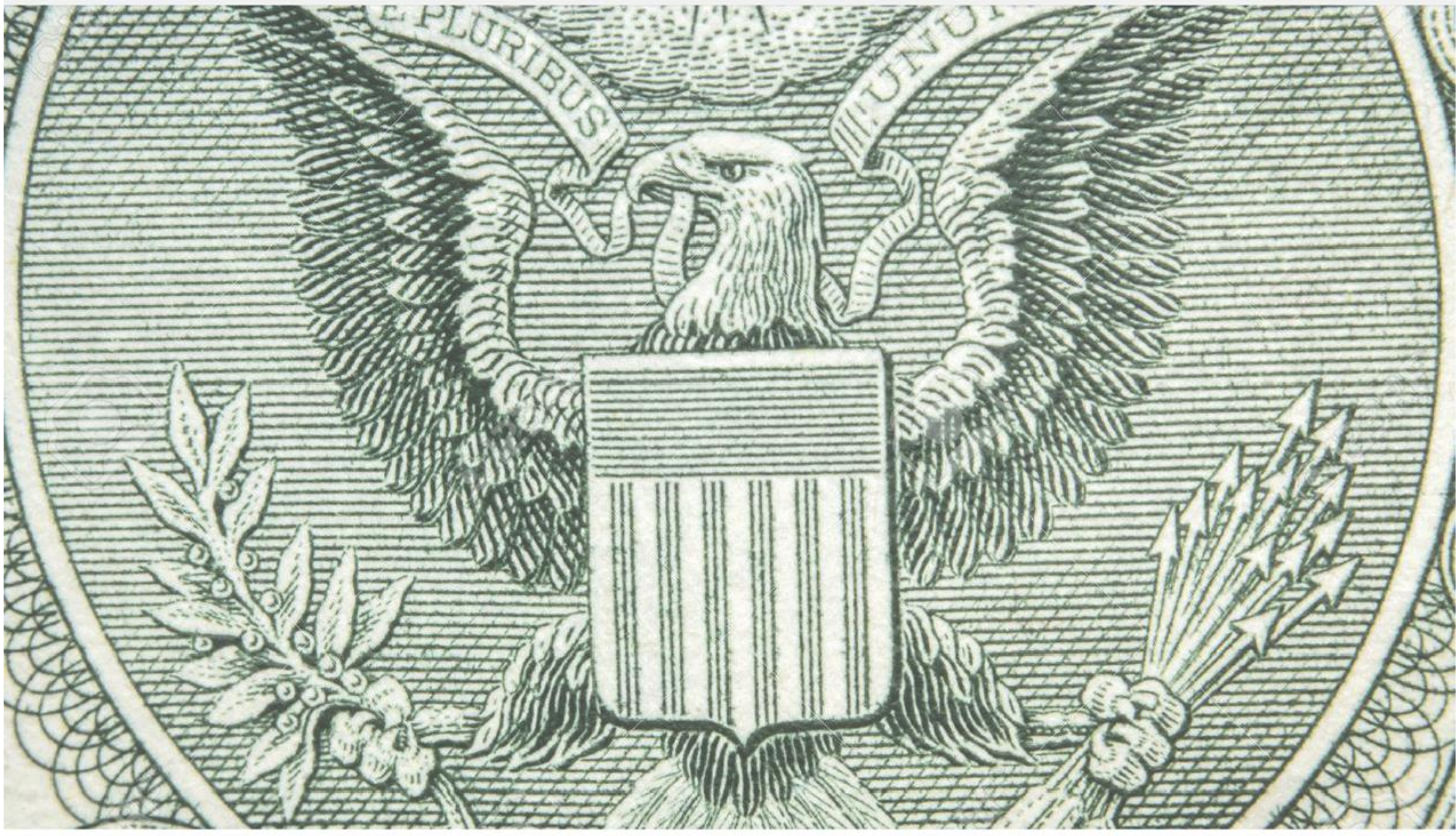
FISCAL BRIEF

State Fiscal Responses During the Last Downturn



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While the spread is still very much in progress, the impact COVID-19 has had on the American economy is unprecedented. The gears of production are grinding to halt as businesses close and workers across the nation engage in social distancing to stop the spread of the virus. Short- unemployment rates are skyrocketed. According to S&P Global Ratings: "While economic data for March is just starting to be released, the severity of the blow from the coronavirus leads us to believe that the U.S. is entering recession--if not already in one." As if this wasn't enough, an ongoing global oil price war, somewhat hidden from the headlines in the midst of the ongoing public health crisis, is wreaking havoc on America's energy sector.

While the full economic ramifications of these disruptions are still unknown, it is safe to say that state coffers will soon be under significant distress. Most major revenue sources will be impacted. Decreased consumer spending will mean lower sales tax revenues. Travel restrictions will result in lower collections for lodging, car rental, and other tourism-related taxes. Job losses and reduced economic activity will reduce personal income and corporate income tax collections. The fall of the stock market will reduce capital gains collections. Lower oil prices and fewer drivers on the road will reduce gas tax collections. The damage to the oil and gas industry will significantly affect severance tax-reliant states. Gambling tax receipts are sure to be down as casinos across the country close their doors.

Some state revenue problems are more immediate than others. While the federal government has sought to provide relief to taxpayers by delaying the filing and payment deadlines, this will have a significant effect on state FY 2020 budgets. Most states automatically couple their income tax deadlines to the federal government's. According to the Federation of State Tax Administrators, "the shift from April 15 to July 15 is pushing revenues from the current fiscal year, where they have already been budgeted, into the next fiscal year. That budget issue is difficult, but the loss of cash flow is creating the larger crisis. States had counted on receiving many billions of dollars in income tax reconciliation payments during April, money that had been budgeted for everything from paying taxpayer refunds to paying the state's share of Medicaid. That loss of cash on hand cannot be replaced easily or cheaply." Difficult times are ahead, and states will need to respond as quickly and effectively as possible.
While the current fiscal crisis is unique, it may be helpful to revisit revenue actions during the Great Recession as states once again chart a course towards recovery. NCSL tracked state fiscal actions at the time through databases and our State Tax Action reports.

Budget Cuts

States are limited in their ability to provide fiscal stimulus during economic downtimes. Unlike the federal government, most states have balanced budget requirements and cannot engage in deficit spending. While the federal government is responding to the current crisis by increasing spending to stimulate the economy, states will likely be forced to reduce spending to ensure it does not outpace revenue.

Twenty-nine states had to resort to across-the-board budget cuts in fiscal years 2010 and 2011. Spending cuts will be more difficult in 2020 than they were during the last downturn. According to the Pew Charitable Trusts, "spending levels in many areas that were cut to free up cash during the Great Recession are still not back to pre-2008 levels. For example, adjusting for inflation, state funding for higher education is still down 13 percent from pre-recession levels, and infrastructure spending is at its lowest point relative to gross domestic product in 50 years." State government employment has been greatly reduced since the last downturn, too. There were 132,000 fewer state government employees in 2018 than there were in 2008.

Rainy Day Funds

The majority of states had to turn to rainy day funds or other special funds to make up for significant budget gaps during the Great Recession. As the National Association of State Budget Officers has noted, these funds were not sufficient to maintain budget stability and most states burned through their reserves in a few months. The good news for states is that many enter the current downturn with generally strong reserve levels and have implemented a number of reforms over the last several years. Overall rainy day fund levels have never been higher.

Use of Temporary Taxes, Targeting High-Income Taxpayers

States tend to increase taxes in economic downtimes to boost revenues and meet required spending amounts. In 2009, in response to the Great Recession, 24 states raised taxes by more than 1% of all revenues, and only one state cut them. Twelve more states raised taxes significantly in 2010, while only one cut them.

The personal income tax was a go-to revenue-raising tool for many states, with several targeting higher-earners. Between FY 2010 and FY 2010, at least ten states increased personal income tax rates, with eight of them targeting the increases towards those with high or relatively high incomes. In many cases, these rate increases were temporary. Several states also increased taxes on capital gains and repealed or reduced available deductions, as well. It may be harder for states to raise rates on high-earners this time around, as the federal Tax Cuts and Jobs Act of 2017 eliminated the deduction for state and local taxes paid, and thus increased the relative burden of state income taxes on wealthier taxpayers.

Broadening the Sales Tax Base

At least 19 states turned to the sales tax to plug budget gaps after the last recession. A few states raised sales tax rates, but most state actions involved broadening the base, eliminating exemptions and vendor compensation fees, and pursuing revenues lost to internet sales. Similar revenue raising opportunities exist for state sales taxes in 2020 and the current fiscal crisis may accelerate sales tax modernization efforts. Much has been made of the fact that state sales taxes generally fail to tax consumption of services and digital products and several states have targeted these potential revenue sources in recent years. Fortunately, most states are now able to collect sales tax on internet sales made by remote retailers, which seem likely to spike in the midst of social distancing requirements.

Business Tax Reform, Elimination of Deductions and Exemptions

Between FY 2010 and FY 2012, several states turned to businesses taxes for revenue. A few states, including North Carolina, Nevada, Oregon and Delaware increased businesses taxes. Several states broadened the base by modifying deductions for net operating losses and reduced or deferred tax credits. A bit later in the recovery, states began seeking business tax relief/reform measures to spur economic growth. In 2011, 20 states cut business taxes or expanded tax credit programs.

Sin and other Excise Taxes

Excise taxes and tourism taxes were also used to help make up shortfalls during the last recession. Between FY 2010 and FY 2012, at least 8 states enacted measures to expand casino gambling or lottery offerings to generate more revenue, four states increased rental car taxes, five states increased motor fuel taxes during this time, and twelve raised significant amounts of revenue by increasing fees tied to licensing, registration, and permitting.

Sin taxes proved to be a popular source of revenue as well. At least 25 states raised taxes on alcohol or tobacco products between FY 2010 and FY 2012 (21 raised tobacco taxes, 11 raised alcohol taxes). Again, in some cases, the new taxes or surcharges were applied only temporarily. Emerging revenue sources like marijuana and electronic cigarettes will likely attract increased attention from states that have not yet chosen to legalize and tax these products.

The current fiscal picture for states is still highly uncertain and changing quickly. Former deputy comptroller of Texas, Billy Hamilton, has advised that: “States should pour all the resources they can into fighting the pandemic, but they also need to make sure the tax and spending decisions made in all areas of the budget are consistent with a sustainable and resilient fiscal structure able to handle the unexpected in the future.” As they collectively move to address coming budget challenges, states should continue to learn from and coordinate with each other to develop the most informed and effective solutions possible.

NCSL Contact:

Jackson Brainerd, 303-856-1346