STATE FISCAL BRIEF

Fiscal Studies Program
The Nelson A. Rockefeller Institute of Government

November 2004
No. 71

2004 Tax and Budget Review

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Highlights

- ❖ In 2004, eight states made significant tax increases totaling almost $2.6 billion.
- ❖ Two states enacted significant tax cuts totaling less than $100 million for fiscal year 2005.
- ❖ Personal income tax increases were almost $1.6 billion.
- ❖ States had to close budget gaps of over $36 billion for fiscal year 2004.
- ❖ Some states still have lingering budget gaps as they prepare their fiscal year 2006 budgets.

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Introduction

By the beginning of 2004, the national economy finally seemed to be on more solid footing. State revenue was also growing almost everywhere. However, states still had to deal with the aftereffects of the recession, including depleted reserve funds and pressures from deferred spending that in many cases exceed the growth in revenue. States had used many one-time measures to balance the prior years' budgets and it was becoming increasingly difficult to find new temporary measures.

Still, most states managed to get through the year without significant tax increases. Only eight states enacted increases, amounting to $2.6 billion a year. These increases affected the personal income tax, the sales tax, and tobacco taxes. Two states managed to enact significant tax cuts, but these only added up to less than $100 million for fiscal year 2005.

Tax Changes Enacted in 2004

In general, we define a significant tax change as an increase or decrease in a state's revenue by at least one percent of general fund expenditures. Many states enacted smaller tax changes in 2004, but we do not consider those here since they have little effect on the total amount of state revenue. 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 revenue. We have included state referendums passed in November 2004 that had significant tax impacts.

Ten states enacted significant tax changes in 2004, for a total net increase in tax revenue of almost $2.5 billion. (See Table 1.) This is relatively small compared to increases of about $6 billion in 2002 and $7 billion 2003. This round of tax increases was the result of the recession of 2001, and was relatively small compared to the increases resulting from the recession of the early 1990s, when state tax increases were as high as $15 billion for a single year.[1]

Tax Increases

Eight states enacted significant tax increases in 2004 for a total of almost $2.6 billion. (See Table 2.) This may represent the last round of significant tax increases that can be associated with the 2001 recession.

Table 1
Significant Tax Changes Enacted in 2004 — Including November Referenda
(effect in millions of dollars for fiscal year 2005, or first full year)

State	Personal Income Tax	Sales Tax	Corporate Income Tax	Tobacco Tax	Other Taxes	Total Net Tax Increases	Changes as % of FY 05 GF
Alabama				$88		$88	1.5
Arkansas		$360				$360	9.9
California	$750					$750	1.0
Colorado				$175		$175	3.0
Iowa		$(63)				$(63)	(1.3)
New Hampshire					$(30)	$(30)	(2.2)
New Jersey	$800					$800	3.1
Oklahoma				$149		$149	3.2
Rhode Island				$35		$35	1.2
Virginia		$202				$202	1.5
Total	**$1,600**	**$499**	**$0**	**$447**	**$(30)**	**$2,466**	0.5
# of States with Significant Changes	2	3	0	4	1	10	

Sources: National Conference of State Legislatures, National Association of State Budget Officers, National Governors Association, various state budget documents and reports.
Parenthesis indicates a tax cut.

Table 2
Significant Tax Increases Enacted in 2004 — Including November Referenda
(effect in millions of dollars for fiscal year 2005, or first full year)

State	*Personal Income Tax*	*Sales Tax*	*Tobacco Tax*	*Total Tax Increases*	*Changes as % of FY05 GF*	*Notes*
Alabama			$88	$88	1.5	Increase in cigarette tax rate.
Arkansas		$360		$360	9.9	Increase in sales tax rate, and base expansion.
California	$750			$750	1.0	New top personal income tax rate. (Full year effect.)
Colorado			$175	$175	3.0	Increase in tobacco tax rates. (Full year effect.)
New Jersey	$800			$800	3.1	Increased top personal income tax rate.
Oklahoma			$149	$149	3.2	Increase in tobacco tax rates. (Full year effect.)
Rhode Island			$35	$35	1.2	Increase in cigarette tax rate.
Virginia		$202		$202	1.5	Sales tax rate increase, base broadened.
Total	**$1,550**	**$562**	**$447**	**$2,559**	0.5	Total Tax increase as % of 50 State GF

Sources: National Conference of State Legislatures, various state budget documents and reports.

In all, states have increased taxes by over $17 billion in the four years since the recession began.

Personal Income Tax Increases

Two states enacted almost $1.6 billion in significant personal income tax increases in 2004. California voters approved Proposition 63, which added an additional 1 percent to the personal income tax for those making over $1 million a year. The money raised will be used for mental health programs. Since this new tax will take effect mid-way through fiscal year 2005, it will raise only $275 million for that year, but will raise $750 million for a full year. New Jersey also increased its top personal income tax rate, raising about $800 million in fiscal year 2005. This money will help fund a property tax rebate program.

Sales Tax Increases

Two states made significant sales tax increases in 2004, amounting to almost $600 million in fiscal year 2005. Arkansas increased its sales tax rate from 5.125 percent to 6 percent, and expanded the tax to cover more types of business, resulting in a revenue increase of $360 million for fiscal year 2005. Virginia increased its state sales tax rate from 3.5 percent to 4 percent, and broadened its base, bringing in over $200 million in additional revenue in fiscal year 2005. This rate increase does not apply to the sales tax on food, which this measure reduces in future years. Part of the sales tax increase is dedicated to property tax relief.

Tobacco Tax Increases

Cigarette and tobacco taxes have been the target of considerable tax increase activity over the last several years. While that activity seems to be dropping off, four states significantly raised their tobacco taxes in 2004, increasing state revenue by over $400 million.

Alabama increased its cigarette tax rate from 16.5 cents a pack to 42.5 cents a pack, raising $88 million for fiscal year 2005. Colorado voters adopted Amendment 35, which increased the cigarette tax from 20 cent a pack to 84 cents a pack, and doubles other tobacco taxes. The $175 million that this will raise annually will go to health related programs. Oklahoma voters adopted Question 713, increasing the cigarette tax to 80 cents a pack and raising $149 million a year. Rhode

Table 3
Significant Tax Cuts Enacted in 2004
(effect in millions of dollars for fiscal year 2005)

State	*Sales Tax*	*OtherTax*	*Total Tax Cuts*	*Changes as % of FY05 GF*	*Notes*
Iowa	$(63)		$(63)	(1.3)	Reinstated energy sales tax phase-out
New Hampshire		$(30)	$(30)	(2.2)	State property tax reduction.
Total	**$(63)**	**$(30)**	**$(93)**	0.0	Total Tax cut as % of 50 State GF

Sources: National Conference of State Legislatures, various state budget documents and reports.

Island increased its cigarette tax by 75 cent a pack, raising $35 million in fiscal year 2005.

Tax Cuts

Two states enacted significant tax cuts in 2004. These cuts amounted to less than a $100 million reduction in fiscal year 2005 revenues. (See Table 3.) Iowa re-enacted an energy sales tax phase out that had been suspended for a year, costing $63 million in fiscal year 2005. New Hampshire reduced it statewide sales tax, including the elimination of about $30 million that would have gone to the state in fiscal year 2005. The rest of the tax, while imposed by the state, goes to local governments directly.

Ballot Measures Affecting Taxes

Ballot measures considered in November 2004, and that affected state taxes significantly in California, Colorado, and Oklahoma, were discussed in the "Tax Increases" section above. There were no ballot measures considered by voters on the November 2003 ballot that would have significantly affected state taxes.

Late Fiscal Year 2004 Tax Changes

Pennsylvania did not enact its fiscal year 2004 budget until after we published our "2003 Tax and Budget Review" last December. This budget included a significant tax increase. The state's flat personal income tax rate was increased from 2.8 percent to 3.07 percent as of January 1, 2004, bringing in over $300 million for fiscal year 2004. The full year effect will be about $740 million.

Oregon voters rejected Measure 30 on February 3, 2004, thereby repealing the significant personal and corporate tax increases enacted the year before, as reported in our "2003 Tax and Budget Review." These increases would have added about $368 million in fiscal year 2004.

Long-Term Effects of Tax Changes

We have been tracking significant tax changes since 1998. As Table 4 shows, we have reported about $23 billion in tax cuts since 1998, with the tax cutting activity tailing off in 2001 as the recession started to take hold. This actually understates total tax cutting activity from 1998 to 2001. Many tax cuts during this period were phased in over several years and in many cases, we counted only the initial year's impact. In addition, states were cutting taxes before 1998. The National Association of State Budget Officers (NASBO), which also calculates the effect of smaller tax and fee changes, has reported that states cut taxes by a net $33.4 billion from fiscal year 1995 through fiscal year 2002.[2]

Between 1998 and 2001, we saw only scattered significant tax increases — usually tied to events or problems unique to particular states. Beginning in 2001, and peaking in 2002 and 2003, states raised taxes in response to the large budget gaps that resulted from the recession of 2001. These tax increases have totaled about $17.9 billion so far, as seen in Table 5.

The tax cuts that states enacted from 1995 to 2000 — affecting state fiscal years 1996 to 2001 — were of a different nature than the increases enacted over the last three years. Using NASBO data, we can see in Figure 1 that 58 percent of the cuts were to the personal income tax. In Figure 2, we can see that the increases since 2002 — affecting state fiscal year 2003 to 2005 — have been more distributed among the various types of tax, with the sales tax and tobacco taxes having the largest shares.

Unlike the tax cuts enacted in the late 1990s, which were usually permanent, many tax increases enacted since 2001 have been temporary — meant to end after the effects of the recession faded. Most of these tax

Table 4
Significant State General Fund Tax Cuts Enacted Since 1998

Year Enacted	*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	1.8%
1999	19	$7,550	1.7%
2000	13	$5,730	1.2%
2001	6	$1,830	0.3%
2002	0	$0	0.0%
2003	1	$304	0.1%
2004	2	$93	0.0%
Total		$23,106	

increases have yet to expire. It remains to be seen if all will actually sunset on schedule.

Budget Issues in 2004

The Economic Picture

The national economy seemed to have recovered from the 2001 recession by the time states adopted their fiscal year 2005 budgets. Real gross domestic product growth was 3.0 percent in 2003, 4.5 percent in the first quarter of 2004, and 3.3 percent in the second quarter.[3] The unemployment rate declined from a post-recession peak of 6.3 percent in June of 2002 to the 5.4 to 5.6 percent range for 2004 so far.[4] There is some variation on the state level, with some states growing strongly and others lagging.

States drew on their budget reserves during the recession and have not really begun to build them back up yet. According to NASBO, state budget balances were $48.8 billion in fiscal year 2000. By the end of fiscal year 2004, they were an estimated $19.1 billion, only a $2 billion net increase from the end of fiscal year 2003.[5]

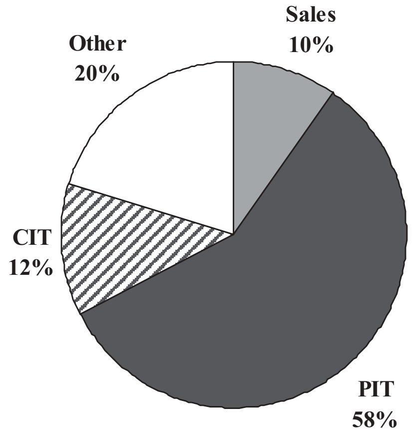
Actions to Close Budget Gaps

When states commenced the budget making process in 2004, the challenges they faced were not as difficult as in the previous two years. However, there were still aggregate budget gaps of $36.3 billion between their projected spending and projected revenues. About two-thirds of the states had gaps. These gaps were closed by a combination of the tax increases mentioned above; spending cuts, use of reserve and other funds,

Table 5
Significant State General Fund Tax Increases Enacted Since 1998

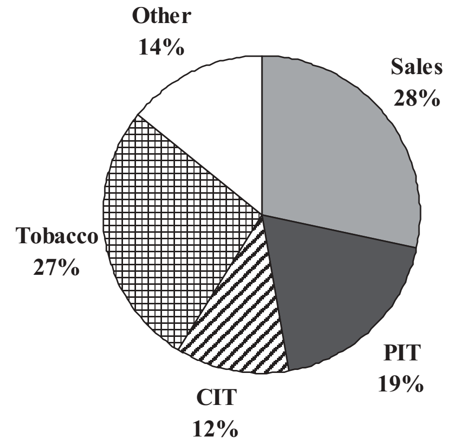
Year Enacted	*Number of States with Tax Increase of One Percent or more of GF Revenues*	*Amount (millions)*	*Percentage of All States' GF Revenues*
1998	0	$0	0.0%
1999	7	$480	0.1%
2000	2	$260	0.1%
2001	6	$1,838	0.4%
2002	15	$5,962	1.2%
2003	18	$6,844	1.4%
2004	8	$2,559	0.5%
Total		$17,943	

Figure 1.
Shares of Tax Cuts FY 1996-2001



Source: National Association of State Budget Officers

Figure 2.
Shares of Tax Increases FY 2003-2005



Source: National Association of State Budget Officers

and state workforce reduction or hiring freezes. States also raised over $700 million from increases in fees and other non-tax revenues.[6]

California

California is the largest state and has the largest budget. Therefore, it always has a big impact on the overall 50-state budget picture. This has been even more the case in recent years, since California's budget problems have been disproportionately bad. In fiscal year 2005, California's budget gap was $15 billion, over 40 percent of the budget gaps for all fifty states. This was after a gap of over $30 billion in fiscal year 2004, which the state closed largely by borrowing.[7]

California closed the fiscal year 2005 gaps through a variety of actions. The state reduced projected spending by $3.4 billion, over half coming from "K-14" spending.[8] The state borrowed $2 billion more, and reduced prior debt service by $1.2 billion. There were about $1.6 billion in revenue increases, including the proceeds of a tax amnesty. The state also diverted about $1.3 billion in property tax revenues to the general fund; the rest was made up by transfers from other state funds.

Since many of the actions that California took to close its fiscal year 2005 budget gap were one-time actions or deferred spending into subsequent years, the budget gaps are expected to persist into future years. The California Legislative Analyst's Office estimates that the fiscal year 2006 gap will be more than $6 billion.

The Prospects for 2005

As the case of California illustrates, not all states are clear of their fiscal problems. Even if the economy remains strong, states still have to deal with prospective problems such as depleted reserve funds, the expiration of temporary tax increases, and rising Medicaid costs, not to mention pressures to increase spending in areas such as education and homeland security.

Most states are past the recession effects on their budgets and moving well into recovery, and it does not seem likely that there will be many major tax increases in the coming year. However, it likewise is unlikely that there will be many major tax cuts. 2005 is therefore likely to be another quiet year on the tax change front.

Governors present their executive budgets over the next few months, and legislatures begin to consider them. There are still some states that will have to deal with lingering economic problems and the hangover from the recession. Most states, however, can finally put this behind them, and merely deal with the routine difficulty of forging balanced budgets.

Endnotes

1 National Governors Association and National Association of State Budget Officers, *Fiscal Survey of the States* (Washington, DC, April 2004).

2 Ibid.

3 United States Department of Commerce, Bureau of Economic Analysis, "News Release," October 29, 2004.

4 United States Department of Labor, Bureau of Labor Statistics, *Labor Force Statistics from the Current Population Survey*, http://data.bls.gov/cgi-bin/surveymost.

5 National Governors Association and National Association of State Budget Officers, *Fiscal Survey of the States* (Washington, DC, April 2004).

6 National Conference of State Legislatures, *State Budget & Tax Actions 2004: Preliminary Report*, July 20, 2004.

7 Legislative Analyst's Office, *California Spending Plan 2004-05: The Budget Act and Related Legislation*, September 2004.

8 K-14 includes primary and secondary education and community colleges.

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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