Dear Members of the Joint Revenue Committee,

With reference to your agenda for the 5/11-12 meeting, please find below my analysis of the state budget situation and its macroeconomic context.

My key findings are:

1. The revenue shortfall in the state budget is not of a temporary nature. It is permanent and caused by a combination of overspending and heavy reliance on severance taxes.
2. The permanent nature of the budget deficit means that temporary solutions to the deficit are ruled out. Any changes to taxes or spending must be permanent in nature and appropriate to the size of the permanent, or structural deficit.
3. Contrary to common belief, the Wyoming economy is not strong. In terms of GDP growth, private-sector job creation and overall government burden we are one of the weakest states in the country.
4. Because of the weak nature of our economy, there is no room whatsoever for tax increases. Only structural spending cuts can put the state budget back on track to balance.

Please find my brief analysis below.

Sincerely,

Sven R Larson, Ph.D., Economist and Public Policy Consultant
slarson@hush.com

======

Structural Spending Cuts: The Only Path to A Balanced Budget

In the depth of the Great Recession, 2010-2013, Wyoming had the worst economic growth of all 50 states:

Real average annual GDP growth, 50 states, 2010-2013

1	North Dakota	9.85%	26	Arizona	1.45%
2	Texas	4.47%	27	Kansas	1.40%
3	Michigan	2.80%	28	South Carolina	1.32%
4	Nebraska	2.63%	29	Pennsylvania	1.27%
5	Oklahoma	2.44%	30	New Hampshire	1.25%
6	Iowa	2.39%	31	Maryland	1.04%
7	Minnesota	2.29%	32	Georgia	1.03%
8	Montana	2.25%	33	North Carolina	0.94%
9	South Dakota	2.22%	34	Virginia	0.92%
10	Oregon	2.16%	35	Florida	0.88%
11	Tennessee	2.07%	36	Illinois	0.85%
12	Indiana	2.07%	37	Idaho	0.84%
13	Kentucky	2.03%	38	New Jersey	0.72%
14	Utah	2.02%	39	Rhode Island	0.69%
15	Ohio	1.92%	40	Mississippi	0.67%
16	Arkansas	1.88%	41	West Virginia	0.60%
17	Massachusetts	1.84%	42	Missouri	0.37%
18	California	1.79%	43	New Mexico	0.16%
19	New York	1.76%	44	Nevada	0.14%
20	Wisconsin	1.67%	45	Louisiana	0.12%
21	Washington	1.67%	46	Connecticut	0.02%
22	Colorado	1.57%	47	Alaska	-0.04%
23	Hawaii	1.57%	48	Maine	-0.27%
24	Vermont	1.57%	49	Delaware	-0.36%
25	Alabama	1.51%	50	**Wyoming**	**-1.28%**

Source: *Bureau of Economic Analysis*.

To some extent the poor performance of the Wyoming economy was due to lackluster demand for our natural resources. Demand for coal has declined substantially, though the bulk of the decline did not take place until after this period. It is also true that growing competition in the oil market has deflated prices; again, though, most of the consequences of new, competing supply were not felt in Wyoming until 2014-2015.

The problem is that outside of the minerals industry there is no private sector of any substance in the state of Wyoming. Even though 90 percent of all private-sector jobs in

Wyoming are not in the minerals industry, the value added to the economy from production in non-minerals industries is very small compared to minerals. This means that the non-minerals industries have a weak ability to carry the burden of government.

Big government is not just a rhetorical punch line in Wyoming, but an economic reality. Because of the weak tax-paying ability of the non-minerals industries, the decline in the minerals industry makes it impossible to maintain a large government sector in our state.

To erase any doubt about the size of government in Wyoming, consider that:

- We have one of the largest government payrolls in the country, consistently over time;
- Government is our second-largest industry;
- Wyoming has the nation's third most burdensome government employee compensation;
- A structural deficit has been visible in the state budget since at least 2014;
- We were home to the third fastest growing government spending in 2012-2014.

Against this background, the latest two reports from the Consensus Revenue Estimating Group are cause for alarm. (There has in fact been cause for alarm ever since the national economy went into a deep recession in 2009.) It is refreshing that the budget deficit is now on almost everyone's lips; it is time to take the next step and eliminate higher taxes as an alternative.

As a matter of fact, Wyoming does not have many options even if tax increases were a realistic option. To see why, consider what would happen if the legislature tried to close its budget gap by means of higher taxes.

First, **the property tax**, from which the state gets approximately $350 million annually. To close a budget deficit of $250 million the state would have to significantly raise the fractional assessment share of the market property value. For example, a property with a market value of $200,000 is today subject to a tax on 9.5 percent of that value; the tax is calculated on a value of $19,000. In order to raise enough money to close a $250 million budget gap the state would have to raise the fraction – the nominal base for the property tax – from 9.5 percent to 16.2 percent. This means that for the property worth $200,000 the property tax would be calculated on the basis of $32,490. Or, to put it bluntly: for every $100 you now pay in property taxes you would be paying $171 after the tax increase.

But what about **the sales tax**? The general sales tax yields approximately $700 million per year (as a trend; annual fluctuations disregarded). The state sales tax rate – not counting local sales taxes – is four percent. By static calculation, an increase in the general sales tax to 5.5 percent would cover a $250-million budget deficit. That said, it is very important to review the dynamic effects of the sales tax, which are discussed separately (below).

Food tax? Wyomiongites spend about $1.8 billion per year on food and beverages "for off-premises consumption", i.e., groceries. A $250 million tax increase based on a food tax alone would result in a 13.5-percent tax rate. Again, this is based on static assessments.

Tobacco tax: Current revenue from this tax is about $28 million. Case closed.

Alcohol tax: Current revenue from this tax is about $1.8 million. Case closed.

All other existing taxes and "fees" are irrelevant by their own quantitative insignificance.

As for non-existing taxes, what about a **personal income tax**? There are different ways to implement a personal income tax, with the flat-rate and progressive-rate tax systems as the best known alternatives.

For reasons that I will not elaborate on here (but I will be happy to explain upon request) a flat income tax would never yield close to the revenue required to close the structural deficit in the state budget. Only a progressive income-tax model could – in theory – provide the necessary revenue.

Arizona is a good example of a state with a progressive-rate income tax. With eight brackets from 2.59 percent to 4.54 percent, if the Arizona model were imported to Wyoming it would, under a strictly static revenue estimate, yield $835 million.

The problem with an income tax that takes this big a bite out of taxpayers' disposable income is that it has substantially negative effects on the Wyoming economy. In plain English, over time it would be practically impossible for the state to collect anywhere near the revenue needed to close the deficit gap in the state budget.

It is very important to keep the dynamic effects of tax increases in mind. Short of a corporate income tax, all alternatives will one way or the other affect the disposable (net-tax) income of Wyoming families.

In 2014, that disposable income was $28.2 billion. That same year, households spent $22.8 billion, which in other words was the total private-consumption expenditure in Wyoming. This means that out of every $100 million in higher taxes, consumers would reduce their spending by, on average, $81 million.

The smaller the tax increase, the more likely it is that consumers will concentrate their spending reductions to durable goods, such as cars, furniture, appliances and similar products. Durable goods currently represent ten percent of private consumption in Wyoming; if their share of reduced spending was twice as high, it would mean reduced sales for durable-goods retailers of $16 million per $100 million in higher taxes.

Larger tax increases will be spread more evenly across private consumption. At $800 million in higher taxes it is a safe bet that everything from groceries to new homes will be affected. Under the Arizona income-tax model, which would cause an initial decline in private consumption by an estimated $647 million, the dynamic effects will come in two forms. The first, as mentioned, is a drastic reduction in consumption, at an amount equal to over 12,000 private-sector jobs.[1] One way or the other, affected businesses will have to respond.

The second form of dynamic effects is the reaction among Wyoming residents to the state's lost status of income-tax free jurisdiction. The outflow of residents seeking a new low-tax jurisdiction will come in two segments: the wealthy whose residence is independent of their income source, and the career professionals who live in Cheyenne but work in the I-25 corridor from Fort Collins to Denver. The combination of the commuting cost and the new income tax (4.24 percent on the margin for incomes $100,000 to $200,000 per year) will likely be enough to eliminate Laramie County and Wyoming as a viable residential alternative.

[1] This is **not** a forecast that 12,000 jobs would be lost. The dynamic effects on the job market from such large reductions in private consumption are too complex to be analyzed under non-parametric conditions. The number of jobs is used for illustrative purposes to highlight the major risks of job losses in the wake of such a massive tax increase as is discussed here.

Without any estimates on the outbound migration, it is still safe to say that the total job losses from any tax increase will have clearly negative effects on the Wyoming economy. Any tax hike is negative, but at this point in the state's business cycle it would have profoundly serious effects:

- As a tax increase reduces disposable income, 81 percent of that reduction translates into lower household spending;
- When households reduce spending, there is a drop in sales-tax revenue;
- The larger the initial tax increase, the larger the effect on reduced household spending – and the larger the loss of jobs as a result of lower household spending;
- Higher unemployment leads to increased costs for welfare and unemployment benefits;
- Lost income, sales and property taxes from outbound migration.

Therefore, as an economist with 15+ years of Ph.D.-level experience with macroeconomic analysis, and 10+ years of experience providing economic research for legislators and political candidates, I simply cannot recommend any tax increase whatsoever.

Sven R Larson, Ph.D., is an economist specializing in macroeconomics and the welfare state. He is the author of Industrial Poverty about the decline in the European economy, and Robbing the Millennials about the looming U.S. debt crisis.