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STATE REVENUES HAVE FALLEN DRAMATICALLY
Tax Increases So Far Have Failed to Fill the Gap

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State tax systems — a major source of funding for public education, health care, public safety, and other services — are producing far less revenue now than they did a few years ago, less revenue than they did at the same point emerging from the last economic slowdown, and less revenue than they have on average since 1970. Since most states must balance their budgets annually, the result is the largest cuts in state spending in a generation.

- The decline in state tax collections since the crisis began has been remarkable. Despite efforts by states to raise taxes, total state tax collections for the 12 months ending in June 2003 – which is when most states' fiscal years end -- were about $21.6 billion less, in nominal terms, than for the same period ending in June 2001, according to the latest quarterly tax collection data from the U.S. Census Bureau. Adjusted only for the general rate of inflation and population growth, revenues in this 12-month period were $56.9 billion less than in 2001.

- In historical terms, state taxes as a share of the economy are lower now than they have been at any time in the last thirty years, with the exception of the double-dip recession of the early 1980s. Even combined with local taxes, which have been more stable in recent years, state and local taxes as a share of the economy are now at their lowest point since the early 1980s, and are well below the 30-year average.

- These shrinking revenues have led many states to reduce expenditures. On average, real per-capita state spending in 2004 will be 2.0 percent lower than it was in 2003. This reduction follows cuts of 1.7 percent in 2002 and 1.3 percent in 2003. In the face of rising health care costs and other spending pressures, these spending cuts are making it impossible for most states to maintain public services at consistent levels.

The decline in state revenue would have been even worse — and led to even larger state budget cuts — had not a majority of states raised taxes. Since late 2001, about 29 states have expanded their tax bases or increased tax rates to lessen the decline in revenues. Such tax increases have been enacted in states with Republican leadership, states with Democratic leadership, and in states with bipartisan leadership. When fully implemented, these tax increases will raise some

$22.4 billion per year that otherwise would have gone uncollected, an amount equal to about 4 percent of total state tax collections.

Although significant, the tax increases enacted during this downturn are far fewer and smaller than the tax *cuts* enacted during the economic expansion of the 1990s. From 1994 to 2001, some 44 states enacted significant tax cuts. The revenue loss resulting from those tax cuts was temporarily offset by unusually high revenue resulting from the usual economic boom of the late 1990s — including the rapid rise of the stock market and the increase in personal consumption. But while those temporary economic conditions have ended, the tax cuts of the 1990s mostly remain in place and are costing states some $40 billion or more per year. The result is that the current round of state tax increases, on aggregate, is only filling in part of the hole left by the tax cuts of the 1990s.

Recent federal actions also are undermining the positive revenue impact of the state tax increases. Over the last three years, the federal government has enacted three tax cuts that have cost many states revenue because of the way the federal and state tax codes interact. Many states have responded by enacting tax-code changes that reduce the revenue loss, but only a very few have entirely avoided it. States are likely to lose $4.2 billion in revenue in fiscal year 2004 and another $4 billion in revenue in fiscal year 2005 as a result of the federal tax cuts, offsetting as much as one-fifth of the total tax increases enacted by states.

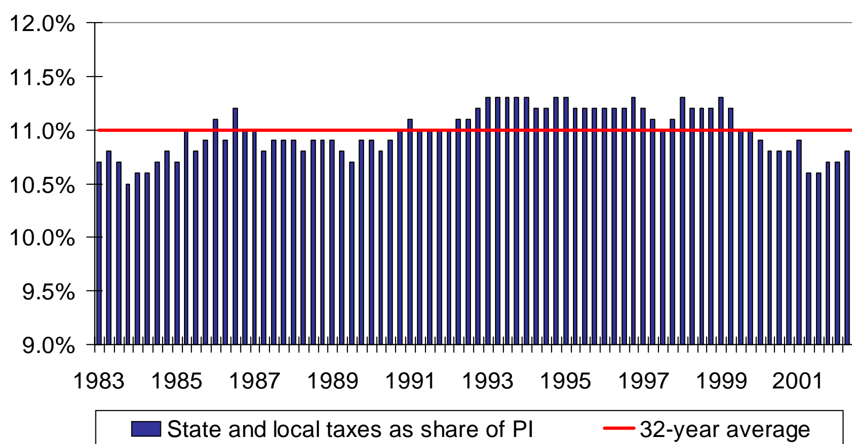
The state tax increases of 2002 and 2003 are — in aggregate — far from sufficient to offset the fiscal pressures states are presently facing. Nor are they likely to be of enough assistance as states face growing fiscal pressures in the future. Over the coming years, state budgets will have to cope with rising costs for such services as education and corrections and a rising elderly population that will place increasing burdens on such state-financed services as Medicaid, among other cost pressures. But because of widely recognized flaws in state tax systems, tax revenues in most states are not expected to keep pace with those costs. These flaws include an inability to fully tax interstate and Internet-based commerce, excessive reliance on stagnant excise-tax revenues, expanded use of tax loopholes by corporations, and relatively flat income taxes that do not grow sufficiently relative to the economy. With some significant exceptions, the tax increases of 2002 and 2003 do not address these flaws; many are temporary or are increases in slow-growing or even declining revenue sources such as cigarette taxes.

It is not too late for states to begin to fix their troubled revenue systems. Indeed, several states in the last two years have moved to improve their tax codes in ways that raise (or protect) revenue now and in the future.

- Over the last two years, Connecticut and Nebraska have increased their state income tax rates, and Massachusetts and Oklahoma (at least temporarily) have reversed some income tax cuts that were enacted in the 1990s. Arkansas, New York, North Carolina, and Oregon have imposed temporary income tax surcharges that could be extended to provide relief from longer-term fiscal pressures.

Figure 1

Despite Enacted Increases, Tax Revenues Are Still Low



Source: Bureau of Economic Analysis. Seasonally adjusted.

- Several states including Arkansas, Connecticut, Massachusetts, Nevada, New York, and Oregon have increased corporate taxes by closing corporate loopholes, temporarily raising rates, and/or other actions. In 2002, New Jersey passed legislation that sharply reduced the number of corporations that are able to manipulate tax laws to avoid paying any corporate income tax at all. Many of these corporate tax increases represented attempts by states to address the long-term decline that is occurring in corporate tax revenues as profitable corporations find new ways to minimize their state tax burdens.

- A few states, most notably Nebraska, raised substantial new sales tax revenue in 2002 and 2003 by broadening their sales tax bases to include more services. Most states exempt many services from their sales taxes. With the service sector of the economy continuing to grow, base expansions like these are important for future revenue stability.

- At a minimum, states can protect existing revenue sources. For instance, some 17 states have protected their estate tax revenue by "decoupling" from the federal estate tax changes. Several other states, such as Connecticut and Michigan, have postponed at least some tax cuts that were originally enacted before the recession and stock market decline made them unaffordable.

State Tax Increases From Late 2001 to Present

Tax Increase > 5%
Tax Increase > 1% and < 5%
Combination of Tax Increases and Tax Cuts
No Significant Tax Increase

Source: Center on Budget and Policy Priorities.

How Far Have State Tax Burdens Fallen?

In the 12 months ending in June 2001, states collected $557 billion in taxes, according to the U.S. Census Bureau. Two years later, in the period ending in June 2003 (the latest period for which state tax data are available from Census), states collected $536 billion — a $21.6 billion decline in nominal dollars.

The decline is even more striking when one takes inflation and population growth into account. With those adjustments, the loss of revenue experienced by states over the last two years has been $56.9 billion — a full 10 percent decline in the annual level of tax collections.

This sharp drop is far more than simply a reversal of the somewhat stronger-than-usual revenue growth of the late 1990s. The 2001-2003 drop-off did not merely return state taxation to a "normal" or typical level relative to the economy. Rather, state taxes now have tumbled to levels that are low by historical comparisons.

- In the 12 months ending in March 2003, state tax collections equaled 5.9 percent of total personal income. This was not only a sharp decline from the levels of the late 1990s — a period in which taxes equaled as much as 6.5 percent of personal

income — but well below the level of taxation in the slow-to-normal periods of growth in the early and mid-1990s.

- Adding local government taxation into the mix does not change this picture. Although local government tax revenues have been stronger in the last two years than state tax revenues, Bureau of Economic Analysis data show that combined state and local tax revenue also are running below the levels of the early and mid-1990s.

- In fact, state and local taxes combined are running at a level of about 10.7 percent of personal income, or roughly three-tenths of a percentage point lower than the average level of state and local taxation since 1970 (see Figure 2).

Tax revenue is likely to stop falling, but so far there is little reason to expect a rebound in the near future that would be strong enough to recoup the lost revenue. In the most recent quarter for which data are available — the April-June 2003 period, which is the quarter in which states typically receive the most revenue — Census data show that state tax collections *in nominal dollars* were virtually unchanged (up by less than 1 percent) from the same period the year before. If one factors out inflation and population growth — not to mention legislated tax changes — the data show clearly that the April-June 2003 period was states' worst quarter for tax receipts in years, the accumulation of several years of declining receipts.

Are States Fixing the Problem?

As bad as they are, state revenue problems would be even worse if many state policymakers over the last two years had failed to raise taxes. Although taxes are typically the last resort of policymakers, many states have found that spending reductions, reserve-fund drawdowns, federal fiscal relief, bond sales, and other actions have been insufficient to bring budgets into balance. Consequently, many have raised taxes.

- About 20 states raised taxes in 2003 to a significant degree, that is, by more than one percent of state tax revenue. Combined with those states that raised taxes in 2002 and in late 2001, 29 states have enacted significant net tax increases over the last two years.[1]

- Some tax increases have been substantial. Some 14 states since late 2001 have implemented tax increases exceeding five percent of state tax revenue. Seven of those larger tax increases were enacted in 2003, in California, Connecticut, Delaware, Nevada, New York, Ohio, and Oregon. (Note that most of the 2003 California increase is a $4 billion annual increase in motor vehicle taxes that resulted not from 2003 legislative action but from a statutory trigger; note also that the newly elected governor is seeking to reverse the increase.)

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[1] Three additional states, Georgia, Michigan, and Rhode Island, also implemented substantial tax increases, but they were offset by tax cuts such that the net annual change in revenue is expected to be less than one percent of revenue.

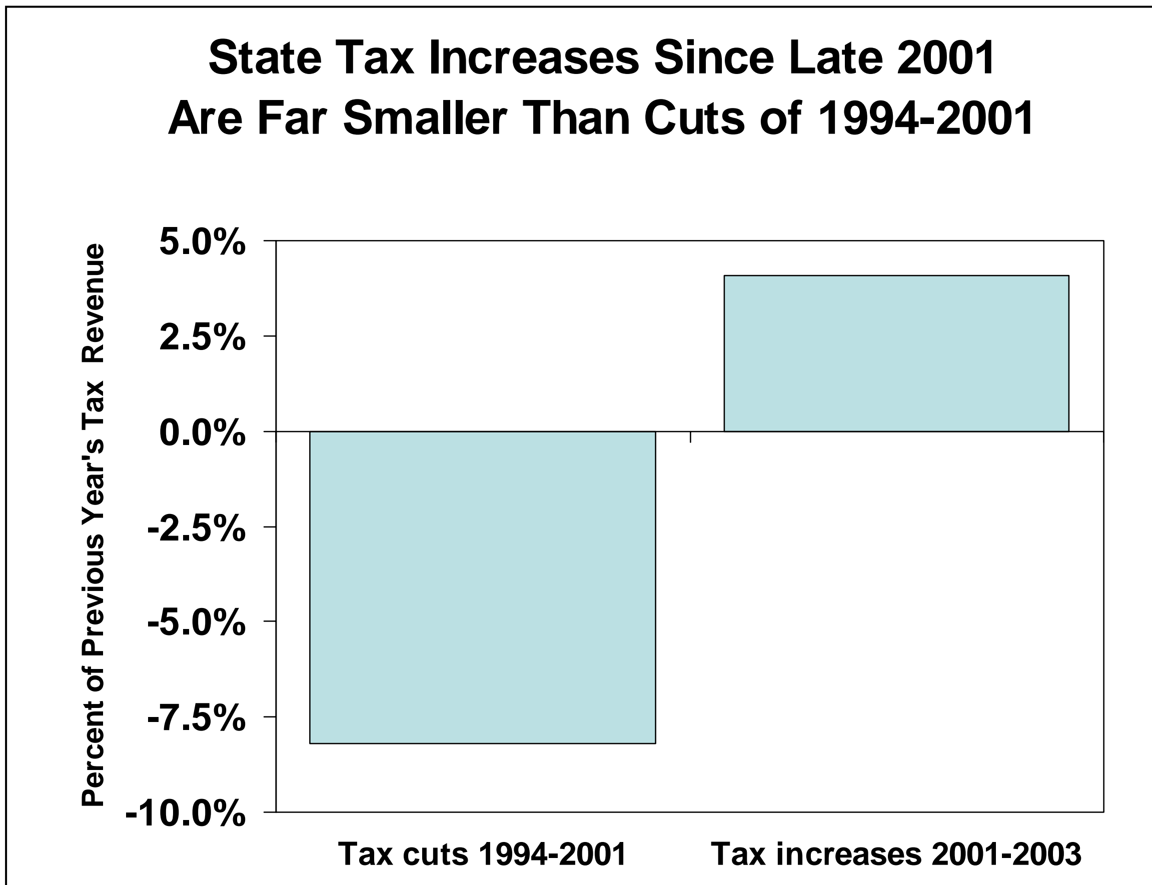
Table 1
State Tax Increases Exceeding Five Percent of Revenues, 2001-2003

State	Major tax actions & year of enactment
California	Corporate income tax increase (2002); increase in motor vehicle taxes (triggered in 2003 by previously enacted statute)
Connecticut	Gasoline and cigarette tax increases (2002); increase in personal income tax top rate, corporate income tax surcharge, increase sales taxes on services, others (2003)
Delaware	Increases in corporate fees and taxes, cigarette tax increase, increased state's share of revenue from slot machines (2003)
Indiana	Sales tax rate increase, cigarette tax increase, gasoline tax increase, increased gambling taxes, utility tax increase (2002)
Kansas	Sales tax rate increase, business tax increase, gasoline tax increase, cigarette tax increase, inheritance tax increase (2002); extended sales tax increase (2003)
Massachusetts	Income tax increases (including capital gains tax increase, personal exemption reduction, and elimination of charitable deduction), cigarette tax increase (2002); closure of corporate loopholes (2003)
Nebraska	Income tax rate increase, cigarette tax increase, sales tax rate increase and base expansion (2002, extended in 2003)
Nevada	Increases in business taxes, gaming fees, cigarette and alcohol taxes (2003)
New Jersey	Corporate income tax increase, cigarette tax increase (2002), increases in cigarette and hotel taxes (2003)
New York	Increase in cigarette taxes (2002); increases in top personal income tax rates and sales tax rate, removal of sales tax exemption for clothing, corporate loophole closures, insurance tax increase (2003)
North Carolina	New top rates for personal income tax, increased sales tax, corporate loophole closures (enacted 2001, extended some provisions 2003)
Ohio	Increased cigarette taxes (2002); sales and gasoline tax rate increases, others (2003)
Oregon	Increased cigarette taxes (2001), personal income tax surcharge and corporate tax increase (2003)
Tennessee	Sales tax rate increase, corporate tax increase, cigarette tax increase, alcohol tax increase (2002)

Notes: For purposes of this analysis, only actual increases (as opposed to postponed tax cuts) are counted. Vermont enacted a large sales tax increase to offset a reduction in school property taxes; since there was essentially no net tax increase, Vermont is not listed here.

- Altogether, the net tax increases of 2003 will raise some $12.2 billion annually when fully implemented. Combined with the tax increases enacted in 2002 and late 2001, states have raised taxes by some $22.4 billion since the beginning of the state fiscal crisis.

Figure 3



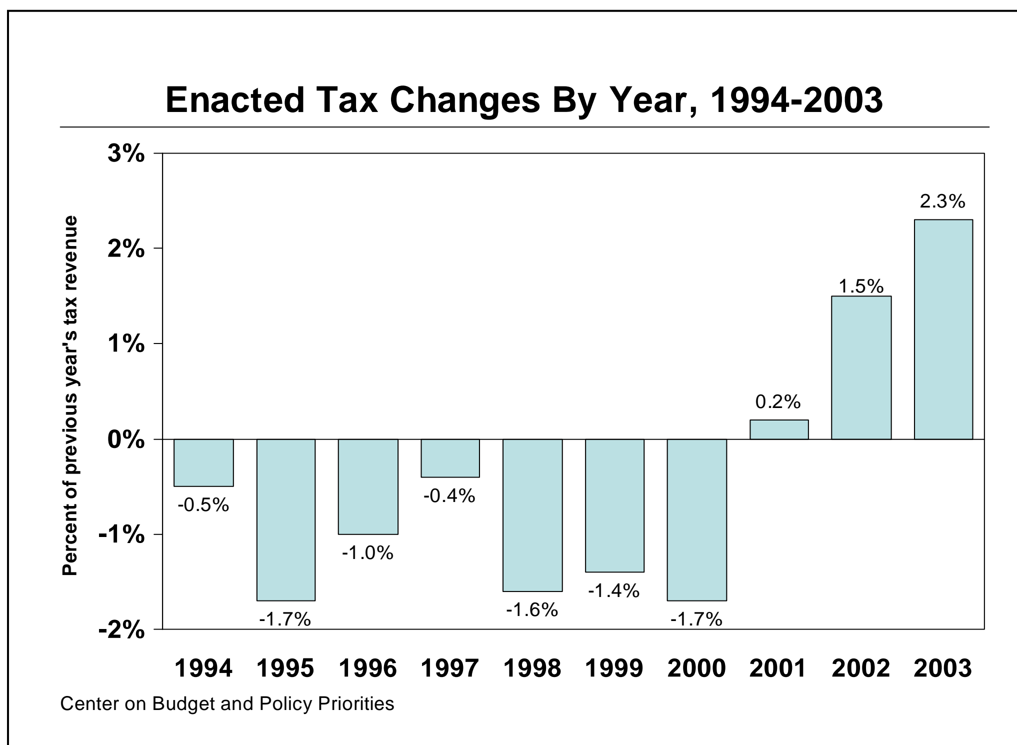
- The tax increases of late 2001, 2002 and 2003 total about 4.1 percent of state tax revenue.

Yet large as those figures are, the recent tax increases remain modest by most standards.

- *The tax increases so far have been too small to restore state tax collections to previous levels*. As noted above, through June 2003 the decline in revenue has been about $56.9 billion. Without the recently enacted tax increases, that gap would be much larger. Even when the 2003 tax increases not yet reflected in the data are factored in, state tax collections will still be tens of billions of dollars behind where they were in the late 1990s and still well below historic levels of taxation.

- *The tax increases are smaller than recent cuts in spending*. States expect to spend approximately 5 percent *less* in FY 2004 than they did in FY2001, adjusting only for population and inflation — a decline of some $26 billion. And that figure doesn't account for increases in health care costs, changing demographics, rising unemployment, or other factors that increase costs for state government. No

Figure 4



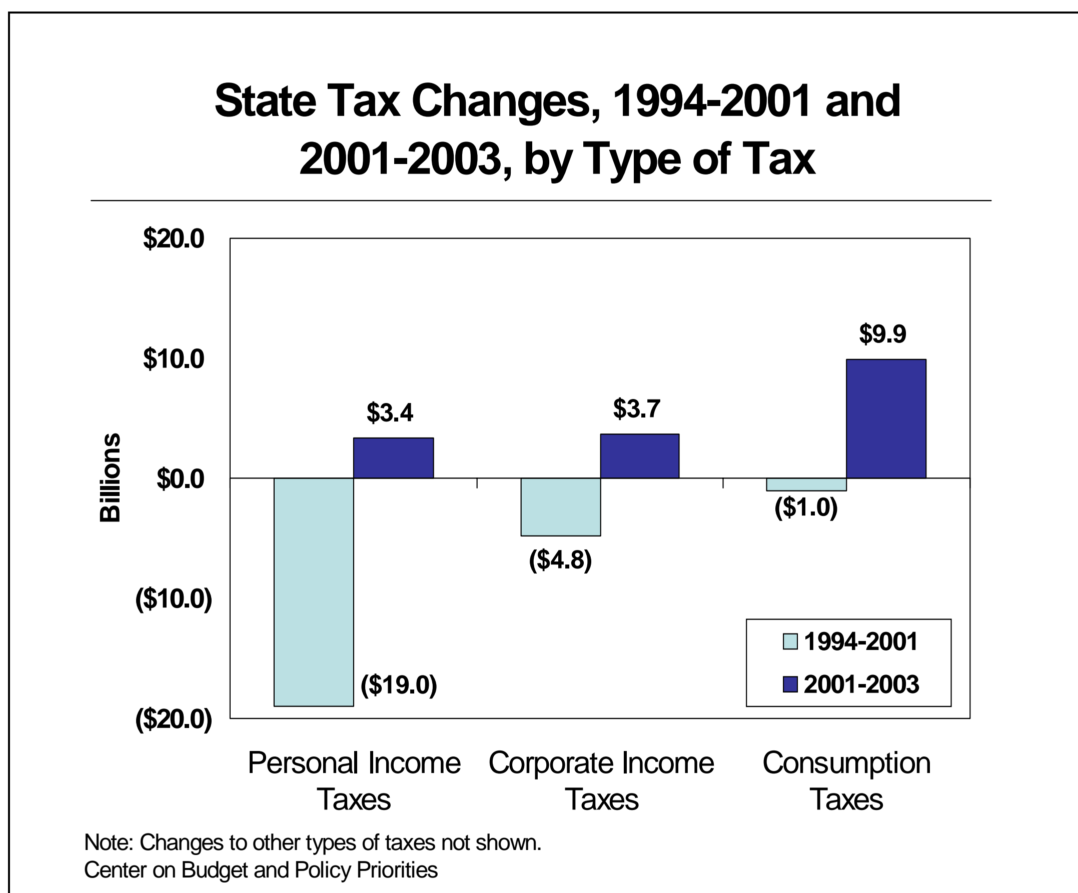
estimate is available of the true value of the public services lost to budget cuts, but it could well approach $60 billion.[2]

- *Recent tax increases are much smaller and less widespread than the tax* cuts *of the 1990s.* From 1994 to 2001, nearly every state cut taxes, and most of the tax cuts were substantial. In 43 states, net tax cuts exceeded one percent of total state revenue, and most were *much* larger than one percent. Aggregate net state tax reductions from 1994 to 2001 equaled about 8.2 percent of state tax revenues. These cuts were permanent. In other words, annual state tax revenue by 2001 had fallen about 8.2 percent — or more than $40 billion — below what it would have been had those 43 states not cut taxes during that time.[3] In the great majority of

[2] One rough way of calculating the lost public services is to compare historic levels of spending growth with more recent levels. In the 1990s — averaging across both the early-1990s recession and the later expansion — real per-capita state expenditures grew slightly below 2 percent annually (incidentally, a lower rate than in previous decades). Had that growth rate continued over the last three years, state spending would be up by about 6 percent rather than down by 5 percent from 2001 levels, a difference of about $59.5 billion. For discussion of spending trends, see Elizabeth C. McNichol, *Fiscal Crisis Is Shrinking State Budgets*, Center on Budget and Policy Priorities, October 2003.

[3] See Nicholas Johnson, *The State Tax Cuts of the 1990s, the Current Revenue Crisis, and Implications For State Services*, Center on Budget and Policy Priorities, November 2002. These calculations are based on a detailed review of tax change data collected in annual surveys by the National Conference of State Legislatures since 1990. In order to come up with a multi-state, multi-year figure, a host of adjustments to the NCSL data were necessary. These adjustments include accounting for timing shifts, phased-in tax cuts, expiring tax increases, and other items missing

Figure 5



the states now raising taxes to a significant degree, the recent tax increases are lower than the tax cuts of the 1990s.

Even when the economy recovers, there is little reason to expect that state revenues will rebound sufficiently to make up for the revenue decline of the past year. A long-recognized flaw in state revenue systems is that they tend to erode relative to economic growth. As the National Governors Association and the National Conference of State Legislatures have reported, the gradual erosion of state revenues occurs largely because of the substantial reliance on sales and excise taxes; items subject to those taxes in most states are declining in the long term as a share of total consumption.

At the same time, state corporate income taxes as a share of corporate profits have steadily declined over several years, partly reflecting corporations' ability to restructure their finances to avoid state taxes. State income taxes do the best job of keeping pace with economic

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from the NCSL survey or otherwise reported in ways that misrepresent the actual impact of tax changes on taxpayer liabilities. Even without these adjustments, the ongoing impact of the tax cuts of the 1990s clearly exceeds that of the current tax increases; for instance, a recent analysis by the Rockefeller Institute of Government finds that total tax cuts from fiscal year 1996 to fiscal year 2002 totaled $33 billion or about 7 percent of tax revenue.

growth over the long term, but they typically are not structured to compensate fully for the gradually declining revenue from other tax sources. As a result, over a period of several years, state tax bases tend to decline as a share of the economy, meaning that — absent such unusual circumstances as existed in the late 1990s — states over the long term must raise taxes or ratchet down spending to keep budgets in balance.

It is possible for states to restructure their taxes to correct these problems. This is not, however, what they have done. Indeed, the majority of the tax increases since late 2001 stand to deepen the structural flaws in state tax systems.

- Some $4.8 billion, or 22 percent, of the total tax increases of the last two years have come from sales taxes. Most of this new revenue was from sales tax rate increases in Indiana, Kansas, Nebraska, New York, North Carolina, Ohio, Tennessee and Vermont. A sales tax rate increase is a quick and administratively straightforward way to raise a large amount of new revenue. But sales tax revenues gradually decline relative to economic activity as the U.S. economy becomes increasingly dependent on services. This is because the sales tax base in most states consists mostly of goods, not services, even as purchases of services grow as a share of the economy.

  On a positive note, a few states have broadened their sales tax bases by adding some services — interstate phone services in South Dakota, cable and satellite television in Utah, and building cleaning and maintenance, security, pest control, automobile washing and painting, computer software training, and installation of taxable items in Nebraska — that were previously exempt.[4] Several other states including Alaska, Montana, Nevada, New Jersey and North Dakota created or increased taxes on tourism related activities, such as hotels and car rentals.

- Some $4.3 billion, or 19 percent, of the tax increases enacted in the last two years have come from cigarette tax rate increases. Some 18 states enacted cigarette tax increases in 2003, bringing the total number of states raising cigarette taxes since late 2001 to 31. Cigarette taxes are a popular way to raise revenue because they discourage people from smoking and because a minority of voters — the minority who continue to smoke despite the tax — bear the burden. But they pose a problem for future revenue adequacy: the new revenue from cigarette taxes not only fails to grow with the economy but actually may be expected to decline over time as smoking rates dwindle.

Altogether, increases in consumption taxes — general sales, cigarette, alcohol and gasoline taxes — have represented $9.9 billion or 44 percent of the total net tax increases of the last two years. Adding in California's recent increase in its property tax on vehicles – a tax which in some ways resembles a consumption tax -- brings the total to 62 percent.

[4] Connecticut enacted both base-broadening and base-narrowing measures in its sales tax, by taxing health and athletic club memberships but repealing the tax on patient care services.

Recent State Tax Changes Largely Have Increased Regressivity — With Some Exceptions

Economists widely recognize that state and local tax systems are "regressive"; that is, lower-income families pay a greater share of their incomes in taxes than do higher-income families. This regressivity results largely from states' substantial reliance on consumption taxes. Poor families spend larger shares of their income on items subject to tax than higher-income families do, so consumption taxes take larger shares of poor families' incomes. Motor vehicle property taxes also appear to be regressive. State personal income taxes generally are at least somewhat progressive, because some have rate structures that tax higher incomes at higher rates, and most exempt the first several thousand dollars of each family's income.

In the current period of rising joblessness and poverty, one might imagine that state tax changes would be structured in ways that minimize new burdens on low- and moderate-income families. But instead, the great majority of the state tax increases since late 2001 — some 62 percent — have been increases in regressive taxes.

The emphasis on boosting regressive taxes is particularly striking in contrast to the nature of the tax cuts enacted in the middle and late 1990s, a period in which states reduced taxes paid predominantly by higher-income households – specifically, personal income taxes, corporate income taxes, and inheritance taxes — far more than they reduced sales taxes and other consumption taxes which are most burdensome for lower-income families. During that period, states reduced personal income taxes, corporate income taxes, or inheritance or estate taxes by about $28 billion, but cut consumption taxes only by a net $1 billion.

A few states appear to have recognized the distributional consequences of raising consumption taxes. Recent tax packages in Connecticut, Massachusetts, Nebraska, North Carolina, and New York, for instance, included not only consumption-tax increases that most heavily affect poor families but also increases in personal income taxes that most heavily impact high-income families. Indiana and Kansas balanced their tax packages in a different way. They set aside a portion of the revenue from increases in consumption taxes to pay for expanded tax credits for low-income families. Specifically, Indiana restructured and expanded its Earned Income Tax Credit, and Kansas increased both its state EITC and its sales tax credit. Those measures will help blunt the disproportionate burden of consumption tax increases on poor families.

Louisiana, in a referendum, went a step further. The state cut sales taxes on groceries and utilities and raised its income tax, thereby reducing the overall burden of taxes on poorer families and increasing the burden on higher-income families.

Fewer states have raised income taxes than consumption taxes over the last two years. Income tax increases account for $3.3 billion in new revenue — about 15% of the total. Nearly half of that new revenue is in New York, where new top rates were levied on higher-income families. Other states with notable personal income tax increases include Arkansas, Connecticut, Massachusetts, Nebraska, North Carolina, Ohio, Oklahoma, and Oregon. (Oklahoma's increase was triggered by a provision in state law that automatically rolls back a previously implemented reduction in income taxes when state revenues fail to meet specified levels.)

States That Aren't Raising Taxes May Be Raising Fees

This report follows the conventional definition of "taxes" to exclude such items as public-university tuition, health care copayments, child care parent fees, and other items more appropriately categorized as "user fees." Increases in user fees resemble tax hikes, however, in the added economic burden they impose on families. On the other hand, fee increases are similar to budget cuts in that they fall on specific segments of the population, while many taxes are more broad-based.

According to the National Conference of State Legislatures, at least 30 states in 2003 raised more than 200 different fees for nearly $2.6 billion in new revenue, on top of nearly $1 billion in fee increases enacted in 2002. These include motor vehicles and drivers' licenses, and court fees, filing fees, and recreational fees. The Kaiser Commission on Medicaid and the Uninsured reports that 21 states expect to charge low- and moderate-income families more for their health care in FY2004.

The NCSL figure substantially understates the number of states raising fees and the resulting new revenue, because it primarily counts fees enacted by state legislation. Many state agencies have latitude to increase fees for services on their own, and many have done so to offset cuts in state general-fund support. For instance, every state university system has raised tuition and fees, and a survey by the National Association of State Universities and Land Grant Colleges found that public universities in some 34 states raised tuition for the 2003-04 school year by more than 10 percent — often much more — adding billions of dollars in added costs to students and their families nationwide.

These fee increases are particularly striking to the extent that they target low- and moderate-income families, such as those that receive health care and child care assistance, at the same time that middle- and upper-income families continue to benefit from the tax cuts that were enacted the 1990s and that remain in place.

Personal income taxes are the broadest-based state taxes; in other words, they cover the broadest range of economic activity. For that reason, they tend to grow in tandem with the economy over time. States would be better prepared to fund services in a stable manner in the future if they looked to personal income taxes rather than consumption taxes as sources of new revenue. (Of course, such stable future funding will not be available if those income tax increases are allowed to expire, as will occur in several of those states over the next two or three years.)

A few states are going in the other direction on personal income taxes: enacting future-year reductions that will undermine, rather than support, the ability of those states to provide services. Georgia, Montana and New Mexico each enacted personal income tax reductions in 2003 that will have most or all of their fiscal impacts in years after 2004 – in other words, outside of those states' budgetary windows. It remains unclear how these tax cuts will be financed if they are, in fact, implemented — for instance, whether these states will need to cut services or raise other taxes in order to keep their budgets in balance.

Are Personal Income Taxes a Sound Revenue Source for States?

State personal income tax revenues generally have declined more in the last two years than have other types of state tax revenue. Particularly sharp declines in California and Oregon have led to high-profile budget problems, raising the question: Is high reliance on a state income tax a bad idea?

The answer appears to be no. State budget problems do not appear to correlate closely with reliance on a personal income tax; several states without income taxes, such as Tennessee and Washington, have had severe budget crunches, and several states with strong progressive income taxes like New Mexico, Utah and Vermont have fared less poorly. In part, this is because when both economic downturn and economic expansions are taken into account, personal income taxes grow faster than other taxes. For instance, data from the Rockefeller Institute of Government show that from 1990 to 2002 — a period including two recessions and one recovery — state personal income tax revenue rose 97 percent (in nominal terms, factoring out legislated changes) while state sales tax revenue rose just 68 percent. The national economy grew 83 percent in that time. In other words, even taking into account the recent drop in income tax revenue, income tax revenue has still grown faster since 1990 than sales tax revenue.

Moreover, the recent unstable performance of the personal income tax, especially in states with substantial high-tech sectors like California and Oregon, may have been an anomaly. Looking over a longer period of time including several economic expansions and downturns, University of Tennessee professor William Fox and colleagues found in a recent study that neither state income taxes nor sales taxes were inherently more volatile than the other. In other words, shifting reliance from the income tax to the sales tax will not necessarily provide more short-run stability.

A bigger factor in California and Oregon's budget problems may have been those states' lack of meaningful rainy-day funds, which most other states have created to soften the blows of revenue downturns. Had those states placed substantial income tax revenue in such funds in the 1990s instead of (for instance) spending it on new tax cuts, their budget problems in the last two years would have been smaller.

Another $3.7 billion of the tax increases of the last two years — about 16 percent of the total — were increases in corporate income taxes. About half of this came from a $600 million to $700 million increase in New Jersey and a $1.2 billion increase in California. The New Jersey action in particular represents an important step toward reforming that state's corporate income tax, because much of the revenue comes from establishing an alternative tax base that is intended to ensure that more profitable corporations pay New Jersey taxes and thereby stem the long-term decline in corporate income tax revenues; another significant portion of revenue comes from closing loopholes in the corporate tax base.[5] New Jersey's corporate income tax increase, therefore, will improve the state's ability to raise revenue over both the short- and long-term. Other states raising substantial new revenue from corporate taxes since late 2001 include Alabama, Delaware, Illinois, Nevada, North Carolina, Oregon and Tennessee.

[5] A portion of that New Jersey revenue, about $200 million, is temporary in nature because it derives from a suspension of a tax deduction for operating losses that is effective only in 2002 and 2003; corporations may be able to recoup much of that amount in later years. The remaining $400 million to $500 million is a permanent revenue increase. These figures exclude an estimated $200 million to $300 million in one-time revenue that the state will gain in fiscal year 2003 only due to timing shifts and to the retroactive implementation of some of the changes.

Table 2
Estimated State Impact of Selected Federal Tax Changes,
State Fiscal Years 2003-05 (Dollars in Billions)

	FY 2003	FY 2004	FY 2005	Total
Bonus depreciation (16 states)	$0.7	$1.6	$0.5	$2.8
Estate Tax (34 states)	1.0	2.0	3.0	6.1
Section 179 (45 states)	-	0.6	0.5	1.1
Total	**$1.7**	**$4.2**	**$4.0**	**$10.0**

Notes: Bonus depreciation figure assumes that the provision will not be extended beyond December 2004. See Appendix for state-by state detail. Numbers may not add due to rounding.

California's increase is less positive because it is only in effect for tax years 2002 and 2003, and starting in 2004 it actually gives corporations a larger tax break than they now enjoy. In essence, the California legislation actually gives most of that $1.2 billion back to California corporations beginning in 2004, plus an additional tax cut, and fails to fix any of the problems contributing to long-term decline in the state's corporate income tax. But both the California and New Jersey business tax increases have the virtue of avoiding placing disproportionate new tax burdens on low- and moderate-income families.

The relatively modest increases in personal income taxes and corporate taxes enacted by states in 2002 and 2003 stand in sharp contrast with the large cuts in personal income taxes and in other progressive taxes from 1994 to 2001. The great majority of the tax reductions enacted from 1994 to 2001 — some 81 percent of total tax cuts, totaling some $28 billion in annual lost revenue to 37 states — were reductions in personal income taxes or similarly progressive taxes. By contrast, just 9 states cut general sales taxes significantly, for a total of only about $3.4 billion. In addition, several states actually increased sales or excise taxes. The *net* reduction in consumption taxes totaled about $1 billion, or less than 4 percent of total tax cuts.

A Fifth of State Tax Increases Are Offset by Lost Revenue Due to Federal Tax Cuts

The tax increases enacted by states in the last two years have been undermined by recent federal actions. As the Appendix to this analysis shows, nearly every state is losing at least a modest amount of revenue — and many are losing a lot of revenue — as a result of the 2001, 2002 and 2003 federal tax cuts. The reason is that nearly every state's tax code is linked to the federal code. When the federal tax code is changed, for instance by altering the calculation of income subject to tax, state tax collections typically are affected.

State policymakers often can avert the loss of revenue by severing those links, or "decoupling." But they often are unwilling or unable to do so. In a few states, state constitutions bar decoupling. In other cases, states choose to continue to conform to the federal tax code – in spite of the revenue loss -- for administrative reasons; decoupling can make it harder for taxpayers to comply and for states to enforce tax laws. Decoupling often poses political

difficulties as well; policymakers sometimes fear that decoupling could be interpreted as a commentary on the soundness of the federal changes.

Recent federal actions with state revenue implications include the 2001 tax law's rapid phase-out of a provision in the estate tax which allows taxpayers to claim a full credit for state estate taxes paid; most states had linked their own estate taxes to this provision. Another federal action was the so-called "bonus depreciation" rule – enacted in 2002 and expanded in the 2003 law -- allowing businesses to claim immediate deductions for certain investment purchases. A third was a similar provision targeted to smaller businesses in the 2003 law, knows as "Section 179 expensing." Other provisions in both the 2001 and 2003 laws also costs states revenue to some degree.

Although many states decoupled from at least one of those federal tax changes, few decoupled from all of them. The resulting revenue loss to states equals approximately $1.7 billion in fiscal year 2003, $4.2 billion in fiscal year 2004, and $4.0 billion in fiscal year 2005, for a three-year total of $10 billion in state tax cuts that are driven by federal tax actions.

These federally-driven state tax cuts are quite large, representing nearly 1 percent of state tax revenue. In other words, even as many states are raising certain taxes, they are also allowing federally driven tax cuts to reduce other taxes. In aggregate, the federally driven tax cuts offset about one-fifth of the state-specific tax increases described in this paper. In many cases, the taxpayers benefiting from the federally driven changes are not the same ones most affected the state changes. For instance, a very small percentage of wealthy families are receiving most of the benefits from the estate-tax changes, while most of the state tax increases described in this paper affect lower and middle income families.

For fiscal year 2005 and beyond, the biggest impact on states is the loss of estate tax revenue. Decoupling from the estate tax is straightforward; 17 states have already done so, and others are likely to consider doing so to avert further revenue loss.

How Are Tax Increases Affecting State Economies?

To the extent states have raised taxes over the last two years, the purpose has been to avert even greater spending cuts. This choice can make sense not only from the perspective of preserving public services, but also from the perspective of accelerating the economic recovery. Although the economic perils of tax increases are often touted by their opponents, spending cuts could actually be more damaging to the nation's economy than tax increases.

As Nobel Prize-winning economist Joseph Stiglitz and Peter Orszag of the Brookings Institution have pointed out, a $1 reduction in state public-sector spending typically results in a $1 reduction in a state's economic activity. A $1 increase in taxes, by contrast, is likely to result in a smaller reduction in a state's economic activity, because to some extent the tax increase would be financed out of reduced savings, or from reduced out-of-state consumption. This is particularly true of tax increases on higher-income individuals, because such individuals are most likely to have access to savings.

Stiglitz and Orszag conclude:

> If anything, tax increases on higher-income families are the least damaging mechanism for closing state fiscal deficits in the short run. Reductions in government spending on goods and services, or reductions in transfer payments to lower-income families, are likely to be more damaging to the economy in the short run than tax increases focused on higher-income families. In any case, in terms of how counter-productive they are, there is no automatic preference for spending reductions rather than tax increases.

The focus of Stiglitz and Orszag's analysis is the short-run impacts of taxes and spending on state economies. Economic research into the long-term tradeoff between taxes and public expenditures also suggest public expenditures can contribute as much, if not more, to economic growth as low taxes. In hundreds of surveys, business executives have placed taxes lower on the list of important location factors than such factors as labor availability, costs and training; access to markets; access to raw materials; transportation costs; public services; and quality of life. Careful studies of the relationships between taxes, spending, and job growth show that undermining a state's educational system, its infrastructure, or other services vital to businesses and workers over the long run can do more damage than abandoning tax cuts that are no longer affordable.[6]

State employment statistics show that a no-new-taxes stance cannot guarantee economic recovery. Several states that avoided tax increases in the 2002 legislative sessions and instead enacted large spending cuts, such as Delaware, Iowa, Kentucky, Michigan, Mississippi, Missouri, and South Carolina, suffered above-average private-sector job loss from July 2002 to July 2003, according to the Bureau of Labor Statistics. Of course, many tax-raising states also lost jobs, but bear in mind that most of them cut spending, too. The state with the largest private-sector job loss from July 2002 to July 2003 was South Carolina, a state that has not raised taxes at all but has cut real per-capita general-fund spending over the last two years by 10 percent, more than double the national average.

How Can States Raise Taxes for Long-Term Adequacy?

This analysis suggests that states have both a short-term revenue problem and a long-term revenue problem. The short-term problem is that they must replace some $38 billion in annual tax revenue. The long-term problem is that if replacement revenues are not well designed, states will continue to lose revenue as a result of structural problems that cause gradual erosion of tax bases. Several options exist that can address both of these problems.[7]

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[6] See for example, Michael Wasylenko, "Taxation and Economic Development: The State of the Economic Literature," *New England Economic Review,* March-April 1997, reprinted in *State Tax Notes*, June 23, 1997, pp. 1883-95; Robert G. Lynch, *Do State and Local Tax Incentives Work?*, Economic Policy Institute, Washington, D.C., 1996; Timothy Bartik, *Who Benefits From State and Local Economic Development Policies*?, W.E. Upjohn Institute for Employment Research, Kalamazoo, Michigan, 1991.

[7] These revenue options are described in a series of Center on Budget and Policy Priorities publications, summarized in *State Tax Increases are Necessary to Preserve Basic Services: Background on Options Available to States*, http://www.cbpp.org/5-21-03sfp.htm

- States can continue to reverse some of the income tax cuts that were enacted in the 1990s. For instance, some 21 states cut top income tax rates from 1994 to 2001. In retrospect, it appears that many of those income tax cuts should have been recognized as unsustainable. In 2002, for instance, Massachusetts reversed 1990s income tax reductions that had become unaffordable. Similarly, Oklahoma benefited from a provision of a 1990s tax rate cut that required the rate cut to be reversed if the state got into fiscal problems.

- States can impose a temporary surcharge on income taxes. Although such temporary action would not improve the long-term prospects for state tax systems, it also would not make the situation worse by increasing the reliance on slow-growing revenue sources such as sales and excise taxes. Arkansas, Nebraska, New York and North Carolina have taken such actions, as did many states in the early 1990s. States may also be able to find other ways to raise more money from income taxes; Louisiana, for instance, has reduced the itemized deductions that taxpayers may claim.

- States can raise more money from their corporate income taxes. Although the corporate income tax has been declining as a revenue source over time, states could stem this decline by closing loopholes and by creating alternative tax bases that ensure that profitable corporations pay at least some tax in states where they do business. Corporate tax measures enacted in the last two years in states like Massachusetts, New Jersey, North Carolina and Ohio were attempts to raise new revenue by fixing some of the problems in corporate taxation.

- States could raise sales tax revenue by broadening their sales tax bases to include more services as Connecticut, Nebraska, and Utah have done. Unlike consumption tax rate increases, the revenue from which is likely to decline over time relative to the economy, sales taxes on services may be more likely to keep pace with economic growth. In some cases they may also be less burdensome on low- and moderate-income consumers.

- States could take steps to protect their estate taxes by “decoupling” from the federal estate tax changes, as some 17 states have done.

At the least, states should not enact new tax cuts or continue to implement phased-in tax cuts. They should follow the lead of states such as Connecticut, Massachusetts, Michigan, and Oregon, all of which in 2002 and/or 2003 postponed at least some planned tax cuts, as several other states did in 2001. Indeed, such states should consider going one step further and canceling those tax cuts altogether in recognition that those tax cuts were predicated on the unusual, unsustainable revenue growth of the 1990s.

Appendix I

Estimated State Tax Revenue Loss Due to Federal Changes and State Failure to Decouple

	Which federal tax changes affect State revenue?			Total state revenue loss ($millions)			
	Estate tax	Bonus depreciation	Section 179	FY 2003	FY 2004	FY2005	Total
Alabama	yes	yes	yes	$65	$184	$79	$329
Alaska	yes	no	yes	1	4	4	8
Arizona	yes	no	No	19	38	58	115
Arkansas	yes	no	yes	5	16	22	43
California	yes	no	no	387	762	1,105	2,253
Colorado	yes	yes	yes	103	177	90	370
Connecticut	yes	no	yes	8	78	112	198
Delaware	yes	yes	yes	23	91	57	171
Florida	yes	yes	yes	299	736	685	1,720
Georgia	yes	no	yes	27	79	109	216
Hawaii	yes	no	yes	11	19	27	57
Idaho	yes	no	yes	3	8	11	22
Illinois	no	no	yes	0	37	32	69
Indiana	yes	no	yes	4	24	27	56
Iowa	yes	no	yes	8	22	31	60
Kansas	no	yes	yes	59	88	26	173
Kentucky	yes	no	yes	11	34	47	92
Louisiana	yes	yes	yes	64	128	58	250
Maine	no	no	no	0	0	0	0
Maryland	no	no	yes	0	16	14	31
Massachusetts	no	no	yes	0	29	26	55
Michigan	yes	yes	yes	118	188	155	461
Minnesota	no	no	yes	67	176	164	407
Mississippi	yes	no	yes	7	19	27	53
Missouri	yes	yes*	yes	30	228	174	432
Montana	yes	yes	yes	24	39	15	78
Nebraska	no	no	no	0	0	0	0
Nevada	yes	no	no	14	23	34	71
New Hampshire	yes	no	yes	6	17	25	49
New Jersey	no	no	yes	0	28	25	54
New Mexico	yes	yes	yes	49	78	37	164
New York	no	no	yes	0	79	76	156
North Carolina	no	no	yes	0	26	23	49
North Dakota	yes	yes	yes	17	27	11	55
Ohio	no	no	yes	0	30	27	56
Oklahoma	yes	yes*	yes	15	45	27	87
Oregon	no	yes	yes	106	158	46	310
Pennsylvania	no	no	yes	0	29	26	55
Rhode Island	no	no	yes	0	3	2	5
South Carolina	yes	no	yes	16	36	48	100
South Dakota	yes	no	yes	9	9	4	22

	Which federal tax changes affect State revenue?			Total state revenue loss ($millions)			
	Estate tax	**Bonus depreciation**	**Section 179**	**FY 2003**	**FY 2004**	**FY2005**	**Total**
Tennessee	yes	no	yes	5	14	19	38
Texas	yes	no	yes	81	175	252	508
Utah	yes	yes	yes	31	75	35	141
Vermont	no	yes*	yes	3	6	3	12
Virginia	no	no	yes	0	22	19	41
Washington	no	no	no	0	0	0	0
West Virginia	yes	yes	yes	40	87	44	171
Wisconsin	no	no	yes	0	18	16	35
Wyoming	yes	no	no	3	5	7	16
District of Columbia	yes	no	yes	8	21	29	57
States total	**34**	**16**	**45**	**$1,745**	**$4,235**	**$3,991**	**$9,971**

*Oklahoma and Vermont decoupled from bonus depreciation for purposes of corporate income taxes but not personal income taxes. Missouri decoupled for FY 2003 only.

Sources: Center on Budget and Policy Priorities estimates based on information from state revenues departments and legislative offices, the Internal Revenue Service, and the Joint Committee on Taxation.