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A Review of 2010's Changes In State Tax Policy

By Joseph Henchman & Xander Stephenson

Introduction

The last few years have seen state lawmakers struggle with unsustainable spending commitments they made when the economy was booming. Year-on-year decreasing tax revenues have not only opened up a widening structural deficit but depleted rainy day funds and overused one-time and emergency budget solutions. The federal stimulus law in 2009, replicated in miniature in the just-passed $26 billion stimulus, runs out in 2011.

According to a July 2010 report from the National Conference of State Legislatures, 41 states closed or are closing a budget gap for their FY 2011 budgets. Thirty-three states project budget gaps for FY 2012 and 23 states for FY 2013. Alarmingly, 25 states have assumed in their FY 2011 budgets the receipt of additional federal aid in amounts that are probably larger than what is actually forthcoming. On the other hand, overall tax receipts increased during the first quarter of 2010, and states as a whole project that FY 2011 revenues will be 3.7% higher than FY 2010.

In addressing gaps between desired spending and projected revenues, state officials must make serious choices. 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 have aimed their taxes at specific groups, such as high-income earners, smokers, or out-of-state business transactions. Some states have raised the sales tax. These revenue sources may provide short-term relief but can cause harm to the state economy in the short and long term.

Another option is to roll back spending growth commitments made during previous years and take actions to spend no more than the state brings in. Some states have resisted the urge to patch their budgets with one-time revenue sources, instead focusing on balancing structural revenues with structural expenses. Arkansas, for instance, uses an innovative priority-based budgeting system. Indiana officials cut spending and assumed no extension of federal aid. States have also drawn down rainy day funds and other balances.

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The third and politically easiest option is to use one-time funds and accounting gimmicks to paper over the current state budget shortfall, without significantly curtailing spending. This irresponsible approach amounts to hoping that the economy will soon recover and bring a surge of tax revenue. California is the poster child of this approach, building for several years 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 examples include Illinois floating bonds to make this year's pension fund payment, and Kentucky ordering 180 days of school instruction but funding only 179 days.

Below are key changes that states have made to their tax systems so far during 2010.

State Changes to Income Taxes

Tax Increases

- Oregon voters on January 26 approved Measure 66 by a margin of 54% to 46%, ratifying an income tax increase retroactive to January 1, 2009. The new brackets are 10.8% on income over $125,000 and 11% on income over $250,000. After 2011, the new 10.8% rate will drop to 9.9%, and the 11% bracket will be eliminated. Oregon's 11 percent personal income tax is now tied with Hawaii's for the highest rate in the country. Because its capital gains tax rate is linked to the income tax, Oregon's tax on investment gains is also the nation's highest.
  - For more information, see *Tax Foundation Fiscal Fact,* No. 206 http://www.taxfoundation.org/research/show/25680.html (1/7/10).
- Ohio postponed for one year a planned 4.2% reduction in income tax rates, due to begin in January 2010.
  - For more information, see *Tax Foundation Fiscal Fact* No. 207 http://www.taxfoundation.org/research/show/25674.html (1/7/10).

Tax Decreases

- New Jersey's "millionaires' tax" income tax rates, with a top rate of 10.75%, were allowed to expire as scheduled on December 31, 2009, despite calls to renew them. Governor Chris Christie (R) vetoed a bill to do so in June 2010.
  - For more information, see an article on Tax Foundation's *Tax Policy Blog,* http://www.taxfoundation.org/blog/show/26454.html (6/21/10).
- Rhode Island on June 5 passed a new tax reform that goes into effect January 1, 2011, eliminating the optional flat-tax method of preparing individual income taxes, reducing the number of tax brackets from five to three, and lowering the top income tax rate, from 9.9% to 5.99%.
  - For more information, see *Tax Foundation Fiscal Fact* No. 232 http://www.taxfoundation.org/research/show/26374.html (6/2//10).

Other Changes

- Maine voters in June 2010 approved Question 1 by a margin of 61% to 39%, repealing a year-old law that would have replaced its four-rate income tax structure with a top rate of 8.5% with a flatter income tax and a top rate of 6.85%. The new system would have taken effect January 1, 2010, but was suspended until the referendum. Maine thus reverted to its existing income tax structure.

- For more information, see an article on Tax Foundation's *Tax Policy Blog,* http://www.taxfoundation.org/blog/show/26408.html (6/9/10).

State Changes to Sales Tax Rates

Rate Increases

- Arizona voters approved Proposition 100 in May by a margin of 64% to 36%, increasing its sales tax by one percentage point, from 5.6% to 6.6%, effective June 1, 2010. This is a temporary increase lasting three years, although a similar sales tax increase in 1983 was made permanent before it expired.
  - For more information, see an article on Tax Foundation's *Tax Policy Blog,* http://www.taxfoundation.org/blog/show/26324.html (5/18/10).
- Kansas in its FY 2010 budget increased its sales tax rate from 5.3% to 6.3%, starting July 1, 2010.
  - For more information, see an article on Tax Foundation's *Tax Policy Blog* http://www.taxfoundation.org/blog/show/25957.html (3/9/10).

Rate Decreases

- Arkansas decreased its sales tax on groceries. They will now be subject to a 2% rather than 3% tax rate.

Other Sales Tax Changes

- **Click-through Nexus/"Amazon" taxes.** Colorado approved H.B. 1193, a tax law designed to compel out-of-state businesses to collect the state's use tax from consumers. The law requires out-of-state online retailers to identify their in-state customers, with costly non-compliance penalties. As predicted, upon enacting this law, out of state retailers terminated affiliate relationships within the state and some have launched a legal battle to challenge the law. New York, Rhode Island, and North Carolina have standard Amazon taxes that impose the obligation directly.
- **Sales tax holidays.** Nineteen states enacted sales tax holidays for 2010 (Alabama, Connecticut, Florida, Illinois, Iowa, Louisiana, Maryland, Massachusetts, Mississippi, Missouri, New Mexico, North Carolina, Oklahoma, South Carolina, Tennessee, Texas, Vermont, Virginia and West Virginia). Some apply broadly to most purchases, but most are targeted to exempt clothing, school supplies, computers, or Energy Star products.
  - For more information, see *Tax Foundation Special Report,* No. 182, "Sales Tax Holidays: Politically Expedient but Poor Tax Policy," http://www.taxfoundation.org/publications/show/26533.html (August 2010).

- **Legalizations.** Rhode Island legalized fireworks on June 14 ahead of July 4, a move that boosted sales tax revenue by approximately $500,000.

State Changes to Selective Sales Taxes

Cigarette Taxes

The federal cigarette tax is $1.0066 per pack of 20 cigarettes, and each state levies a tax in addition to this. Five states have increased cigarette taxes so far in 2010, compared to 18 states in 2009. Hawaii is the only state to raise the tax in both 2009 and 2010.

- Hawaii: from $2.60 to $3.00
- New Mexico: from 91 cents to $1.66
- New York: from 2.75 to $4.35
- South Carolina: from 7 cents to 57 cents
- Utah: from 70 cents to $1.70

Soda Taxes

New York again considered a tax on sugary sodas, attracting much national attention before the idea was shelved in March. Mississippi is also considering legislation to tax syrup used to sweeten soda at the distributor level. Colorado in May removed sugared beverages and candy from the list of groceries that were exempt from the sales tax. Washington enacted a new soda tax, adding 2 cents to every 12 oz. can, and extended the sales tax to candy. The District of Columbia also considered a soda tax, but ultimately removed soda from the list of exempt groceries.

Gasoline Taxes

Nebraska has raised its gasoline excise tax in two steps, from 27.3 cents to 28 cents.

Powerball

Eleven states (Georgia, Illinois, Maryland, Massachusetts, Michigan, New Jersey, New York, Ohio, Texas, Virginia, and Washington) began selling PowerBall tickets in 2010, bringing the total number of states participating in the multistate jackpot game to 42. In tax terminology, the "profit" generated when states monopolize gambling operations is best categorized as a selective sales tax on the tickets.

Other State Tax Changes

Film Tax Credits

Virginia enacted a film tax credit program in June, joining over 40 states offering tax incentive packages to motion picture productions. The program begins in 2011 and caps credits at $2.5 million per year. Iowa, Kansas, and New Jersey, on the other hand, eliminated or suspended their film tax credit program, the first states in the nation to do so.

Energy Taxes

Wyoming will be placing a tax on wind energy beginning in 2012. The Wyoming Legislature passed a $1 per megawatt hour wind energy generation tax and allowed a sales tax exemption for renewable energy projects to expire at the end of 2011.

Estate Taxes

Hawaii in June re-enacted its estate tax, which had been dormant since 2005. On April 30, the Legislature overrode a veto by Governor Linda Lingle (R) and imposed a tax on estates of Hawaii residents over $3.5 million ranging from 0.8% to 16% rate on estates over $10.1 million. Nonresidents receive a reduced exemption, paying estate tax on as little as $60,000 of property.

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 2010 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. 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 the capital gains, wages and dividends of high-income individuals. When state revenue surged during the prosperous economic times in the middle of the decade, lawmakers responded by increasing spending levels to match those revenue surges. 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*.

The lesson to be learned from California is twofold: revenue surges in good times will not 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.