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Fiscal Fact

Trend #6: Tax Abolition

Top 10 State Tax Trends in Recession and Recovery, 2008 to 2012

By

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Seven states have no income tax and five states have no sales tax. Abolishing an entire tax means ridding your taxpayers of the associated compliance costs and loss to economic growth, but one must figure out whether to make up the revenue with spending cuts or higher taxes elsewhere. No state has abolished a major tax since Alaska ended its income tax in 1980, but some are now trying.

How a state's budget will deal with the loss of a major revenue source is of course a vital question. If the revenue is merely swapped with an equivalent amount from a tax that imposes similar compliance costs, nothing is gained. North Dakota proponents point to rapidly growing revenues from oil, the Oklahoma proposal emphasizes spending reductions, the original Kansas proposal relied on loophole closures, and the Missouri proposal recommended a sales tax base expansion to services.

Income tax reductions or repeals in particular are under consideration in a number of Midwestern states, characterized by a *Wall Street Journal* article entitled "The Heartland Tax Rebellion."¹ If all proposals come to pass, an income tax-free zone could stretch from Texas north through Oklahoma and Kansas and east to Missouri.

Significant repeal action has occurred with estate and inheritance taxes. For decades, states received essentially free tax money since the federal estate tax included a dollar-for-dollar credit for any state estate tax paid. Taxpayers paid the same amount whether or not the state taxed estates, so most states adopted an estate tax. This federal practice was ended in 2001, and state estate taxes began to have visible economic costs.

Ohio's estate tax ends in 2013, Indiana's inheritance tax ends in 2021, and reduction and repeal proposals are under serious consideration in many other states.² While only a small number of taxpayers pay an estate or inheritance tax, the compliance costs of these "death taxes" are much more widespread. Many individuals engage in complex estate planning and/or buy insurance policies to avoid the estate tax. Put another way, the estate tax is one of the least efficient taxes, imposing huge compliance costs for each dollar of revenue collected, relative to other taxes.

¹ <http://online.wsj.com/article/SB10001424052970203889904577200872159113492.html>

² See *Wall Street Journal*, *Death Tax Defying: Estate tax repeal gains momentum in the states*, (Mar. 23, 2012), <http://online.wsj.com/article/SB10001424052702304459804577285730572940746.html>.

Oklahoma Income Tax Repeal Proposal. In late 2011, the Oklahoma Council on Public Affairs (OCPA) released an economic analysis of a two-stage income tax reform proposal.³ In its first stage, the present seven-bracket system with a top rate of 5.3% on income over \$8,700 would be replaced by a 3 percent flat tax. This first reform would be revenue-neutral, paid for by the elimination of deductions and credits. The second stage reform would reduce this lowered tax over ten years until it is eliminated completely. Both phases of the reform are likely to significantly reduce compliance costs and increase economic growth, although supporters and opponents dispute the exact amount. On one hand, Dr. Art Laffer (of the “Laffer Curve”) estimates growth will replace 23 percent of the lost revenue; a fierce critic, Dr. Kent Olson of Oklahoma State University, says it will only replace 9 percent of the lost revenue.⁴ Governor Mary Fallin (R) has pushed for an income tax reduction taking the top rate to 3.5 percent, although some legislators are pushing for a smaller cut to just below 5 percent next year.⁵

Kansas Income Tax Repeal Proposal and Reduction. With the group Kansans for No Income Tax⁶ pushing for full income tax repeal, Governor Sam Brownback (R) in January proposed replacing the current three income tax brackets and top rate of 6.45% with two brackets and a 4.9% top rate.⁷ The lowest income tax rate would also drop from 3.5% to 3%. Brownback proposed paying for much of the rate cut through the elimination of credits and deductions. After much debate, legislators ultimately approved a version that reduces rates without significantly broadening bases, reducing revenue by \$2.7 billion over four years.⁸

Missouri Income Tax Replacement Proposal. A proposed ballot initiative sought to eliminate the state’s income tax, replacing it with a broader sales tax with a rate up to 7%.⁹ (The state sales tax rate is currently 4.225%.) Although revenue-neutral, the proposal drew opposition from Governor Jay Nixon (D) and the Missouri Association of Realtors, among others.¹⁰ Proponents aimed for the November 2012 ballot, but a judge in April 2012 voided all the collected signatures, ruling that the state-authored summary on the initiative petitions was misleading.¹¹ Sponsors had insufficient time to then meet the May 6 deadline for filing new petition signatures. The proposal will thus not be on the 2012 ballot but may return in the future.

³ Oklahoma Council on Public Affairs, *Eliminating the State Income Tax in Oklahoma: An Economic Assessment* (Nov. 2011), http://s3.amazonaws.com/assets.ocpa.com/assets/images/334/original/OCPA_ALME_Income_Tax_FINAL.pdf.

⁴ Compare *id.* with Kent Olson, *The Voodoo Economics of Phasing Out Oklahoma’s Personal Income Tax* (Mar. 14, 2012), http://dl.dropbox.com/u/19732897/OLSON_VOODOO_PHASING_OUT_INC_TAX.pdf.

⁵ Sean Murphy, *Steep Income Tax Reduction Won’t Happen This Year, Gov. Fallin Says*, ASSOCIATED PRESS (Apr. 30, 2012), <http://newsok.com/oklahoma-gov.-mary-fallin-says-huge-tax-cut-off-for-2012/article/3671126/?page=1>.

⁶ Kansans for No Income Tax, <http://www.kansansforincometax.com>.

⁷ Joseph Henschman, *Kansas Legislators Review Tax Cut Estimates*, TAX FOUNDATION TAX POLICY BLOG (May 2, 2012), <http://www.taxfoundation.org/blog/show/28187.html>.

⁸ See Mark Robyn, *Not in Kansas Anymore: Income Taxes on Pass-Through Businesses Eliminated*, TAX FOUNDATION FISCAL FACT NO. 302 (May 29, 2012), <http://taxfoundation.org/article/not-kansas-anymore-income-taxes-pass-through-businesses-eliminated>; Mark Robyn, *Legislators Maneuver in Kansas’s Income Tax Reform Debate*, TAX FOUNDATION TAX POLICY BLOG (May 11, 2012), <http://www.taxfoundation.org/blog/show/28212.html>.

⁹ Ballotpedia, *Missouri Income Tax Replacement Initiative* (2012), [http://ballotpedia.org/wiki/index.php/Missouri_Income_Tax_Replacement_Initiative_\(2012\)](http://ballotpedia.org/wiki/index.php/Missouri_Income_Tax_Replacement_Initiative_(2012)).

¹⁰ See *id.*

¹¹ See Rudi Keller, *Judge blasts tax plan ballot descriptions*, COLUMBIA (MO.) DAILY TRIBUNE (Apr. 14, 2012), <http://www.columbiatribune.com/news/2012/apr/14/judge-blasts-tax-plan-ballot-descriptions/>.

Ohio Estate Tax Repeal. In 2011, Ohio Gov. John Kasich (R) signed into law a repeal of that state's estate tax, effective January 1, 2013.¹² The tax presently is imposed at 6%-7% on estates valued over \$338,333.

Indiana Inheritance Tax Phaseout. Indiana officials in March 2012 approved a plan to phase down the state's estate tax over time, with full repeal occurring in 2021.¹³ An immediate change is an increase in the exemption level from \$100,000 to \$250,000. Indiana's death tax effective rates were the highest among the states.

North Dakota Property Tax Repeal Proposal. On June 12, North Dakota voters will decide whether their newly oil-rich state will abolish all property taxes.¹⁴ Measure 2 would, depending on the perspective, be an \$800 million blow to essential government services or merely the latest of a long string of sensible taxpayer restraints on property taxation in the footsteps of California's Proposition 13, Massachusetts's Proposition 2-1/2, and recent property tax caps in Indiana, New Jersey, and New York. At minimum, if it passes, it will be another example of the ability of each our fifty states to try different policy ideas and see what works and what does not.

Pennsylvania Property Tax Repeal Proposal. Pennsylvania legislators are expected to consider a bill, HB 1776, which would eliminate school district property taxes and replace the revenue by (1) broadening the sales tax to some services, (2) raising the sales tax rate from 6% to 7%, and (3) raising the income tax from 3.07% to 4.01%.

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¹² See Joseph Henchman, *Ohio Officials Look at Estate Tax Repeal*, TAX FOUNDATION TAX POLICY BLOG (Jan. 28, 2011), <http://taxfoundation.org/blog/ohio-officials-look-estate-tax-repeal>.

¹³ See Jordan King & Mark Robyn, *Indiana Legislature Approves Plan to Eliminate Inheritance Tax*, TAX FOUNDATION TAX POLICY BLOG (Mar. 13, 2012), <http://taxfoundation.org/blog/indiana-legislature-approves-plan-eliminate-inheritance-tax>. 23, 2012), <http://online.wsj.com/article/SB10001424052702304459804577285730572940746.html>.

¹⁴ See Joseph Henchman, *North Dakota Voters to Decide Abolition of Property Tax*, TAX FOUNDATION TAX POLICY BLOG (Apr. 16, 2012), <http://www.taxfoundation.org/blog/show/28129.html>.