Abstract: In this case study, the deputy director in a state budgeting and planning office has been asked to provide information on the financial and political implications of eliminating personal income tax in the state. The deputy director has asked her two assistants to evaluate the proposal and provide input on the impact of eliminating personal income tax; the two assistants present valid arguments for their positions but end at diametrically opposed stances regarding the value of eliminating the personal income tax. The case study is designed to stimulate analysis of alternative sources of revenue, and/or reducing expenditures, as well as the broader social and political implications of abolishing personal income tax. The scenario of the case study has relevance as a number of states already have eliminated personal income tax, and other states are considering eliminating personal income tax. The situation presented in the case study, as well as the discussion questions that follow, is intended to have students consider the elimination of personal income tax in their home state or the state in which they are studying, as well as consider how compromise could be achieved on this contentious issue, which has political, social, economic, and budgetary significance and implications. The case study is appropriate for use in university-level courses in budgeting, political science, public administration, and public policy.

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A Taxing Dilemma

The Situation

Jill Scott, the deputy director of her state’s budget and planning agency, has worked in the public sector for six years and was seen as a rising star with potential to one day become director of the department. In fact, she had been fast-tracked and received promotions so that the current director of the Department of Revenue, a political appointee, relied on her whenever there were substantial issues that required a balance between financial and political aspects.

When Jill was called to the director’s office she figured that something significant was in the works, but she had no idea how significant. The director told her that there was considerable momentum toward eliminating personal income tax in the state; major political players, including one of the gubernatorial candidates in the upcoming election, along with many legislators, were behind the plan. The director wanted more details on the implications of moving toward the elimination of tax on the income of individuals and how that might impact revenues and expenditures as well as economic growth. Ms. Scott was given the task of providing an outline of the financial and political effects of the proposal.

Jill returned to her office and looked out the window. There were a number of questions in her head and she wasn’t sure where to start; she admitted to herself that the idea of eliminating personal income taxes seemed like a campaign promise and political rhetoric that would not hold up to sound economic reasoning, and her initial thought was that eliminating personal income tax would wreak havoc on a state budget that was just recovering from the Great Recession; she knew that over the past several
years personal income tax collections accounted for between 20-25% of total revenue in the state. She set a meeting for tomorrow morning with her two assistants in order to get their views. In the meantime, Ms. Scott had other issues that needed her attention, and the idea of eliminating income tax would need to wait until tomorrow morning. She knew that her assistants would be eager to tackle the issue; both were recent university graduates and loved the challenges that an issue like this posed.

The Meeting

Jill and her assistants, Robert Gomez and Drishti Ghosh, sat down and right away Robert was enthusiastic for the idea of eliminating personal income tax. He had done his homework and noted that nine states already had eliminated personal income tax in whole or in part, and several other states were considering the policy.

Robert argued that over the past several years, state departments and agencies had been forced to do more with less (one of Robert's favorite buzz phrases) and therefore administrators could continue to find ways to make their agencies more efficient without a noticeable drop in service levels.

Drishti, Jill's other assistant, jumped in at this point. “But don’t you think there are limits to this ‘doing more with less’? Now that the economy is starting to get back on solid footing, people will be expecting more in terms of the variety of services as well as service levels. We cannot eliminate a quarter of our revenues and not expect services to suffer.” Drishti clearly was more tepid toward the idea of eliminating personal income tax.
Robert, however, was ready for this argument and asserted that the issue needed to be looked at from a long-term perspective. “Drishti,” he said, “have you forgotten your economic lessons? Empirical data have shown that states without individual income tax have higher than average rates of job growth, and economic growth rates in those states also are greater. This is exactly what we need; eliminating personal income tax is a boon. We can expect businesses to move to our state; as businesses move to the state, we can expect more people, especially those with education, to relocate to our state. Besides, people are going to love not having to pay income tax.”

“Well, Robert, you may have forgotten your political lessons. Governing is not about merely making people happy,” quipped Drishti. “And not only that, if population increases as you think is going to happen – which I doubt since I do not think people make decisions to move based on whether they will have to pay income tax – that will mean a greater demand on state services, a need to expand infrastructure, and higher expenditures. How do we reconcile that when we are eliminating revenues?”

Jill stepped in at this point, not wanting the discussion to degenerate any further into an argument. “Let’s focus on some of the technical aspects.” Jill highlighted the composition of the state’s revenue:

Personal income tax – 24%
Corporate income tax – 5%
Sales tax – 62%
Property tax – 6%
Licenses and other sources – 3%
“If personal income tax goes away, where do we make up that revenue? Can we increase sales tax to a higher level, or do we consider increasing the corporate income tax rate, along with the tax rate on other revenue sources?”

**Robert’s Position**

Robert advocated increasing sales tax to make up for nearly all of the proportion of tax revenue that would be lost if personal income taxes were eliminated. He highlighted that in recent years, sales tax made up the following percentages of total tax revenue for states without personal income tax:

- Florida: 83%
- Nevada: 77%
- South Dakota: 79%
- Texas: 77%
- Washington: 80%
- Wyoming: 44%
- Alaska: 3.5%


(Robert noted that nearly all of Alaska’s tax revenue (82%) and a notable portion of Wyoming’s tax revenue (38%) comes from severance taxes on natural resource extraction.)

Robert argued that increasing sales taxes so that they brought in another 20% of the total revenues would allow the state to alleviate a significant drop off in total revenues; he also noted that increasing sales taxes so that they brought in another 20% of total revenues would put sales tax revenues in the state at 82%, which would not be out of line with other states that do not have a personal income tax. Further, he asserted that sales taxes could be tailored in such a way that they could target visitors to the state, for example by increasing hotel and rental car tax rates. This would make any sales tax increases more palatable to residents of the state. Robert postulated that a tax
system that was consumption-based, rather than income-based, would be better and more equitable because people would be taxed on what they consume rather than tying taxes to what people produce through their work output. Further, since tax systems tend to be complex and convoluted, eliminating personal income tax would remove the accompanying loopholes in the tax system; Robert emphasized that this would make the state revenue department more effective as it could concentrate on revenue collection and audits within the remaining tax structures.

In terms of expenditures, Robert strongly believed that state agencies could continue to tighten their belts and eliminate any wasteful spending. He also supported the idea that some state services could be delegated to local governments.

**Drishti’s Position**

Drishti, on the other hand, promoted the idea that corporate income taxes should be increased. She was in favor of substantially increasing the corporate tax rate to make up for foregone personal income tax revenue, essentially increasing corporate tax rates to a level that would be equivalent to about 10-15% of the state budget. She reasoned that with the economy improving, businesses would be able to absorb the increase in the tax rate; further, businesses would merely pass on the tax increase to consumers and without having to pay personal income taxes, consumers would have more disposable income. An additional 10-15% of total revenues could be garnered through higher rates for licenses and an increase in property tax revenues. Drishti reasoned that if Robert’s position that businesses were going to be moving to the state, property values likely would be increasing and so property tax revenues would
concomitantly increase. She noted that in the state some businesses are not required to have a license, while other businesses are required to have multiple licenses; she believed that this would be an opportunity to streamline the licensing guidelines in the state while at the same time ensuring that more revenue could be received from this source.

In regard to expenditures, Drishti felt that there were few available options for state agencies to reduce expenditures since sizeable cutbacks already had been made in the past few years. Further, noting that if Robert’s projected population increases were to occur, there would be greater demand on state services, and upgrades to and expansion of infrastructure would be necessary – as it was, infrastructure improvements had been neglected for a long time; in such a scenario, the revenue foregone from abolishing personal income tax would be even more profound. Drishti vehemently opposed the idea of delegating some state services to local governments since cities and counties, like the state, already had been stretched to the limits since the Great Recession.

Drishti also argued that shifting to a system in which taxes are consumption-based, rather than income-based, is regressive and would be harmful to lower-income residents of the state. Although nobody likes to pay taxes, people were wise enough to know that government services are needed; she concluded by highlighting that the debate over the size of the federal debt has brought the issue of fiscal responsibility to the forefront of people’s conscience. Drishti felt that the proposal to cut personal income tax was a political minefield; if it truly was such a great idea, why had forty-one states and the federal government not followed this path.
Conclusion

Jill realized that both Robert and Drishti had relevant ideas, and both were entrenched in their perspectives. She felt that giving them time to reflect on the various ideas shared in the meeting would be useful.

“OK, this is an important topic and there are valid positions on each side of the debate, but I need to have some more specific suggestions to bring to the director. We also need to consider some of the political implications of these proposals. You have mentioned the possible relocation of businesses to the state, followed by an increase in population as people move to the state to get jobs. These have political effects and consequences. Also, consider the fact that if the state is to eliminate personal income tax, there is no going back because it will be extremely unpopular politically to reinstitute the personal income tax at some point in the future.” Jill also observed that politicians in the state had complained openly about the federal government passing unfunded mandates to the state; as such, how would it look if the state government were to turn around and pass on unfunded mandates to local governments in an effort to shed expenditures?

“Have a look at the following video links and come back tomorrow morning with specific proposals – I can tell you now, there likely will need to be some compromise from what I have heard today.”