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2003 Tax and Budget Review

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Highlights

- ❖ In 2003 legislative sessions, 18 states made significant tax increases totaling almost $6.2 billion for fiscal year 2004.
- ❖ Sales tax increases amounted to over $2.4 billion.
- ❖ Personal income tax increases were almost $1.9 billion.
- ❖ States have also increased fees by at least $2.6 billion.
- ❖ States have cut expenditures. Higher education has suffered especially large cuts.
- ❖ States are again facing budget gaps as they prepare their fiscal year 2005 budgets.

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Introduction

Despite some improvement in their economies, states continued to confront fiscal difficulties in 2003. While revenue was not declining as sharply as it had the previous year, it was still sluggish. States also encountered increasing demands for state spending as the after effects of the recession, notably relatively high unemployment, persisted. Meanwhile, many of the fixes states had found for their budget gaps the year before— use of reserves, revenue accelerations, borrowing against tobacco settlement funds, etc. — were one-time measures.

Having exhausted many of the more palatable options, some states turned to tax increases. Eighteen states had significant tax increases, which together added almost $6.2 billion to projected state revenue in fiscal year 2004. Unlike the previous year, several states made significant increases in major taxes such as the personal income and general sales tax. No state enacted a significant new tax cut in 2003. Only one state — Pennsylvania — had not completed work on its fiscal year 2004 budget at the time that this report was completed.

Tax Changes Enacted in 2003

In general, we define a significant tax change as one that increases or decreases a state's revenue by at least one percent of general fund expenditures. We have made a partial exception this year, since many states enacted two or more separate tax increases each of which fell just below one percent. In these cases, if the increase in a particular tax was more than one-half of a percent and the total tax increases for the state added up to more than one percent of annual general fund expenditures, they were counted. Many states enacted even smaller tax changes in 2003, but we did not consider those here since they had little effect on the total amount of state revenue. Also not counted here were delays in planned tax cuts or increases, or other changes that did not affect actual state revenue collections — though they might have affected projected revenue.

Tax Increases

Eighteen states enacted significant tax increases in 2003, increasing tax revenue in fiscal year 2004 by almost $6.2 billion. (See Table 1.) This is in addition to the nearly $6 billion in tax increases enacted in 2002. These amounts, however, still fall 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] Many of the tax increases enacted in 2003 are temporary, meant to sunset in two or three years.

Personal Income Tax Increases

Four states enacted a total of almost $1.9 billion in significant personal income tax increases in 2003. New York enacted a top rate in legislation that will sunset after two years. The rate increase plus other changes in New York's personal income tax will raise about $1.4 billion in fiscal year 2004.[2] Oregon also had temporary tax increases. It enacted a temporary graduated personal income tax surcharge, which, combined with other changes, will raise about $299 million. Oregon's surcharge will expire in two years unless the fiscal problems persist, in which case the state will extend the surcharge for an additional year. Connecticut reduced the maximum amount that a personal income taxpayer may claim for a property tax credit, which will raise about $112 million annually. Arkansas added a three percent surcharge to the personal income tax for three years, which will raise $56 million annually.

Sales Tax Increases

Five states made significant sales tax increases in 2003 amounting to over $2.4 billion in fiscal year 2004. Ohio increased its sales tax rate from five percent to six percent for two years, expanded its sales tax base, and made other changes, which collectively resulted in a projected net revenue increase of about $1.3 billion for fiscal year 2004. New York raised its state sales tax rate from four percent to 4.25 percent for two years, and removed the exemption for clothing (except for two one-week holidays) — changes expected to raise an additional $899 million to $941 million for fiscal year 2004. Idaho and Vermont increased their sales tax rates from five percent to six percent, resulting in $165 million in additional revenue in fiscal year 2004 of $165 million for Idaho and $28 million for Vermont. Nebraska broadened its sales tax base to raise $24 million in fiscal year 2004. This is slightly less than one percent of Nebraska's general fund spending, but since the tax increase took effect three months into the fiscal year, the fiscal year 2004 impact was limited. The full-year effect will exceed the one percent threshold.

Corporate Income Tax Increases

Four states increased corporate income taxes in 2003, adding over $400 million to state tax revenue. New York made changes to insurance company taxes and disallowed some corporate income tax deductions, raising $153 to $273 million in fiscal year 2004. Delaware increased the corporate franchise tax rate, raising an additional $91 million annually. Connecticut adopted a one-year corporation tax surcharge and changed reporting requirements, raising an extra $89

Table 1
Significant Tax Increases Enacted in 2003
(effect in millions of dollars for fiscal year 2004)

State	*Personal Income Tax*	*Sales Tax*	*Corporate Income Tax*	*Tobacco Tax*	*Other Taxes*	*Total Significant Tax Increases*	*Increases as % of FY 03 GF*	*Notes*
Arizona					$70	$70	1.2	Elimination of Medicaid exemption in insurance premiums tax.
Arkansas	$58			$57		$115	3.5	PIT surcharge and repeal of working taxpayers credit; tobacco tax rate increase.
Connecticut	$112		$89			$201	1.7	Reduction in maximum property tax credit; CIT surcharge and change in reporting requirements.
Delaware			$91	$29		$120	4.8	Corporate franchise tax rate increase; cigarette tax rate increase.
Georgia				$180		$180	1.1	Tobacco tax rate increase.
Idaho		$165		$23		$188	9.6	Sales tax and cigarette tax rate increases.
Montana				$27		$27	2.1	Cigarette tax rate increase.
Nebraska		$24				$24	0.9	Broadening of sales tax (took effect 10/03).
Nevada				$63	$243	$306	15.9	Cigarette tax rate increase; new business payroll tax; new real estate transfer tax; new live entertainment tax; gaming tax rate increase.
New Jersey				$179	$140	$319	1.4	Cigarette tax rate increase; new hotel occupancy tax.
New Mexico				$31	$32	$63	1.6	Removal of health care premium tax exemption; cigarette tax rate increase.
New York	$1,415	$899	$153			$2,467	6.2	Temporary new top PIT and other changes; removal of sales tax clothing exemption plus rate increase; insurance tax change.
Ohio		$1,320			$122	$1,442	6.3	Sales tax rate increase; motor fuel tax increase.
Oregon	$299		$69			$368	9.7	PIT surcharge and other changes; CIT graduated minimum tax and other changes.
Vermont		$29				$29	3.3	Sales tax rate increase.
Washington					$134	$134	1.2	Motor fuel tax increase.
West Virginia				$55	$45	$100	3.2	Cigarette tax rate increase; addition of price-based component to motor fuel tax.
Wyoming				$20		$20	2.7	Tobacco tax rate increase.
Total	**$1,884**	**$2,427**	**$402**	**$664**	**$786**	**$6,173**	1.3	Total Tax increase as % of 50 State GF
# of States with Significant Changes	4	5	4	10	7	18		

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

million in fiscal year 2004. Oregon reduced tax credits to raise $69 million more annually.

Tobacco Tax Increases

While fewer states increased their tobacco taxes in 2003 than in 2002, there was still a large amount of activity in this area. Ten states enacted significant hikes in their tobacco taxes in 2003, increasing revenue by almost $700 million in fiscal year 2004.

Georgia more than tripled the tax on a pack of cigarettes, which increased from 12 cents to 37 cents, raising $180 million in fiscal year 2004. New Jersey's cigarette tax rate went from $1.50 a pack to $2.05 a pack (the highest rate in the nation), raising $179 million in fiscal year 2004. Nevada enacted a 45-cent per pack cigarette tax increase, raising $63 million in fiscal year 2004. Arkansas increased its cigarette tax from 24 cents per pack to 55 cents per pack to raise $57 million in fiscal year 2004. West Virginia increased its cigarette tax rate by more than three times. It went from 17 cents per pack to 55 cents per pack, raising $55 million in fiscal year 2004. Delaware increased its cigarette tax rate from 24 cents a pack to 55 cents a pack, raising $29 million in fiscal year 2004. Montana almost quadrupled its cigarette tax rate, from 18 cents per pack to 70 cents per pack, raising $27 million in fiscal year 2004. Idaho's cigarette tax rate went from 28 to 59 cents per pack, raising $23 million in fiscal year 2004. Wyoming had the biggest proportional increase in its cigarette tax rate. The state quintupled the rate from 12 cent a pack to 60 cents a pack and raised an additional $20 million annually

Other Tax Increases

Significant increases in various other taxes contributed about $1.2 billion in fiscal year 2004 to state tax revenue. Nevada enacted a number of new taxes and tax increases. The largest of these was a 0.7 percent business payroll tax, although the $140 million it raised was partially offset by the repeal of a $100 per employee business license tax, which cut revenue by $61 million in fiscal year 2004. Nevada also had a new 0.26 percent real estate transfer tax, a 10 percent live entertainment tax, and a 0.5 percent increase in the gaming tax rate. New Jersey enacted a 7 percent state hotel occupancy tax. Washington State increased motor fuel taxes from 23 cents per gallon to 28 cents per gallon, raising $134 million in fiscal year 2004. Arizona eliminated a Medicaid exemption in the insurance premium tax, raising $70 million in fiscal year 2004.

Tax Cuts

No state enacted significant tax cuts in 2003. The only state still phasing in significant tax cuts enacted in previous years was Hawaii, where personal income tax revenue will be reduced by an estimated $44 million and sales tax revenue by $31 million.

Ballot Measures Affecting Taxes

Louisiana's Amendment No. 2 (known as the "Stelly Plan"), adopted by voters on November 5, 2002, was the only major tax change ballot measure passed during 2002. Ultimately, it is revenue neutral, since the approximately $300 million gained by revising personal income tax brackets and changing deductions is offset by the amount of revenue lost through the elimination of the sales tax on food and utilities. Even though many of these tax changes are still coming into effect in fiscal year 2004, they are not shown in Table 1, or included in the calculation of total tax increases, since their net impact is negligible.

The largest tax package considered by voters in 2003 was Amendment 1 in Alabama. It would have raised net taxes by about $650 million in fiscal year 2004, with the bulk of the increases coming from the personal income and sales taxes. However, Alabama's voters overwhelmingly rejected the measure on September 9. There were no significant tax change packages on the states' November ballots.

Long-Term Effects of Tax Changes

We have been tracking significant tax changes since 1998. As Table 2 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.[3] 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, 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.[4]

Between 1998 and 2001, we saw only scattered significant tax increases — usually tied to events or problems unique to particular states. In 2001 and more strongly in 2002 and 2003, however, states raised taxes in response to the large budget gaps that resulted from the recession of 2001. (See Figure 1.) These tax

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	1.8%
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%
Total		**$23,013**	

increases have totaled about $15.0 billion so far, as seen in Table 3.

Unlike the tax cuts enacted in the late 1990s, which were usually permanent, many of the tax increases enacted since 2001 have been temporary — intended to end after the effects of the recession faded. Most of the tax increases have yet to expire. It remains to be seen if all will actually sunset on schedule.

The cumulative effect of significant tax cuts since 1998 has been to reduce state revenue by about 5.1 percent, while the cumulative effect of significant tax increases during the same period has been to increase state revenue by about 3.1 percent. If states had made none of these tax increases or reductions in the last six years, they would currently be collecting about two percent more annually.

Fees

In previous years, we have not covered fee changes in the states. Generally, these changes have been small and scattered, and have made up only a small proportion of the total revenue changes enacted by states in any given year. This year, however, the picture is quite different. The National Conference of State

Figure 1
Total Significant State Tax Cuts and Increases, 1998 to 2003, First Fiscal Year Effect

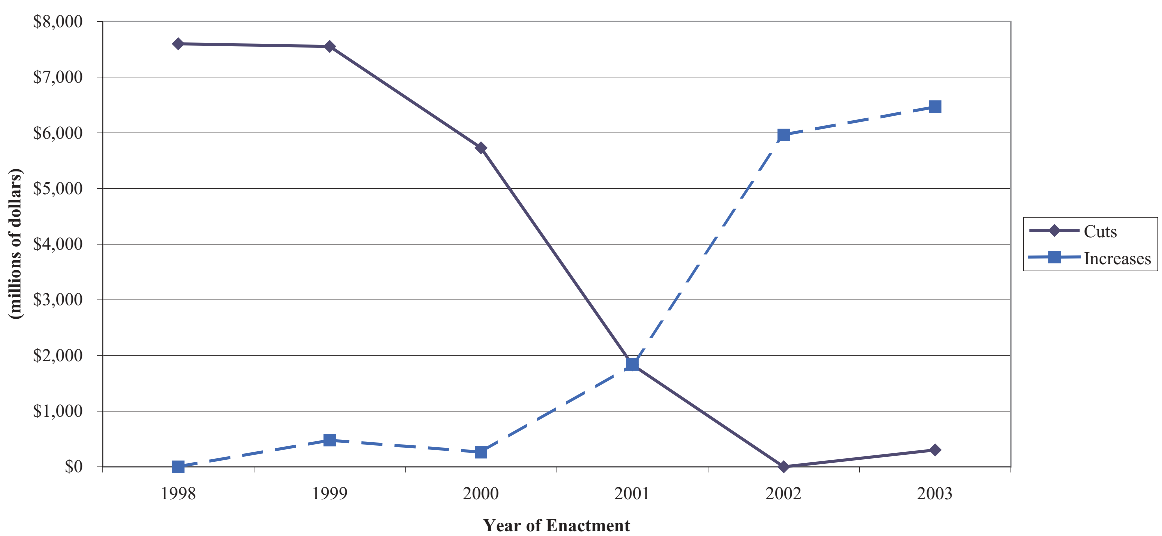

Table 3 Significant Tax Increases Enacted Since 1998			
Year Enacted	*Number of States with Tax Increase of One Percent or more of GF Revenues*	*Amount (millions)*	*Percentage of All States' GF Revenues*
1998	0	$0	0.0%
1999	7	$480	0.1%
2000	2	$260	0.1%
2001	6	$1,838	0.4%
2002	15	$5,962	1.2%
2003	18	$6,472	1.3%
Total		**$15,012**	

Legislatures has reported that in 2003, 30 out of 42 states for which they had data have raised fees, resulting in a $2.6 billion annual net revenue increase.[5] This was nearly three times the total fee increase seen in 2002, which in turn was the largest increase seen since at least 1992. This shift toward fee increases appears to result from states shying away from more tax increases, while still needing new revenue to close budget gaps.

Budget Issues in 2003

The Economic Picture

The 2001 recession officially lasted only eight months, ending in November of that year.[6] Real gross domestic product growth, which slowed to 0.3 percent in 2001, recovered to 2.4 percent in 2002 and seems to be accelerating in 2003, reaching 8.2 percent for the third quarter in the Bureau of Economic Analysis' preliminary estimate.[7]

On the other hand, unemployment was still at 6.0 percent in October 2003, down only slightly from its peak of 6.4 percent in June 2003.[8] This mixed picture continued to put pressure on state budgets. In addition, many of the actions that states took to close budget gaps in 2001 and 2002 simply deferred their problems to subsequent years. This resulted in the tax and fee increases noted above, and in the depletion of budget reserves. According to the National Association of State Budget Officers, state budget balances were $48.8 billion in fiscal year 2000. By the end of fiscal year 2003, they had plunged to an estimated $6.4 billion, the lowest level since 1992.[9]

Table 4 Higher Education Spending Cuts and Tuition Increases			
	Fiscal Year		
	2002	*2003*	*2004*
Total State Higher Education Expenditures (billions of dollars)	$63.3	$62.5	$60.5
Percent decrease		-1.3%	-3.2%
	School Year		
	2001-02	*2002-03*	*2003-04*
Median Public University Undergraduate Tuition and Fees	$3,439	$3,825	$4,291
Percent increase		11.2%	12.2%

Source: State Higher Education Executive Officers, "Appropriations of State Tax Funds for Operating Expenses of Higher Educaiton," http://www.sheeo.org/finance/fiscalres.htm; Illinois State University, Center for the Study of Education Policy, "Grapevine," http://www.coe.ilstu.edu/grapevine; U.S. Department of Education, National Center for Education Statistics, Integrated Postsecondary Education Date System (IPEDS), "Fall Enrollment" and "Institutional Characteristics" surveys; 2003-04 College Board Annual Survey of Colleges.

Actions to Close Budget Gaps

States faced aggregate budget gaps of $78.4 billion as they confronted their fiscal year 2004 budgets.[10] They closed some of this gap was closed by using tax and fee increases, budget reserves, tobacco settlement funds, an injection of about $10 billion in extra federal aid, accounting gimmicks such as revenue acceleration and inter-fund transfers, and in some cases (including California) borrowing. State budget cuts also helped close the gaps.

The National Conference of State Legislatures found that states have used a variety of means to bring their fiscal year 2004 budgets back into balance. Thirty-one of 43 states surveyed made spending reductions. Fourteen states made across-the-board cuts, 15 states targeted corrections, 15 targeted Medicaid, and eleven states targeted K-12 education.[11]

Higher Education

Higher education has taken a particularly hard hit. Table 4 shows that states have been reducing spending on higher education while public colleges and universities have been increasing their tuitions and fees. States have cut their higher education spending by 3.2 percent for fiscal year 2004, and tuition and fees have increased by 12.2 percent for the 2003-2004 school year. This was on top of the spending cuts and tuition increases of the previous year. Twenty-six states cut higher education spending in 2004; meanwhile public university tuition and fees increased in all 50 states.

The Prospects for 2004

The sharp decline in revenue in fiscal year 2002 was followed by sluggish revenue growth in fiscal year 2003. States have used much of their rainy day funds and other reserves to close the budget gaps of the last couple of years. They have also used revenue accelerations, spending deferrals, and other one-time gap closers. This effectively delayed many budget problems until the upcoming fiscal year. Even strong revenue collections in fiscal year 2004 are unlikely to enable states to overcome these problems.

In fact, a National Conference of State Legislatures survey reported the appearance of gaps in their fiscal year 2004 budgets between the beginning of that fiscal year and November 2003. Sixteen states reported that revenues are below estimates. The situation is not nearly as bad as it was a year ago, but this is more indication of continuing problems.[12]

Looking to the next fiscal year and new state budgets, the Center for Budget and Policy Priorities has reported that 21 states are already projecting budget gaps for fiscal year 2005 and that states estimated these gaps to range from $31.7 billion to $33.3 billion. California has the largest projected gap, $8 billion or 11 percent of its general fund budget. New Jersey has the largest gap as a percentage of its general fund budget: 17 percent, or $4 billion.[13]

As states begin work on the fiscal 2005 budgets over the next few months, they will once again be faced with either cutting spending or raising taxes. Neither option is popular or easy.

Endnotes

1 National Governors Association and National Association of State Budget Officers, *Fiscal Survey of the States* (Washington, DC, June 2003).

2 The legislative branch estimated a $1.75 billion effect for the New York PIT increases, while the executive branch is using a $1.4 billion estimate. We use the lower estimates in this and all other cases of a conflict.

3 We have included the total effect of Louisiana's November 2002 Amendment 1 in both Table 2 and Table 3. It appears as a $304 million tax cut in 2003 in Table 2, and adds $299 million in tax increases to 2003 in Table 3.

4 National Governors Association and National Association of State Budget Officers, *Fiscal Survey of the States* (Washington, DC, June 2003).

5 National Conference of State Legislatures, *State Budget & Tax Actions: Preliminary Report*, August 28, 2003.

6 Business Cycle Dating Committee, National Bureau of Economic Research, *July 17, 2003 Announcement*.

7 United States Department of Commerce, Bureau of Economic Analysis, "News Release," November 25, 2003.

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

9 National Governors Association and National Association of State Budget Officers, *Fiscal Survey of the States* (Washington, DC, June 2003).

10 National Conference of State Legislatures, *State Budget & Tax Actions: Preliminary Report*, August 28, 2003.

11 Ibid.

12 National Conference of State Legislatures, *State Budget Update: November 2003.*

13 Center on Budget and Policy Priorities, "A Brief Overview of State Fiscal Conditions and the Effects of Federal Policies on State Budgets." October 22, 2003.

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. Emrah Arbak assisted with the collection of data for this report.

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