Governor Mike Pence

WINNING THE JOBS WAR: THE ECONOMIC CASE FOR A 10 PERCENT REDUCTION IN INDIANA'S INCOME TAX

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Introduction: The Competition for Jobs and Investment

In today's global economy, states that work to make themselves more attractive places to do business are winning the jobs war. Capital, companies, and individual entrepreneurs are highly mobile, and more than ever, the economic environment within a state exerts a strong influence on where they move. Underperforming states typically lag because they are wedded to history or the status quo, both of which may have served them well in the past but not today.

Indiana has made a lot of progress in recent years, owing mostly to our state leaders' efforts to get our fiscal house in order and provide policy stability for private enterprise. But it would be unwise for us to believe that Indiana's recent progress secures our economic future. Whether we like it or not, we are engaged in a constant battle for the talent, investment, ideas, and businesses that will create the jobs of the future here in the Hoosier state. The outcome is nowhere near guaranteed. Indiana's future depends on how well we fare in this battle.

In 2012 Indiana ranked 16th in the United States in personal income growth, but we rank 39th in the nation in per capital personal income, which is 86 percent of the national average.[1] Our per capita GDP ranks just 32nd in the country at $36,970, more than $5,000 below the national average[2]. 2011 GDP growth was not much better, ranking 25th in the country at 1.1 percent.[3] Our per capita GDP growth is a bit better, but not by much. Over the past year, the Hoosier State ranked 15th nationally in job growth – good, but not good enough.[4]

We rank in the upper half of U.S. states in college enrollment and graduation, but we fall to 44th nationally in the percentage of our workforce with college degrees. Why? Not because we graduate too many people, but because we have not grown and attracted enough high-demand, high-wage jobs. As a result, Indiana is a net exporter of talent to other growing states.

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[1] Bureau of Economic Analysis, *STATE PERSONAL INCOME 2012*
http://www.bea.gov/newsreleases/regional/spi/2013/pdf/spi0313.pdf

[2] Bureau of Business and Economic Research, *Real Per Capita Gross Domestic Product by State*
http://bber.unm.edu/econ/st-gdp5.htm

[3] Bureau of Economic Analysis, *WIDESPREAD ECONOMIC GROWTH ACROSS STATES IN 2011*
http://www.bea.gov/newsreleases/regional/gdp_state/2012/pdf/gsp0612.pdf

[4] W.P. Carey School of Business, Arizona State University, *Job Growth USA*
http://wpcarey.asu.edu/bluechip/jobgrowth/JGU_States.cfm

In fact, we are second nationally in attracting out-of-state students to our universities. But we lose them – and our own home-grown talent – in droves after graduation.[5]

Indiana sits at a historic crossroads. Our state's business, education, and political leadership have an opportunity to take the state to a new level in national and global competitiveness. Now is not the time for resting on our laurels, but for renewing our focus on what Indiana needs to achieve if we are to succeed in our aspirations to make the Hoosier state the best place in America to start, grow and run a business.

Tax Policy as Jobs Policy

There are a number of critical factors that make states competitive. Tax policy is undeniably at the top of the list. Tax rates on individuals and businesses clearly influence behavior, and as a result, forward-looking states are perpetually assessing how to make their tax climate more attractive to investment. One state's tax climate drives people and jobs away while another state's attracts them.

Governor Pence has called for a 10 percent reduction in Indiana's income tax for precisely this reason. Indiana needs every possible tax advantage if we hope to achieve the level of job growth that most lawmakers and business leaders wish for.

Over the past decade, job growth in the nine states without an income tax outperformed the national average by 25.6 percent. These nine states only account for approximately 20 percent of the U.S. population, but they created 62 percent of the nation's jobs over the past ten years.[6] At least five states across America are looking at ways to eliminate their income taxes. Governor Pence's proposal has been criticized by some as a step too far, but viewed against the broader backdrop of what is occurring in other states, one could just as reasonably ask whether it goes far enough.

The Governor believes a 10 percent income tax reduction in Indiana will keep the Hoosier state on a positive trajectory in the competition for jobs and investment. He also believes that given national trends, we should engage in the debate about tax policy in Indiana with a sense of urgency.

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[5] Battelle Technology Partnership Practice, *Indiana's Competitive Economic Advantage: The Opportunity to Win the Global Competition for College Educated Talent*, Battelle Memorial Institute, 2012

[6] *The State Tax Reformers*, The Wall Street Journal, January 29, 2013
http://online.wsj.com/article/SB10001424127887323968304578245720280333676.html

Even though states without income taxes are "where the action is," a meaningful reduction in income taxes without eliminating them would spur the kind of economic growth in Indiana that so many lawmakers and business leaders say they would like to see. Studies on the effects of income taxes on economic growth make this point abundantly clear.

- A study by economists Robert Barro and C.J. Redlick shows that reducing income tax rates by one percent can increase economic growth the following year by 0.5 percent.[7]

- The near-term effects on the economy can be even greater. A study by Karel Mertens and Morten Ravn found that a 1 percent reduction in the average personal income tax rate generates a 1.4 percent increase in real GDP the following quarter and a 1.8 percent the following three quarters. The authors write, "Cuts in [average personal income tax rates] raise employment, consumption and investment."[8]

- In a study by Randall Holcombe and Donald Lacombe the authors assess the difference in income tax rates on both sides of the borders of neighboring states with similar geography and climate and concluded that over a 30-year period, states that raised their income taxes had slower growth and an average 3.4 percent reduction in per capita income.[9] The important takeaway from this study is that geography, climate and industrial similarities matter less than the tax environment when it comes to economic and income growth.

> "*Taken as a unit, our results provide strong support for the idea that lower tax burdens tend to lead to higher levels of economic growth. Among tax variables, individual income taxes matter most*." – Brian Goff, Alex Lebedinsky, and Stephen Lile

- If other states across America lower their income tax burden while Indiana's rate remains the same, our income tax burden will, in effect, be seen as increasing. Having higher rates puts us at a disadvantage.

- A study by Barry Poulson and Jules Gordon Kaplan found that higher income tax rates had a negative effect on growth in part because the higher the income tax rate, the higher the level of government revenue. States in which the rate of revenue growth was held below the rate of income growth achieved higher rates of overall economic

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[7] Robert J. Barro & Charles J. Redlick, *Macroeconomic Effects from Government Purchases and Taxes*, National Bureau of Economic Research, September 2009.

[8] Karel Mertens & Morten Ravn, *The Dynamic Effects of Personal and Corporate Income Tax Changes in the United States*, Center for Economic Policy Research, September 2011.

[9] Randall G. Holcombe & Donald J. Lacombe, *The Effect of State Income Taxation on Per Capita Income Growth*, Public Finance Review, May 2004.

growth.[10] "The evidence supports previous studies that find a significant negative impact of higher marginal tax rates on state economic growth. Further, the evidence shows that states with higher marginal income tax rates appear to be at a disadvantage in achieving higher rates of economic growth."

- W. Robert Reed studied the 48 continental states over three decades and found that a one percentage point increase in the tax burden is associated with a 2.59 percent decrease in per capita income in the first five years and 1.56 percent in future five-year periods. He concludes that "higher taxes are associated with lower investment, lower employment growth and lower population growth."[11]

- We can summarize these research findings with this statement from Brian Goff, Alex Lebedinsky, and Stephen Lile, whose study assesses a number of variables affecting economic growth on states between 1997 and 2005: "Taken as a unit, our results provide strong support for the idea that lower tax burdens tend to lead to higher levels of economic growth. Among tax variables, individual income taxes matter most."[12]

To care about growth in jobs, GDP, and income is to care about income taxes.

In addition, if we care about fostering a more entrepreneurial ecosystem in Indiana, we should care about the role income taxes play.

A growing body of research over the past few years has shown that young, fast-growing companies account for the bulk of new job creation. States with more entrepreneurial activity therefore experience higher rates of job growth than states with fewer entrepreneurs.

Income tax rates matter for entrepreneurship. A study by Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey Rosen found that higher income tax rates lead to fewer entrepreneurs. Their study concluded that a 5 percent increase in income tax rates lowers the proportion of entrepreneurs that make new capital investments by 10.4 percent, resulting in lowered capital outlays of 9.9 percent.[13]

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[10] Barry W. Poulson & Jules Gordon Kaplan, *State Income Taxes and Economic Growth*, Cato Journal, 2008.

[11] W. Robert Reed, *The Robust Relationship between Taxes and State Economic Growth*, University of Canterbury, October 2006

[12] Brian Goff, Alex Lebedinsky & Stephen Lile, *A Matched Pairs Analysis of State Growth Differences*, Contemporary Economic Policy, April 2012.

[13] Robert Carroll, Douglas Holtz-Eakin, Mark Rider, & Harvey S. Rosen *Entrepreneurs, Income Taxes, and Investment* National Bureau of Economic Research, January 1998.

If we care about unleashing entrepreneurial potential and creating a new era of job growth in Indiana, we have to weigh our decisions about our tax burden with great care. Since job growth comes primarily from young firms, we need to ensure that our tax environment is as optimal as it can be so that we do not push entrepreneurs to states that are outcompeting us.

As other states move to lower income tax rates, Indiana must not stand still.

There is much talk about the tough times the middle class is having these days. Many politicians treat the middle class as yet another demographic to target with government programs and services.

Governor Pence takes a different view. Middle-class parents and children want opportunity. They want good jobs and the future those jobs make possible. Smart tax policy that lowers the tax burden on families and small businesses is directly related to fostering the kind of vibrant economic environment that middle class families are hoping for.

Acting with Urgency

We need to act boldly and swiftly to keep Indiana moving in the right direction. Critics of Governor Pence's proposal to reduce income taxes by 10 percent have dismissed its effect on individual household budgets. While this may sound like a fair point, it misses the main point. As the foregoing section indicates, the overall economic effect of lowering tax rates is a benefit to Hoosier households in the form of jobs, income growth, and economic growth.

Understood correctly, our situation requires a sense of urgency. Why? Even though our lawmakers have made laudable changes to Indiana's tax code in recent years, our tax situation is still more challenging than is often noted. Indiana needs additional income tax relief.

Consider the following:

- Indiana's tax burden rose from 8.2 percent to 9.6 percent of state income over the last decade, the 23rd highest in the country.[14]
- Federal taxes have been increased on businesses that employ 54 percent of the private workforce. These tax increases could threaten as many as 710,000 jobs this year alone.[15]

[14] Elizabeth Malm & Gerald Prante, *Annual State-Local Tax Burden Ranking*, Tax Foundation, October 2012

[15] Drs. Robert Carroll &Gerald Prante, *Long-run Macroeconomic Impact of Increasing Tax Rates on High-Income Taxpayers in 2013*

- Hoosier workers have recently seen their payroll taxes go up from 4.2 percent to 6.2 percent.[16]
- As the Affordable Care Act is fully implemented, small businesses will find it increasingly harder to hire new workers. A recent survey from the U.S. Chamber of Commerce found that 72 percent of small business owners said that complying with the new law will make hiring workers more difficult.[17]
- A study by the Kelley School of Business at Indiana University found that nearly 15 percent of all the new jobs created from 2003-2008 in Indiana would have been at risk had the Affordable Care Act been in effect during that period.[18]

Providing tax relief on multiple fronts is an important way for Indiana to free up capital in the private economy for investment and continued growth.

If we lower Indiana income taxes by 10 percent, Indiana will have the lowest tax burden in the Midwest at 9.29 percent of state income.

In addition, lowering income taxes by 10 percent would put $500 million back into the private economy.

Finally, as the research cited earlier indicates, Indiana can expect to see an increase in Gross State Product and personal income as a result of a 10 percent tax reduction.

The Pence Tax Proposal: Affordable and Doable

Some have suggested that we can't afford to cut income taxes by 10 percent if we also want to invest in our schools and our transportation infrastructure. The budget that Governor Pence submitted shows that the 10 percent income tax cut and priority investments in education and transportation are not mutually exclusive.

In addition, the April revenue forecast, which estimates revenue at $290 million above the previous December forecast, underscores this point even more.

The reality is that the short- and long-term budget outlook for the state is quite positive. After years of financial mismanagement that led to annual deficits exceeding $700 million per year,[19]

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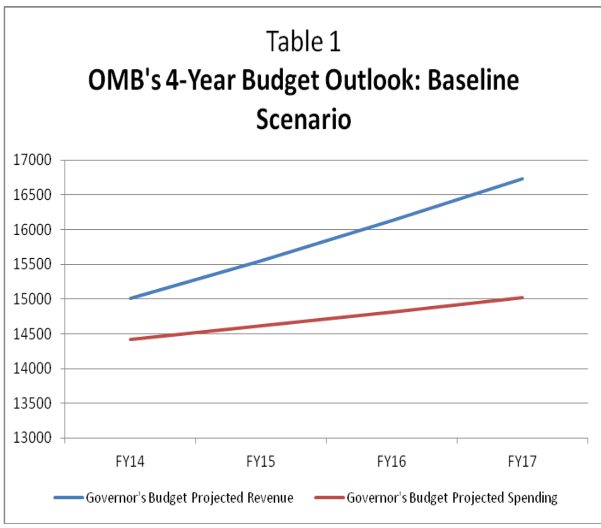
[16] Hadley Malcolm, *Payroll Tax Increase may Nick Consumer Spending*, USA Today, January 22, 2013 http://www.usatoday.com/story/money/personalfinance/2013/01/21/payroll-tax-increase-retail/1823649/

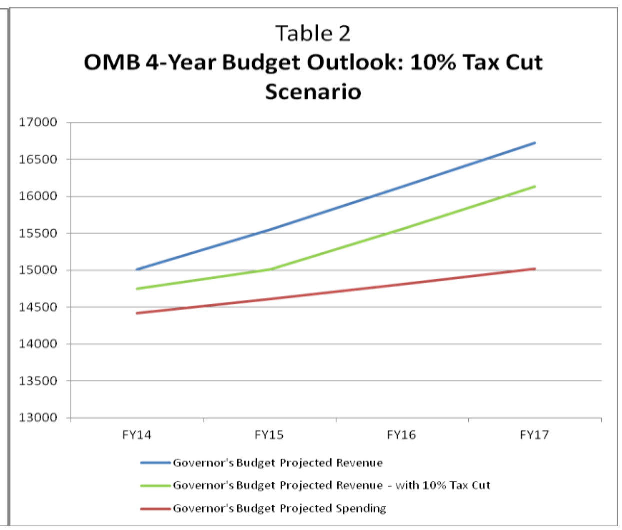
[17] Harris Interactive, *United States Chamber of Commerce Q2 Small Business Study*, July 16, 2012

[18] Timothy F. Slaper & Ryan A. Krause, *Where the Jobs Are*: *A Report on Job Creation in Indiana*, Indiana University Kelley School of Business, January 2012

Governor Daniels, Senate President Long, and Speaker Bosma passed honestly balanced budgets and practiced the fiscal discipline necessary to reverse course. Now we have annual surpluses in excess of $700 million, reserves in excess of $2 billion, and AAA credit ratings from all three rating agencies, which confirms the strength of our state's balance sheet.

Because of our financial strength, OMB's 4-year budget outlook projects that revenues will greatly exceed expenses in the next four years, with annual surpluses estimated at $593 million in Fiscal Year 2014 growing to $1.7 billion in Fiscal Year 2017 (see Table 1).[20] It should be noted that, among other things, OMB's four-year budget outlook assumes 1 percent increase in K-12 tuition support, 1 percent increase in higher education funding, standard increases in Medicaid spending, contractual increases at the Department of Corrections, and requested increases for the Department of Child Services. [21]





Although the tax cut would reduce revenue in excess of $500 million when fully implemented, the state will still have healthy budget surpluses to invest in additional funds for schools and transportation (see Table 2 above and Table 3 below).

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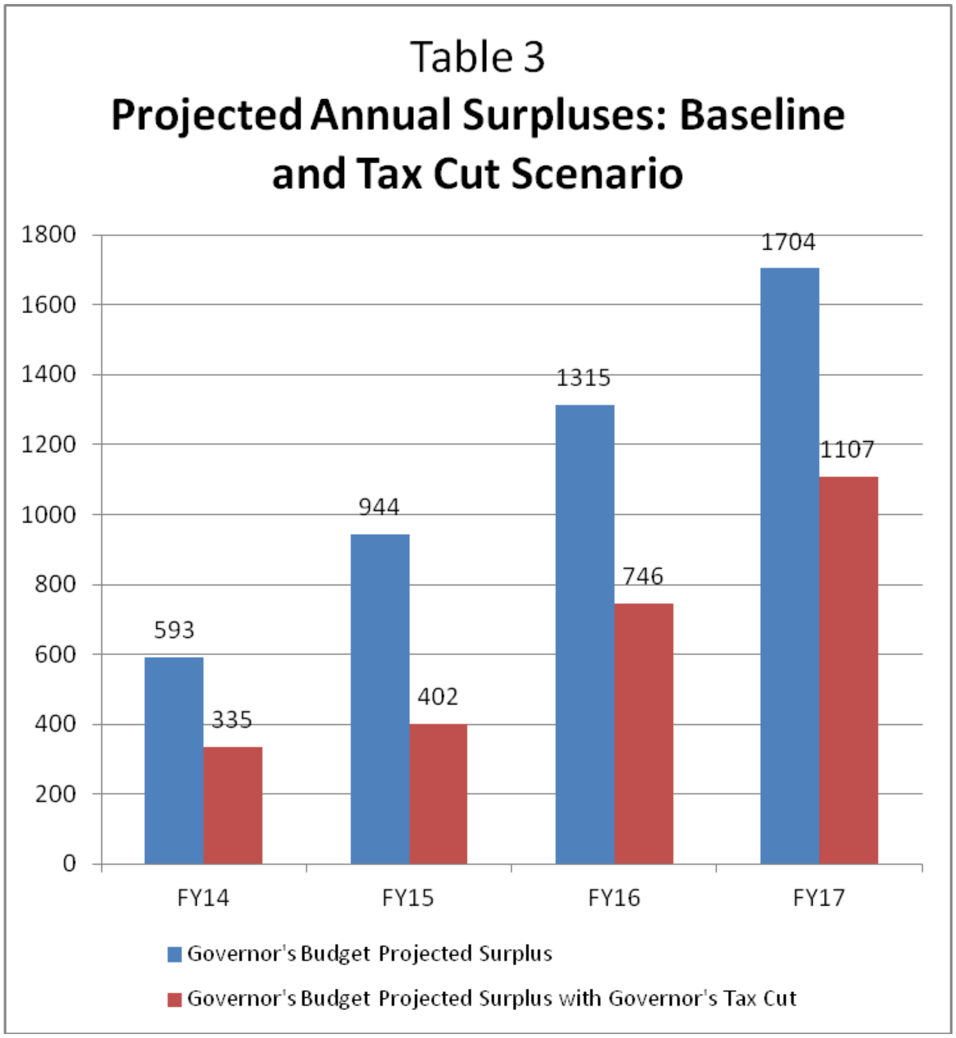
[19] John Ketzenberger, *Indiana's Fiscal Condition: A Different Set of Policy Choices*, July 12, 2012 http://www.indianafiscal.org/pdf/IFPI-Report-on-Indianas-Fiscal-Condition.pdf

[20] Indiana State Budget Agency, *4-Year Budget Outlook: Surplus Statement,* April 16, 2013 http://www.in.gov/sba/files/FY14-17_4-year_budget_outlook_surplus_statement_04-16-13.pdf

[21] A full list of assumptions made in this 4-year outlook is located at http://www.in.gov/sba/files/FY14-17_4-year_budget_outlook_assumptions_12-31-12.pdf.



Governor Pence's tax proposal is clearly affordable and doable. In conclusion, the larger question, given the impact of lower income taxes on economic growth, is how Indiana can afford not to cut taxes. As other states in America are working to out-do us in economic competitiveness, now is the best time to provide income tax relief to Hoosiers and increase Indiana's competitiveness as a business and lifestyle destination.