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2001 Tax and Budget Summary

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Highlights

- The seven-year streak of significant net tax cuts ended in 2001.
- Six states — Colorado, Connecticut, Idaho, Minnesota, Oregon, and South Dakota — enacted significant tax cuts, reducing fiscal year 2002 revenues by $1.8 billion.
- Another six states — Arizona, Arkansas, Minnesota, New Hampshire, New Jersey, and North Carolina — enacted significant tax hikes, increasing fiscal year 2002 revenues by $1.8 billion.
- Four states are offering rebates or making temporary tax cuts. These will amount to $1.7 billion of the fiscal year 2002 tax cuts.
- The current recession has opened large gaps in the fiscal year 2002 budgets of at least 42 states.
- The weak economic climate augurs fewer significant tax cuts and possibly more significant tax increases in the budget decisions that will be made in the next few months.

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Introduction

In 2001, states ended a streak of seven consecutive years of significant net tax cuts. As previously enacted tax cuts reduced fiscal year 2002 revenues, six states enacted significant new tax increases, six others made significant tax cuts, with one doing both. Taken together, these tax changes resulted in no significant overall change in state tax revenues. (See Table 1.)

In the *State Fiscal Brief* that covered the tax changes enacted in 2000, we predicted a continuation of tax cuts in 2001, *provided that* the strong economy continued.[1] Since then, however, the souring of the economic climate, which could first be seen in some states as early as the fall of 2000, has spread to the rest of the country. Consequently, most states, projecting reduced revenue growth for fiscal 2002, avoided both new tax cuts and tax increases. Now, as even those projections turn out to have been overly optimistic in many cases, numerous states are facing budget shortfalls that are putting extreme pressure on them as they finish fiscal 2002 and prepare fiscal 2003 budgets.

Tax Changes Enacted in 2001

In this brief, we define a significant tax change as one that increases or decreases a state's revenues by at least one percent of general fund expenditures. Many states enacted smaller tax changes in 2001, but those are not considered here since they have little effect on the size of state revenues.

Tax Cuts

Six states enacted significant tax cuts in 2001, down from 14 in 2000. In all, these cuts reduced fiscal 2002 revenues by $1.8 billion. (See Tables 2 and 3.) This was a noticeable reduction from the size of tax cuts in the three previous years. Moreover, almost all of these cuts were rebates or other temporary reductions in state revenues. Tax cuts enacted in 2001 do not tell the whole fiscal 2002 tax cut story. Some states — including Hawaii, Maryland, Michigan, New Jersey, New York, Rhode Island, and Wisconsin — enacted tax cuts in previous years that are still phasing in during fiscal 2002. Although these cuts significantly reduced taxpayer liability, they do not appear in Table 3, which is limited to newly enacted tax cuts.

Table 1
Significant Tax Changes Enacted in 2001 — Including November 2000 Referenda
(Effect in millions of dollars for fiscal year 2002)

State	*Personal Income Tax*	*Sales Tax*	*Corporate Income Tax*	*Property Tax*	*Other Taxes*	*Total Significant Tax Changes*	*Changes as % of FY01*
Arizona		$486				$486	7.5%
Arkansas		$180				$180	5.5
Colorado*		($562)				($562)	(8.4)
Connecticut*		($111)				($111)	(1.0)
Idaho	($58)					($58)	(3.1)
Minnesota*		($791)		$296		($495)	(3.8)
New Hampshire			$5	$79		$84	7.8
New Jersey			$420			$420	2.0
North Carolina	$126	$246				$372	2.7
Oregon*	($299)					($299)	(6.1)
South Dakota					($9)	($9)	(1.1)
Total	**($231)**	**($552)**	**$425**	**$375**	**($9)**	**$8**	
# of States with Significant Changes	3	6	2	2	1	11	

* Cuts include rebates and/or temporary tax cuts.
Note: Numbers in parentheses are negavie (cuts).

Table 2 Significant Tax Cuts Enacted Since 1998			
	Number of States with Tax Cut of One Percent or more of GF Revenue	*Amount (millions)*	*Percentage of All States' GF Revenues*
1998	22	$7,599	1.79%
1999	19	$7,550	1.68
2000	13	$5,730	1.24
2001	6	$1,830	0.33

Personal Income Tax Cuts

In previous years, several states made significant cuts in their personal income taxes. This only partially counteracted the rapid growth of personal income tax revenues, which were responding very strongly to the rise of the stock market and its disproportionate effects on high-income individuals. The economic weakening in 2001 both reduced growth in the personal income tax and created less impetus to cut this tax.

In 2001, just two states made significant reductions in their personal income taxes, amounting to only a $357 million reduction in fiscal 2002 revenues. Idaho reduced all PIT rates by 0.4 percent of income, costing the state $58 million in fiscal 2002. Oregon voters adopted an increase in the allowed deduction of federal income tax, which is costing $50 million in fiscal 2002. These were the only two changes enacted in 2001 that resulted in a significant permanent reduction in PIT revenues. Oregon also offered a "kicker" refund, discussed in more detail in the section on rebates below. During fiscal 2002, some other states are still phasing in significant personal income tax reductions enacted in previous years. Hawaii and Wisconsin were in the second year of personal income tax reductions. Maryland is still phasing in a rate reduction passed in 1997.

Table 3 Significant Tax Cuts Enacted in 2001 — Including November 2000 Referenda (Effect in millions of dollars for fiscal year 2002)						
State	*Personal Income Tax*	*Sales Tax*	*Other Taxes*	*Total Significant Tax Cuts*	*Cuts as % of FY01 GF*	*Notes*
Colorado*		($562)		($562)	(8.4)%	Sales tax rebate
Connecticut*		($111)		($111)	(1.0)	Suspended sales tax on hospital patient care
Idaho	($58)			($58)	(3.1)	PIT rate cut
Minnesota*		($791)		($791)	(6.0)	Sales tax rebate
Oregon*	($299)			($299)	(6.1)	PIT deduction increase by referendum and "kicker" rebate (see text)
South Dakota			($9)	($9)	(1.1)	Inheritance tax repeal by referendum
Total	**($357)**	**($1,464)**	**($9)**	**($1,830)**		
# of States with Significant Cuts	2	3	1	6		
* Cuts include rebates and/or temporary tax cuts. Note: Numbers in parenthesis are negative.						

Sales Tax Cuts

The effect of all sales tax cuts was $1.5 billion for fiscal 2002. Colorado and Minnesota made rebates in sales tax revenues this year, as they had in previous years. These are discussed in the section on rebates. The only other significant sales tax cut in 2001 was also temporary. Connecticut suspended its sales tax on hospital patient care for two years, a move that will cost the state $111 million in fiscal 2002. There were no significant permenent sales tax cuts in 2001.

Other Tax Cuts

No state enacted significant tax cuts affecting the corporate income tax or property taxes this year. The only other significant tax cut took place in South Dakota, where voters approved a referendum to repeal the inheritance tax. This will cost the state $9 million in fiscal 2002.

Rebates and Temporary Tax Cuts

As in previous years, many states that rank high on our list of tax cutting states have been using temporary tax cuts or rebates. Rebates allow lawmakers to take credit for passing a tax cut each year that the state sends out a rebate check, even if the check is smaller than the year before — in essence a tax increase. And in the event of an economic downturn, they can always stop the temporary cuts. To some extent, this happened in 2001 as the number of states enacting temporary tax cuts declined to four from six the year before. Constitutional provisions require the rebates in Colorado and Oregon. In all, the rebates and temporary cuts accounted for $1.7 billion, or almost all of the tax cuts enacted in 2001. (See Table 4.)

The sales tax is a popular mechanism for rebates. Unlike the personal income tax or property taxes, the sales tax is not deductible on taxpayers' federal tax returns. Thus, state sales tax rebates may not cause federal tax liability to increase. In addition, a broader cross section of the population pays the sales tax, and so a sales tax-based rebate should reach more people. Colorado and Minnesota once again gave sales tax rebates this year. Both states calculate the sales tax rebate as a proportion of reported income, not as a portion of actual sales tax payments. Colorado is compelled by the state's Taxpayer's Bill of Rights (TABOR) amendment to rebate all surpluses exceeding a revenue growth limit. In fiscal 2002, the state will return $562 million through the sales tax rebate and $365 million through other mechanisms. The total is about $44 million less than in fiscal 2001. Colorado's revenue estimators currently do not expect the state to issue rebates next year.

Connecticut suspended its sales tax on hospital patient care for two years, as discussed in the section on sales tax cuts.

Minnesota is refunding $791 million of its fiscal 2001 surplus in the current year using a sales tax rebate mechanism. Last year the state rebated $635 million, so the net increase is $156 million. The state is projecting a deficit in the current budget, so there is unlikely to be another sales tax rebate next year.

Oregon has a law that requires the state to rebate any excess over 102 percent of the revenue projection at the time of the biennial budget adoption (called the "two percent kicker"). For the fiscal 1999-2001 biennium there was an excess of $249 million, which the state will rebate in fiscal 2002. The kicker rebate would have been $106 million larger if lawmakers had not moved that amount in Medicaid payments into a special account. Oregon's current revenue projections for the fiscal 2001-2003 biennium is well below that used when the budget was adopted last summer, so it now appears unlikely there will be a rebate in fiscal 2004.

Ohio has been rebating large portions of its surpluses of recent years by making temporary reductions in its personal income tax rates. In 2000, Ohio reduced its PIT rates by over 6 percent, saving the state's taxpayers $610 million. In 2001, there was no such temporary

Table 4
Significant Rebates and Temporary Tax Cuts Affecting Fiscal Year 2002

State	*Tax*	*Amount (millions)*
Colorado	Sales	$562
Connecticut	Sales	$111
Minnesota	Sales	$791
Oregon	PIT	$249
Total		**$1,713**

reduction; the state allowed the PIT rates to go up to their "normal" levels, resulting in an increase in tax rates from the previous year.

Effect on Taxpayer Liability

If we look at the effect of rebates from this year and last year on actual taxpayer liability, we find that taxpayers are actually paying more in fiscal 2002 because they did not receive rebates they had in fiscal 2001. Table 5 shows some of last year's rebates and the effective tax increases this year. The net increase in taxpayer liability amounts to about $900 million. On the other hand, counting the effect of previously enacted significant tax changes phasing in during fiscal 2002 creates a net decrease in taxpayer liability of over $1 billion.

The National Conference of State Legislatures, which uses a taxpayer liability model, counts the phasing in of previously enacted tax changes as well as minor tax changes. It has reported a $1.8 billion reduction in net tax collections in fiscal 2002.[2] The National Association of State Budget Officers, using a different method, estimated that enacted state taxes and fees will increase fiscal 2002 revenues by about $350 million.[3]

Tax Increases

In the 1998-2000 period few states enacted significant tax increases. Those that did so either had growth that lagged behind the national average, or they had to respond to court decisions or other special circumstances. In 2001, more states experienced revenue trouble and there were more tax increases. Six states enacted tax hikes in 2001 that increased tax revenues in fiscal 2002 by $1.8 billion. This was considerably more than in previous years, though not nearly as much as during the recession of the early 1990s, when annual tax increases amounted to as much as $15 billion.[4] (See Table 6.)

In both Arizona and Arkansas, voters increased the sales tax rate by referendum in November 2000. Arizona earmarked the additional $486 million for education. Arkansas will use its additional $180 million to pay for a local property tax reduction.

Minnesota adopted a new state tax on business property, raising $296 million in fiscal 2002. New Hampshire increased the business profits tax, the business enterprise tax, the communications tax, and the real estate transfer tax; these increases provided $84 million in fiscal 2002 to help pay for the state's education funding package. New Jersey closed an inadvertent loophole that allowed certain limited liability corporations to avoid taxes. This should increase New Jersey's corporate income tax collections by $420 million in fiscal 2002.

A large budget gap in North Carolina led that state to raise both the personal income tax and the sales tax significantly. These increases, which are only temporary, are part of a package of tax changes that will increase tax collections by $652 million in fiscal 2002. North Carolina was one state where the tax increases in 2001 clearly resulted from declining revenues brought on by the slowing economy.

Table 5
Effect of Rebates on n Taxpayer Liability
(in millions of dollars)

State	*Significant Rebates 2001*	*Significant Rebates 2002*	*Net Change in Taxpayer Liability*
Colorado	$668	$562	$106
Connecticut	$0	$111	($111)
Illinois	$280	$0	$280
Minnesota	$635	$791	($156)
Missouri	$98	$0	$98
Ohio	$610	$0	$610
Oregon	$0	$249	($249)
Pennsylvania	$330	$0	$330
Total	**$2,621**	**$1,713**	**$908**

Table 6
Significant Tax Increases Enacted in 2001 — Including November 2000 Referenda
(Effect in millions of dollars for fiscal year 2002)

State	*Personal Income Tax*	*Sales Tax*	*Corporate Income Tax*	*Property Tax*	*Total Significant Tax Changes*	*Changes as % of FY01 GF*	*Notes*
Arizona		$486			$486	7.5%	Rate increase by referendum
Arkansas		$180			$180	5.5	Rate increase by referendum
Minnesota				$296	$296	2.3	New state property tax
New Hampshire			$5	$79	$84	7.8	Various business tax increases
New Jersey			$420		$420	2.0	Closure of limited liability
North Carolina	$126	$246			$372	2.7	Temporary sales and PIT rate increases
Total	**$126**	**$912**	**$425**	**$375**	**$1,838**		
# of States with Significant Increases	1	3	2	2	6		

Ballot Measures Affecting Taxes

As mentioned above, in November 2000 voters in four states — Arizona, Arkansas, Oregon, and South Dakota — approved ballot measures that led to significant changes in fiscal 2001 tax collections. By contrast, none of the ballot measures approved in November 2001 will significantly affect state tax collections in coming years; in fact, none of the measures rejected by voters would have had a significant effect either. In all, it was a very quiet year as far as taxation ballot measures go.

Budget Issues in 2001

Economic Picture

After ten years of growth, the national economy slipped into recession in 2001. Real growth in the gross domestic product for 2000 was 4.1 percent. In 2001, however, growth fell to 1.3 percent year-over-year in the first quarter and to 0.3 percent in the second quarter. In the third quarter, the real GDP declined by 1.3 percent.[5] The National Bureau of Economic Research has set the "official" beginning of the recession as being in March 2001.[6] The unemployment rate, which was 4.2 percent in January of 2001, had increased to 5.8 percent by December. Another early sign of weakness was in aggregate state budget balances, which declined from $43.7 billion at the end of fiscal 2000 to $34.1 billion at the end of fiscal 2001.[7]

The recession did not begin simultaneously in all parts of the country and in all sectors of the economy. The Midwestern and Southeastern states experienced weakness in employment growth earlier than other regions of the country, probably due to the greater dependence of these states on manufacturing, which began to slump in mid 2000. Overall, the economic picture was still mixed when most states enacted their fiscal 2002 budgets in the spring or summer of 2001. Most states projected slowing but still positive economic and revenue growth.[8] The September 11th attacks made the situation worse, especially in the most strongly affected states — New York and Virginia, notably — and in the most affected sectors — travel and tourism. However, the overall slump had spread to most of the country even before September.

Major Budget Items

Widespread revenue distress along with doubts about the strength of the economy and caution regarding revenue growth have led most states to chart a course of fiscal moderation in 2001: no major tax cuts and no large spending increases. According to a survey conducted by the National Conference of State Legislatures, states used a variety of means to besides tax increases to balance their fiscal 2002 budgets: ten states made cuts in projected spending, ten used reserve or "rainy day" funds, three delayed spending, and three tapped their tobacco settlement funds.[9]

The real state budget story of 2001, however, took place after most states had enacted their budgets. Table 7 shows 43 states that are projecting shortfalls in their fiscal 2002 budgets and the measures they have taken to close those budget gaps. In some cases, these gaps represent a large part of the state's revenues and expenditures.

What to Expect in 2002

Even as states come to grips with the gaps appearing in their current budgets, many are also crafting budgets for fiscal 2003. Since the economy will probably continue to slump at least into the beginning of 2002, states will not have much good revenue news to help them develop balanced budgets. Thus we expect to see few if any significant tax cuts enacted in 2002. Conversely, we may well see additional significant tax increases — even though most state lawmakers are reluctant to use this option.

Spending enacted in 2003 will not show the strong growth seen in the late 1990s; it may even mark a real decline from the spending enacted in 2001. States are likely to use budget reserves and tobacco settlement funds to help balance budgets. Some states may receive extra assistance from the federal government, possibly tied to rebuilding and security stemming from the terrorist attacks, but this is unlikely to make up for the revenue shortfall — especially since the federal government is having revenue problems of its own.

It is likely that the budget season in 2002 will be long and difficult. In a strong contrast to the very favorable conditions of the late 1990s, when states were able to both increase spending and cut taxes, this year's budget gaps and weak projections may force some states to consider doing the opposite. In what is an election year for most governors and state legislators, lawmakers in many states will face an array of politically unpopular choices, including spending cuts and tax increases.

Endnotes

1 Nicholas W. Jenny, "2000 Tax and Budget Summary," *State Fiscal Brief #60* (Albany, NY: The Nelson A. Rockefeller Institute of Government, September 2000).

2 National Conference of State Legislatures, "Preliminary Report: Executive Summary," *State Budget & Tax Actions 2001*, August 1, 2001.

3 National Governors Association and National Association of State Budget Officers, "Preliminary Release," *Fiscal Survey of the States*, January 2002.

4 National Governors Association and National Association of State Budget Officers, *Fiscal Survey of the States* (Washington, DC, June 2001).

5 United States Department of Commerce, Bureau of Economic Analysis, "News Release," December 21, 2001.

6 National Bureau of Economic Research, "The Business-Cycle Peak of March 2001" November 2001.

7 National Conference of State Legislatures, "Preliminary Report."

8 Nicholas W. Jenny and Donald J. Boyd, "State Budgetary Assumptions in 2001 — States Will Be Lowering Their Economic Forecasts," *State Fiscal Brief #62* (Albany, NY: The Nelson A. Rockefeller Institute of Government, May 2001).

9 National Conference of State Legislatures, "Preliminary Report."

Table 7
FY 2002 Shortfalls and State Actions

State	FY 2002 Projected Shortfall (millions)	Percentage of FY 2000 GF Expenditures	Action
Alabama	$160	3.1%	Enacted $162M tax package to prevent cuts to education spending
Alaska	$906	40.1	$2.8B Constitutional Budget Reserve can be used
Arizona	$850	14.1	Legislative proposal would cut most spending by 6%, saving $284M; schools and public safety excepted
Arkansas	$20	0.6	
California	$4,500	6.8	Gov. Davis (D) ordered state hiring freeze and agency cuts of $150M
Colorado	$385	6.4	Lawmakers passed measure to cut $392M in capital projects; Gov. Owens (R) ordered an across-the-board cut of 1%, exempting K-12 education and Medicaid
Connecticut	$96	0.9	Legislature passed bill to reduce spending by about $200M
Florida	$1,300	7.0	$1B in spending cuts enacted; legislature passed 18 month delay of intangible personal property tax cut
Georgia	$600	4.4	Gov. Barnes (D) ordered spending cuts of 2.5%
Hawaii			Gov. Caytano (D) declared an economic emergency in the state
Idaho	$36	2.1	Gov. Kempthorne (R) ordered across-the-board spending cuts of 3%; asked legislature to use “rainy day” fund
Illinois	$500	2.2	Gov. Ryan (R) ordered $485M in budget cuts and a hiring freeze
Indiana	$450-600	5.0-6.7	Gov. O’Bannon (D) ordered a 7% cut in state spending and a pay freeze for executive staff
Iowa	$158	3.3	Gov. Vilsack (D) ordered across-the-board spending cuts of 4.3%
Kansas	$113	2.6	State revenue forecasters cut FY 2002 estimate by $113.4M
Kentucky	$533	8.1	Gov. Patton (D) proposed spending cuts of $498M
Maine	$30	1.3	Gov. King (I) proposed cuts totaling about $15M and a hiring freeze
Maryland	$124	1.4	Gov. Glendening (D) ordered $205M in cost cutting including: a 1.5% agency spending cut, a hiring freeze, and deferments of capital project funding
Massachusetts	$1,400	6.7	Enacted FY 2002 budget was cut by $605M, state reserves were tapped for $700M
Michigan	$642	6.5	Gov. Engler (R) proposed $319M in spending cuts, revenue transfers, layoffs, and use of “rainy day” and tobacco settlement funds
Minnesota	$1,953	17.0	Gov. Ventura (I) said he will consider tax increases
Mississippi	$80	2.3	Gov. Musgrove (D) ordered $55M in spending cuts
Missouri	$324	4.4	Gov. Holden (D) ordered $232M in spending cuts, also reallocation of tobacco settlement, Medicaid, and other funds
Nebraska	$220*	9.4	Enacted $171M in budget cuts
Nevada			Gov. Guinn (R) instituted a hiring freeze; some agencies are freezing one-time expenditures
New Hampshire			Gov. Shaheen (D) ordered 1% cut in state spending

Table 7 (continued)
FY 2002 Shortfalls and State Actions

State	*FY 2002 Projected Shortfall (millions)*	*Percentage of FY 2000 GF Expenditures*	*Action*
New Jersey	$1,900	9.8	Acting Gov. Donald DiFrancesco (R) ordered $32M in spending cuts, a partial hiring freeze, and 5% across-the-board cuts
New Mexico	$12	0.4	
New York	$3,000	8.1	Gov. Pataki (R) ordered a hiring freeze; legislature enacted an expansion of casino gambling
North Carolina			Gov. Mike Easley (D) ordered 4% agency cuts; legislature enacted $650M in tax increases in FY 2002 budget
Ohio	$1,500*	3.9	Gov. Taft (R) ordered a hiring freeze; legislature passed balanced-budget measure containing $308M tax increase
Oregon	$900*	8.7	
Pennsylvania	$622		Gov. Ridge (R) ordered a $200M spending freeze before leaving office
Rhode Island	$80-100	3.6-4.5	Gov. Almond (D) called on state departments and agencies to limit expenditures
South Carolina	$500	9.7	State financial board ordered 4% across-the-board spending cut; “rainy day” fund was tapped for $100M
South Dakota	$12	1.6	
Tennessee	$300	4.6	
Utah	$200	5.9	Gov. Leavitt (R) ordered $73M in spending cuts
Vermont	$35-50	4.1-5.8	Gov. Dean (D) ordered $17M in cuts
Virginia	$1,300	11.5	Gov. Gilmore (R) ordered an across-the-board budget reduction of 2%; state will probably use $1B in cash reserves
Washington	$200-1,000	2.0-9.8	Gov. Locke (D) proposed $566M in spending cuts, and $573M new money from lottery and gambling
Wisconsin	$300-1,300	2.7-11.5	Gov. McCallum (R) ordered a hiring freeze and 3.5% spending cut

FY 2000 actual expenditures from National Governors Association and National Association of State Budget Officers, The Fiscal Survey of the States, June 2001.

* Indicates biennium total

The Nelson A. Rockefeller Institute of Government

The Nelson A. Rockefeller Institute of Government, the public policy research arm of the State University of New York, was established in 1982 to bring the resources of the 64-campus SUNY system to bear on public policy issues. The Institute is active nationally in research and special projects on the role of state governments in American federalism and the management and finances of both state and local governments in major areas of domestic public affairs.

The Fiscal Studies Program

The Institute's Fiscal Studies Program, originally called the Center for the Study of the States, was established in May 1990 in response to the growing importance of state governments in the American federal system. Despite the ever-growing role of the states, there is a dearth of high-quality, practical, independent research about state and local programs and finances.

The mission of the Fiscal Studies Program is to help fill this important gap. The Program conducts research on trends affecting all 50 states and serves as a national resource for public officials, the media, public affairs experts, researchers, and others. The Program is directed by Donald J. Boyd, who has spent two decades analyzing state and local fiscal issues.

This Report

This report was written by Nicholas W. Jenny, Senior Policy Analyst with the Program. Michael Cooper, the Rockefeller Institute's Director of Publications, did the layout and design, with assistance from Michele Charbonneau.

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