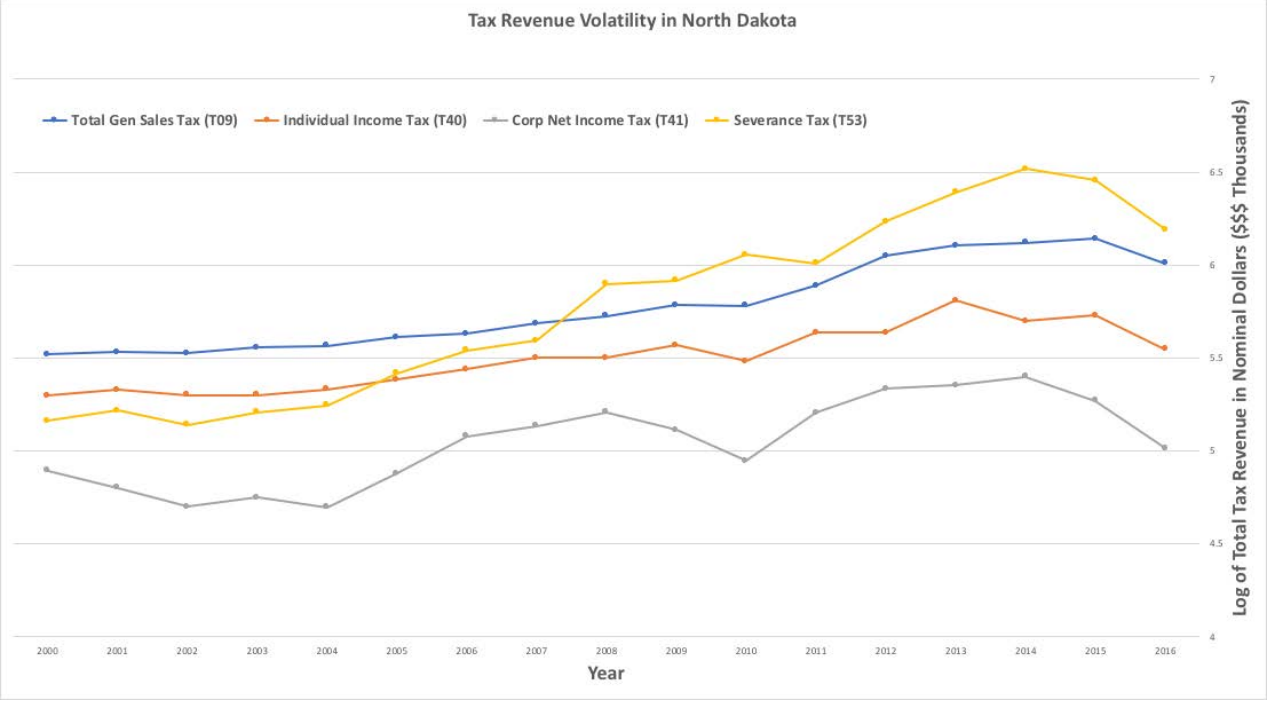
Reliance on income-based taxes is especially troublesome for states during difficult economic times. Taxes on corporate and personal income – particularly the portion from "pass-through" businesses filing under the personal income tax code and taxes on investment income – are extremely volatile relative to taxes on sales and property taxes. For instance, using data from the U.S. Census Bureau's *State Tax Collection Survey,* we see that during the Great Recession, North Dakota's corporate income tax collections fell by more than 5 percent

and personal income tax collections fell by more than 1.5 percent, all in short order. Over the same period, general sales tax collections fell by less than 0.05 percent.

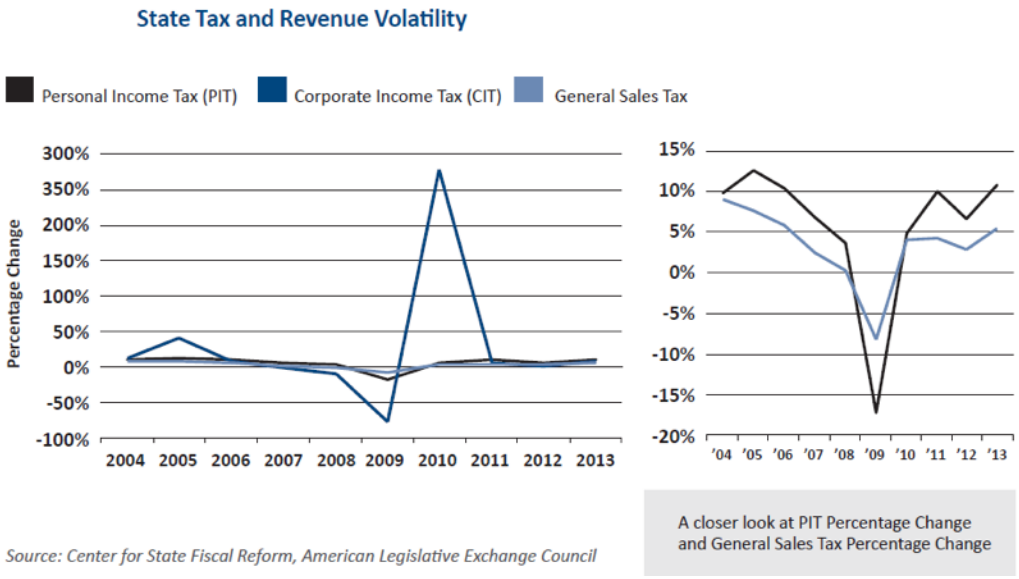
For perspective, the same Census Bureau data show 2016 severance tax revenues accounted for 41.7 percent of total state revenues, sales taxes for 27.4 percent, personal income tax for 9.46 percent, and corporate income tax for 2.7 percent.

Due to the scale of these numbers, however, we cannot fully see the sheer scope of the differences among these revenue sources without a few mathematical tools. Taking the logarithm of each of these variables is a convenient way to express the large numbers and solves the data's "skewness" problem. In layman's terms, skewness is when a few data points or one variable is much larger than the bulk of the data, and a base-10 logarithm is roughly the number of digits in that number. In this case, the skewness came from the revenue of severance taxes being so much larger than the others. By standardizing the data, it also helps us see more detailed variation and easily measure percent change.

As you can see in the graph which shows the logged data, corporate and individual income tax collections both had acute and substantial declines while general sales tax collections declined more slowly and to a far lesser extent.



North Dakota's experience here is not much different from the nation as a whole. As we can see in the figure of data from across all states, during the Great Recession period individual income and corporate income tax collections declined substantially while the decline in sales tax revenues was smoother and to a lesser extent.



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

To summarize the literature: taxes on income and capital stunt economic growth and destabilize state budgets. And among taxes on income, flat taxes are less harmful to growth than progressive, bracketed systems.

Shifting state revenue collection away from reliance on wage income, investment income, and business income ensures that when the economy enters a recession – characterized by a drop in aggregate wage income due to exacerbated unemployment, depressed business revenues, and poorer performance of investments –state tax revenues have a softer decline than they otherwise would.

Stable, predictable revenues allow policymakers to allocate funding based on long-term needs and where it will have the greatest impact. Further, when a recession does hit, and revenues fall, they will fall more slowly and more predictably, ensuring the provision of core government services while giving lawmakers more latitude to prioritize funding.

This point is especially relevant to North Dakota, where a disproportionate number of jobs, and thus the tax revenue they generate, come from the energy industry. Should another large slump in the energy market occur, severance tax revenues will predictably decline, but so too will income tax collections due to job losses in the industry. Given that income tax and severance tax revenues together make up more than 50 percent of North Dakota's total annual tax revenue, a slump in energy markets is more likely to put the budget under greater stress than under some alternative systems. Consumption, and thus revenues from taxes on it, may

decline during a recession, but this occurs more slowly and to a lesser extent than income, particularly business net income.

Speaking broadly, North Dakota is well positioned to adopt pro-growth reforms to its tax code. North Dakota's low tax rates on personal and corporate income, both of which rank in the 10 lowest nationwide. It cannot be understated how pro-growth even just simplifying the tax code is. When we talk about broad bases and low rates, that's understood to be within the structure of which taxes are least economically damaging. As we noted earlier, taxes on consumption are the least distortive, so naturally, a tax on consumption with as broad a base as possible – meaning a limit on special preferences – allows the rate to be as low as possible. Diversification for minimizing risk might work with investing, but not with taxation, largely due to the distortive nature of certain taxes. Having a code with many forms of taxes, does not increase revenue stability in the down years – rather it injects volatility. Having a tax code with one or two broad-based, and minimally distortive consumption taxes, even with relatively higher rates is far preferable. A simple, fair tax code not only simplifies paperwork and lowers compliance costs for businesses, but also reduces tax avoidance behavior and lowers collection costs for government.

In the competition for resources and residents, you can fall behind simply by standing still. And there is great momentum for tax reform across the nation. In just the last five years, 30 states have made significant pro-growth policy changes that have provided billions of dollars in broad-based tax relief for their citizens.

The *Rich States, Poor States: ALEC-Laffer Economic Competitiveness Index* — is a roadmap to economic growth based on free-market fiscal policy reform. The report presents rankings of the 50 states based on the relationship between policies and performance. Its economic outlook rankings are based on 15 equally-weighted economic policy variables, including tax rates, labor policy, and the regulatory climate.

States that keep taxes low, avoid job-killing over-regulation, and follow prudent budget practices, consistently outperform their highly taxed, over-regulated counterparts. And these policies affect where businesses and individuals choose to set up shop.

How does North Dakota rank?

North Dakota's economic competitiveness has improved substantially over the past few years. Since 2008, the state has moved from 18th place in economic outlook to 4th in this year's *Rich States, Poor States: ALEC-Laffer State Economic Competitiveness Index*.

Looking at the tax policy variables, North Dakota's personal income tax ranks 10th, the corporate income tax 7th, the property tax burden 9th, sales tax burden 47th, remaining tax burden 31st, and recently legislated tax changes is 1st. The state's overall economic outlook rank of 4th represents the culmination of a number of recent positive policy changes.

Examples of pro-growth reforms

There are perhaps no clearer examples to follow than Tennessee and North Carolina, whose pro-growth tax reforms and budget prioritization have made them economic powerhouses in recent years. People are moving to Tennessee every day. In fact, since 2013, domestic in-migration has grown by a whopping 113 percent. That's nearly 94,000 new residents in just 5 years…and that number grows every day. Why? With no taxes on wage income, we can tell you it's not entirely for the country music. The state has experienced tremendous growth over the last 10 years, and much of that, if not all, is due to its pro-growth policies and a citizens-first approach to governing. Adding to the magnetism derived from no income tax on wages, in 2017 the legislature and governor agreed on legislation formally adopting a phase-out the state's investment income tax called the Hall Tax. Better still, 2016 marked the death of the Volunteer State's "Death Tax" after a four-year phase-out.

Tennessee is in the bottom 10 states for property tax burdens, and although the state has the 8th highest sales tax revenues as a percentage of gross state product (GSP) in the nation—total tax revenues as a share of GSP make Tennessee the 3rd lowest-taxed state in the nation.

In 2016, Tennessee received the highest credit rating in the nation: a AAA credit rating from all three of the major credit rating agencies—Standard and Poor's (S&P), Fitch, and Moody's—for the first time since 2000 and only the second time in the state's history. Even better, the state has ended each of the past two years with surpluses, 2017's being an astounding $2 billion.

Tennessee's economy has grown by more than 3.5 percent every year since 2013, including a blistering high of 5.9 percent in 2015! It's clear what having no income tax and a pro-growth attitude toward tax policies have done for the Volunteer State. North Carolina is a similar if slightly different story.

Despite being handed a $3 billion budget deficit in 2011, North Carolina's General Assembly took great strides in repairing the ailing budget and its structural problems, all while providing nearly half a billion dollars in small business tax relief.

But they didn't stop there. Next, they repealed the state's "Death Tax" for 2013. An incredible reform that North Dakota has also achieved! North Carolina's 2013 reforms raised standard deductions for single and joint filers, consolidated the individual income tax brackets, and cut the top rate.

Lawmakers also addressed the state's corporate income tax– formerly highest in the southeast – passing legislation reducing it for 2014, 2015, 2016, and 2017, all contingent upon meeting stringent revenue triggers, of course. In 2015, and 2017, lawmakers cut personal income taxes, both times by cutting the rate and raising standard deductions.

North Carolina's commitments to tax reform have spurred near-record growth since 2013. The phase-in of additional income tax relief has further enhanced the state's economic competitiveness. Strong domestic in-migration and non-farm payroll job growth put North Carolina ahead of every regional competitor and in the top-10 nationwide in overall economic performance, according to *Rich States, Poor States*. Taking all cuts into account, lawmakers will have provided an estimated $15 billion in tax relief for citizens of the Tar Heel State—an average of nearly $1,500 for each resident.

They've also shown, contrary to popular criticism, that you can cut taxes without endangering your budget. In spite of all these tax cuts, the state has maintained its AAA bond rating, met every revenue requirement, balanced its budget every year, and have ended every year since 2015 with a large budget surplus. Lawmakers in North Carolina had enough in surplus funds to give teachers a substantial pay increase. North Carolina serves as a textbook example of what pro-growth tax and budget reform can provide for an economy.

What about Kansas?

Of course, even in the face of all of this positive economic data from the North Carolina and Tennessee tax reforms, some opponents of tax reform might suggest the policy experiences in Kansas since their 2012 tax cuts prove tax reform does not produce growth. In reality, the Kansas tax reform story is far from the abject failure some like to suggest. In fact, recent data suggest there were some very positive trends for hardworking taxpayers in Kansas, before taxes were subsequently raised.

Perhaps the most important complexity to keep in mind is the Kansas tax reform plan was never fully implemented as intended. Many political compromises gave us the fiscal policy patchwork that Kansas taxpayers now face. Taxes were lowered, but spending was not. Then taxes were raised in a significant way. Some of the tax increases came in the form of broad-based retail sales taxes, while others were discriminatory taxes on consumers of specific products.

Many critics of the Kansas tax reform experience are quick to point to relatively lackluster economic growth and budget shortfalls in the years following tax reform as proof of the reforms' failure. However, like many other states at the time, the significant downturn in oil prices and agriculture prices hit Kansas especially hard. Controlling for these sectors, the rest of the Kansas economy enjoyed growth.

Kansas provides a number of important lessons, the most important of which is that broad-based tax relief must be paired with responsible prioritization of spending. After all, taxes and spending are opposite sides of the same fiscal coin. Kansas has increased actual annual general fund spending by more than $2.94 billion since 1995. This is an 89 percent increase. Adjusted for inflation, this is still an outsized 55 percent increase during a period in which population grew by only approximately 12 percent. Since 2012 alone, general fund spending has increased by more than 4 percent adjusted for inflation. In short, for every 1 percent in population growth from 1995-2017, spending increased by nearly 5 percent in real terms. Based on this spending growth, it is clear why Kansas has faced budget shortfalls as they reduced tax rates.

Much of the criticism about Kansas is based on preconception and myth, rather than empirical data and actual trends. Pro-growth tax relief can be trusted to make states more competitive, but it takes time to develop and must be offset with appropriate spending reforms.

As we wrap up our thoughts here, it is important to reiterate that tax policy has the power to make or break a state's economic competitiveness. Overall, the economic evidence clearly showcases the success of states that have enacted pro-growth tax reforms. The 50 "laboratories of democracy" give us numerous examples of this every year.

Thank you for allowing us to share all of this information today. We hope some of this research and analysis aids you in devising the best path to maintaining the great prosperity North Dakota has enjoyed in recent years.

We look forward to answering any questions.