Taxes on the Horizon?

History suggests states often turn to tax increases in painful post-recession periods.



BY RON SNELL

ill states raise taxes in 2011?

Many governors have sworn they won't, and it's unlikely legislatures would even consider tax increases with the threat of a veto hanging over them. Anti-tax sentiment, partisan politics and the pain tax increases can inflict all argue against hikes.

But not so fast. A new study by the National Conference of State Legislatures shows a close link between recessions and tax increases, particularly in the years after recessions have ended. The effects of recessions linger and that's when states increase taxes.

So tax increases, however reluctantly approved, remain a distinct possibility during this post-recessionary year.

TAX DELAY

Although state tax increases usually closely follow recessions, legislators try to delay them as long as possible for several good reasons.

- ◆ Tax increases can have a damaging effect on consumers and businesses already experiencing falling incomes.
- ◆ Raising taxes can make policymakers appear to be insensitive to their constituents' economic distress.
- ◆ Policymakers don't want to act prematurely. If they increase taxes in a downturn that proves

to be short and shallow, this pre-emptive action could be interpreted as an overreaction.

Lawmakers prefer to respond to falling revenues by reducing or postponing expenditures, tapping into reserves and finding ways to postpone tax increases.

BALANCING ACT

As legislators know very well, state fiscal conditions do not respond immediately to the end of a recession.

About 70 percent of state tax collections are from taxes that respond quickly to the economic cycle—the general sales, personal income and corporate income taxes.

When consumer and business spending slows, for example, states feel the pain pretty quickly. Similarly, personal income tax withholding on wages and salaries also is a sensitive indicator.

The other portions of the personal income tax base and the corporate income tax respond more slowly to changing economic conditions. Every April, when the previous year's tax obligations are resolved, the final numbers indicate current economic trends.

State tax responsiveness to economic conditions can extend the damage to state finances after a recession ends. Even with a recovery underway, persistently high unemployment can drag down growth in personal income, consumption and corporate profits, and thus slow growth in state tax collections.

After the recession of 1990-1991, the national unemployment rate stayed above the 1990 level of 5.6 percent until 1995. After the 2001 recession, employment did not return to the level of 2000 until 2006. The end of the 2007-2009 recession similarly has been followed by a very slow recovery, with employment remaining well below pre-recession levels. Earnings, personal consumption and construction—three sources of tax growth in good times—only have begun to affect state revenue collections.

In addition to economic conditions, the other driver of post-recession tax increases is state governments' commitments to balance their budgets, whether an annual or biennial cycle. States go to heroic lengths to avoid borrowing for operating expenses, even if they do not always succeed.

States usually balance their responses to budget gaps with a combination of budget cuts and revenue increases, but when budget cuts go deeper than the public will tolerate, raising taxes becomes a viable response.

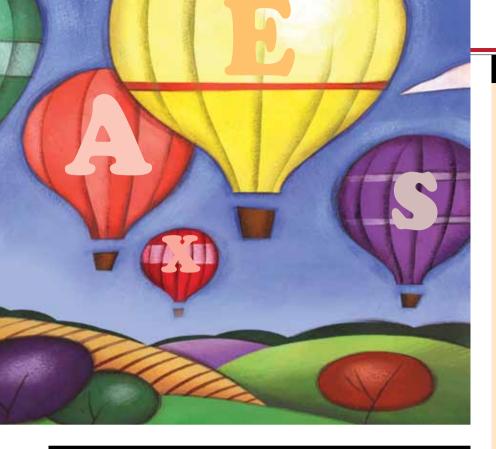
Since 1988, states reached that situation after the recessions of 1990-1991 and 2001. The depth and persistence of the latest recession brought states to that place in 2009, and its lingering aftermath could conceivably return them there in 2011.

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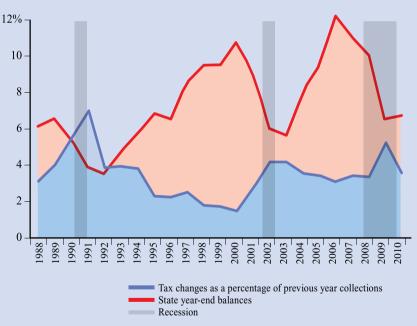
Read the full report, "NCSL Fiscal Brief: How State Tax Policy Responds to Economic Recessions," at www.ncsl.org/magazine.

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30 STATE LEGISLATURES APRIL 2011



THE UPS AND DOWNS OF STATE TAXES



Enacted Changes in State Taxes by Year of Enactment and State Year-End Balances 1988–2009

The chart shows state tax changes enacted between 1988 and 2010, a period that included three recessions. Recessions are indicated by vertical gray. The blue line shows state tax changes as a percentage of previous-year collections. The red line shows state year-end balances. Year-end balances are a reliable indicator of state fiscal conditions; rising state balances indicate favorable fiscal conditions, and falling balances reflect the opposite. Year-end balances include what's in states' general funds at the end of a year with their rainy-day funds.

This chart indicates significant tax increases occurred while balances were falling, or shortly after they had fallen, during the last three recessions.

RESPONDING TO RECESSIONS

This breakdown of the nation's past three recessions shows how lawmakers responded with tax policy.

RECESSION: JULY 1990—MARCH 1991: State year-end balances—the amount in state general funds at the end of a year combined with any rainy-day funds—peaked at the end of FY 1989, which was June 30, 1989, for 46 states. This high point came at the end of legislative sessions in which lawmakers collectively increased taxes by about 0.6 percent. As the country entered the recession in 1990, balances continued to fall, and legislators responded with tax increases averaging 3.4 percent.

In 1991, state fiscal conditions continued to deteriorate, and state officials enacted the largest collective state tax increase on record, 5.4 percent, effective in FY 1992. State year-end balances continued to fall well after the end of the recession, and hit their lowest point on record in June 1992 at 0.6 percent. States had no more appetite for tax increases in 1992, after which state finances began a recovery that lasted into 2000.

RECESSION: MARCH—NOVEMBER 2001: State year-end balances hit what was then a record high of 10.4 percent at the end of FY 2000. The downturn that began in March 2001 was sharp but short. Year-end balances fell to 4 percent at the end of FY 2002. By the time the recession began, policymakers had cut taxes for six years in a row, and continued with very modest cuts in 2001.

State fiscal difficulties lingered after the recession ended, causing state year-end balances to fall further in FY 2003. In their 2002 and 2003 sessions, legislators enacted tax increases that were modest in comparison to those of the early 1990s: 1.6 percent of previous-year collections each year. Recovery benefited state budgets in the following years, and year-end balances hit a new record high of 12.3 percent by the end of FY 2006.

RECESSION: DECEMBER 2007—JUNE 2009: The latest recession lasted longer than its two predecessors combined, and longer than any 20th century recession except the big one from 1929 to 1933.

State year-end balances fell slightly from their FY 2006 high by the end of FY 2007, but remained at almost 11 percent. Legislatures enacted relatively small tax increases in 2007 and 2008: 0.6 percent and 0.5 percent of collections, respectively.

By the time legislatures convened in 2009, the devastating impact of the recession on tax collections was clear. Balances at the end of FY 2009 were lower than they had been since 2004, and state officials responded by enacting the largest collective tax increases since 1991.

APRIL 2011 STATE LEGISLATURES 31