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Some States Respond to Budget Shortfalls with Tax Increases

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Introduction

The 2010 fiscal year began on July 1 in 46 states, so this is a logical time to take stock of the state-level tax changes enacted so far this year. Due to lower-than-expected revenues, states that have no rainy day fund have faced the choices that every state budget crunch poses: scrapping plans for new spending, cutting spending on existing programs, or raising taxes.

Almost every state has cut spending, but some were not willing to balance their budgets without raising taxes as the 2009 fiscal year wound down. This Fiscal Fact will highlight three categories of taxation that have been particularly susceptible to changes this year: personal income tax, sales tax and excise taxes.

Seven states have raised income taxes in 2009; three lowered them. Four states have raised sales taxes, ten states raised cigarette taxes, and two states have raised excise taxes on alcohol.

Income Tax

Ten states have made significant changes to personal income taxes during 2009, most of them retroactive to January 1, 2009. Three found ways to lower their tax rates, and among the seven that increased them, new personal income tax rates targeted at higher-income filers were the most common additions. Many of the new taxes are scheduled in law to expire after two or three years; some are permanent.

- **California** added 0.25% to each income tax bracket in May, retroactive to January 1 and expiring on December 31, 2010. In a departure from the norm, California's income tax increases were spread over the whole income distribution, rather than targeting only high income earners. While the state has had a millionaire's tax for several years, the recent

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broad-based increase may be a response to lessons learned about the risk of relying too heavily on the highly volatile incomes of high-income earners.

- As part of the fiscal year 2010 budget, **Delaware** lawmakers increased the state's top income tax rate by one percentage point, from 5.95% to 6.95%. The rate kicks in at taxable income of \$60,000 for single filers and applies to tax years beginning on or after January 1, 2009.
- On May 11, as part of a package of tax increases, **Hawaii's** lawmakers added three new income tax rates on high-income earners, retroactive to January 1: 9% on income over \$150,000, 10% on income over \$175,000, and 11% on income over \$200,000 for single filers. In a ranking of states with the highest top statutory income tax rates, Hawaii now ties Oregon for first place. It is one of four states that have crossed the psychological 10% barrier, three of which made that jump this year.
- In late June **New Jersey** enacted temporary income tax increases on individuals making over \$400,000 as part of their fiscal year 2010 budget, joining the ranks of states with double-digit income tax rates. The new rates for single filers are 8% on income over \$400,000, 10.25% on income over \$500,000, and 10.75% on income over \$1,000,000. The increased rates will apply to tax year 2009 only. The rate increases temporarily give the garden state the third highest top statutory income tax rate.
- **New York** added two income tax brackets, 7.85% on income over \$200,000 and 8.97% on income over \$500,000 for single filers retroactive to January 1, 2009. The new rates are temporary and will be in effect for 3 years.
- **Oregon** lawmakers enacted two new income tax rates on high income earners in June as part of the state's fiscal year 2010 budget. The rates are 10.8% on income over \$125,000, and 11% on income over \$250,000 for single filers. The new 11% rate means that Oregon now shares the number one spot with Hawaii for highest state-level income tax rate. The new rates apply to tax years 2009 through 2011, after which the 10.8% rate will be reduced to 9.9% and the 11% rate will be eliminated. Strangely, while Oregon has historically tied its bracket levels to inflation in order to avoid unintended tax increases, the new brackets will not be indexed to inflation. As a result, inflation will push more taxpayers into the higher brackets each year.
- In June **Wisconsin** legislators added one high-income tax rate to their rate structure. The new rate is 7.75% on income over \$225,000 for single filers.

Going against the general trend this year, three states have actually been able to lower their income tax rates.

- On June 12 the governor of **Maine** signed a major tax reform plan that is predicted to neither raise nor lower revenue. The plan abolishes the four-rate income tax structure and replaced it with a much flatter structure with two rates, both lower than the 8.5% top rate of the system they are replacing: 6.5% on income under \$250,000, and 6.85% on income over \$250,000 for single filers. The new rates will take effect on January 1, 2010. These lower rates were made possible in a revenue-neutral plan by broadening the sales tax base.¹
- **North Dakota** also reduced income tax rates this year, cutting each income tax rate by about 14 percent. That brought the top rate down from 5.54% to 4.86% on income over \$372,950 for single filers. The new rates are effective as of January 1, 2009.
- **Vermont** reduced income tax rates slightly across the board. The top rate dropped from 9.5% to 9.4% on income over \$372,950 for single filers. The changes are retroactive to January 1, 2009.

Sales Tax

Sales tax changes have been fewer. Of the four states that are enacting higher sales taxes, two raised their rates by an unusually large amount: Massachusetts and California raised their rates by 25% and 13% respectively. The tax hikes in Nevada and Minnesota were more typical, up by about 5%.

- **California** has increased its sales tax from 7.25% to 8.25%, a 13% increase. This, though a large increase, does not tell the complete story of California sales tax. A number of counties and cities have passed increases of their own. The combined rate in Los Angeles County is now 9.75%. Two cities within Los Angeles County, Pico Rivera and South Gate, now have rates of 10.75%. Additionally Avalon, El Monte, and Inglewood have exceeded 10% threshold.
- **Massachusetts** has enacted the largest percentage increase of any state, moving from 5% to 6.25%, a 25% increase. Massachusetts is estimating its budget shortfall at \$5 billion and this drastic increase is meant to fill that gap. The decision to raise the rate rather than broaden the base is not a sound policy judgment, and it will hurt Massachusetts in interstate comparisons, such as the Tax Foundation's *State Business Tax Climate Index*. Last year Massachusetts ranked ninth best in the sales tax sub-index of that comparative study.
- **Minnesota's** sales tax now stands at 6.875% up from 6.5%. This increase was passed by referendum last November but went into effect at the start of this fiscal year.
- The sales tax was increased to 6.85% in **Nevada** in an effort to help reduce the state's budget shortfall. This is a 5% increase from the previous level of 6.5%.

Excise Taxes

When states cannot muster political support for broad-based tax increases on income, sales or property, and are equally unwilling to cut spending, they usually turn to selective excise taxes. These are targeted taxes on particular goods imposed at a given rate per unit. Most popular excise tax increases this year have been those on products consumed by a minority of the population, products such as alcohol and tobacco.

Alcohol

Tax increases on alcoholic beverages were enacted by two states, New York and New Jersey. Beer was targeted by New York; the rate increased to \$0.14 per gallon from \$0.11 per gallon. New Jersey instead implemented an additional \$1.10 per gallon excise taxes on spirits, bringing the total to \$5.50. This results in a 25% increase in spirits taxes in New Jersey. Both states, however, raised the excise state on wine. New York's rate went from \$0.19 to \$0.30 per gallon, and New Jersey's rose from \$0.70 to \$0.875 per gallon.

Cigarettes

State cigarette taxes have been around since Iowa first enacted one in 1921. However, in recent years the cigarette tax has become an increasingly popular tax. Table 1 shows the ten states that have increased cigarette excise taxes this year.

Table 1			
Cigarette Tax Increases in 2009			
	Previous Rate	Enacted Increase	New Rate
Arkansas	\$0.59	\$0.56	\$1.15
Florida	\$0.34	\$1.00	\$1.34
Hawaii ²	\$2.00	\$0.60	\$2.60
Kentucky	\$0.30	\$0.30	\$0.60
Mississippi	\$0.18	\$0.50	\$0.68
New Jersey	\$2.58	\$0.13	\$2.70
New Hampshire	\$1.33	\$0.45	\$1.78
Rhode Island	\$2.46	\$1.00	\$3.46
Vermont	\$1.99	\$0.25	\$2.24
Wisconsin	\$1.77	\$0.75	\$2.52

Analysis

While many states have enacted various tax increases to fill projected budget gaps or to fund new programs, the increases have largely focused on two sources: personal income taxes and excise taxes. There are a couple of lessons that can be drawn from these tax increases.

Personal Income Taxes

With state revenues declining due to the tough economic situation, most state leaders in 2009 have tapped high-income earners, 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.³ 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 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.⁴ 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 an estimated \$26 billion.

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.

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.⁵ In recognition of the long-term volatility and spending problems as well as the anti-business tax climate, Gov. Schwarzenegger has said that he wants fundamental tax reform, not just short-term solutions.⁶

Two interesting proposals are on the table in California. One would flatten the personal income tax, eliminate the corporate income tax, eliminate the state's general sales tax, and add a business net receipts tax. The other would simplify the personal income tax to two rates, reduce the corporate income tax, and reduce the sales tax. Both of these proposals are aimed at addressing the problem of volatility associated with high-income earners and the goal of promoting long-term economic growth. California lawmakers need to consider these or similar proposals as a part of their budget solution, and other states suffering from ongoing budgetary troubles would be wise to consider similar proposals.

Sales Taxes

Sales tax rates have continued to be increased this year. An alternative that the Tax Foundation supports instead of raising the rate is to broaden the base. A sales tax with few exemptions will be able raise the same amount of revenue at a lower rate. Maine was able to lower their income tax rate substantially this year by broadening the sales tax rate.

Excise Taxes

The standard economic justification for excise taxes is to help align the private and the social costs of an activity. There are cases where not all of the costs of an activity are borne by the direct producer and consumer. The textbook example is of automobiles and gas usage. In driving, an individual is creating both more pollution and more traffic for everyone. The individual does not bear all the costs for this action so they will tend to over-consume up until the private costs equal the private benefits. A properly implemented excise tax would increase the private costs to equal the social costs. This sort of taxation is known as Pigouvian taxation after British economist Arthur Pigou. Unfortunately, states have increased certain excise taxes this year, most notably

cigarette taxes, as general revenue raisers that extract far more revenue than a Pigouvian tax would call for.

On the positive side, what states did not increase is sometimes as important as what they did. The zero rates on sales and income that some states maintain remain sacrosanct. Seven states still have no individual income tax: Alaska, Florida, Nevada, South Dakota, Texas, Wyoming and Washington. New Hampshire and Tennessee tax interest and dividends but not wages. Five states have no state-level general sales tax: Alaska, Delaware, Montana, New Hampshire and Oregon.

Conclusion

A number of states are still negotiating their 2009-2010 budgets, and income tax increases are under consideration in several, including Illinois, Connecticut, Arizona and Pennsylvania. 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 can make a state less attractive and create more volatility in an already uncertain economic climate.

Notes

¹ See Kail Padgitt, “The Pine Tree State Chops Down Income Tax: Maine Enacts Major Tax Reform,” *Tax Foundation Fiscal Fact No. 174* (June 2009), at <http://taxfoundation.org/publications/show/24775.html>.

² Hawaii has scheduled an increase to \$2.80 on July 1, 2010 and another to \$3.00 to July 1, 2011.

³ 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>.

⁴ 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>.

⁵ See Josh Barro, “2009 State Business Tax Climate Index,” *Tax Foundation Background Paper No. 58* (October 2008), at <http://taxfoundation.org/publications/show/22658.html>.

⁶ See Joseph Henchman, “California Announces Appointees to Tax Reform Commission,” (December 2008), at <http://www.taxfoundation.org/blog/show/24056.html>.