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State Tax Policy Research

State Tax Trends Over Twenty-Five Years: Tax Increases Down, Revenue Sources Shifting

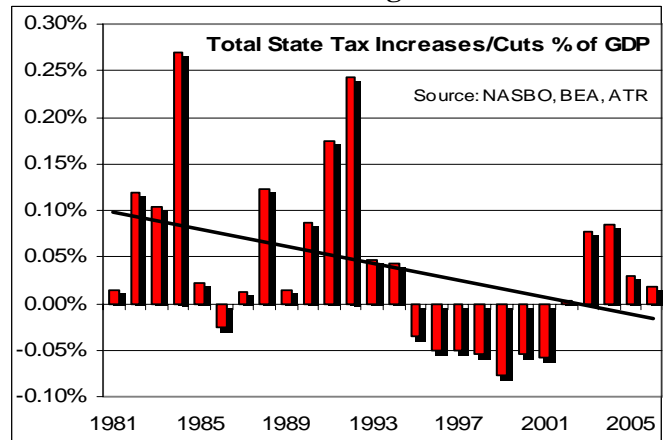
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Post-1990 Recession Marked a Major Shift in State Tax Policy

Key Points:

- Over the past 25 years, state tax policy has fundamentally changed as restructuring of state economies forced policymakers to enact more competitive policies and as the tax issue has become potent in political campaigns.
- An analysis of 25 years of state tax data finds 1) Tax increases are getting smaller (particularly in recessions); 2) Tax cuts during growth periods are becoming more prevalent; and 3) Revenue sources have shifted away from income taxes to more targeted tax increases such as tobacco and other forms of double taxation on consumption.
- Tax increases as a percentage of Gross Domestic Product (GDP) peaked at 0.08% in the previous recession, less than one-third the size of tax increases in the 1981 and 1990 recessions.
- States have moved to cutting taxes during periods of sustained growth unlike previous growth periods which were characterized with tax increases. In the 1990's states cut taxes seven consecutive years saving taxpayers \$37 billion.
- During the 1990s recession, states raised \$5.15 in income taxes for every \$1 of tobacco tax increases. In the 2001 recession, states raised just \$0.86 from income taxes for every \$1 of tobacco tax increases. Tobacco tax increases represent 30% of all tax increases since the 2001 recession.

State Tax Increases Declining Over Past 25 Years



The change in policy is timed to the post-1990 recession as governors and state legislators were voted out of office in response to the massive tax increases enacted during the recession. Subsequently, the new governors and legislators began enacting tax cuts as the nation entered a sustained period of growth.

Moreover, migration flows began to accelerate as higher-income taxpayers and an aging population moved to lower-tax jurisdictions. This migration is placing competitive pressures on other states to keep their income, sales, and corporate tax rates at restrained levels.

However, the increases in excise taxes and the multiple layers of taxation on certain products is a cause for concern as is rapid entitlement spending which could threaten the gains achieved over the past decade. Without significant reforms to state spending, these gains will be short-lived.

State Tax Policy 1981-1994

Over the last twenty-five years, state tax policies have undergone fundamental changes. Whereas raising taxes to fund spending increases was once the norm during economic expansions and contractions, a distinct shift occurred following the 1990 recession period.

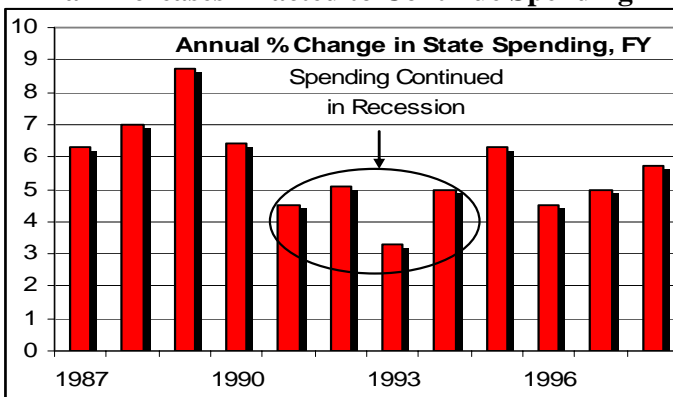
This shift is characterized by states beginning to cut taxes while the economy is growing and state tax hikes decreasing in both size and scope during the latest recession. Moreover, lawmakers are eschewing broad-based increases on income, sales, and corporate taxes have and are instead targeting narrow groups, such as tobacco.

Twenty-five years ago, faced with the deep recession in the early 1980s, states raised expansive taxes such as income, sales, and corporate taxes. By imposing broad-based tax burdens, states were able to generate large amounts of revenue from the entire working population to fund massive spending increases.

Even after the recession, states continually raised their income taxes (albeit much slower than during the recession) throughout the economic expansion of the 1980s. Due to strong economic growth, state government coffers continued to swell; yet, states continued raising taxes in order to fund new costly programs.

Subsequently, the 1990 recession hit and states again turned to taxpayers to shoulder the burden of bloated spending programs. As the chart below demonstrates, states continued to increase spending throughout the 1990 recession by raising taxes, specifically income taxes. Between 1990 and 1994, states raised their income taxes 42 times generating a cumulative \$33 billion in tax revenue.

Tax Increases Enacted to Continue Spending



Tax Issue Emerges, Migration Expands

The voters’ focus on the 1990s tax increases severely changed the dynamics of state tax policy. Concurrently, the spread between the highest and lowest tax states was increasing which led to an out-migration of higher-income residents.

It was during this recession that Pennsylvania’s Gov. Robert Casey (D) enacted a \$2 billion income tax increase by hiking the rate from 2.1 to 2.8 percent. From 1990 to 1995 net job creation in the state was stagnant.¹

In New Jersey, Gov. Jim Florio (D) increased the state income, sales, and corporate tax in 1990. Many attribute his failed campaign for reelection in 1993 to be a condemnation of these tax hikes. In New York, one-time presidential favorite and long-time governor Mario Cuomo (D) was defeated by a little known Assemblyman George Pataki (R) in a campaign that focused on the tax increases enacted during this time.

California’s Gov. Pete Wilson (R) and state legislators hit taxpayers in 1991 with \$7.2 billion in tax increases including a 3/4-cent sales-tax increase, expanded to cover snack foods, newspapers, and bottled water; two new personal-income-tax brackets; and a two-year suspension of corporate net operating loss deductions. By 1993, more than 30,000 corporations had shut down, and for the first time in California’s history, more people left the state than entered.²

State Migration Expands Due to Tax Increases

Low Tax States 2,845,700	Net Domestic Migration 1990-1999, 10 Highest/Lowest Ind. Income Tax Burdens
	High Tax States -2,151,300
Source: Vedder	

With differences in state tax increases among the states, the tax burden as a percentage of income varied considerably across the country. In fact, Tennessee’s tax burden was 8.3 percent in 1994 compared to 13.7 percent in New York according to the Tax Foundation.³

This substantial difference led to an out-migration of higher income and older residents in search of lower tax states. Tax-raising states began to feel the pressure as their higher income residents, who pay a disproportionate share of state taxes, began to flee. The acknowledgement that high-tax states had to change policies to compete signaled the spreading recognition of the inverse relationship between taxes and economic growth and shaped the future behavior of governors and state legislatures.

Post-1994: Tax Cutting Begins

The 1980s and 1990s represented the two largest economic expansions in the nation’s history. However, a new pattern emerged in the 1990s economic expansion that was drastically different than the behavior of lawmakers during the 1980s expansion. In the 1980s, states essentially “held the line” on new tax increases with very few tax cuts. Some states even raised income, sales, and corporate taxes while the economy was expanding to fund substantial spending increases in corrections, education, health care and welfare.⁴

While states continued to spend at rates well above inflation in the boom of the late 1990s/early 2000s, (state general fund spending grew 7% in 1999, 6.6% in 2000 and 8% in 2001⁵), the policy decisions differed from the earlier expansion.

In the 1990s, tax cuts were in vogue and states cut taxes an unprecedented seven consecutive years, saving taxpayers over \$37 billion.⁶

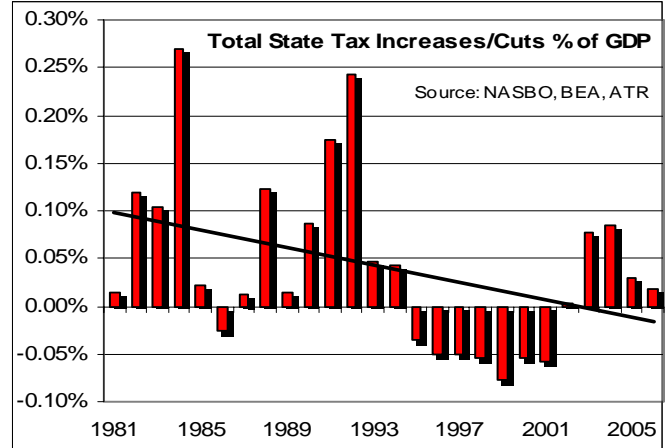
In an effort to stem the out-migration of residents, state income taxes were cut nine consecutive years. In 1999 alone, 29 states cut their income tax rates since more people working and higher capital gains revenue left states flushed with tax revenues. From 1995 through 2002, states cut their income taxes 137 times resulting in nearly \$20 billion of savings for taxpayers. Clearly, the tide was shifting as the U.S. entered the 2001 recession.

Fewer Tax Increases

Although states were asserting that they faced the worst budget deficits since the Great Depression, the 2001 recession marks a transformation of state tax policy. State tax increases were far smaller in the 2001

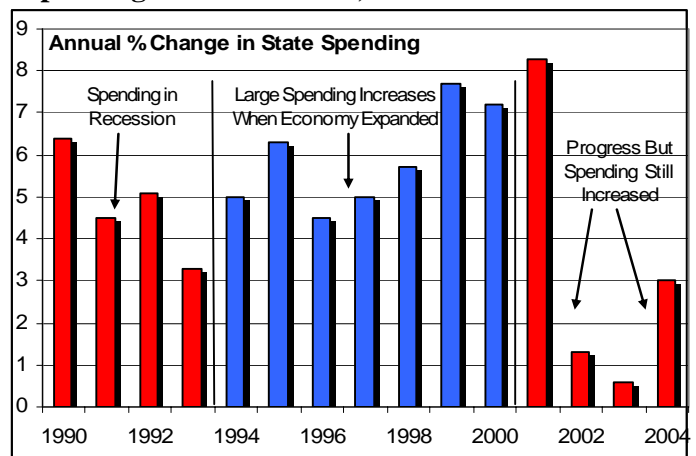
recession than in the recessions 1980s and 1990s. Tax increases as a percentage of Gross Domestic Product (GDP) peaked at 0.08% in the previous recession, less than one-third the size of tax increases in the 1981 and 1990 recessions.

State Tax Increases Declining Over Past 25 Years



With tax increases less palatable compared to the 1990 recession state policymakers were forced to tighten the belt of government operations. In the 1990 recession, states continued to increase spending in the 4-5 percent range annually. This time around, spending increases hovered around the range of 1.5 to 3 percent.

Spending Growth Slowed, More Restraint Needed



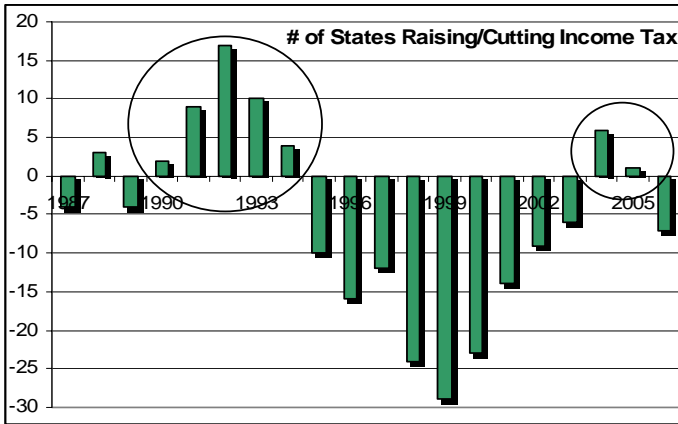
If states had cut spending, no tax increases would have been needed. Tax increases, albeit smaller than previously, were only enacted to increase spending. Dramatic spending increases during the late 1990’s created new entitlement programs such as free healthcare, increased public employee benefits, and state aid to localities. Since these are formula based

programs they automatically increased even though revenues were declining.

The slowdown in spending growth spurred a shift away from broad traditional revenue sources toward smaller sources. The income tax was a main source of new revenue for states during the 1990 recession and the tax was increased a net 42 times from 1990-1994. However, unlike previous recessions, elected officials shied away from raising taxes on an expansive set of voters.

Despite a hemorrhaging of income tax revenues in the last recession, largely from plunging capital gains revenue, only in two years was there a net increase in income tax hikes. Clearly states began to show restraint in raising income taxes.

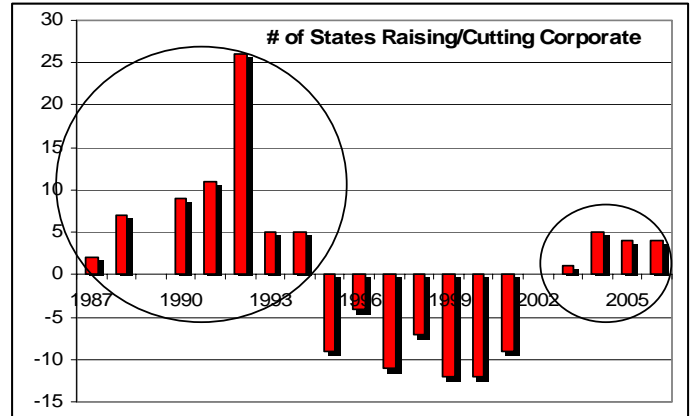
What a Difference a Decade Makes



A similar trend emerges in state elected officials' behavior towards corporate and sales taxes. In the early 1990s, corporate taxes were raised 56 times. Corporate taxes were raised by a far smaller amount in the previous recession compared to the 1990's. Politicians viewed corporations as a cash cow to deal with their budget problems 15 years ago. However, the lessons learned from that experience is that jobs will move with businesses.

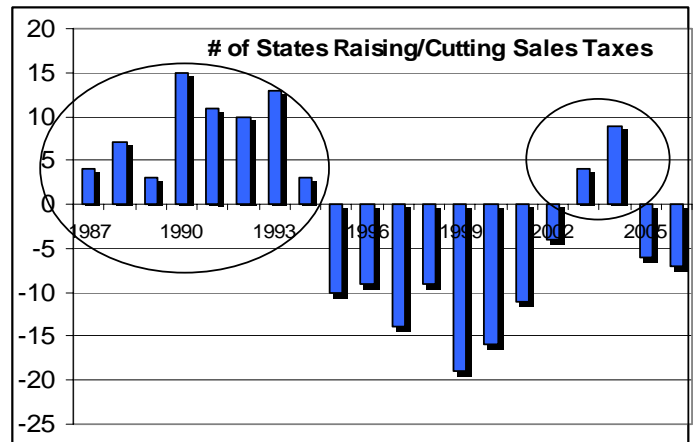
Although most states learned that lesson, some continued to increase corporate taxes more recently. Also, while the quantity of tax increases is substantially down, a number of states moved to "reform" their system by imposing new forms of double taxation and creating state level corporate Alternative Minimum Taxes, both of which are damaging to state economic growth.

Fewer Corporate Tax Increases



A clear decline exists in sales tax rates as well. In a deviation from the late 1980s and the early 1990s, when states hiked their sales tax rates 66 times, sales taxes were increased only 13 times following the 2001 recession. In fact, the sales tax increases following the 2001 recession were 36 percent lower than those of the previous recession.⁷

Sales Tax Increases Also Way Down

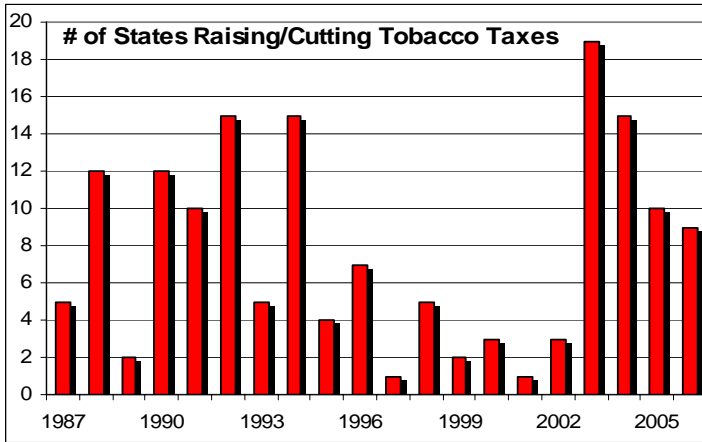


Shifting Revenue Sources

What the former governors and their successors learned from the early 1990s tax increases is that large, broad-based tax increases are political losers and leads to a loss of businesses, jobs, residents, and economic growth. However, as there is still not an appetite to cut spending, tax increases are still being enacted, albeit smaller amounts. Smaller revenue increases can now be targeted, double and triple taxation on items such as tobacco, telecommunications, and housing. By targeting their tax increases to narrower segments of the population, legislators divide taxpayers into smaller groups and minimize voter backlash.

Specifically, states have found tobacco to be their biggest cash cow in the most recent recession. The graph below shows the striking increases in tobacco taxes on the state level following the 2001 recession and continuing through the current expansion. Unlike the downward trends evident in income, corporate, and sales tax increases, it is increasingly popular to target the estimated 21 percent of adults who use tobacco products.⁸

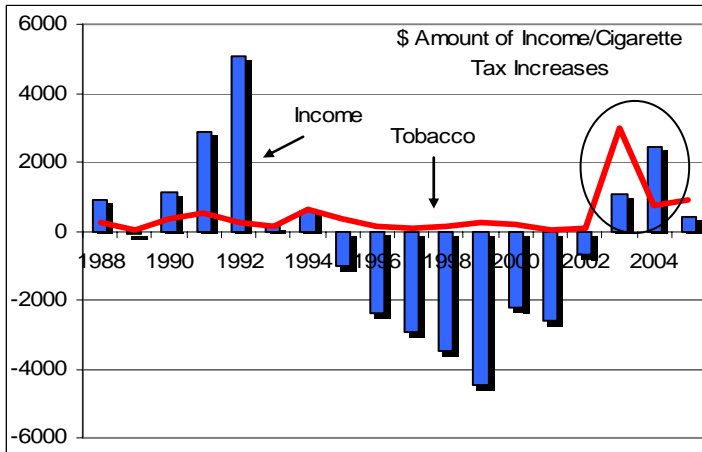
Tobacco Becomes the Cash Cow for States



During the 1990s recession, states raised \$5.15 in income taxes for every \$1 of tobacco tax increases. In the 2001 recession, states raised just \$0.86 for every \$1 of tobacco tax increases.⁹ In other words, states raised more money from tobacco than they did from the income tax in the previous recession.

As a result of this shift, tobacco tax increases represented 30 percent of tax increases during the last recession compared to just 5 percent during the 1990 recession. In 2002 alone, 20 states raised their tobacco taxes.¹⁰

More Tobacco Than Income Tax Increases



Less Income Tax, More Tobacco Tax

% of Total Tax Increase Revenue Enacted By Source

Year	Income	Sales	Corporate	Tobacco
90-92	38%	28%	15%	5%
03-05	26%	31%	12%	30%
Change	-12%	3%	-2%	25%

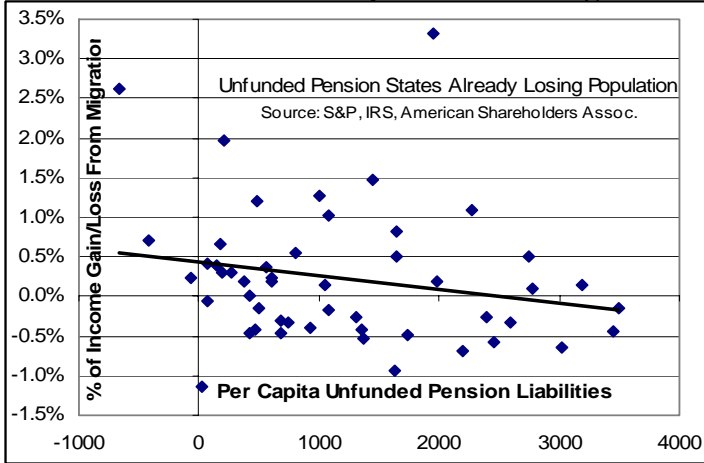
Tobacco is not the only scapegoat targeted in the shifting tax policies. In 2006, 31 states debated alcohol tax increases which seek to increase taxes on a product already subject to a sales tax and then hit with a special tax. This is also emerging in telecommunications and housing.

Most of these smaller tax increases are already occurring in states with a high tax burden. And although less visible to voters than broad-based taxes, the imposition of these tax increases compound over time and increase the cost of living. While it takes time for this “nickel and dime” tax increase strategy to impact the cost of living, as the taxes and fees continue to rise, there will be an acceleration in the out-migration of residents in future years.

Taxes matter and states raising taxes are losing population. In 2004 alone, the nine states with no income tax gained an additional 323,579 domestic residents from the 41 states with an income tax. The residents moving to states with no income tax took with them an additional \$10.6 billion of adjusted gross income according to data by the Internal Revenue Service. Furthermore, the states facing the largest fiscal problems from large unfunded liabilities in healthcare and pensions already face the largest out-migration of residents. Tax increases will only further this out-migration.

This problem will be compounded in 2007 and beyond as states will be required to account for unfunded healthcare liabilities. Moreover, as the population ages, many state workers will be retiring and ready to collect their pension and healthcare benefits. Reforms in state spending are clearly needed now to further enhance the gains made over the last 25 years but also to avoid erasing the gains achieved. The aging of the baby boomers will place a significant strain on policymakers and reform is needed to ensure taxpayers are protected in the future. These changes are needed now or taxpayers will be facing enormous tax increases.

Unfunded Pensions = Population Out-Migration



capital gains and dividends. With the run-up in the 1990’s stock market, states became flush with temporary capital gains revenue and used that to increase spending permanently. When the stock market declined, states lost up to 80 percent of this revenue source but continued spending. This was a major factor driving tax increases. By removing capital gains revenue from the general budget (or eliminating this growth inhibiting tax), states will have greater predictability in budgeting and consequently less appetite for tax increases.

Great progress has been made over the past twenty-five years. State policymakers received the message following the 1990 recession – tax increases are politically unpopular and reduce economic growth in their states. Therefore, the latest recession experienced fewer tax increases and much fewer tax increases on capital, the key to economic growth.

At the same time some progress has been made on spending, with state spending growing at a much slower rate than in previous recession. But spending still increased and tax increases were needed to pay for this spending. Furthermore, future spending will have to increase by even greater amounts as the bill needs to be paid for entitlement spending. As such, large scale reforms will be needed or policymakers will face another situation akin to the 1990 recession, when voters made their displeasure felt by throwing elected official out of office. Taxpayers also made their displeasure known by migrating to lower tax states.

Endnotes

- ¹ Stephen Moore and Dean Stansel’s Cato White Paper “Tax Cuts and Balanced Budgets: Lessons from the States.” 9/17/96
- ² Lawrence J. McQuillan and Andrew M. Gloger. “California’s Tax Follies” in National Review Online, 4/7/03.
- ³ ATR analysis of historical Tax Foundation data. www.taxfoundation.org
- ⁴ Stephen Moore, “Dire States” in *National Review*, July 29, 1991
- ⁵ Chris Edwards, Steve Moore, and Phil Kerpen’s 2003 Cato Briefing Paper “States Face Fiscal Crunch after 1990s Spending Surge.”
- ⁶ Based on NASBO data, ATR calculations, \$2004
- ⁷ NASBO, “Fiscal Survey of the States,” various issues
- ⁸ Center for Disease Control 2005 estimates. www.cdc.gov
- ⁹ NASBO, “Fiscal Survey of the States,” various issues
- ¹⁰ Chris Edwards, Steve Moore, and Phil Kerpen’s 2003 Cato Briefing Paper “States Face Fiscal Crunch after 1990s Spending Surge.”

Recommendations and Conclusion

Despite the progress on taxes over the last 25 years, more needs to be done to build on this foundation. Our analysis of state tax and spending trends reveals states continue to spend too much during upturns in the business cycle and then taxpayers are left paying the bill with additional tax increases during recessions.

First, a constitutional limit on state spending to the rate of population plus inflation growth will ensure the tax revenue gains during upturns can be used to offset the revenue losses during recessions. Such limits prevent large entitlement programs from being created during upturns in the business cycle, thus minimizing risk to taxpayers.

Second, large scale reform of state pension and healthcare systems are needed to prevent large tax increases in the future. Eight of the last 10 changes to the state pension system have come in the form of moving from defined benefit (DB) to defined contribution (DC) plans.

Under a DB plan, taxpayers are forced to contribute more to the system when the economy is in recession and also has a high level of unpredictability. Moving to a DC plan, as the private sector has done, creates better predictability for state taxpayer contributions and will remove the current unfunded liabilities in the system. Similar changes should be made for healthcare through the use of Health Savings Accounts (HSAs).

Finally, states need to curtail their reliance on volatile revenue sources such as non-wage income including