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2002 Tax and Budget Review and 2003 Budget Preview

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Highlights

- ❖ Fifteen states made significant tax increases totaling almost $6 billion.
- ❖ Tobacco taxes constituted over $2 billion of the tax increases.
- ❖ The ending of tax rebates in three states effectively raised taxes by another $1.6 billion.
- ❖ States have had to cut spending as fiscal year 2003 has progressed.
- ❖ States confront even larger budget gaps in fiscal year 2004.
- ❖ It is likely that 2003 will bring more tax increases and spending cuts.

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Introduction

The year 2002 was extremely challenging for the states as they struggled with the effects of the recession. Revenues declined sharply while demands for state spending continued to increase. Not surprisingly, then, no state enacted significant new tax cuts, while 15 enacted significant tax increases. This was the first year with significant net tax increases since 1993. (See Table 1.) With continued weakness in revenues it is likely that the trend of tax increases will continue into 2003.

Most of the 15 states that increased taxes significantly stayed away from increases in major taxes such as the personal income or general sales taxes, favoring tobacco tax increases instead.

Tax Changes Enacted in 2002

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 2002, but we do not consider those here since they have little effect on the size of state revenues. Also not counted here are delays in planned tax cuts or increases, or other changes that do not affect actual state revenue collections – though they may affect projected revenues.

Tax Increases

Fifteen states enacted significant tax increases in 2002, increasing tax revenues in fiscal year 2003 by almost $6 billion. This was a considerable change from 2001, when six states enacted $1.8 billion in tax increases. The amount, however, falls far short of those seen during the recession of the early 1990s, when state tax increases reached as high as $15 billion in a single year.[1]

Personal Income Tax Increases

Massachusetts enacted the only significant personal income tax increase in 2002. The state reduced the personal exemption for married joint filers from $8,800 to $6,600 and reduced exemptions for other types of filers proportionately. This will raise about $360 million more in fiscal year 2003. Massachusetts also froze its personal income tax rate at 5.3 percent instead of reducing it to 5.0 percent as had been planned.

Sales Tax Increases

Four states made significant sales tax increases amounting to over $1.2 billion in 2002. Indiana increased its sales tax rate from five percent to six percent, raising $393 million in fiscal year 2003. Kansas increased its sales tax rate from 4.9 percent to 5.3 percent; the rate is scheduled to fall to 5.2 percent in 2004 and to 5.0 percent in 2005. Including the effects of a slight broadening of the sales tax base, revenues will increase by $155 million in fiscal year 2003. Nebraska enacted a one-year increase in the sales tax rate from 5.0 percent to 5.5 percent, along with an expansion of its base. This will raise about $83 million in fiscal year 2003. Tennessee will raise about $600 million in fiscal year 2003 by increasing the state portion of its sales tax from 6.0 percent to 7.0 percent, excluding food.

Corporate Income Tax Increases

Only two states increased corporate income taxes in 2002, but both increases were rather large, boosting state tax revenue by $2 billion. California suspended the corporate net operating loss deduction for two years, raising $1.2 billion a year. New Jersey made several changes to its corporate income tax, increasing revenue by $836 million in fiscal year 2003.

Tobacco Tax Increases

The most popular targets for revenue increases in 2002 were tobacco taxes. In all, 19 states enacted tobacco tax increases. In 11 of these states, the changes increased general fund revenues by one percent or more – our threshold for significance. Together the increases in these 11 states added over $2 billion to state tax revenue in fiscal year 2003.

The largest tobacco tax increase was in Pennsylvania, which more than tripled the tax per pack of cigarettes, raising it from 31 cents to $1.00. As a result, the state will bring in an extra $570 million in fiscal year 2003. Indiana also better than tripled its cigarette tax rates. Meanwhile in Connecticut, Kansas, Ohio, and Vermont the rate went up by double or more.

Tax Cuts

The year 2002 marked the end of a period of widespread tax cutting in the states. In Table 2, we see that these cuts added up to $22.7 billion from 1998 to 2001. According to the National Association of State Budget Officers, states cut taxes by $33.1 billion from 1995 to 2001.[2] In 2002, in contrast, no state enacted significant tax cuts, although some were still phasing in tax cuts enacted in previous years. Among these states are Hawaii and Michigan, which both made cuts reducing taxpayer liability significantly in fiscal year 2003.

Table 1
Significant Tax Increases Enacted in 2002 — Including November 2001 Referenda
(effect in millions of dollars for fiscal year 2003)

State	*Personal Income Tax*	*Sales Tax*	*Corporate Income Tax*	*Tobacco Tax*	*Other Taxes*	*Total Significant Tax Increases*	*Increases as % of FY 02 GF*	*Notes*
California			$1,200			$1,200	1.6	Suspension of deduction for net-operating losses
Connecticut				$122		$122	1.1	Cigarette tax increase
Indiana		$393		$268	$290	$951	9.7	Sales tax rate increase, cigarette tax increase, new riverboat gambling tax
Kansas		$155		$82		$237	5.8	Sales tax rate increase, cigarette tax increase
Massachusetts	$360					$360	1.7	Decreased personal exemptions
Michigan				$259		$259	3.0	Increase in cigarette and tobacco taxes
Nebraska		$83				$83	3.5	Expansion of sales tax base and temporary rate increase
New Jersey			$836	$243		$1,079	5.4	Various CIT changes, tobacco tax increases
Ohio				$260		$260	1.2	Cigarette tax increase
Oregon				$67		$67	1.5	Cigarette tax increase
Pennsylvania				$570		$570	3.0	Cigarette tax increase
Rhode Island				$24		$24	1.0	Cigarette tax increase
Tennessee		$600				$600	8.7	Increased sales tax rate excluding food
Vermont				$20		$20	2.4	Cigarette tax increase
Washington				$130		$130	1.2	Cigarette and tobacco taxes increased by initiative
Total	**$360**	**$1,231**	**$2,036**	**$2,045**	**$290**	**$5,962**	1.2	Total Tax increase as % of 50 State GF
# of States with Significant Changes	1	4	2	11	1	15		

Sources: National Conference of State Legislatures, National Association of State Budget Officers, National Governors Association, various state budget documents and reports.

Table 2
Significant Tax Cuts Enacted Since 1998

	Number of States with Tax Cut of One Percent or more of GF Revenues	*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%
2002	0	$0	0.00%
Total		$22,709	

Rebates

Many of the tax cuts in previous years were rebates or temporary tax cuts. Rebates allow a cut in taxes when times are good, but do not reduce the tax base. Some states continued their rebates from year to year, either because the states were constitutionally or statutorily required to rebate excess revenues – as in Colorado and Oregon – or simply as an alternative to permanent tax cuts or spending increases. The advantage to rebates of this kind is that they cease when state revenue declines, as was the case in 2002. In essence, however, the end of the rebate is a tax increase. The three states listed in Table 3 all had rebates in fiscal year 2002 but did not renew them for fiscal year 2003, resulting in an increase in taxpayer liability of $1.6 billion over and above the tax increases discussed above.

Total Effect of Tax Changes

Adding up the effect of enacted tax increases and lapsed rebates results in significant tax increases of about $7.6 billion in fiscal year 2003. Our approach focuses on large tax changes and their effect on the current fiscal year. Other ways of looking at tax changes show the same general pattern of increases.

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 $6.7 billion net increase in taxes in fiscal year 2002.[3] The National Association of State Budget Officers and the National Governors Association use a method more like ours, but including the effects of smaller tax changes and fees. They estimate that enacted changes in state taxes and fees will increase fiscal year 2003 revenues by about $8.3 billion.[4]

Ballot Measures Affecting Taxes

The only ballot measure from November 2001 that significantly increased taxes for fiscal year 2003 was a referendum in Washington State to increase the tobacco tax. November 2002 elections featured a pair of measures that would have significantly affected state tax collections, but neither was adopted.

The most sweeping measure was Question 1 in Massachusetts, which would have eliminated the personal income tax in that state – a tax that generated about $7.9 billion in fiscal year 2002. This measure was defeated 55 percent to 45 percent. Arkansas voters turned down a measure that would have eliminated the sales tax on food and medicine.

Table 3
Significant FY 2002 Rebates Not Repeated in FY 2003

State	*Tax*	*Amount (millions)*
Colorado	Sales	$562
Minnesota	Sales	$791
Oregon	PIT	$249
Total		**$1,602**

Budget Issues in 2002

The Economic Picture

The recession, which began in 2001, continued to affect state budgets into 2002. Real gross domestic product growth in 2001 was only 0.3 percent; it recovered to 2.4 percent in 2002, but was only 1.4 percent in the fourth quarter of that year.[5] Unemployment was 6.0 percent in December 2002, the highest it had been since July 1994.[6] States continued to draw down their budget balances, which declined from $37.8 billion at the end of fiscal year 2001 to an estimated $17.1 billion at the end of fiscal year 2002.[7]

Actions to Close Budget Gaps

When states developed their fiscal year 2003 budgets, they faced an aggregate budget gap of about $49.1 billion. They closed some of this gap with combinations of tax increases, spending cuts, and the use of budget reserves and other revenue sources. However, this did not end the states' problems with their fiscal year 2003 budgets. A survey conducted in January 2003 by the National Conference of State Legislatures (NCSL) found that a further gap of about $25.7 billion had opened in the aggregated state budgets. This amounts to 5.2 percent of original fiscal year 2003 appropriations.[8] This gap is traceable to continued sluggish revenues and some expenditure overruns – especially in Medicaid.

The NCSL survey found that states have been using a variety of means to bring their fiscal year 2003 budgets back into balance. A total of 32 states made spending reductions. Table 4 shows which types of programs and expenditures are on the chopping block.

Table 4
Proposed and Actual Cuts in FY 2003 Spending

Program Areas	***Number of States Making Cuts***
K-12 Education	9
Higher Education	13
Medicaid	13
Welfare (TANF)	1
Corrections	9
Local Revenue Sharing	9
Across-the-Board	29

Source: National Conference of State Legislatures, *State Budget Update: February 2003.*

The Prospects for 2003

The sharp decline in revenue in fiscal year 2002 has been followed by sluggish revenue growth in fiscal year 2003, barely keeping up with inflation. States used much of their rainy day funds and other reserves they built up in the late 1990s in order to help close the fiscal 2003 budget gaps. They have also used revenue accelerations, deferrals of spending, and other one-time gap closers. This had the effect of rolling some of fiscal 2003 budget problems into fiscal 2004.

Therefore, if the gaps in the current budget were not a big enough problem, even larger gaps loom in states' fiscal year 2004 budgets. Estimates of the fiscal year 2004 budget gaps range from $68.5 billion to $85 billion.[9] In California alone the gap has been estimated at $26.1 billion or more, or about 30 percent of that state's general fund. Table 5 shows some of the gaps that states need to close in their fiscal 2004 budgets.

Since most of the budget reserves, and other one-time budget closers were used last year, states now confront painful choices. Governors in at least 17 states have proposed tax increases to help close the budget gaps in their states, and most of the executive budgets have spending below the level needed to maintain current services.

As was the case last year, the 2003 budget season is likely to be difficult and extended. States can now feel only nostalgia for the boom times of the late 1990s, when they could increase spending and cut taxes at the same time. Now states are confronted with the necessity of doing the opposite: raising taxes and cutting spending – neither of which is likely to be popular politically and both of which are, ironically, bad for the economy.

Endnotes

1 National Governors Association and National Association of State Budget Officers, *Fiscal Survey of the States* (Washington, DC, November 2002).

2 Ibid.

3 National Conference of State Legislatures, "Preliminary Report: Executive Summary," *State Budget & Tax Actions 2002*, revised August 28, 2002. This preliminary report included data from only 47 states.

4 National Governors Association and National Association of State Budget Officers, *Fiscal Survey of the States*, November 2002.

5 United States Department of Commerce, Bureau of Economic Analysis, "New Release," February 28, 2003.

6 United States Department of Labor, Bureau of Labor Statistics, *Labor Force Statistics from the Current Population Survey*.

Table 5
FY 2004 Budget Gaps

State	Estimated Budget Gap (in millions)	State	Estimated Budget Gap (in millions)
Alaska	$896.0	Missouri	$1,000.0
Arizona	$1,500.0	Montana	$116.0
Arkansas	$0.0	Nebraska	$350.0
California	$26,100.0	New Hampshire	$148.0
Colorado	$398.0	New Jersey	$4,600.0
Connecticut	$1,700.0	New York	$9,300.0
Delaware	$196.1	North Carolina	$2,000.0
Georgia	$721.0	Oklahoma	$299.8
Hawaii	$80.0	Oregon	$576.0
Idaho	$160.0	Rhode Island	$173.9
Illinois	$3,500.0	South Carolina	$400.0
Iowa	$413.8	South Dakota	$54.2
Kansas	$750.0	Texas	$3,700.0
Louisiana	$600.0	Vermont	$30.0
Maine	$475.0	Virginia	$1,100.0
Maryland	$853.2	Washington	$1,000.0
Massachusetts	$3,000.0	West Virginia	$200.0
Michigan	$1,250.0	Wisconsin	$1,999.0
Minnesota	$2,367.0	Wyoming	$0.0
Total — 39 States			**$68,507.0**

Source: National Conference of State Legislatures

7 National Governors Association and National Association of State Budget Officers, *Fiscal Survey of the States*, November 2002.

8 National Conference of State Legislatures, *State Budget Update: February 2003.*

9 Ibid; Center on Budget and Policy Priorities, *State Budget Deficits For Fiscal Year 2004 Are Huge And Growing*, January 23, 2003.

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

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