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2005 Tax and Budget Review

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Highlights

- ❖ Eleven states made significant changes in tax collections affecting fiscal year 2006.
- ❖ Six states made tax cuts totaling about $2.1 billion, almost three-quarters of which was in the sales tax.
- ❖ Seven states made tax increases totaling about $1.3 billion, 90 percent in tobacco taxes.
- ❖ This was the first year with net tax cuts since 2000.
- ❖ States are in a strong position as they consider budgets for fiscal year 2007.

Introduction

As the states began to consider their annual budgets at the beginning of 2005, they stood in generally sounder financial condition than at any time since the end of the 2001 recession. The national economy had been growing for three years. With a few exceptions, states had managed to restore balance to their budgets, but the pressure to make good on deferred spending in many areas and to build up budget reserves was still strong. Much of the strong revenue growth seen in the previous year had also been taken up in replacing one-time measures that were used to shore up state budgets weakened by revenue shortfalls in the early years of the decade.

However, states did enact net significant tax cuts in 2005, the first year with net cuts since 2000. The net cuts were only about $850 million, but may represent a transition from the period of tax increases following the recession to a new period of tax cutting. In all, with improving economies and competing demands for budget actions, 2005 was not a very active year either for tax increases or tax cuts.

Tax Changes Enacted in 2005

In general, we define a significant tax change as an increase or decrease in a state's revenue of at least one percent of general fund expenditures. Many states enacted smaller tax changes in 2005, 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 the lapsing of temporary tax measures that reduced collections significantly for fiscal year 2006, even though they may not involve specific new legislation passed during 2005.

Eleven states enacted significant tax changes in 2005, for a total net cut in tax revenue of about $850 million. (See Table 1.) This net change is small compared to the sizable net tax changes in six of the previous seven years, as shown in Table 2. This would seem to have been a transitional year, with some states increasing taxes, while other states cut them. The magnitude of these tax changes — the increases in seven states and the decreases in six — also is much more modest than the increases enacted from 2002 through 2004 and the decreases passed in the years prior to 2001. Since the round of tax increases resulting from the 2001 recession would seem to be over, we can observe that it was quite mild compared to increases resulting from the recession of the early 1990s, when state raised their taxes by as much as $15 billion in a single year.[1]

Tax Cuts

Six states implemented significant tax cuts for fiscal year 2006. This included several instances where states ended or modified temporary tax increases enacted in the aftermath of the 2001 recession. These cuts amounted to over a $2.1 billion reduction in fiscal year 2006 revenue for the affected states. (See Table 3.) All of these tax cuts were in the personal income and sales taxes.

Personal Income Tax Cuts

Four states had significant cuts affecting the personal income tax. These actions reduced state revenue by over $600 million in fiscal year 2006.

Arkansas repealed a 3 percent income tax surcharge, reducing collections by about $57 million for fiscal year 2006. Kentucky reduced the personal income tax rate for the $8,000 to $75,000 income range from 6 percent to 5.8 percent, and made other changes in the tax, reducing collections by $142 million for fiscal year 2006. Ohio has enacted a five-year, 21 percent cut in all of its personal income tax rates, to be phased in at 4.2 percent a year. This cut, along with other changes in the personal income tax, will result in a reduction of $330 million in fiscal year 2006. When fully implemented, the personal income tax rate cut will amount to about $2.2 billion a year. Oklahoma reduced its personal income tax rate from 6.65 percent to 6.25 percent, costing $108 million a year.

Table 1
Significant Tax Changes Enacted in 2005
(Effect in millions of dollars for fiscal year 2006, or first full year)

State	*Personal Income Tax*	*Sales Tax*	*Corporate Income Tax*	*Tobacco Taxes*	*Other Taxes*	*Total Net Tax Increases*	*Changes as % of FY06 GF*
Arkansas	($57)					($57)	-1.5%
Idaho		($183)				($183)	-8.4%
Kentucky	($142)		$143	$181		$181	2.2%
Maine				$52		$52	1.8%
Minnesota				$179		$179	1.2%
New Hampshire				$45		$45	3.4%
New York		($610)				($610)	-1.3%
North Carolina				$189		$189	1.1%
North Dakota					$10	$10	1.0%
Ohio	($330)	($712)		$487		($555)	-2.2%
Oklahoma	($108)					($108)	-2.0%
Total	**($637)**	**($1,505)**	**$143**	**$1,133**	**$10**	**($856)**	-0.1%
# of States with Significant Changes	4	3	1	6	1	11	

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

Table 2 Significant State General Fund Tax Changes Enacted Since 1998			
Year Enacted	*Increases (millions)*	*Cuts (millions)*	*Net Changes (millions)*
1998	$0	($7,599)	($7,599)
1999	$480	($7,550)	($7,070)
2000	$260	($5,730)	($5,470)
2001	$1,838	($1,830)	$8
2002	$5,962	$0	$5,962
2003	$6,844	($304)	$6,540
2004	$2,559	($93)	$2,466
2005	$1,286	($2,142)	($856)

Sales Tax Cuts

Three states had significant cuts in the sales tax that amounted to over $1.5 billion for fiscal year 2006.

A temporary sales tax increase in Idaho ended, reducing the rate from 6 percent to 5 percent; this cost the state about $183 million in revenue for fiscal year 2006. New York also had a temporary sales tax increase end, reducing the state rate from 4.25 percent to 4 percent, and costing about $610 million a year. Ohio had enacted a temporary tax increase from 5 percent to 6 percent that was due to end, but the rate was instead set at 5.5 percent, resulting in a reduction of $712 million for fiscal year 2006.[2]

Tax Increases

Seven states enacted significant tax increases in 2005 for a total of almost $1.3 billion. (See Table 4.) Most of the increases were in tobacco taxes, which has been a popular target of state tax increases for several years now.

Tobacco Tax Increases

In 2004, only four states enacted significant tobacco tax increases, and it seemed like the states' big move to increase these taxes was tapering off. However, in 2005, six more states significantly raised their tobacco taxes, increasing state revenue by over $1.1 billion, and there are more proposals to increase these taxes in 2006.

Kentucky raised its cigarette tax from 3 cents a pack to 4 cents a pack, added a 26 cents a pack surcharge, increased taxes on other tobacco products, and raised $180 million for fiscal year 2006. Maine increased its cigarette tax rate from $1 to $2 a pack, and increased other tobacco taxes; this added $52 million to

Table 3 Significant Tax Cuts Enacted in 2005 (Effect in millions of dollars for fiscal year 2006)					
State	*Personal Income Tax*	*Sales Tax*	*Total Net Tax Increases*	*Changes as % of FY06 GF*	*Notes*
Arkansas	($57)		($57)	-1.5%	Repeal of income tax surcharge.
Idaho		($183)	($183)	-8.4%	End of temporacy sales tax rate increase. Full year effect.
Kentucky	($142)		($142)	-1.7%	Cut in PIT rate and other changes.
New York		($610)	($610)	-1.3%	Ended temporary sales tax rate increase.
Ohio	($330)	($712)	($1,042)	-4.1%	Cut in PIT rate, cut in sales tax rate, and other changes.
Oklahoma	($108)		($108)	-2.0%	Cut in top PIT rate. Full year effect.
Total	**($637)**	**($1,505)**	**($2,142)**	-0.4%	Total net tax increase as % of 50 State GF.
Sources: National Conference of State Legislatures, National Association of State Budget Officers, National Governors Association, various state budget documents and reports. Parentheses indicate tax cut.					

fiscal year 2006 collections. Minnesota enacted a 75 cents a pack health impact fee, but it has been struck down by a state court as violating the agreement that Minnesota has with the tobacco companies; the state is appealing. The fee was supposed to have raised $179 million a year.[3] New Hampshire increased its cigarette tax from 52 cents a pack to 80 cents a pack, and raised other tobacco taxes, increasing revenue by $45 million. North Carolina raised its cigarette tax from 5 cents a pack to 30 cents a pack and also made increases in other tobacco taxes. This added $189 million a year; another 5 cent a pack increase is scheduled for fiscal year 2007. Ohio increased its tobacco tax rate from 55 cents a pack to $1.25 cents a pack, as well as made other changes to tobacco taxes, for an increase of $487 million for fiscal year 2006.

Other Tax Increases

Kentucky made a number of changes to their business taxes, including most limited liability entities under the corporate tax, a new method of calculating the alternative minimum corporate taxes, and loophole closings. These changes will raise a net $143 million more for fiscal year 2006. However, other provisions, including the repeal of the corporate license tax and a cut in the top corporate tax rate will result in revenue reductions in future years. North Dakota increased its motor fuel tax from 21 cents a gallon to 23 cents a gallon, raising about $10 million a year. Other states, including Washington State, also had motor fuel tax increases, but this was the only state that had an increase that was more than 1 percent of the state general fund budget.

Ballot Measures Affecting Taxes

There were no ballot measures passed by voters on the November 2005 ballot that would have significantly affected state taxes. Ballot measures passed by voters in November 2004 were covered in *State Fiscal Brief #71*.[4]

Long-Term Effects of Tax Changes

We have been tracking significant tax changes since 1998. As Table 5 shows, we have reported about $25 billion in significant tax cuts since 1998, with the tax cutting activity tailing off in 2001 as the recession started to take hold. It finally began to pick up again in 2005, but has not reached the levels seen before the recession.

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

Table 4
Significant Tax Increases Enacted in 2005
(Effect in millions of dollars for fiscal year 2006, or first full year)

State	*Corporate Income Tax*	*Tobacco Taxes*	*Other Taxes*	*Total Net Tax Changes*	*Changes as % of FY06 GF*	*Notes*
Kentucky	$143	$181		$324	3.9%	Various changes in CIT, surcharge on cigarette tax and new tax on other tobacco products.
Maine		$52		$52	1.8%	Increases in cigarette and tobacco tax rates.
Minnesota		$179		$179	1.2%	Imposed health impact fee (adminstered like tax). Struck down by court, appealed.
New Hampshire		$45		$45	3.4%	Increases in cigarette tax rate, expansion of tobacco tax.
North Carolina		$189		$189	1.1%	Increases in cigarette and tobacco tax rates. Full year effect.
North Dakota			$10	$10	1.0%	Increase in motor fuels tax rate.
Ohio		$487		$487	1.9%	Increase in cigarette tax rate, and other changes.
Total	**$143**	**$1,133**	**$10**	**$1,286**	0.2%	Total net tax increase as % of 50 State GF.

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

Table 5
Significant State General Fund Tax Cuts Enacted Since 1998

Year Enacted	*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	1.8%
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%
2005	6	$2,142	0.4%
Total		**$25,248**	

the recession of 2001. Total significant tax increases from 1998 through 2005 have been about $19 billion, as seen in Table 6.

Budget Issues in 2005

The Economic Picture

At the time states enacted their fiscal year 2006 budgets the national economy was growing strongly. Real gross domestic product growth was 4.2 percent in 2004, 4.3 percent in the first quarter of 2005, and 3.5 percent in the second quarter.[5] The national unemployment rate declined from 5.7 percent in January 2004 to 5.2 percent in January 2005, and declined further to 5 percent in June 2005.[6] Growth was stronger in some parts of country, but only a few states were not sharing in the expansion.

States were able to build up their budget reserves somewhat during fiscal year 2005. According to the National Association of State Budget Officers, state budget balances were $38.5 billion at the end of fiscal year 2004, about 6.9 percent of expenditures. This was short of reserves of 10.4 percent of expenditures in fiscal year 2000, before the recent recession, but a considerable improvement from the low of 3.2 percent of expenditures reached in fiscal year 2003.[7]

Spending Actions in 2005

Medicaid spending increases outpaced other major categories of spending for the fiscal year 2006 budgets enacted in 2005. According to a survey by the National Conference of State Legislatures, general fund spending on Medicaid increased 7.2 percent in 44 states. Primary and secondary education general fund spending grew 6.0 percent. Higher education general fund spending grew 5.7 percent. Corrections general fund spending grew 3.8 percent.[8]

The Prospects for 2006

Governors are currently presenting their executive budget proposals, and legislatures will soon begin to consider and enact them. We have already seen some sizable tax cuts proposed in some states. Governor Pataki of New York is proposing a cut in several different taxes, totaling almost $900 million in fiscal year 2007, and about $3.3 billion a year when fully phased in after three years. Governor Napolitano of Arizona is proposing a package of tax cuts worth $100 million a year. Governor Lingle of Hawaii has proposed using $300 million of that state's surplus for tax cuts.

State tax revenue is growing strongly, and most states are looking at sizable surpluses in their fiscal year 2006 budgets, so we should expect to see more tax cut proposals. However, there are still considerable pressures on states from rising Medicaid and other health care costs, and pressure to dedicate increased resources to such spending areas as education and homeland security. There is also concern that large federal budget deficits will result in sizable cuts in aid to the states.

Still, it is likely that tax cuts will play a significant part of the budget process this year, especially since 2006 is an election year in most states.

Table 6 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%
2005	7	$1,286	0.2%
Total		**$19,229**	

Endnotes

1 National Governors Association and National Association of State Budget Officers, *Fiscal Survey of the States* (Washington, DC, December 2005).

2 As usual, we calculate this from the level paid the previous year, rather than the level at which it would have been had the originally planned reduction taken place.

3 Normally, we do not count fees in this report, but as this fee operates exactly like a cigarette tax we are including it.

4 Rockefeller Institute of Government, *2004 Tax and Budget Review,* November 2004.

5 United States Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts Tables, www.bea.gov/bea/dn/nipaweb/index.asp.

6 United States Department of Labor, Bureau of Labor Statistics, *Labor Force Statistics from the Current Population Survey*, www.bls.gov/cps/home.htm.

7 National Governors Association and National Association of State Budget Officers, *Fiscal Survey of the States* (Washington, DC, December 2005).

8 National Conference of State Legislatures, *State Budget & Tax Actions 2005: Preliminary Report*, September 22, 2005.

Technical Notes

The estimates of "legislated changes" include the effects of changes in tax rates and tax bases and acceleration of tax payments. They also include a very few major non-legislated changes, such as adjustments for changes to the accounting system or for particularly egregious delays in processing of receipts.

We developed the estimated effects of legislated changes in several ways. The starting point is a survey of legislated tax changes published by the National Conference of State Legislatures, augmented by state publications and contacts. We modify the estimates to take account of differences in the timing of the receipt of revenue. For example, when the sales tax rate is changed, revenue is not usually affected until a month after the effective date of the legislation because businesses are allowed to retain revenue for a few weeks before remitting it to the state. Likewise, if a tax cut took effect in February 2004 and continued throughout fiscal year 2005, part of its effect occurred in fiscal year 2004 and part in fiscal year 2005.

Most of these estimates are the ones used at the time legislation was enacted. In some cases, states rely on estimates that are too optimistic or pessimistic. For example, a state might anticipate that a sales tax increase would generate an extra $300 million based on the assumption of strong retail sales. If sales are lower than assumed, the tax increase will produce less than that. The Nelson A. Rockefeller Institute of Government modifies the preliminary estimates with the assistance of revenue estimators after revenue is collected.

Reports on state tax revenue published by the Rockefeller Institute of Government do not cover 100 percent of the taxes collected by states. They use the broadest measure of revenue reported on a timely basis in a single report, but often do not include earmarked taxes like those on motor fuels or taxes collected by agencies other than the revenue department, such as insurance taxes in many states. Various other adjustments are made to revenue to make it as comparable as possible. For more information, please contact the Institute's Fiscal Studies Program.

In 46 states, Fiscal 2005 was from July 1, 2004 to June 30, 2005. Four states have different fiscal years: Alabama and Michigan (October 1, 2004 to September 30, 2005), New York (April 1, 2004 to March 30, 2005) and Texas (September 1, 2004 to August 30, 2005).

About The Nelson A. Rockefeller Institute of Government's Fiscal Studies Program

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 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. Donald J. Boyd, who has spent two decades analyzing state and local fiscal issues, is director of Fiscal Studies.

This report was written by Nicholas W. Jenny, a senior policy analyst with the Program. Michael Cooper, the Rockefeller Institute's Director of Publications, did the layout and design of this report, with assistance from Michele Charbonneau. Barbara Stubblebine edited the report.

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