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A Review of Significant State Tax Changes During 2009

By Joseph Henchman

Introduction

During most of this decade, state lawmakers responded to surging tax revenue by boosting state spending growth to an unsustainable level. Now that boom has turned to bust, significant structural budget deficits have opened up in many states. Throughout 2009, state officials struggled to close these gaps. They face three choices to meet their budgetary obligations.

One option is to raise taxes. Officials generally claim that the budget cannot or should not be cut any further, and that the benefits of tax increases for the state budget outweigh the economic damage they can do in an economic downturn. Most states taking this option aimed their taxes at specific groups such as high-income earners, smokers, or out-of-state business transactions. These revenue sources may provide short-term relief but can cause substantial economic harm to the state economy in the medium and long term.

The opposite approach is the second option: roll back spending growth commitments made during previous years and take actions to spend no more than the state brings in. Arkansas and Indiana have taken this path.

The final and politically easiest option is to use one-time funds and accounting gimmicks to paper over the current state budget shortfall, but without significantly curtailing spending. This irresponsible approach amounts to praying that the economy will soon recover and bring a surge of tax revenue. California has taken this path for several years in addition to raising already-high taxes, building up to a crisis in 2009 when the state issued IOUs, borrowed, seized funds from local governments, and enacted requirements that companies increase withholding to 110% of what workers owed—in essence an interest-free loan to the state.

Other factors in these decisions have been the draw down of rainy day funds by most states (Texas notably has several billion dollars remaining), the availability of one-time stimulus aid but with strings that forbid cuts to huge swaths of state budgets, and increasing abuse of state Medicaid matching funds as a way to shift state general spending to the federal taxpayer.

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For more information on each state's tax system, see the Tax Foundation State Tax Information website at www.taxfoundation.org/research/topic/9.html.

State Changes to Individual Income Taxes

Increases

- **California** in May added 0.25% to each income tax bracket, retroactive to January 1, 2009 and expiring December 31, 2010.
    - For more information, see *Tax Foundation Fiscal Fact,* No. 170, "A Golden Opportunity: California's Budget Crisis Offers a Chance to Fix a Broken Tax System," (5/18/09).
- **Connecticut** in September added a new top bracket of 6.5% on income over $500,000, retroactive to January 1, 2009.
    - For more information, see the Tax Foundation report, "Connecticut Tax Hikes in Proposed Budget," (8/27/09).
- **Delaware** in June added a new top rate of 6.95% on income over $60,000 retroactive to January 1, 2009.
- **Hawaii** in May added three new brackets retroactive to January 1, 2009: 9% on income over $150,000; 10% on income over $175,000; and 11% on income over $200,000.
    - For more information, see *Tax Foundation Fiscal Fact,* No. 169, "The Price of Paradise: Hawaii Becomes Fifth State to Adopt New Income Tax Brackets on High-Earners," (5/12/09).
- **New Jersey** in June added three new brackets retroactive to January 1, 2009 and expiring 12/31/09: 8% on income over $400,000; 10.25% on income over $500,000; and 10.75% on income over $1 million.
    - For more information, see *Tax Foundation Fiscal Fact,* No. 171, "New Jersey's Governor Corzine Proposes 10.75% Income Tax Rate," (5/27/09).
- **New York** in May added two income tax brackets retroactive to January 1, 2009 and expiring December 31, 2011: 7.85% on income over $200,000 and 8.97% on income over $500,000.
    - For more information, see *Tax Foundation Fiscal Fact,* No. 159, "New York Governor Paterson's Tax and Fee Proposals a Mixed Bag," (1/22/09).
- **North Carolina** in August imposed a tax surcharge of 2% on those with incomes over $60,000 and 3% on those with incomes over $150,000, retroactive to January 1, 2009 and expiring December 31, 2010.
    - For more information, see the Tax Foundation report, "North Carolina Reportedly Reaches Budget Deal," (8/3/09).
- **Oregon** in July approved the addition of two new brackets retroactive to January 1, 2009 and expiring 12/31/11: 10.8% on income over $125,000 and 11% on income over $250,000. After 2011, the former bracket will become 9.9% and the top bracket will be eliminated. However, a petition drive subsequently forced a public vote on the tax increases, which will be held on January 26, 2010. If Measure 66 passes, the tax increases will take effect, retroactive to January 1, 2009. If Measure 66 fails, the tax increases will be cancelled.
    - For more information, see *Tax Foundation Fiscal Fact,* No. 175, "The Dam Bursts in the Beaver State: Oregon's Wave of Tax Increases and New Spending," (7/9/09), and the Tax Foundation report, "Oregon Sets Referendum on Highest State Income Tax," (12/18/09).
- **Wisconsin** in June added a new top bracket: 7.75% on income over $225,000.

Reductions

- **Louisiana** in 2008 reduced rates on some incomes by adjusting the bracket structure beginning January 1, 2009. The 6% bracket that formerly kicked in at $25,000 now begins at $50,000.
  - For more information, see the Tax Foundation report, "Louisiana Governor Jindal Stands By Tax Cuts and Tax Credits; Holds Off Using Rainy Day Fund," (12/29/08).
- **Maine** in June replaced its progressive high-rate structure with a flatter income tax that will take effect January 1, 2010. The current four-rate structure with an 8.5% top rate will be replaced with two rates: 6.5% on the first $250,000 of income, and 6.85% on income over $250,000.
  - For more information, see *Tax Foundation Fiscal Fact,* No. 174, "The Pine Tree State Chops Down Income Tax: Maine Enacts Major Tax Reform" (6/23/09).
- **North Dakota** in May cut each income tax rate by about 14 percent, retroactive to January 1, 2009. The top rate was brought down from 5.54% to 4.86%.
  - For more information, see the Tax Foundation report*,* "North Dakota Cuts Income Tax," (5/27/09).
- **Ohio** reduced its income tax across the board slightly as part of package to phase out the corporate income tax, phase in a gross receipts tax, cut the sales tax slightly, phase out the inventory tax, and reduce the income tax by 21% over five years. The income tax reduction scheduled for 2010 has been postponed.
  - For more information, see the Tax Foundation report, "Ohio Governor Picks Up Votes for Preventing Income Tax Cut," (12/2/09).
- **Vermont** in June reduced income taxes slightly across the board, retroactively to January 1, 2009. The top rate dropped from 9.5% to 9.4%. They will be lowered again across the board on January 1, 2010, when the top rate will drop to 8.95%. Further reductions or changes are being considered.
  - For more information, see the Tax Foundation testimony, "Vermont Income Tax Proposals Would Enable Elimination of Sales Tax," (12/3/09).

State Changes to Sales Taxes

- **California** increased its sales tax from 7.25% to 8.25%; the average combined state-local sales tax is now 9.06%, the second highest in the country. The increase went into effect April 1, 2009. Five cities (Avalon, El Monte, Inglewood, Pico Rivera, and South Gate) have sales taxes over 10%.
  - For more information, see *Tax Foundation Fiscal Fact,* No. 170, "A Golden Opportunity: California's Budget Crisis Offers a Chance to Fix a Broken Tax System," (5/18/09).
- In the fall, **Connecticut** officials enacted a planned reduction in the state sales tax from 6% to 5.5% but subsequently cancelled the reduction.
  - For more information, see the Tax Foundation report, "Connecticut Sales Tax Reduction Cancelled," (12/2/09).
- **Massachusetts** increased its sales tax from 5% to 6.25%, beginning August 1, 2009.
  - For more information, see the Tax Foundation report, "Flurry of Cross-Border Shopping After Massachusetts Raises Tax," (9/11/09).
- **Minnesota** increased its sales tax from 6.5% to 6.875%, implementing a referendum passed in November 2008 to increase taxes for arts and environmental projects. The increase went into effect on July 1, 2009.

- **Nevada** increased the sales tax for local schools from 2.25% to 2.60%, resulting in an increase in the total state sales tax from 6.5% to 6.85%. With local sales taxes, the average sales tax is now 7.59%.
    - For more information, see the Tax Foundation report, "Nevada Governor to Veto Increase to Sales, Payroll, Hotel, and Car Taxes," (5/28/09) (the veto was subsequently overridden by the legislature).
- **North Carolina** increased its sales tax from 4.5% to 5.5%, effective September 1, 2009, and to 5.75% effective October 1, 2009. The tax will revert to 5.5% on July 1, 2011. North Carolina now has a combined average state and local sales tax rate of 8.07%, moving from 26th highest sales tax in the country to 8th highest sales tax in the country.
    - For more information, see the Tax Foundation report, "North Carolina Reportedly Reaches Budget Deal," (8/3/09).
- **District of Columbia** increased the sales tax from 5.75% to 6.00%, effective October 1, 2009.
    - For more information, see the Tax Foundation report, "D.C. Approves Tax Hikes," (8/3/09).

State Changes to Cigarette Excise Taxes

Tax rates are per pack of 20 cigarettes. For a complete list of cigarette tax rates and for research on the topic, click here.

- **Federal**: from 39 cents to $1.0066
- **Arkansas**: from 56 cents to $1.15
- **Colorado**: Subjected to state sales tax in addition to excise tax
- **Connecticut**: from $2.00 to $3.00
- **Delaware**: from $1.15 to $1.60
- **Florida**: from 34 cents to $1.34
- **Hawaii**: from $2.20 to $2.60 (will rise to $2.80 on July 1, 2010 and $3.00 on July 1, 2011)
- **Kentucky**: from 30 cents to 60 cents
- **Mississippi**: from 18 cents to 68 cents
- **New Hampshire**: from $1.33 to $1.78
- **New Jersey**: from $2.58 to $2.70
- **North Carolina**: from 35 cents to 45 cents
- **Pennsylvania**: from $1.35 to $1.60
- **Rhode Island**: from $2.46 to $3.46
- **Vermont**: from $1.99 to $2.24
- **Wisconsin**: from $1.77 to $2.52
- **District of Columbia**: from $2.00 to $2.50
- **Puerto Rico**: from $1.23 to $2.23

State Changes to Alcohol Excise Taxes (Beer, Wine, and Spirits)

For a complete list of alcohol tax rates, click here.

- Illinois
- Massachusetts
- New Jersey
- New York
- North Carolina

Miscellaneous

- **Plastic Bag excise taxes** (sometimes mischaracterized as "fees") have been proposed in several places, including a planned enactment that was repealed before it took effect in Seattle. The **District of Columbia** enacted an excise tax of 5 cents on the retail use of plastic bags in certain circumstances, which takes effect January 1, 2010.
  - For more on the District of Columbia tax, see the Tax Foundation report, "D.C. Charge on Plastic Bags is a Tax, Not a Fee," (11/17/09).
  - For more on the Seattle tax, see the Tax Foundation reports, "Proposed Seattle Bag Tax Criticized," (6/30/08) and "No Bag Tax in Seattle," (8/19/09).
- **"Amazon" Taxes**: **North Carolina** and **Rhode Island** in 2009 followed **New York**'s 2008 action in adopting an "Amazon" tax, which imposes a tax collection obligation on out-of-state companies that have affiliate and advertising relationships with in-state companies. The U.S. Supreme Court has ruled that such taxation beyond a state's borders violates the U.S. Constitution, and the case is currently being litigated in New York courts. Many large retailers cancelled their affiliate and advertising operations in North Carolina and Rhode Island after their "Amazon" taxes were passed. California and Hawaii passed similar laws but they were vetoed by their respective governors.
  - For more on Amazon taxes, see the Tax Foundation report, "'Amazon' Tax: Unconstitutional and Unwise," (9/15/09).
- **Obesity and soda taxes** were proposed in New York and elsewhere but not enacted. Such proposals are cloaked in health-consciousness rhetoric despite the unlikelihood that obesity is best addressed by taxing one product used by obese and non-obese alike.
  - A forthcoming Tax Foundation report will examine the issue of obesity and soda taxes.

Lessons: Real Tax Reform Means Spending Restraint and Broad Tax Bases with Low Rates

With state revenues declining due to the tough economic situation, most state leaders in 2009 have tapped high-income earners, smokers, out-of-state business transactions, or other targeted groups, those being the only people that politicians feel safe raising taxes on. But the increases have come from a minority of states, and others should be cautious about enacting substantial tax increases in the midst of a recession on anyone.

High-income people have much more volatile income than middle-income wage-earners, largely because capital gains and business income are sensitive to changes in the economy and fluctuate rapidly.[1] Relying too heavily on these sources of income for tax revenue leads to unpredictability in tax revenues in the long run, with revenues surging in good economic times and plunging in bad. Increasing the progressivity of a state's tax system will exaggerate these effects, and states need to consider this when evaluating their fiscal situations.

When deciding in which state to live or locate their business, one of the factors that top earners must weigh is the marginal tax rate they will face in each state. While high statutory tax rates on high incomes may bring a revenue increase in the short term, they can harm long-term economic growth as providers of jobs and capital choose to locate in lower-tax states.

California has experienced these problems first hand. Even before the recent tax increases, California had relied heavily on taxing capital gains and other income from high-income individuals. When the state experienced a huge revenue surge during the prosperous economic times in the middle of the decade lawmakers responded by increasing spending levels to match those revenue surges.[2] Each year between 1999 and 2003, California general fund spending ranged between $71 billion and $75 billion. But encouraged by rapidly increasing revenues, spending reached $99 billion by 2007, a 31% increase over 2003. During the same period inflation increased 12% and the state population grew just 5%.

But decreasing spending is not nearly as easy as increasing spending, and when revenues fell California was left with a budget shortfall that has been estimated to be as high as $40 billion. Reluctant to cut spending but apparently wary of becoming any more reliant on volatile revenue from high-income earners, the legislature passed a broad-based income tax increase. Even with the tax increase and additional spending cuts, the shortfall still stands at tens of billions of dollars.

In addition to the volatility and spending issues, California's business environment has consistently ranked in the bottom five in the Tax Foundation's *State Business Tax Climate Index*.[3]

The lesson to be learned from California is twofold: states should not assume that revenue surges in good times will continue indefinitely, and the more reliant a state is on high-income earners the bigger hit they will sustain when those revenue surges eventually end. Therefore, legislators should adopt wise spending and tax policies that recognize and prepare their states for these economic realities.

Conclusion

When the recession ends, states need to have the right policies in place that will promote economic growth and maintain revenue stability. Relatively high taxes on high-income individuals, smokers, and out-of-state business transactions can make a state less attractive and create more volatility in an already uncertain economic climate.

Notes

[1] See Joseph Henchman, "State Budget Shortfalls Present a Budget Reform Opportunity," *Tax Foundation Special Report,* No. 164 (February 2009), at http://www.taxfoundation.org/files/sr164.pdf.
[2] See Joseph Henchman, "A Golden Opportunity: California's Budget Crisis Offers a Chance to Fix a Broken Tax System," *Tax Foundation Fiscal Fact,* No. 170 (May 2009), at http://taxfoundation.org/publications/show/24712.html.
[3] See Kail Padgitt, "2010 State Business Tax Climate Index," *Tax Foundation Background Paper,* No. 59 (September 2009), at http://taxfoundation.org/publications/show/22658.html.