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# State Tax Changes During 2010

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## Introduction

While at the federal level officials and stakeholders debated whether to extend all of the 2001-03 tax cuts, at the state level the debate turned more on balancing budgets. Due to a combination of improving revenues and growing political opposition to increased state-level taxes and additional federal aid to states, 2010 proved to be a lighter year on state-level tax changes than anticipated. But as temporary federal stimulus aid ends in mid-2011 and with many states still not balancing their projected revenues with desired expenses, 2011 may be a year of dramatic tax increases.

The Fiscal 2011 budget year began for most states in mid-2010. While 25 states initially budgeted for the receipt of additional federal aid that was not forthcoming, slowly increasing tax receipts and some efforts to tackle programmatic spending have eased pressure on many states. The U.S. Census Bureau reported in December 2010 that state and local tax revenues for the third quarter were up 5.2% over the third quarter the previous year, marking the fourth consecutive quarter of positive

## Key Findings

- *Due to a combination of improving revenues and growing political opposition to increased state-level taxes and additional federal aid to states, 2010 was a lighter year on state-level tax changes than anticipated. But as temporary federal stimulus aid ends in mid-2011 and with many states still not balancing their projected revenues with desired expenses, 2011 may be a year of dramatic tax increases.*
- *In addressing gaps between desired spending and projected revenues, state officials have relied on three choices: raise taxes, roll back spending growth commitments made during previous years and take actions to spend no more than the state brings in, or use one-time funds and accounting gimmicks to paper over the current state budget shortfall, without significantly curtailing spending.*
- *Most of the states that raised taxes in 2010 have aimed the increases at specific groups, such as high-income earners, smokers, or out-of-state business transactions. These revenue sources may provide short-term relief but can cause harm to the state economy in the short and long term.*
- *State policymakers should learn two lessons from California: revenue surges in good times will not continue indefinitely, and the more reliant a state is on high-income earners, the bigger hit it will sustain when those revenue surges eventually end.*

growth. For the twelve months ending September 2010, total state and local tax revenue was $1.278 trillion, a level second only to the 2008 peak of $1.307 trillion. (See Table 1.)

*Table 1*

*Total State and Local Tax Revenue (in $ millions)*

| Twelve-Month Period Ending | State & Local Tax Revenue | Year-over-Year Growth |
|---|---|---|
| September 2010 | $1,278,397 | 1.77% |
| September 2009 | $1,256,121 | (3.93%) |
| September 2008 | $1,307,489 | 4.09% |
| September 2007 | $1,256,083 | 5.57% |
| September 2006 | $1,189,853 | 7.66% |
| September 2005 | $1,105,199 | 7.19% |
| September 2004 | $998,198 | 7.78% |
| September 2003 | $926,161 | 3.67% |
| September 2002 | $893,395 | 0.21% |
| September 2001 | $891,557 | 3.45% |

Source: U.S. Census Bureau.

At the same time, rainy day funds are mostly depleted and states are overrelying on one-time and emergency budget solutions.

In addressing gaps between desired spending and projected revenues, state officials must make serious choices. One option is to raise taxes. Officials generally claim that the budget cannot or should not be cut any further, and that the benefits of tax increases for the state budget outweigh the economic damage they can do in an economic downturn. Most states taking this option have aimed their taxes at specific groups, such as high-income earners, smokers, or out-of-state business transactions. Some states have raised the sales tax. These revenue sources may provide short-term relief but can cause harm to the state economy in the short and long term.

Another option is to roll back spending growth commitments made during previous years and take actions to spend no more than the state brings in. Some states have resisted the urge to patch their budgets with one-time revenue sources, instead focusing on balancing structural revenues with structural expenses. Arkansas, for instance, uses an innovative priority-based budgeting system. Indiana officials cut spending and assumed no extension of federal aid.

The third and politically easiest option is to use one-time funds and accounting gimmicks to paper over the current state budget shortfall, without significantly curtailing spending. This irresponsible approach amounts to hoping that the economy will soon recover and bring a surge of tax revenue. California is the poster child of this approach, building for several years up to a crisis in 2009 when the state issued IOUs, borrowed, seized funds from local governments, and enacted requirements that companies increase withholding to 110% of what workers owed (in essence an interest-free loan to the state). Illinois may have surpassed California at fiscal irresponsibility by simply refusing to pay months' worth of bills. Another notable example is Kentucky ordering 180 days of school instruction but funding only 179 days.

Below are key changes that states made to their tax systems during 2010.

## State Changes to Individual Income Taxes

### *Individual Income Tax Increases*

- **Oregon** voters on January 26 approved Measure 66 by a margin of 54% to 46%, ratifying an income tax increase retroactive to January 1, 2009. The new brackets are 10.8% on income over $125,000 and 11% on income over $250,000. After 2011, the new 10.8% rate will drop to 9.9%, and the 11% bracket will be eliminated. Oregon's 11 percent personal income tax is now tied with Hawaii's for the highest rate in the country. Because its capital gains tax rate is linked to the income tax, Oregon's tax on investment gains is also the nation's highest.

- "Oregon Referendum Could Reinstate Higher Income Tax Rates," http://www.taxfoundation.org/research/show/25680.html (1/7/10)

### *Individual Income Tax Decreases*

- **California**'s across-the-board addition of 0.25% to each tax bracket will expire on schedule on December 31, 2010, after existing for two years. The top rate will drop from 10.55% on income over $1 million to 10.3%. Newly elected Gov. Jerry Brown (D) has proposed a ballot initiative to re-enact the higher rates.
  - "A Golden Opportunity: California's Budget Crisis Offers a Chance to Fix a Broken Tax System," http://www.taxfoundation.org/research/show/24712.html (5/18/09)
  - "New California Governor Proposes Initiative to Extend Tax Increases," http://www.taxfoundation.org/blog/show/26938.html (1/3/11)
- **Maryland**'s top income tax rate of 6.25% on income over $1 million expired as planned on December 31, 2010. The tax had been enacted on a temporary basis in 2008. Newly re-elected Gov. Martin O'Malley (D) opposes the extension of the tax. The City of Baltimore increased its income tax from 3.05% to 3.2%, effective January 1, 2011.
- **New Jersey**'s "millionaire's tax" income tax rates, with a top rate of 10.75%, were allowed to expire as scheduled on December 31, 2009, despite calls to renew them. Governor Chris Christie (R) vetoed a bill to do so in June 2010. The new top rate is 8.97%, matching New York.
  - "New Jersey Millionaire's Tax," http://www.taxfoundation.org/blog/show/26454.html (6/21/10)
- **North Carolina**'s tax surcharge of 2% on those with incomes over $60,000 and 3% on those with incomes over $150,000 expires on December 31, 2010, after existing for two years.
  - "North Carolina Reportedly Reaches Budget Deal," http://www.taxfoundation.org/blog/show/24965.html (8/3/09)
- **Ohio** postponed for one year a planned 4.2% reduction in income tax rates, due to begin in January 2010. This income tax reduction will now occur in January 2011.
- **Rhode Island** on June 5 passed a new tax reform that goes into effect January 1, 2011, eliminating the optional flat-tax method of preparing individual income taxes, reducing the number of tax brackets from five to three, and lowering the top income tax rate, from 9.9% to 5.99%.
  - "Rhode Island Officials Consider Tax Reform," http://www.taxfoundation.org/research/show/26374.html (6/2/10)

### *Other Individual Income Tax Developments*

- **Maine** voters in June 2010 approved Question 1 by a margin of 61% to 39%, repealing a year-old law that would have replaced its four-rate income tax structure, which has a top rate of 8.5%, with a flatter income tax and a top rate of 6.85%. The new system would have taken effect January 1, 2010, but was suspended until the referendum. Maine thus reverted to its existing income tax structure.
  - "Maine Rejects Tax Reform Measure," http://taxfoundation.org/blog/show/26409.html (6/9/10)
- **Washington** voters in November 2010 rejected Initiative 1098, which would have instituted an income tax in the state but only on high-income earners.

- "Washington Voters to Consider High-Earner Income Tax," http://www.taxfoundation.org/research/show/26803.html (10/26/10)
- "Washington Voters Again Reject State Income Tax," http://www.taxfoundation.org/blog/show/26826.html (11/3/10).

## State Changes to Sales Taxes

### *Sales Tax Increases*

- **Arizona** voters approved Proposition 100 in May by a margin of 64% to 36%, increasing the sales tax by one percentage point, from 5.6% to 6.6%, effective June 1, 2010. This is a temporary increase lasting three years, although a similar sales tax increase in 1983 was made permanent before it expired.
  - "Arizona Votes Today on Sales Tax Increase," http://www.taxfoundation.org/blog/show/26324.html (5/18/10)
- **Kansas** in its Fiscal Year 2010 budget increased its sales tax rate from 5.3% to 6.3%, starting July 1, 2010.
  - "Kansas Legislation Calls for Tax Increases," http://www.taxfoundation.org/blog/show/25957.html (3/9/10)

### *Sales Tax Decreases*

- **Arkansas** decreased its sales tax on groceries. They will now be subject to a 2% rather than 3% tax rate.
- **Massachusetts** approved a ballot initiative in November to eliminate its sales tax on alcohol sold in stores, effective January 1, 2011.

### *Other Sales Tax Changes*

- **California's** sales tax is scheduled to drop by 1 percentage point on July 1, 2011, as a temporary tax expires. Newly elected Gov. Jerry Brown (D) has proposed a ballot initiative to extend the tax.
  - "New California Governor Proposes Initiative to Extend Tax Increases," http://www.taxfoundation.org/blog/show/26938.html (1/3/11)
- **Click-through nexus/"Amazon" taxes. Colorado** approved H.B. 1193, a tax law designed to compel out-of-state businesses to collect the state's use tax from consumers. The law requires out-of-state online retailers to identify their in-state customers, with costly non-compliance penalties. As predicted, upon enactment of this law, out-of-state retailers terminated affiliate relationships within the state and some have launched a legal battle to challenge the law. A similar regulation in **North Carolina** has been invalidated on First Amendment grounds. **New York**, **Rhode Island**, and **North Carolina** have standard Amazon taxes that impose the obligation directly. The legal fight over New York's law continues.
  - "'Amazon Tax' Laws Signal Business Unfriendliness and Will Worsen Short-Term Budget Problems," http://www.taxfoundation.org/research/show/25949.html (3/8/2010)
  - "New York Court Sends 'Amazon Tax' Case Back for More Information, http://www.taxfoundation.org/research/show/26829.html (11/4/10)
  - "ACLU Joins Fight Against North Carolina 'Amazon Tax' Disclosure Demands," http://www.taxfoundation.org/blog/show/26461.html (6/24/10)
  - "Colorado's Amazon Tax: It's an Amazon Tax," http://www.taxfoundation.org/blog/show/25961.html (3/10/10)
- **Sales tax holidays.** Nineteen states held sales tax holidays for 2010 (Alabama, Connecticut, Florida, Illinois, Iowa, Louisiana, Maryland, Massachusetts, Mississippi, Missouri, New Mexico, North Carolina,

Oklahoma, South Carolina, Tennessee, Texas, Vermont, Virginia and West Virginia). This compares to 16 states in 2009 and 17 states in 2008. Compared to 2009, four states added a holiday (Florida, Illinois, Maryland, and Massachusetts) and one state dropped its holiday (Georgia). Some sales tax holidays apply broadly to all purchases, but most are targeted to exempt clothing, school supplies, computers, or Energy Star products.

- "Sales Tax Holidays: Politically Expedient but Poor Tax Policy," http://www.taxfoundation.org/publications/show/26533.html (7/26/2010).

- **Legalizations.** Rhode Island legalized fireworks on June 14 ahead of July 4, a move that boosted sales tax revenue by approximately $500,000.

## State Changes to Corporate Income Taxes

### *Rates*

- **Kansas** reduced its corporate income tax rate from 7.05% to 7.00%, effective tax year 2011.
- **Massachusetts** reduced its corporate income tax from 8.75% to 8.25%, effective tax year 2011. It will drop further to 8.0% in 2012.
- **Ohio**'s corporate franchise tax completed its five-year phaseout in 2010, being replaced in full by the Commercial Activities Tax (CAT) on gross receipts.

### *Other*

- **Iowa's** Supreme Court agreed with a Department of Revenue ruling imposing the state's corporate income tax on businesses with sales in Iowa but no property or employees in Iowa. Generally, states adhere to a "physical presence nexus" rule for their corporate income tax.
- **Connecticut** implemented a broad version of this economic nexus standard in January 2010, without limits to particular types of activity or including a *de minimis* threshold.
- **Washington** also adopted an economic nexus standard in June 2010 for its Business & Occupation (B&O) gross receipts tax.
  - "Iowa Reaching Beyond Borders with Corporate Income Tax," http://www.taxfoundation.org/blog/show/26939.html (1/3/11)

## State Changes to Excise Taxes

### *Cigarette Taxes*

The federal cigarette tax is $1.0066 per pack of 20 cigarettes, and each state levies a tax in addition to this. Seven states have increased cigarette taxes so far in 2010, compared to 18 states in 2009. Hawaii is the only state to raise the tax in both 2009 and 2010, and will raise it again to $3.20, effective July 1, 2011.

- **Hawaii**: from $2.60 to $3.00
- **Minnesota**: from $1.50 to $2.46
- **New Mexico**: from 91 cents to $1.66
- **New York**: from $2.75 to $4.35
- **South Carolina**: from 7 cents to 57 cents
- **Utah**: from 70 cents to $1.70
- **Washington**: from $2.025 to $3.025

### *Taxes on Soda*

- **Colorado** in May removed sugared beverages and candy from the list of groceries that were exempt from the sales tax.
- **Mississippi** is also considering legislation to tax syrup used to sweeten soda at the distributor level.
- **New York** again considered a tax on sugary sodas, attracting much national attention before the idea was shelved in March.

- **Washington** enacted a new soda tax, adding 2 cents to every 12 oz. can, and extended the sales tax to candy, but voters repealed it at the ballot box. (Tax increases on beer and phones lines remain in effect.)
- The **District of Columbia** also considered a soda tax, but ultimately removed soda from the list of exempt groceries.

### *Gasoline Taxes*

Many states regularly adjust gasoline excise tax rates with changes in inflation and prices. These minor changes are excluded from this list. However, a notable change in this regard was in **Nebraska**, where the combined gasoline taxes rose to 28 cents per gallon (up 0.3 cents) from July 1, 2010 to December 31, 2010, and will drop to 27.3 cents effective January 1, 2011.

- **California** reduced its state sales tax on gasoline (separate from the gasoline excise tax) from 8.25% to 2.25% (excluding local sales taxes and state revenue directed to local governments), replacing it with an increase of 17.3 cents in the gasoline excise tax, to 35.3 cents per gallon. This complex "gas tax swap" took effect on July 1, 2010, for the purpose of negating a ballot-approved requirement to spend on public transit the revenue from the state sales tax on gasoline.
- **Minnesota**'s gasoline excise tax went up slightly from 27.1 cents to 27.5 cents, effective July 1, 2010. It will go up further to 28.0 cents on July 1, 2011.
- **Oregon**'s combined gasoline taxes go up from 25 cents to 31 cents on January 1, 2011.

### *Multistate Lotteries*

**Eleven states** (Georgia, Illinois, Maryland, Massachusetts, Michigan, New Jersey, New York, Ohio, Texas, Virginia, and Washington) began selling Powerball tickets in 2010, following a cross-selling agreement between the two multistate jackpot games Powerball and Mega Millions, bringing the total number of Powerball states to 42. California is the only state with a lottery that is not participating.

In addition, 29 states joined Mega Millions: Arizona, Arkansas, Colorado, Connecticut, Delaware, Idaho, Indiana, Iowa, Kansas, Kentucky, Maine, Minnesota, Missouri, Montana, Nebraska, North Carolina, North Dakota, New Hampshire, New Mexico, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Vermont, Wisconsin and West Virginia. The only lottery states not participating in Mega Millions are Florida and Louisiana. In tax terminology, the "profit" generated when states monopolize gambling operations is best categorized as a selective sales tax on the tickets.

## Other State Tax Changes

### *Film Tax Credits*

State governments have paid billions of dollars in tax incentives to motion picture and television production companies over the past decade, with the number of states offering such programs growing dramatically from five in 2002 to 44 in 2009. The year 2010 saw the first-ever decline, as four states (Arizona, Iowa, Kansas, and New Jersey) suspended or ended their programs. The Wisconsin program has also been severely capped, with a $500,000 limit. Other states, notably Rhode Island, considered similar suspensions or eliminations but did not enact them. At the same time, urged by Gov. Bob McDonnell (R), Virginia added a $2.5 million program to begin in 2011.

State officials are increasingly recognizing that film tax credit programs do not pay for themselves, routinely overstate their economic and job creation benefits, have great potential for abuse and waste, and are a priority for government spending. It has also become increasingly difficult to outbid a few states with preposterously generous programs (particularly

Louisiana, Michigan, and New York) for productions. A Tax Foundation report in early 2010 outlined these issues.

- "Movie Production Incentives & Film Tax Credits: Blockbuster Support for Lackluster Policy," http://www.taxfoundation.org/publications/show/25706.html (1/14/10)
- "States Slashing Film Tax Subsidies," http://www.taxfoundation.org/blog/show/26865.html (11/24/10)
- "Virginia to Offer Tax Credits for Movie Production," http://www.taxfoundation.org/blog/show/26276.htmll (5/4/10)
- "Map: Film Tax Credits by State, 1992-Present)," http://www.taxfoundation.org/taxdata/show/26243.html (4/20/10)
- "Corruption and Abuse in Iowa's Film Tax Credit Program," http://www.taxfoundation.org/blog/show/25210.html (9/22/09)

### *Energy Taxes*

- **Hawaii** enacted a $1 per barrel tax on all petroleum products imported into the state, for the purposes of funding alternative energy development and food safety.
- **Wyoming** will be placing a tax on wind energy beginning in 2012. The Wyoming Legislature passed a $1 per megawatt hour wind energy generation tax and allowed a sales tax exemption for renewable energy projects to expire at the end of 2011.

### *Estate Taxes*

- **Hawaii** in June re-enacted its estate tax, which had been dormant since 2005. On April 30, the Legislature overrode a veto by Governor Linda Lingle (R) and imposed a tax on estates of Hawaii residents over $3.5 million ranging from 0.8% to a 16% rate on estates over $10.1 million. Nonresidents receive a reduced exemption, paying estate tax on as little as $60,000 of property.
- **Rhode Island** raised its exemption level from $675,000 to $850,000, effective January 1, 2010.

## Lessons: Real Tax Reform Means Spending Restraint and Broad Tax Bases with Low Rates

With state revenues declining due to the tough economic situation, many state leaders in 2010 sought to tap high-income earners, smokers, out-of-state business transactions, or other targeted groups, those being the only people that politicians feel safe raising taxes on. But the increases have come from a minority of states, and others should be cautious about enacting substantial tax increases on anyone in the midst of a recession.

High-income people have much more volatile income than middle-income wage-earners, largely because capital gains and business income are sensitive to changes in the economy and fluctuate rapidly. Relying too heavily on these sources of income for tax revenue leads to unpredictability in tax revenues in the long run, with revenues surging in good economic times and plunging in bad. Increasing the progressivity of a state's tax system will exaggerate these effects, and states need to consider this when evaluating their fiscal situations.

When deciding in which state to live or locate their business, one of the factors that top earners must weigh is the marginal tax rate they will face in each state. While high statutory tax rates on high incomes may bring a revenue increase in the short term, they can harm long-term economic growth as providers of jobs and capital choose to locate in lower-tax states.

California has experienced these problems firsthand. Even before the recent tax increases, California had relied heavily on taxing the capital gains, wages and dividends of high-income individuals. When state revenue surged during the prosperous economic times in the middle of the decade, lawmakers responded by increasing spending levels to match those revenue surges. Each year between 1999 and 2003, California general fund spending ranged between $71 billion and $75 billion. But encouraged by rapidly increasing revenues, legislators increased spending to $99 billion by 2007, a 31% increase over 2003. During the same period inflation increased 12% and the state population grew just 5%.

But decreasing spending is not nearly as easy as increasing spending, and when revenues fell California was left with a budget shortfall that has been estimated to be as high as $40 billion. Reluctant to cut spending but apparently wary of becoming any more reliant on volatile revenue from high-income earners, the legislature passed a broad-based income tax increase. Even with the tax increase and additional spending cuts, the shortfall still stands at tens of billions of dollars.

In addition to the volatility and spending issues, California's business environment has consistently ranked in the bottom five in the Tax Foundation's *State Business Tax Climate Index*.

The lesson to be learned from California is twofold: revenue surges in good times will not continue indefinitely, and the more reliant a state is on high-income earners, the bigger hit it will sustain when those revenue surges eventually end. Therefore, legislators should adopt wise spending and tax policies that recognize and prepare their states for these economic realities.

## Conclusion

When the recession ends, states need to have the right policies in place to promote economic growth and maintain revenue stability. Relatively high taxes on high-income individuals, smokers, and out-of-state business transactions can make a state less attractive and create more volatility in an already uncertain economic climate.

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