

U.S. State Tax Policies: What Happens After the Great Depression?

Yuhua Qiao

Political Science Department
Missouri State University
Springfield, MO, United States of America
yuhuaqiao@missouristate.edu

Abstract—This paper examines U.S. state tax actions in the post-Great Recession years and explains the impact on state fiscal sustainability. State legislators in many states have taken tax actions, making an effort to reform their tax systems. Yet the major tax changes came from a handful of states, and overall changes in income tax and sales tax do not show strong evidence that they have improved state fiscal sustainability.

Keywords: state tax actions, fiscal sustainability, Great Recession

I. INTRODUCTION

The 2007-2009 Great Recession delivered a heavy blow to U.S. state government budgets. The immense revenue shortages not only reflected state financial vulnerability to the economic cycle but also exposed their deep-rooted long-term fiscal imbalance. Ten years after the Great Recession, what changes have the state governments made with their tax policies? Has the change led to a sustainable state tax system? This paper will first highlight the impact of the Great Recession on state budgets and the issue of fiscal sustainability. Then the author will present state tax changes in recent years and discuss the impact on the state's long-term fiscal health.

II. THE GREAT DEPRESSION AND ITS IMPACT ON STATE BUDGET

State governments play a crucial role in the U.S. federal system. Their major revenues come from personal income tax (PIT) and sales and use tax (SUT), and they are responsible for many important services citizens use, including highway, Medicaid, public welfare, correction, higher education, and public education. Unlike the federal government, state governments are legally required to balance their operating budgets. While it is always tough to weather any recession, the Great Recession imposed one of the most difficult times in state budgeting history. Revenue collection in mid-2009 was 17% lower than the previous year [1]. Serious revenue shortage persisted in the years immediately after the recession- \$256 billion during FY 2009 - FY 2011 [2]. FY 2010 was the worst year with 49 states facing a total revenue shortfall of \$191 billion, 29% of the state general fund revenue. Arizona's revenue shortfall was 65% of its state budget, California 52%, Nevada 46%, Illinois 43.7%, and New Jersey 40% [3].

At the same time, with the high unemployment rate, demand for public welfare — particularly Medicaid and unemployment insurance — escalated. Though the federal government provided \$245 billion in general fiscal relief, including \$90 billion for Medicaid, the budget gap remained wide [1]. To close the budget gap “states reduced general fund expenditures by \$64 billion over the s two-year period of fiscal 2009 and 2010 and enacted \$39.7 billion in revenue increases.” [4] (p. 7). The cuts fell on nearly every program, including public education [5]. States also used other methods to reduce budgets, including agency consolidation, employee layoffs, furloughs, reduced local aid, decreased state employee benefits and scaled-down services [4]. This paper will focus on the tax changes states have made.

III. FISCAL SUSTAINABILITY AND THE EROSION OF THE TAX SYSTEM

Though the financial crisis is the result of the economic recession, it also exposed the dire long-term fiscal imbalance state governments have been in. Over the decades, state governments have encountered a structural fiscal imbalance, revenue- expenditure gap caused by revenue and spending policies, not by economic downturns. In the past decade policy makers and academia have painfully realized that the fiscal challenges state/local governments are confronting will last not a few years, but decades. They started to frame the discussion from "the broader and long-range perspective of fiscal sustainability" [6] (p. 460). The problems undermining fiscal sustainability lie with both the revenue side and the expenditure side. Several spending pressures have been widely discussed, including Medicaid, public education, public infrastructure, and public pensions [6] [7]. On the revenue side, state and local governments have seen their revenue capability eroded by the obsolete sales tax structure [8], numerous tax credits and revenue caps, and restrictions imposed on governments by voters, among others [9] [10]. Take sales tax for example. It mainly taxes the consumption of physical goods, not of many services. States could not require remote sellers to collect sales tax. Therefore, the significant increase in consumption of services (68% of US GDP) and online sales eroded the sales tax base, causing states to lose billions of revenues every year.

Though academia and policymakers have recognized the state governments are not fiscally sustainable, the Great Recession and its brutal effects on state budgeting highlight the urgency as to how to address the issue. Among the various

responding efforts, some are short-term temporary fixes, but the severe revenue collapse and the prolonged slow recovery forced state lawmakers to go beyond that. However, with economic recovery in recent years, we also observe that elected officials have turned to cut taxes and to delay addressing fiscal problems. So how have states changed their taxes? And have these changes helped restore state fiscal sustainability?

IV. STATE TAX CHANGES

Table I shows that in the eleven years (e.g., 2008 – 2018) under examination, seven years saw net tax increases and four saw net tax decrease (See Column 9). If we look at the years 2008 -2012, there are net increases in four of the five years. FY 2009 saw the largest tax increase since 1991 with the amount of \$28.5 billion or a 3.7% increase over the previous tax collection. Twenty-four states increased taxes that year by more than 1%. This reflects the need for more revenue for the services during the Great Recession and the years after. However, the year 2011 saw for the first time an overall tax reduction since 2001. This is the result of the expiration of several temporary tax increases state legislatures passed in 2009. For instance, the California legislature voted to let the temporary income and sales tax increase expire as planned. In 2012, the net tax increase of over \$4 billion reflected various state tax actions in all tax categories, including California \$5.5 billion income and sales tax increase approved by voters.

However, the subsequent years of 2013 -2018 witnessed either net reduction or small increases except for FY 2017. The relatively large amount of tax increase for FY 2017 is the result of the combined state tax actions, including the large income tax increases in Kansas and Illinois and large corporate income tax increase in Delaware. Both Kansas and Illinois were facing a severe revenue shortage. Delaware reformed its corporate franchise tax [11].

If we look at each individual tax, state governments almost always increase the following taxes: health care tax, tobacco tax, alcoholic beverage tax, and motor fuel tax (See Column 5-8). Only in two years (FY 2012 and FY 2018), the net amount of health care tax declined, and they are the results of single state action. For instance, in 2012, California let the temporary 2.35 percent tax on MediCal managed care plans expire [11]. The story is different for the major taxes (e.g. personal income tax, corporate income tax, and sales and use tax) (see Column 2-4). States tend to increase these taxes only in the recession years or years immediately after the recession as mentioned earlier. During FY 2013-2016, there was a multi-year trend of lowering both personal income tax and corporate income tax. The desire and the tendency to cut tax is always louder than to raise it. State governments tend to increase sales tax more often than income tax. This is because sales tax can be exported to nonvoters. Sales tax is expected to increase in the coming years because in 2018 the U.S. Supreme Court allowed states to require remote sellers to collect sales tax.

Table I provides a general picture of tax changes in all the states. As state governments make their own fiscal policies, the tax actions can differ a great deal from one another depending on their financial stress, their tax structure, the political party of the state leadership, and legal restraints. Over the years, some

states raised their taxes while others cut them. Some reforms are big, while others are minor ones. Table II shows the number of states and the names of those that increased the tax by 1-4.9% and by 5% and more, and those that cut taxes.

Table II shows that 2009 was the year with the largest number of states raising tax revenues and the largest number of states raised the tax revenue with a 5% increase or more. In recent years, fewer states have increased tax with 5% or above. With the economy recovering, states do not have the pressures to raise a large amount of tax revenue. At the same time, more states cut taxes. We also see that in all the years besides 2009 and 2015, more than 30 states do not take any significant actions.

Tables II and III also show that the major tax actions take place in a number of states. For example, the large personal income tax increase takes place in California, Connecticut, Illinois, Kansas, and New York. Large personal income tax cuts occur in Ohio, North Carolina, Indiana, and Missouri. Most states take mixed actions. Over the years 19 states had a net increase in their personal income tax while 24 had a net decrease; 16 had a net increase of the corporate income tax while 22 a net decrease. For sales tax, more states raised than those that decreased it. Many of the tax changes are temporary. Temporary tax increases are easy to approve and can provide the sizeable amount of revenue that the state governments badly need for vital government services. The downside is that the state governments may still face the revenue shortfall upon the planned expiration dates, and they do not correct the structural imbalance.

V. THE IMPACT OF THE REFORMS ON STATE TAX SYSTEM

Based on the above descriptions, the author makes the following observations. First, in the post-Great Recession years, state legislators in many states have taken tax actions, showing an effort to reform their tax systems, Yet the major tax changes come from a handful of states as shown in Tables II and III. Second, facing the dire fiscal situation, state governments will increase taxes. However, without the fiscal pressure, an effort to raise tax is not sustainable as we see the declining number of states raising tax rates and more adding tax breaks and cutting corporate income tax. In the post-Great Recession years, tax cuts are still very popular as the last few years have seen a great deal effort to cut income taxes. This is surprising because many assume that the state officials will learn the lesson from the Great Recession and reform their major revenue taxes to put them on a more fiscally sustainable path. Third, the non-major taxes (e.g., healthcare-related tax, tobacco-related tax, alcohol tax, and motor fuel tax) are easy targets for state governments to increase. However, they are often earmarked for certain programs, and do not improve the general fund health. Fourth, the overall changes in income and sales tax, the major revenue source for state general fund, do not show strong evidence of state fiscal system improvement. Over the years, only a little over half of the states have a net tax revenue increase due to their tax actions and less than half or roughly half states have a net gain in each of the major taxes. Among the tax increases, many are temporary. They expired or will expire. This will not correct the fiscal imbalance. In addition, the tax bases for the major taxes have not broadened very much.

TABLE I. NET STATE TAX CHANGES BY TYPE OF TAX IN MILLIONS OF DOLLARS

Years 1	Personal income 2	Corp income 3	Sales & use 4	Health care 5	Tobacco 6	Alcoholic beverage 7	Motor fuel 8	Net Change	
								\$ Impact 9	% of last year
2018	-44.2	29.6	847.1	-3.8	298.6	0.0	143	1,295.60	(0.14%)
2017	4,333.0	335.4	-1915.2	530.0	47.7	6.9	2,762.0	6,931.8	(.75%)
2016	-884.3	-736.7	788.6	1,348.8	1,008.2	18.2	923.3	2,340.8	(0.3%)
2015	-1,999.8	-514.6	151.5	311.9	547.6	7.7	1,120.2	-324.0	(-0.0)
2014	-2,985.0	-1,150.3	-420.4	520.5	-8.7	0	89	-3121.7	(-0.4%)
2013	-1,956.1	82.1	770.4	474.6	384.4	5.1	-531.9	-978.0	(-0.1%)
2012	2,837.2	822.0	428.1	-393.9	372.4	0.0	-57.1	4,082.3	(4.1%)
2011	2,994.9	-804.9	-5244.7	1955.9	51.9	24.1	12.0	-1,960.4	(-0.3%)
2010	-656.4	494.3	1,736.5	1,298.1	602.7	34.2	48.2	3,959.4	(0.6%)
2009	11,406.1	2,014.5	7,236.5	2,535.4	1,898.2	192.6	1,871.2	28,588.2	(3.7%)
2008	-254.3	2,347.0	688.9	237.2	464.0	141.1	35	3,803.4	(0.5%)

^a. Source: Author's compilation based on *State tax actions: Special Fiscal Report* (a series of reports including 2008-2018) [11]

TABLE II. NUMBERS OF STATES WITH TAX CHANGES

	Increase tax		No significant Changes	Decrease of 1% or more (names of states)
	5% & over (names of states)	1% to 4.9%		
2008	1 (IN)	6	39	4 (GA, NM, ID, OR)
2009	7 (CT, DE, WI, CA, NV, OR, NY)	17	25	1 (ND)
2010	3 (KS, AZ, WA)	9	37	1 (NJ)*
2011	2 (CT, IL)	7	32	8 (ME, NY, MI, OH, IA, ND, NC, CA, WV)
2012	0	3	44	3 (ID, KS, NY)
2013	1(MN)	6	36	7 (AK, AZ, IA, ME, OH, ND, WI)
2014	0	5	41	4 (IL, IN, MN, OH)
2015	3(CT, LA, NV)	12	29	6 (FL, IN, ND, OH, RI, TX, NY)
2016	2 (LA, SD)	4	39	5 (GA, IN, MS, NM, WI)
2017	3(DE, IL, KS)	7	38	2 (NJ, TN)
2018	2 (KS, OK)	6	36	6 (ID, IA, MO, NE, NH, WI)

^b. * **NJ**: This indicates the expiration of a previous temporary tax increase, not the deliberate cut. Sources: The author constructed the table based on *State tax actions: Special Fiscal Report* (a series of reports including 2008-2018) [11].

Instead, more credits are inserted into the tax bases in recent years. One major exception is with the remote sales tax. In 2018 the US Supreme Court struck down physical presence

requirement for substantial nexus. This opened new revenue opportunities for states. Indeed, 34 states have adopted laws to tax remote sales and 10 states have expanded remote sales tax

by the end of 2018. In the years to come, this is an area that we expect state actions [11]. A few states like Kentucky and Connecticut have expanded sales tax to cover more digital goods and more services, but expansion is still difficult in many states.

Public finance literature is consistent that good tax policy is one with a broad base. Though states can reach to remote sales now, the proliferation of tax expenditures with all other areas violates this basic rule. A stable and sustainable tax system hinges on a broad tax base and reasonable tax rates. Yet, only a few states have raised their taxes permanently. It is fair to say that state tax changes in the post-Great Recession years have

only made little progress to improve their long-term sustainability. Many factors explain the tax changes. In examining state tax changes, the dominant one to increase tax is the presence of the fiscal crisis. American anti-tax sentiment and pro-business culture and promoting economic development push for tax cuts. Tax reforms are always difficult because they always have to meet competing goals. The government officials have to be honest with the public, communicating with them about fiscal situations in both the short-run and the long run. This paper has limitations. Due to the limited space, the author is not able to examine tax reforms at the individual state level and to discuss the tax changes from other important perspectives such as equity and economic efficiency.

TABLE III. NUMBER OF STATES THAT INCREASES/DECREASES THE MAJOR TAXES OVER 2009-2018

	PIT	CT	SUT	Three Tax Total
Total amount of increases (in million dollars)	12,720.80	2,916.50	5,034.10	20,671.40
No. of states increase the tax	19	16	27	26
No. of states decrease the tax	24	22	33	20

^c Sources: The author's calculation based on *State tax actions: Special Fiscal Report* [11].

REFERENCES

- [1] T. Gordon, "State budgets in recession and recovery" Brookings Institute, <https://www.brookings.edu/research/state-budgets-in-recession-and-recovery/>, Oct. 27, 2011.
- [2] National Association of State Budget Officers (NASBO), *The Fiscal Survey of State 2009*. National Association of State Budget Officers. <https://higherlogicdownload.s3.amazonaws.com/NASBO/9d2d2db1-c943-4f1b-b750-0fca152d64c2/UploadedImages/Fiscal%20Survey/fsfall2009.pdf>, Dec. 2009.
- [3] P. Oliff, C. Mai, and V. Palacios, "States continue to feel recession's impact," Center on Budget and Policy Priorities, <https://www.cbpp.org/research/states-continue-to-feel-recessions-impact>, June 2012.
- [4] National Association of State Budget Officers (NASBO), "State budgeting and lessons learned from the economic downturn: Analysis and commentary from state budget officers," <https://www.nasbo.org/reports-data/lessons-learned-from-the-economic-downturn>, Summer 2013.
- [5] M. Leachman, N. Aleares, and K. Masterson, "Most state have cut school funding, and some continue cutting," Center on Budget and Policy Priorities, <https://www.cbpp.org/research/state-budget-and-tax/most-states-have-cut-school-funding-and-some-continue-cutting>, Jan. 2016.
- [6] R. B. Ward, and L. Dadayan, "State and local finance: Increasing focus on fiscal sustainability," *Publius*, vol. 39, no. 3, pp. 455-475, Summer 2009.
- [7] J. I. Chapman, "State and local fiscal sustainability: The Challenges." *Public Administration Review*, Special issue, pp. 115 -131, Dec. 2008.
- [8] R. Tannewald, "Are state and local revenue systems becoming obsolete?" *National Tax Journal*, vol. 55, no. 3, pp. 27-43, Sept. 2001.
- [9] I R. Zahradnik, I. J. Lav, and E. McNichol, "Faulty foundations: State structural budget problems and how to fix them" Center on Budget and Policy Priorities, <http://www.cbpp.org/files/5-17-05sfp.pdf>, May 2005.
- [10] Y. Qiao, "Voter initiatives and their impact on state budget balance" *Journal of Budgeting, Accounting & Financial Management*, vol. 27. No. 1, pp. 1-36, 2015.
- [11] National Conference of State Legislature, *State Tax Action: A Special Report*, series from 2009-2018.