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THE STATE TAX CUTS OF THE 1990S, THE CURRENT REVENUE CRISIS, AND IMPLICATIONS FOR STATE SERVICES

By Nicholas Johnson

Summary

States now face a gigantic revenue problem. Total state tax revenue in fiscal year 2002 was some $38 billion lower than it was in the previous year after adjusting for inflation. Some 45 states lost revenue. Official forecasts released to date suggest that state revenues at best will hold steady after adjusting for inflation in fiscal year 2003, meaning that none of that $38 billion is likely to be recouped this year. Indeed, the revenue hole could get even deeper.

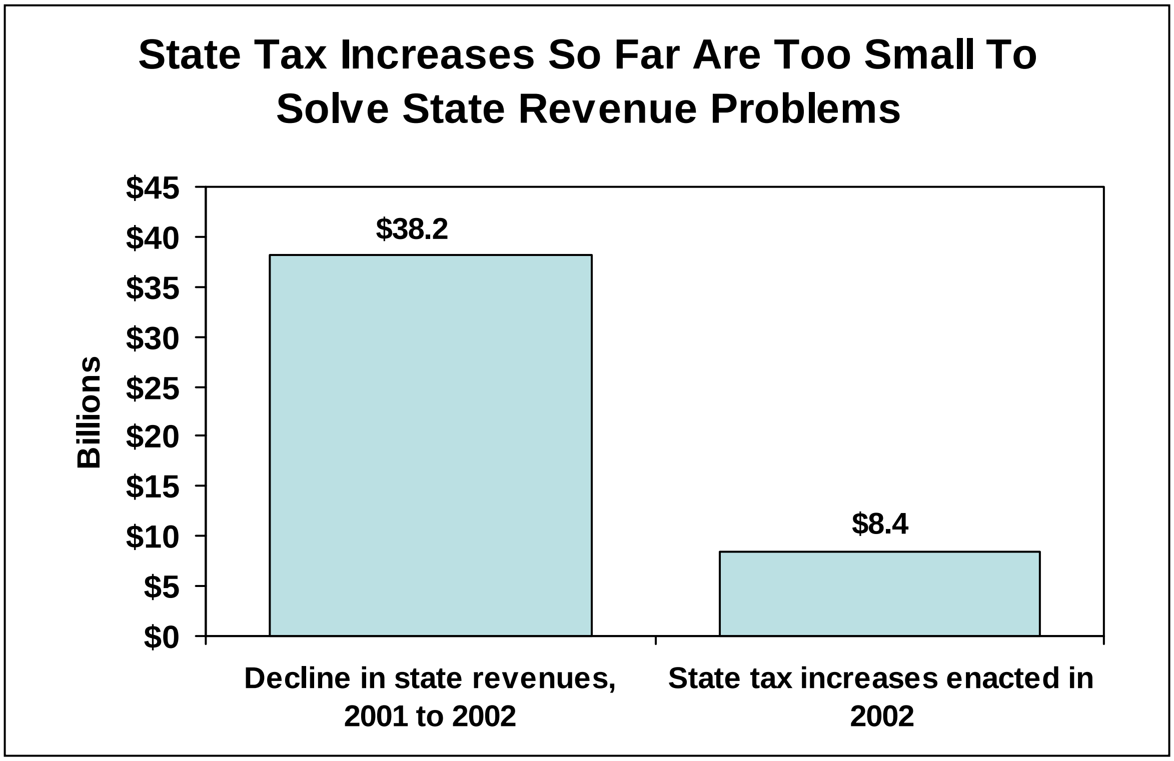
These revenue problems are taking a substantial toll on the services provided by state governments. Many states, for instance, are reducing health insurance benefits or eligibility for low-income families, or are increasing the amount that poor families must pay to access health insurance. Many states are reducing eligibility for child-care subsidies for working families; many are raising tuition for students at public colleges and universities. And further such cuts are likely to occur as states exhaust their rainy day funds and other one-time mechanisms for shoring up budgets.

The revenue problems that states now face contrast sharply with the situation in the recent past.

- In the mid- to late-1990s and into 2000 and 2001, revenue collections grew substantially as a result of unusually high — as it turned out, unsustainably high — levels of economic activity, particularly personal consumption and capital gains realizations. These revenue windfalls turned out to be temporary, as capital gains have declined dramatically, and the growth in personal consumption as a share of income is unlikely to be sustainable.

- Many states used those *temporary* levels of revenue growth to finance largely *permanent* tax cuts. Based on revenue forecasts that assumed revenue growth would continue at or near the levels of the late 1990s, some 43 states enacted large tax cuts in 1994 through 2001. These tax cuts, net of a few tax increases enacted in those years, reduced revenue by some 8.2 percent of state tax revenue nationwide. The ongoing loss of state tax revenue resulting from the net tax cuts enacted from 1994 to 2001 is more than $40 billion per year.

Figure 1



- Not surprisingly, states that enacted very large tax cuts in the 1990s are in the biggest fiscal trouble now. For instance, the ten states with the largest tax cuts in the 1990s faced a median budget gap in 2002 equal to nine percent of state spending, and a 13 percent gap in 2003. By contrast, the ten states that cut taxes the least in the 1990s had a median budget gap in 2002 equal to five percent of state spending and a one percent gap in 2003.

The scale of the current fiscal downturn was not necessarily predictable, although states should have known the good times would not last forever. It is relatively unusual for a recession and a sharp stock market decline, the two most proximate causes of the fiscal crisis, to occur at the same time. Moreover, to avoid tax cuts entirely in the 1990s arguably would have been politically difficult for states, given the large scale of the revenue windfalls. Now that the economic activity that led to those windfalls has proven unsustainable, however, states should be reconsidering those tax cuts and in many cases ending them or enacting equivalent tax increases.

Yet with very few exceptions, the tax cuts enacted in 1994 through 2001 that are costing states over $40 billion per year remain in place. States have reversed almost none of those tax cuts. Nor, in general, have they enacted other tax increases to take their place.

- The net tax increases enacted to date in 2002 will raise just $8.4 billion per year, an amount equal to about 1.5 percent of total state tax collections.

- That amount, $8.4 billion, is sufficient to replace only about one-fifth of the immediate decline in revenue that is causing states' present fiscal problems.

- Just 16 states have passed significant net tax increases, that is, measures that increase revenue by one percent or more.[1] In six of those 16 states — Indiana, Kansas, Massachusetts, Nebraska, New Jersey and Tennessee — the tax increase exceeded three percent of state tax revenue. In another ten of those 16 states, the tax increase was between one percent and three percent of tax revenue.

- Another five states passed significant tax increases while allowing significant tax cuts enacted in previous years to take effect. In each of these states, Hawaii, Maryland, Michigan, New York and Rhode Island, a cigarette tax increase was largely or entirely offset by a personal income tax reduction (along with reductions in corporate taxes in New York and vehicle excise taxes in Rhode Island). The combined effect of the tax increases and tax cuts was to do relatively little to raise net tax revenue in those states.

- The remaining 29 states have enacted no significant net tax increases in 2002.

The failure of states to act affirmatively to confront their revenue problems stands in contrast to their actions in previous economic downturns. Recessions nearly always reduce state government revenues, and as a result states typically cut spending and also raise taxes to balance their budgets. This was true in the wake of the 1990-91 recession, when some 44 states raised taxes along with reducing spending. By contrast, only a few states have raised taxes since the recent recession began in 2001.

Moreover, widely acknowledged structural problems with state budgets are likely to preclude substantial growth in state tax bases even when the economy enters a full recovery, whenever that might be. For instance, state sales taxes bases are gradually eroding as the economy moves from (taxed) goods to (untaxed) services. Most states are suffering from increasing activity by corporations to exploit loopholes in state corporate income tax systems. And states do not make as much use as they could of the personal income tax, which is the broadest-based tax and the one tax with the potential to offset the decline of those other taxes in the long term.

To the extent that they have made any tax changes, states in 2002 have largely perpetuated, and in some cases exacerbated, these underlying flaws in state revenue structures.

[1] A number of additional states took steps other than tax increases to boost revenue, such as changing the statutory relationship between state tax codes and the federal code to avoid revenue reductions stemming from federal tax changes, accelerating tax payment dates, delaying the effective dates of previously enacted tax cuts, or increasing fees. A few states went in the opposite direction, for instance changing the relationship between state and federal tax codes in such a way as to reduce revenues. This analysis does not count such actions as either tax increases or tax reductions; see Appendix.

- Increases in consumption taxes — cigarette, general sales, alcohol and gasoline taxes —represent the great majority of the tax increases of 2002, representing $5.1 billion or 60 percent of the total.

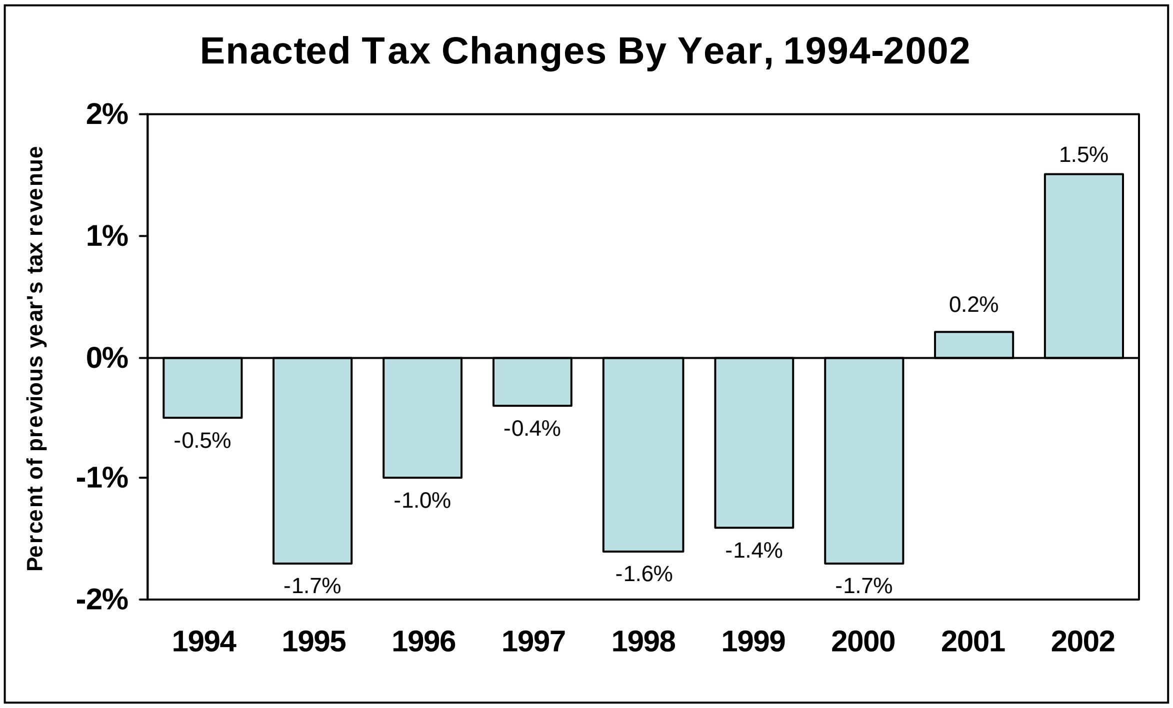
Table 1
Notable State Tax Increases in 2002

States with major tax increases (net greater than three percent of state tax revenues):	
Indiana	Sales tax rate increase, cigarette tax increase, gasoline tax increase, increased gambling taxes, utility tax increase
Kansas	Sales tax rate increase, business tax increase, gasoline tax increase, cigarette tax increase, inheritance tax increase
Massachusetts	Income tax increases (including capital gains tax increase, personal exemption reduction, and elimination of charitable deduction), cigarette tax increase
Nebraska	Income tax rate increase, cigarette tax increase, sales tax rate increase and base expansion
New Jersey	Corporate income tax increase, cigarette tax increase
Tennessee	Sales tax rate increase, corporate tax increase, cigarette tax increase, alcohol tax increase
States with smaller but still significant tax increases (net between one percent and three percent of state tax revenues):	
Alaska	Alcohol tax increase
Arizona	Cigarette tax increase
California	Suspend corporate net operating loss deduction
Connecticut	Limit corporate tax credits, increase gasoline and cigarette taxes
Illinois	Cigarette and gambling tax increases
Ohio	Income tax increase on trusts, cigarette tax increase
Oklahoma	Income tax rate increase (triggered automatically under pre-existing statute)
Oregon	Cigarette tax increase
Pennsylvania	Cigarette tax increase
Vermont	Cigarette tax increase
States with combination of significant tax increases and tax cuts (net impact less than 1 percent of state tax revenue):	
Hawaii	Cigarette tax increase; continued phase-in of personal income tax cut
Maryland	Cigarette tax increase; continued phase-in of personal income tax cut
Michigan	Cigarette tax increase; continued phase-in of personal income tax cut
New York	Cigarette tax increase; continued phase-in of corporate and personal income tax cuts
Rhode Island	Cigarette tax increase; continued phase-in of cuts to personal income tax and vehicle excise tax

Note: Excludes postponed tax cuts, fee hikes and some other revenue measures; see Appendix.

Cigarette taxes are by far the leading type of tax increase enacted in 2002, accounting for about $3.4 billion or 41 percent of the new tax revenue. Cigarette

Figure 2



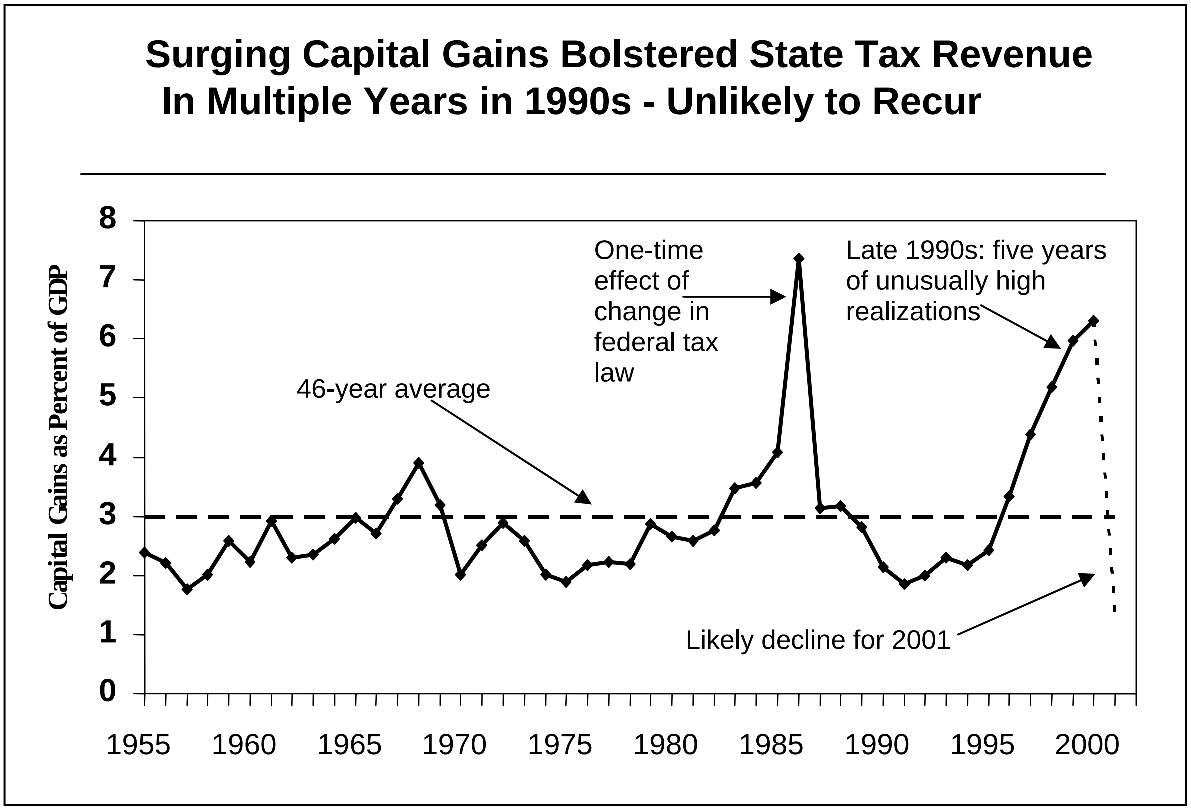
consumption is declining, and tax increases accelerate that decline, so that while these tax increases bring in more revenue in the short term, the new revenues decline over time. Sales tax changes — mostly flat rate increases — account for another $1.5 billion or 18 percent of the total net tax increases. The revenues raised by these taxes as well, although important in the short run, fail to grow with the economy, with the likely result of future budget shortfalls.

- By contrast, personal income taxes — the most broad-based form of tax and therefore the tax most likely to grow with the economy and to distribute burdens fairly across the income spectrum — account for just $700 million or 9 percent of the total net tax increases.

- Corporate income tax increases account for $2.1 billion or 25 percent of the total net tax increases. Much of that expected revenue comes from just one state, California, which expects to raise $1.2 billion this year by reducing corporations' ability to deduct past years' operating losses. Unfortunately for the long-term revenue picture in California, the increase is structured to allow corporations to reclaim the additional taxes they have paid beginning three years from now, and even gain an additional tax break, meaning that there is a long-term revenue loss rather than a gain.

On the positive side, a few states in the last year not only raised new revenues, but included in their packages measures that respond to these structural flaws. These revenue actions provide possible models for other states to consider as alternatives to budget cuts.

Figure 3



- Massachusetts and Oklahoma reversed some income tax cuts that were enacted in the 1990s. They were two of 21 states from 1994 to 2001 that cut top income tax rates, actions which in retrospect were unsustainable. The remaining 19 states similarly could reverse those rate reductions in whole or in part to raise new revenue. Nebraska and (in 2001) North Carolina imposed temporary income tax surcharges. Louisiana voters in November raised income taxes to pay for a sales tax reduction, a change which is revenue-neutral in the short run but which will help the tax system keep pace with economic growth in the longer term.

- New Jersey sharply reduced the number of corporations that are able to manipulate tax laws to avoid paying any corporate income tax at all. Although state corporate income taxes have been declining as a revenue source over time, states can 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. The New Jersey increase represents the most significant attempt to do so by any state this year, although other states are considering comparable action.

- Nebraska raised substantial new sales tax revenue in 2002 by broadening its sales tax base 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 Nebraska's are important for future revenue stability.

At a minimum, states can protect existing revenue sources. For instance, some 16 states have protected their estate tax revenue by "decoupling" from the federal estate tax changes, and 30 states have protected their corporate income taxes by decoupling from changes in federal depreciation rules. (See box on page 15.) Several other states, such as Connecticut, Florida, and Michigan, have postponed at least some tax cuts that were originally enacted before the recession and stock market decline made them unaffordable.

Prelude to Crisis: The Tax Cuts of 1994-2001

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 today is about 8.2 percent — or more than $40 billion — lower than it would be had those 43 states not cut taxes during that time.[2]

At the time they were enacted, the large tax cuts of 1994-2001 may have appeared affordable in many states because tax revenues were coming in at levels above expectations and many states were running record surpluses. Those higher-than-expected tax revenues were due to a variety of factors. Capital gains realizations were at all-time highs for several years in a row because of the remarkable increase in the stock market, boosting income taxes. The stock market increase coupled with a run-up in consumer debt also fueled a dramatic increase in personal consumption, from less than 90 percent of disposable personal income in the early 1990s to about 95 percent by decade's end, boosting sales tax revenue. Corporate profits were also high. With this unusually high and rapidly growing revenue stream, states could cut taxes while maintaining spending growth at about the same level as in previous decades and also accumulating rainy day funds that, although insufficient to weather the current fiscal crisis, were quite large by historic standards.[3]

Unfortunately, to a large extent the trends that underlay the tax cuts of the 1990s have turned out to be unsustainable. Capital gains realizations, following the decline of the stock market, have dropped substantially. While it is widely expected that capital gains will return to their long-term historical level of about three percent of GDP once the economy recovers, few if any economists would forecast a return to the level of capital gains realizations of the late 1990s, which reached 6 percent of GDP. Personal consumption as a share of income has leveled off and even declined a bit to 93 percent in the most recent quarter, although it has not yet returned to the sub-90 percent range in which it generally rested from the 1960s through the early 1990s.

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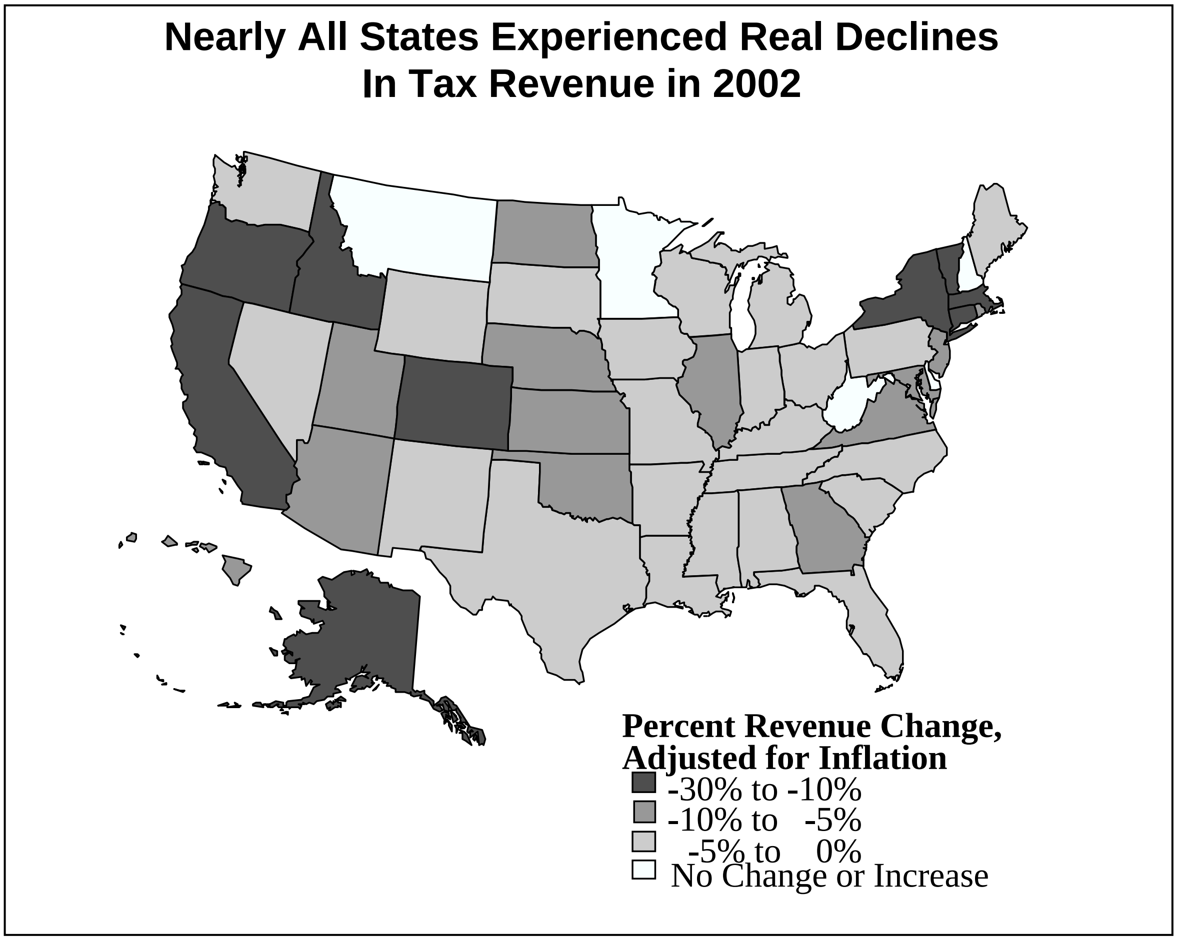
[2] These are net figures, reflecting both tax increases and tax cuts. A few states raised some taxes in the 1994-2001 period, such as gasoline or cigarette taxes, while cutting other taxes.

[3] Inflation-adjusted state spending per person increased by an average of 2.8 percent per year between 1989 and 1999, less than the 3.2 percent average annual growth between 1959 and 1999 and about the same rate as overall economic growth in the 1990s. See Elizabeth C. McNichol and Kevin Carey, *Did States Overspend During the 1990s?* Center on Budget and Policy Priorities, October 2002.

Figure 4



In other words, the tax cuts of the 1990s were financed largely by *temporary* economic conditions that have now ceased. But the tax cuts themselves were designed to be *permanent.* At present, nearly all of those tax cuts remain in place.[4] Only a minority of states have been willing to reclaim even a small portion of that revenue.

The Fiscal Crisis of 2002: State Revenue Responses

In fiscal year 2002, the temporary economic conditions that financed the tax cuts of the 1990s came to an end. States in fiscal year 2002 collected about $38 billion less in taxes than in the previous year, after adjusting for inflation. That decline equals close to 8 percent of total state tax revenue. Making further adjustments for population growth and the impact of net tax

[4] A few states in the 1990s did implement temporary tax reductions, such as one-time tax rebates in Connecticut and Minnesota that have now ended or temporary sales tax rate reductions such as California's. Those temporary tax cuts are not counted within this analysis. Note also that each of the states enacting temporary tax reductions also enacted large permanent tax cuts that remain in place.

Table 2
State Tax Collections Changes, FY 2001 to FY 2002 (July-June period) (adjusted for inflation)

State	Change in Tax Collections	State	Change in Tax Collections	State	Change in Tax Collections
Alabama	-2.1%	Louisiana	-0.3%	Ohio	-2.9%
Alaska	-29.3%	Maine	-4.5%	Oklahoma	-6.7%
Arizona	-7.8%	Maryland	-6.3%	Oregon	-21.7%
Arkansas	-2.4%	Massachusetts	-13.5%	Pennsylvania	-4.3%
California	-19.1%	Michigan	-4.2%	Rhode Island	-7.6%
Colorado	-11.7%	Minnesota	2.8%	South Carolina	-4.8%
Connecticut	-12.5%	Mississippi	-2.3%	South Dakota	-2.1%
Delaware	2.0%	Missouri	-2.1%	Tennessee	-4.2%
Florida	-0.7%	Montana	0.5%	Texas	-3.3%
Georgia	-6.4%	Nebraska	-5.4%	Utah	-5.5%
Hawaii	-5.2%	Nevada	-0.3%	Vermont	-11.3%
Idaho	-11.8%	New Hampshire	3.7%	Virginia	-5.6%
Illinois	-5.4%	New Jersey	-9.3%	Washington	-3.3%
Indiana	-3.4%	New Mexico	-2.7%	West Virginia	1.9%
Iowa	-4.1%	New York	-12.6%	Wisconsin	-2.5%
Kansas	-7.8%	North Carolina	-2.3%	Wyoming	-1.8%
Kentucky	-2.6%	North Dakota	-6.1%	50 states	-7.9%

Source: Center on Budget and Policy Priorities calculations from Rockefeller Institute of Government data.

increases that took effect in 2002, the decline equals $44 billion or about 9 percent of total state revenue.[5] (See Table 2.)

As a result of these revenue declines, the National Conference of State Legislatures reports that 45 states in fiscal years 2002 and/or 2003 faced budget gaps equal to at least one percent of general fund spending. Some 33 states faced gaps equal to at least five percent of spending.

Compared with the size of the problem, the tax increases of 2002 have been quite modest in scope.

- States in 2002 have enacted net tax increases totaling $8.4 billion per year, an amount equal to about 1.5 percent of states' total tax collections in the previous fiscal year.

- The $8.4 billion in tax increases will be sufficient to fill only about one-fifth of the real revenue decline that has occurred since fiscal year 2001.

[5] These figures were calculated from the state revenue data that the Rockefeller Institute of Government collects and reports in its *State Revenue Reports* (http://www.rockinst.org/publications/state_revenue_reports.html). Rockefeller Institute data generally include only general-fund taxes and therefore exclude motor fuel taxes and some other taxes.

- Although nearly every state faces substantial budget problems, just 16 states have passed significant net tax increases, that is, measures that increase taxpayers' liability by one percent or more.[6] In six states — Indiana, Kansas, Massachusetts, Nebraska, New Jersey and Tennessee — the tax increase exceeded three percent of state tax revenue. In another ten states, the tax increase amounted to between one percent and three percent of state tax revenue.

- The remaining states enacted no significant net tax increases. In fact, two states — Hawaii and Maryland — actually reduced overall taxes in their 2002 sessions, as cigarette tax increases in each of those states were outweighed by the implementation of larger, previously enacted reductions to income taxes. In three other states, Michigan, New York and Rhode Island, the revenue effect of significant cigarette tax increases was in large part offset by the decision to allow reductions to personal income taxes and other taxes to continue to phase in, with the result that net tax increases were less than one percent of state tax revenue. Louisiana voters approved a revenue-neutral "tax swap" — a sales tax cut and income tax increase — that is described in more detail below.

Even among the states enacting significant net tax increases this year, the amount of those increases generally fell far short of compensating for the size of the large tax cuts implemented from 1994 to 2001. Of the 16 states that raised taxes significantly in 2002, 13 states — Arizona, California, Connecticut, Illinois, Indiana, Kansas, Massachusetts, Nebraska, New Jersey, Ohio, Oklahoma, Oregon and Pennsylvania — had enacted large tax cuts in the period from 1994 to 2001. But only in three of those 13 states, Indiana, Kansas, and Nebraska, do the tax increases of 2002 appear to be large enough to balance out the tax cuts of 1994-2001.[7]

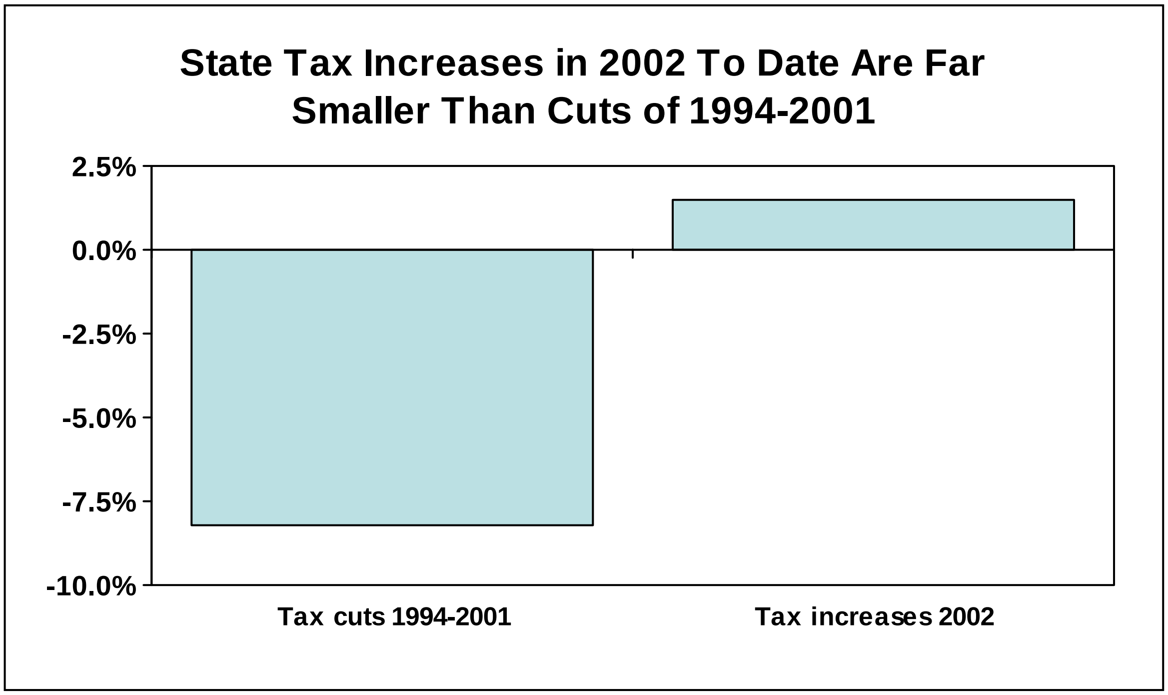
Failing to Raise Taxes When Needed: Consequences for Public Services and Families

By avoiding a tax increase, state policymakers may believe they are protecting their constituents. In fact, the consequences of failing to raise taxes during a budget crisis can be severe for state residents. The reason is that states face balanced-budget requirements, and so failing to raise taxes in a fiscal crisis typically leads to spending cuts. Indeed, this is what has happened. A July NCSL report indicates that at least 29 states cut spending to balance their 2002 budgets, and at least 26 states cut spending to balance their 2003 budgets. The true number is

[6] Some other states raised taxes, but the net revenue effect was less than 1 percent of total revenue. A number of additional states took other steps to boost revenue, such as changing the statutory relationship between state tax codes and the federal code to avoid revenue reductions stemming from federal tax changes, accelerating tax payment dates, delaying the effective dates of previously enacted tax cuts, or increasing fees. A few states went in the opposite direction, for instance changing the relationship between state and federal tax codes in such a way as to reduce revenues. This analysis does not count such actions as either tax increases or tax reductions.

[7] In Kansas and Nebraska, the net tax increases of 2002 roughly appear to have equaled the net tax cuts of 1994-2001. In Indiana, the tax increase of 2002 at the state level exceeded the tax cuts of the earlier period only because the tax increase of 2002 also financed a very large reduction in local property taxes that was made necessary by a court decision.

Figure 5



probably higher. Data from state budget departments shows that nationwide, real, per-capita state spending declined in fiscal year 2002 and is projected to decline again in 2003.

- The Kaiser Commission on Medicaid and the Uninsured reports that a large number of states have reduced deeply health care benefits for low-income children, families and senior citizens. Specifically, 25 states have changed eligibility rules so that fewer people can participate, 22 states have reduced benefits for those who are eligible, 21 states have instituted or increased copayments for prescription drugs, and 16 states have increased copayments for some or all services other than prescription drugs.[8]

  Many of the states that enacted reductions in benefits and eligibility or increases in copayments also chose not to raise taxes, including Delaware, Florida, Georgia, Idaho, Iowa, Michigan, Missouri, Montana, Utah, Washington, and Wisconsin.[9] Notably, each of those states reduced taxes significantly from 1994 to 2001. Had any one of those states rolled back some or all of the tax reductions of 1994-2001, the health care cuts could have been averted or minimized.

- A recent report by the Children's Defense Fund found that states — including many states that have avoided raising taxes — have reduced funding for child

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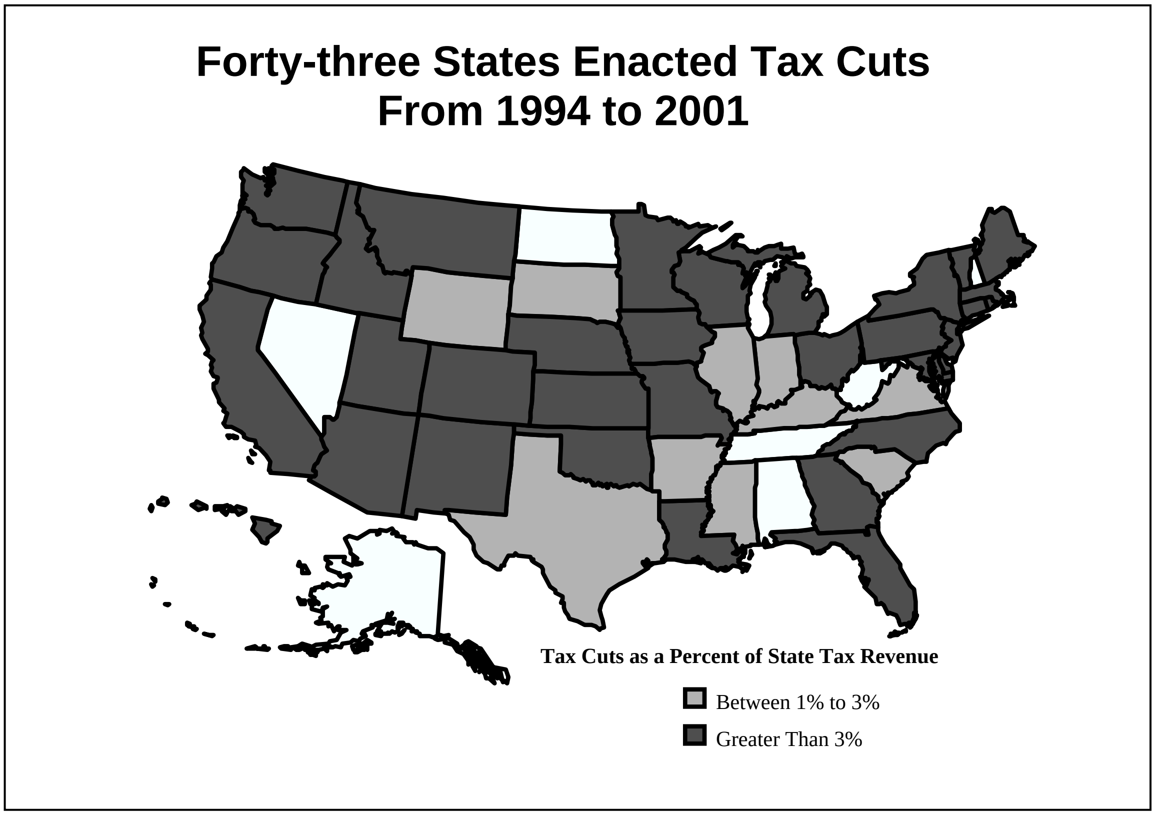
[8] Kaiser Commission on Medicaid and the Uninsured, *Medicaid Spending Growth*, September 2002.
[9] The reductions in several of those states are described in Leighton Ku, Donna Cohen Ross, and Melanie Nathanson, *State Medicaid Cutbacks and the Federal Role in Providing Fiscal Relief to States*, Center on Budget and Policy Priorities, revised August 2, 2002.

Figure 6

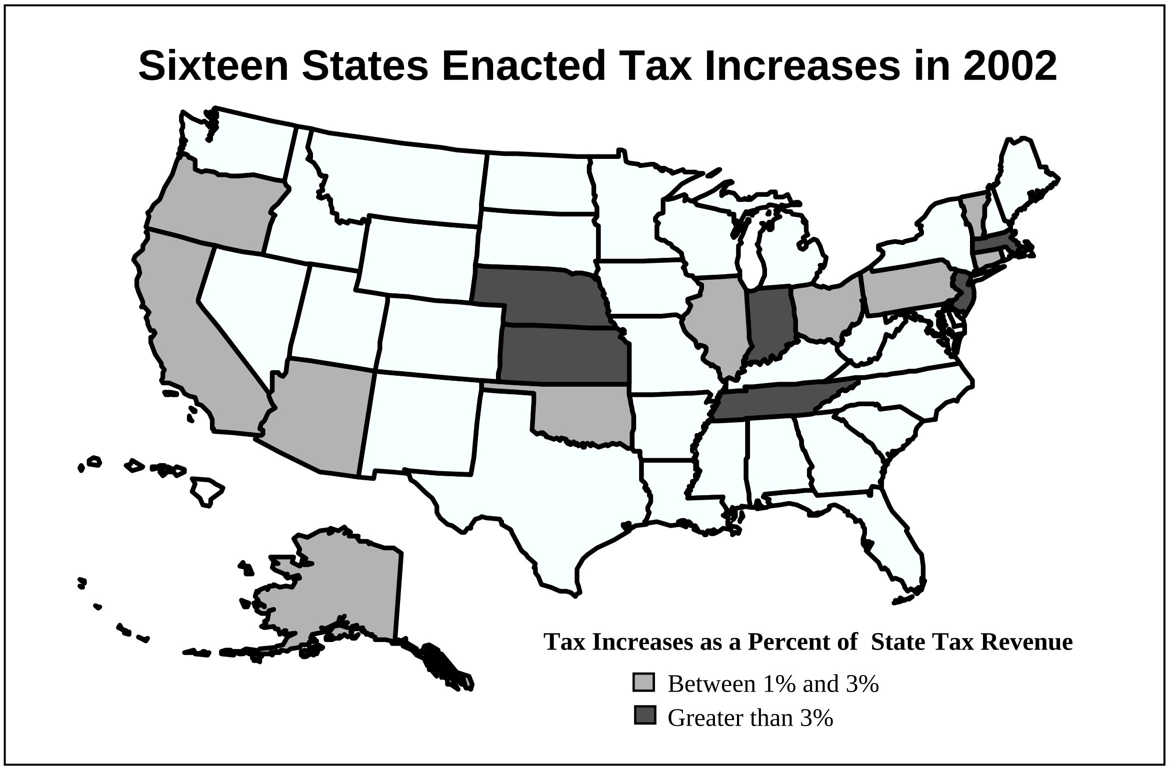


care for working families. Many of those budget reductions are already making it more difficult for working families to pay for care. For instance, waiting lists for child care programs exist in 19 states and are growing larger. Over the past two years, Florida added more than 12,000 children to its waiting list, while Texas added more than 5,000 children. Tennessee and Minnesota also have greatly increased their waiting lists. Eligibility for services has been restricted in a number of states, including Colorado, Nebraska, New Mexico, Washington and West Virginia. Parent fees have increased in a number of states, including Montana, New York, Washington and West Virginia.[10]

- The decision not to raise taxes has been costly for many families with college students, because many state institutions of higher education have acted to make up for lost revenues by sharply increasing tuition or making other cuts. Nationwide, the College Board reports that the cost of education at state colleges and universities is rising faster than the cost at private schools. For example, freshmen at Texas A&M University are paying at least 26 percent more in tuition and fees in 2002 than in 2001. Pennsylvania State University increased tuition by 13.5 percent. Virginia's George Mason University, South Carolina's Clemson University and the University of Washington raised tuition by 16.5 percent, 27 percent and 16 percent respectively. Tuition at Iowa's public universities rose

[10] Children's Defense Fund, *Low-Income Families Bear the Burden of State Child Care Cutbacks*, September 2002.

Figure 7



18.5 percent for the current year, and another 17.6 percent increase is proposed for next year. Public universities in Idaho, Minnesota, Missouri, and Montana all are implementing tuition increases of more than ten percent. All of those states cut taxes in the 1990s, and none of them raised taxes significantly in 2002.

The tradeoff between reductions in public services and tax increases has been made particularly clear in Oregon. The legislature there referred to the voters a proposal to raise income tax rates temporarily producing new revenue of $310 million. If that measure does not pass in the January election, spending will be reduced by an equivalent amount, which state officials project will lead to about 2,850 schoolteacher layoffs and closure of several prisons, among other reductions.

Current Tax Actions Bode Long-term Problems

States are not expecting revenues to grow much in real per-capita terms in the current year. A July survey from the National Conference of State Legislatures forecasts 3.7 percent nominal revenue growth for fiscal year 2003, approximately equal to the combination of predicted inflation and population growth. That figure takes into account the implementation of new tax increases described in this analysis; states that are not increasing taxes likely are experiencing even less revenue growth or in many cases even revenue declines. More recently,

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.

As this report notes, a number of the states that cut taxes in the 1990s and have avoided raising taxes in the current year nonetheless are imposing new economic burdens on families in the form of higher fees. For example, Iowa cut income taxes sharply in 1997, costing the state close $400 million per year. The tax cut is still in place, giving typical middle-income taxpayers an average benefit of about $100 to $200 per year. But for a family with a student at a state university, that benefit is being wiped out this year by in-state tuition increases of about $1,200 per year (with an additional $1,300 increase proposed for next year) caused by some $124 million in reduced state funding for higher education.

states have released revenue estimates that show collections falling below expectations, so 3.7 percent growth may be overly optimistic.

Such flat revenues in many states will not be sufficient to balance budgets in 2003 and/or 2004, even accounting for the tax increases and service reductions already enacted. States to a large extent balanced their 2002 budgets by withdrawing money from rainy day funds, financing capital expenditures with bonds instead of operating revenue, shifting the timing of payments to local governments, and the like. Such one-time revenues and savings will be less available in many states in coming years.

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 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.

States' Backdoor Tax Cut: Phasing out Estate Taxes

This analysis so far has omitted one of the largest tax changes that states may be implementing over the next several years: repeal of their estate taxes. Beginning in tax year 2002 and continuing through 2005, some 34 states are on track to lose most or all of their revenue from the estate tax. The reason is that in most states, the amount of estate tax that is owed to the state is based on the tax credit that estates may claim under federal law. This tax credit has existed for decades as a way for states effectively to receive a portion of the revenue under the federal estate tax. But last year, Congress chose to eliminate that credit by tax year 2005 as part of a broader measure that repeals the federal estate tax in 2010.

If states do not enact affirmative legislation to protect their estate taxes, a very small number of very large estates in each state will receive a large tax break at exactly the same time that many states are raising taxes on less-wealthy families or cutting spending on low-income programs. Sixteen states have already chosen to protect their revenue from the estate tax by "decoupling" from the federal estate tax changes enacted by Congress in 2001. States that fail to decouple increase the size of their budget deficits and raise the likelihood of other spending cuts, other tax increases, or both. In most of the 34 states that are on track to lose this revenue, the elimination of estate taxes has occurred as a result of conformity to federal changes, without explicit legislative action

Although the number of families likely to benefit from the repeal of estate taxes in most states is small, typically a few hundred or a few thousand families, the revenue at stake is substantial. In the 34 states that have failed to decouple so far, revenue losses are projected to total $1 billion in fiscal year 2003, rising to $5 billion annually beginning by fiscal year 2007.

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 of 2002 stand to exacerbate the structural flaws in state tax systems.

- Some $3.4 billion, or 41 percent, of the tax increases enacted in 2002 have come from cigarette tax rate increases. Cigarette tax increases have been enacted in 20 states in 2002, although the net tax increases in a few of those states did not exceed one percent of total revenue. 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. From a tax policy perspective, however, they are problematic, because the new revenue they generate may be expected to decline over time as smoking rates dwindle.

- Some $1.5 billion, or 18 percent, of the net tax increases of 2002 have come from sales taxes. Nearly all of the new revenue was from sales tax rate increases in Indiana, Kansas, Nebraska, and Tennessee. Sales taxes, like cigarette taxes, are problematic. 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.

The Tax Cuts of the Mid- to Late-1990s Appear To Have Outweighed Previous Years' Tax Increases

The tax cuts that states began enacting in 1994 may be viewed, in one sense, as a response to the tax increases enacted in response to the recession and ensuing state budget crunch of the early 1990s. Alternatively, the net tax increases enacted from 1990 to 1993 may be viewed simply as replacing the revenue lost during a period of substantial tax cuts in the economic expansion of the mid- and late-1980s. Those tax cuts, in turn, may approximately have mirrored tax increases during the early 1980s. And so on, back through business cycles.

In some periods, the tax cuts enacted during the boom years may have exceeded in scale the tax increases enacted in downturns. In other cases, the reverse may be true and legislated tax increases may have exceeded the tax cuts. To complicate the picture further, external economic or demographic forces or changes in federal tax law can raise or lower a state's overall tax level without any legislative action.

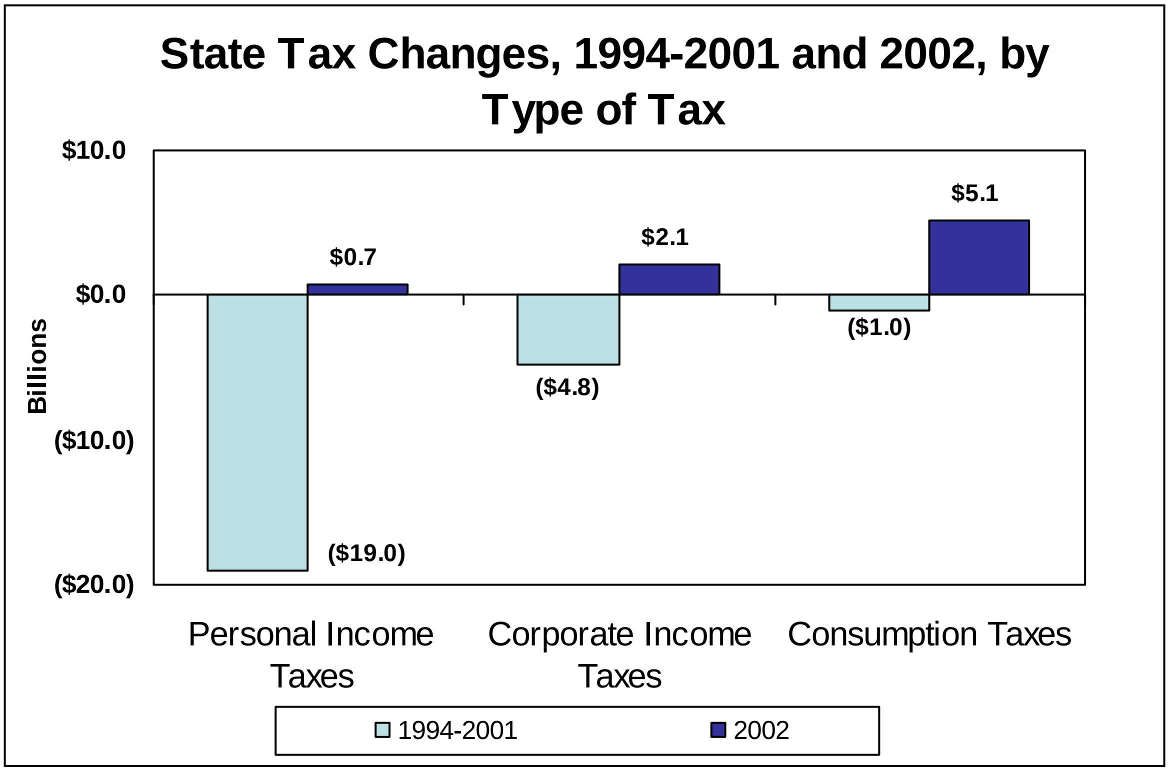
One way to gauge the ongoing impact of all these changes on tax burdens is to track actual tax collections as a share of the economy. According to the Department of Commerce's National Income and Product Accounts data, state and local tax collections since 1970 have averaged about 11.0 percent of total personal income. Overall tax levels fluctuated somewhat more in the 1970s and in the early 1980s, ranging from a high of 12.1 percent to a low of 10.1 percent, than they have in recent years. From the mid 1980s to the late 1990s, state and local taxes as a share of personal income remained quite close to the 11 percent mark.

Total tax collections began their current slide, relative to total personal income, in late 1999. According to the NIPA data, taxes fell below the 32-year average in mid-2000. In 2002, they fell to 10.5 percent, their lowest level since 1985. This decline suggests that the tax cuts of the 1990s, perhaps combined with other changes outside the control of state policymakers, generally outweighed tax increases enacted earlier in the decade.

> On a positive note, Nebraska not only raised its sales tax rate but also broadened its sales tax base by adding some services — building cleaning and maintenance, security, pest control, automobile washing and painting, computer software training, and installation of taxable items — that were previously exempt.

Altogether, increases in consumption taxes — cigarette, general sales, alcohol and gasoline taxes — have represented the great majority of the tax increases enacted in 2002, representing $5.1 billion or 60 percent of the total.

Figure 8



Note: Changes in other taxes are not shown.

By contrast, relatively little of the tax increases of 2002 (and in fact almost all of the tax cuts) have been in personal income taxes. Total personal income tax increases totaling about $1.3 billion were offset by other reductions in personal income taxes — mostly previously enacted cuts that were allowed to go forward — for a net increase of $700 million, or about 9 percent of the total net increases. States with notable personal income tax increases include Louisiana (see below), Massachusetts, Nebraska, Ohio and Oklahoma. (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.)[11]

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.

For this reason, the Louisiana "tax swap" approved by voters in November is important. An increase in Louisiana's income tax (achieved by reducing the income level at which the top 6 percent rate takes effect, plus disallowance of a large portion of itemized deductions) will pay for repeal of the state's sales taxes on groceries and utilities. Although revenue-neutral in the initial

[11] Several other states, including Oregon, postponed scheduled personal income tax reductions; for purpose of this analysis, as described in the Methodology section, such postponements are not considered tax increases.

State Tax Increases of 2002 Largely Have Failed to Address Problem of 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. State personal income taxes generally are at least somewhat progressive, because they have rate structures that tax higher incomes at higher rates, or because they exempt the first several thousand dollars of each family's income.

The large tax cuts states enacted from 1994 to 2001 tended to make tax systems more regressive, because 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. Of the $35 billion in net tax cuts enacted from 1994 to 2001, some $28 billion were cuts in personal income taxes, corporate income taxes, or inheritance or estate taxes; only about $1 billion in net tax cuts were reductions to sales and excise taxes. In other words, when states cut taxes in the 1990s, the benefits of the tax cuts flowed disproportionately to higher-income families.

Now that states have begun to raise taxes again, the burdens also have been directed disproportionately to lower-income families. This is because increases in consumption taxes — cigarette, general sales, alcohol and gasoline taxes — have represented the great majority of the tax increases of 2002, representing $5.1 billion or 60 percent of the total. Increases in personal and corporate income taxes have been far smaller.

A few states appear to have recognized the distributional consequences of raising consumption taxes. The tax packages passed in Massachusetts and Nebraska, for instance, include not only consumption-tax increases that will more heavily affect poor families but also increases in personal income taxes that will most heavily impact high-income families (a capital-gains tax rate hike in Massachusetts, a personal income tax rate increase in Nebraska). 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 raising its income tax, thereby reducing the overall burden of taxes on poorer families and increasing the burden on higher-income families.

(Another state, Tennessee, also made a very small gesture of recognition of the regressivity problem: the state exempted from its one-penny sales tax increases the purchase of grocery-store food, a particularly regressive component of the sales tax. Nonetheless, since the sales tax increase will apply to all other purchases, and since Tennessee neither coupled the sales tax increase with more progressive tax increases nor enacted offsetting tax relief for poor families, the overall tax increase still will be more burdensome on poor families than on higher-income families.)

few years, the measure will increase the state's revenue over time; legislative analysts point out that income taxes tend to grow far faster than sales taxes on grocery and utilities taxes, yielding a projected $50 million in additional revenue by 2007.

Another $2.1 billion of the tax increases of 2002 — about 25 percent of the total — were increases in corporate income taxes. Nearly all 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.[12] New Jersey's corporate income tax increase, therefore, will improve the state's ability to raise revenue over both the short- and long-term. California's increase is less positive for the middle- and long terms, 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 tax increases have the virtue of avoiding placing disproportionate new tax burdens on low- and moderate-income families.

The relatively scant increases in personal income taxes and corporate taxes enacted by states in 2002 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 $27 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.

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.

- States can 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

[12] 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.

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. Nebraska and (in 2001) 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, is reducing 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. The corporate tax increases enacted in 2002, most notably New Jersey's as well as increases enacted in North Carolina and Ohio in 2001 were attempts to fix some of the problems in the corporate tax. [13]

- States could raise sales tax revenue by broadening their sales tax bases to include more services. Such base expansion was a significant part of Nebraska's revenue-raising package in 2002, and other states are considering similar action. 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 16 states have done. (See box on page 15.)

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 Massachusetts, Michigan, and Oregon, all of which in 2002 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 predicted on the unusual, unsustainable revenue growth of the 1990s.

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[13] Some ways states can do this are described in Michael Mazerov, *Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States,* Center on Budget and Policy Priorities, April 2002.

States That Cut Taxes Most in the 1990s Financed the Tax Cuts with Revenue Windfalls; Now They Face Big Deficits

Many states that cut taxes in the 1990s also experienced strong economic growth. The links between economic growth and tax actions are complicated, but it is likely that the economic growth in tax-cutting states was likely a contributor to the budget surpluses that helped pay for the tax cuts more than it was a result of the tax cuts, as a few analysts have argued. In other words, in most states, the tax cuts of the 1990s were not an expression of a particular "small-government" fiscal policy, but rather resulted from revenue windfalls generated by the economic boom. States that enacted big tax cuts often did so because they thought they could afford it, not because they desired to cut spending.

This conclusion is supported by an examination of the states near the ends of the tax-cutting spectrum in the 1990s. It turns out that state government spending rose no less in states that cut taxes the most than in states that cut taxes the least, and in some cases it rose even more. For instance, the ten states that cut taxes the most during the 1994-2001 period experienced median spending growth of 6.9 percent annually. The ten states that cut taxes least during that period had median spending growth of 5.7 percent.

Not surprisingly, the states that cut taxes the most in the 1990s generally are in the biggest fiscal trouble now. The ten largest tax-cutting states of the 1990s had median budget gaps in 2002 and 2003 equal to 9 percent and 13 percent of state spending respectively. The ten states that cut taxes the least in the 1990s had a median budget gap in 2002 equal to 5 percent of state spending and a 1 percent gap in 2003.

State Tax Cuts. 1994-2001, and Fiscal Outcomes, 2002-03

	Tax cuts as a percent of total taxes, 1994-2001	Annual state spending growth, 1994-2000 (nominal)	Budget deficits as share of spending, 2002	Budget deficits as share of spending, 2003
Ten states enacting very large tax cuts	16.2%	6.9%	9.0%	13.0%
Ten states enacting smaller or no tax cuts	0.3%	5.7 %	4.9%	1.0%
All fifty states	8.2%	6.1%	5.4%	5.3%

Note: States enacting very large tax cuts from 1994 to 2001 include Arizona, Colorado, Connecticut, Delaware, Massachusetts, Michigan, Minnesota, New Jersey, New York, and Oregon. States enacting relatively modest or no tax cuts from 1994 to 2001 include Alabama, Alaska, Mississippi, Nevada, New Hampshire, North Dakota, South Carolina, Tennessee, West Virginia, and Wyoming.
Sources: National Conference of State Legislatures; U.S. Census Bureau Government Finances; Center on Budget and Policy Priorities.

The Economic Impacts of Tax Changes

In order to balance their budgets in the current fiscal crisis, with most of their reserves depleted, states face a choice: They can cut services while protecting the large tax cuts of the 1990s; or they can protect public services by raising taxes. Which choice states make could have significant implications for whether the nation's economy emerges from the recent recession or whether the recession is extended. 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.[*]

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[*] 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.

Table 3
Current Budget Problems in 34 States with Major Tax Cuts in the 1990s
(tax cuts exceeding 3% of state tax revenue)

	Examples of Major 1994-01 Tax Cuts	Tax Increase Enacted in 2002: Major tax increase (over 3% of state tax revenue)	Tax Increase Enacted in 2002: Smaller tax increase (between 1% and 3%)	Medicaid Cuts Enacted in FY 02 and/or Planned in FY 03 — Examples*	Cuts in Other Services — Some Examples
Arizona	Reduced personal income tax rates, reduced corporate taxes, eliminated state property tax.		Cigarette tax increase (voter-approved)	Considering cutting eligibility for pregnant women.	Froze child care provider reimbursements. Reduced aid to disabled adults and funding for after-school programs.
California	Top income tax rates expired, increased dependent credit, reduced vehicle taxes.		Temporary business tax increase	Delayed coverage expansion for 200,000 parents, reduced funding to local eligibility offices	Froze child care provider reimbursements. Cut funding for education for welfare recipients. $750 million in unspecified cuts to be made by governor.
Colorado	Reduced personal income tax rate, reduced sales tax rate, new tax credits			Reductions in eligibility planned or likely	Five counties have closed child care enrollment. University tuition increase of up to 9 percent for 2002-03.
Connecticut	Reduced personal and corporate income taxes, motor fuel taxes, and inheritance taxes		Cigarette and gasoline tax increases, limit corporate credits	Plans to cut eligibility for seniors; considering benefit reductions.	Closed child care enrollment for many families. Closed special courtrooms for drug offenders.
Delaware	Reduced personal income tax rates			Instituted copayments and reduced outreach.	Delaware State University tuition up 7 percent for 2002-03.
Florida	Reduced intangibles tax			Reduced dental benefits for 28,000 individuals, reduced eligibility for senior citizens.	Increased child care wait lists. Several thousand state workers laid off.
Georgia	Reduced personal income taxes, eliminated sales tax on groceries			Estimated 5,000 individuals will lose coverage; reduced coverage for those moving from welfare to work.	
Hawaii	Reduced personal income taxes and sales tax on business-to-business sales		Cigarette tax increase offset by income tax cut		Planned teacher bonuses canceled.
Idaho	Reduced personal income tax rates			Eliminated some dental benefits, reduced eligibility for disabled.	Tuition increases at state universities of 10-12 percent two years running.
Iowa	Reduced personal income tax rates and inheritance tax			Reduced dental services.	State university tuition up 18.5 percent in 2002-03; additional 17.6 percent increase proposed for next year. State worker furloughs and layoffs.

	Examples of Major 1994-01 Tax Cuts	Tax Increase Enacted in 2002: Major tax increase (over 3% of state tax revenue)	Tax Increase Enacted in 2002: Smaller tax increase (between 1% and 3%)	Medicaid Cuts Enacted in FY 02 and/or Planned in FY 03 — Examples*	Cuts in Other Services — Some Examples
Kansas	Repealed inheritance tax, increased personal income tax deduction, and new corporate tax credits	Sales tax rate increase, other increases		Reductions in benefits and eligibility planned or likely	University of Kansas tuition increased over 20 percent for 2002-03; cut aid to schools $17.5 milion.
Maine	Increased personal exemption, reduced sales taxes				
Maryland	Reduced personal income tax rates, new sales tax exemptions, corporate tax cuts		Cigarette tax increase, offset by income tax cut		Tuition at state universities increased 9.5 percent over two years.
Massachusetts	Reduced personal income taxes and corporate income taxes; reduced estate tax	Income tax and cigarette tax increases		50,000 individuals lost health coverage. Copayments increased.	Reduced number of child care slots; reduced funding for employment services for cash assistance.
Michigan	Reduced personal income tax rate and single business tax rate		Cigarette tax increase, offset by income tax cut	Postponing/dropping plan to expand coverage to low-income working families.	Froze revenue-sharing with local governments for 2003 at nominal 2002 levels.
Minnesota	1999 and 2000: reduced personal income tax rates			Eligibility cuts planned or likely	University tuition increases of 7.5 percent to 16 percent for 2002-03.
Missouri	Reduced personal income taxes, reduced sales tax on groceries			Health coverage may be eliminated for 36,000 low-income parents. Dental coverage eliminated for 300,000 people.	State university tuition increased 14 percent for 2002-03.
Montana	Reduced personal income tax, repealed inheritance tax			Increased cost-sharing (highest in nation).	Increased parent fees for child care and froze child care provider reimbursements. Cut local school funding below 2002 levels.
Nebraska	Reduced personal income taxes	Sales and income tax increases, others		25,000 people lost health insurance	Cut eligibility for child care subsidies.
New Jersey	Reduced personal income tax rates	Corporate tax increases, others		Stopped enrolling additional working poor families.	State university tuition increased by up to 10 percent.
New Mexico	Reduced personal income tax rates, reduced gasoline tax				Cut eligibility for child care subsidies.

		Tax Increase Enacted in 2002			
	Examples of Major 1994-01 Tax Cuts	**Major tax increase (over 3% of state tax revenue)**	**Smaller tax increase (between 1% and 3%)**	**Medicaid Cuts Enacted in FY 02 and/or Planned in FY 03 — Examples***	**Cuts in Other Services — Some Examples**
New York	Reduced personal income tax rates, reduced estate tax, reduced corporate income tax rates, repealed sales tax on clothing		Cigarette tax increase, offset by income tax cut		
North Carolina	Reduced personal income taxes, repealed intangibles tax, repealed sales tax on groceries			Reduced eligibility for pregnant teens.	Aid to local governments cut $333 million for FY 2003; localities will have option to raise sales tax ½ cent to make up the difference.
Ohio	Reduced personal and corporate income taxes and estate tax			Considering limits on use of prescription drugs.	Reduced state housing assistance for the elderly. Average 18 percent tuition increase for new state university students.
Oklahoma	Reduced personal income tax rates		Raised personal income tax rates	Planned elimination of coverage for 79,000 people.	
Oregon	Reduced personal and corporate income taxes		Cigarette tax increase	Will increase cost-sharing and reduce benefits.	Eliminated substance abuse treatment for 2,500 individuals. Community college enrollment cut by 25,000.
Pennsylvania	Reduced corporate income and franchise taxes		Cigarette tax increase	Eligibility reductions planned or likely.	Expanded child care wait lists; Penn State tuition up 13.5 percent for 2002-03.
Rhode Island	Reduced personal income tax rate		Cigarette tax increase, offset by income tax cut	Cut benefits, raised copayments for families and children.	Cancelled planned child care expansion; university tuition up 8.7 percent for 2002-03.
Texas	Reduced property tax (replaced lost revenue from state funds)			Considering copayment increases and other changes	
Utah	Reduced personal income tax rate, sales tax rate			Cut benefits, raised copayments	University of Utah tuition increase of 9.3 percent for 2002-03.
Vermont	Reduced personal income tax rate		Cigarette tax increase	Considering copayment increases.	
Virginia	Reduced local vehicle property tax (replaced lost revenue from state funds)				Plan to lay off several thousand workers; university tuition increases averaging 11 percent implemented and additional increases considered.

	Examples of Major 1994-01 Tax Cuts	Tax Increase Enacted in 2002: Major tax increase (over 3% of state tax revenue)	Tax Increase Enacted in 2002: Smaller tax increase (between 1% and 3%)	Medicaid Cuts Enacted in FY 02 and/or Planned in FY 03 — Examples*	Cuts in Other Services — Some Examples
Washington	Reduced business taxes and vehicle taxes			Eliminated coverage for legal immigrants in Medicaid, reduced eligibility for elderly and disabled. Further cuts considered.	Cut eligibility for child care assistance; increased parent copayments. University tuition increased 16 percent. K-12 aid cut $92 million.
Wisconsin	Reduced personal income taxes			Underfunding of Medicaid and children's health program by $60 million will lead to unspecified cuts later.	Average tuition increase of 9 percent at state universities.

Sources: Kaiser Commission on Medicaid and the Uninsured; Children's Defense Fund; National Association of State Colleges and Land-Grant Universities; National Conference of State Legislatures; news reports; Center on Budget and Policy Priorities.
Note: Major tax cuts and increases are those exceeding 3 percent of state tax revenue. States with smaller tax cuts in the 1990s are not shown.
*Many states also reduced or froze Medicaid payments to providers.

Appendix
About the Data in This Report

The primary sources for the aggregate dollar amounts of tax changes in the years 1990 through 2001 are a series of annual reports issued by the National Conference of State Legislatures (NCSL) entitled *State Tax Actions* (prior to 1993, *State Budget and Tax Actions*). NCSL collects its estimates of the effects of tax changes from state legislative fiscal offices, and reports these changes by state and by type of tax. The 2002 data in this report are based on preliminary data from NCSL's forthcoming report for this year, combined with information collected directly from state revenue departments and legislative fiscal offices.

The NCSL data generally reflect the effects of tax changes implemented in the fiscal year following the one in which the change was enacted. For instance, the aggregate tax changes reported in 2000 *State Tax Actions* are based on estimates of revenue impacts for fiscal year 2000-01 (the 12-month period which in most states ended June 30, 2001).

The dollar totals in this analysis do not exactly equal the total tax changes reported by NCSL in each of the years covered. Adjustments were made for a variety of reasons. Most of the adjustments are consistent with principles outlined in a series of analyses produced by the Nelson A. Rockefeller Institute of Government from 1991 to 1995.[14]

- NCSL has changed its method of accounting for tax changes since 1990. In the early 1990s, NCSL followed what it called the "baseline method." Under this method, when a state postponed a scheduled tax reduction, it was counted as a tax increase. The expiration of a temporary tax was not counted at all. And the out-years of a multi-year phased-in tax change were not counted either. NCSL now tends to favor the "taxpayer liability" method, which focuses on year-to-year changes to actual taxes paid. Under this method, the postponement of a scheduled tax cut usually does not count, but the expiration of a temporary tax change and the out-years of a phased-in tax change are both counted when they take effect. The NCSL data from the early 1990s were adjusted in this report to conform to the "taxpayer liability" method NCSL now tends to use. In addition, to maintain consistency, the expiration of a one-time tax reduction or tax rebate is counted in this report as a tax increase; in other words, the tax-reducing impact of one-time tax cut or rebate is offset by the tax-increasing impact of its expiration the following year. (Note that the National Association of State Budget Officers, which produces similar analyses of state fiscal actions, continues to follow the "baseline" method.)

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[14] Steven D. Gold, "1995 Tax Cuts: Widespread But Not Revolutionary," December 1995; "State Tax Cuts: 1994 as Prelude to 1995," January 1995; "Tax Increases Shriveled in 1993," December 1993; "The Anatomy and Magnitude of State Tax Increases in 1992," January 1993; and "How Much Did State Taxes Really Go Up in 1991?", February 1992. All published by the Center for the Study of the States (now the Fiscal Studies Program), Nelson A. Rockefeller Institute of Government, Albany, N.Y.

- Unlike in NCSL reports, the dollar amounts in this report generally exclude changes in local taxes even when those changes were mandated or financed at the state level. For example, state-mandated, state-financed reductions in vehicle property taxes in Indiana, Rhode Island and Virginia are excluded, as are a 1997 property tax cut in Texas and the large reduction in local property taxes that was part of Indiana's 2002 tax bill. The 1994 consumption tax changes in Michigan, which financed local property tax reductions, are also excluded. In general, these exclusions tend to understate the extent of state tax cuts in the 1990s, and overstate the net tax increases in 2002.

- Health care provider taxes, which many states increased or decreased in the 1990s in response to technical issues surrounding the financing of Medicaid programs, are not included in this report. NCSL includes such taxes.

- Actions taken to conform to or decouple from changes in federal tax laws are not reported consistently to NCSL in the *State Tax Actions* survey, even though such actions can dramatically affect total liability (for an example, see box on page 15). Therefore, they are not counted in this analysis either as tax increases or as tax decreases.

- In states where major tax changes went into effect partway through a fiscal year, the revenue estimates are adjusted to reflect the impact of the change in the first full year following implementation.

Unemployment insurance taxes, motor vehicle license fees and other types of fees, and revenues from state lotteries, none of which are included in the NCSL tax data, are also excluded from this analysis.