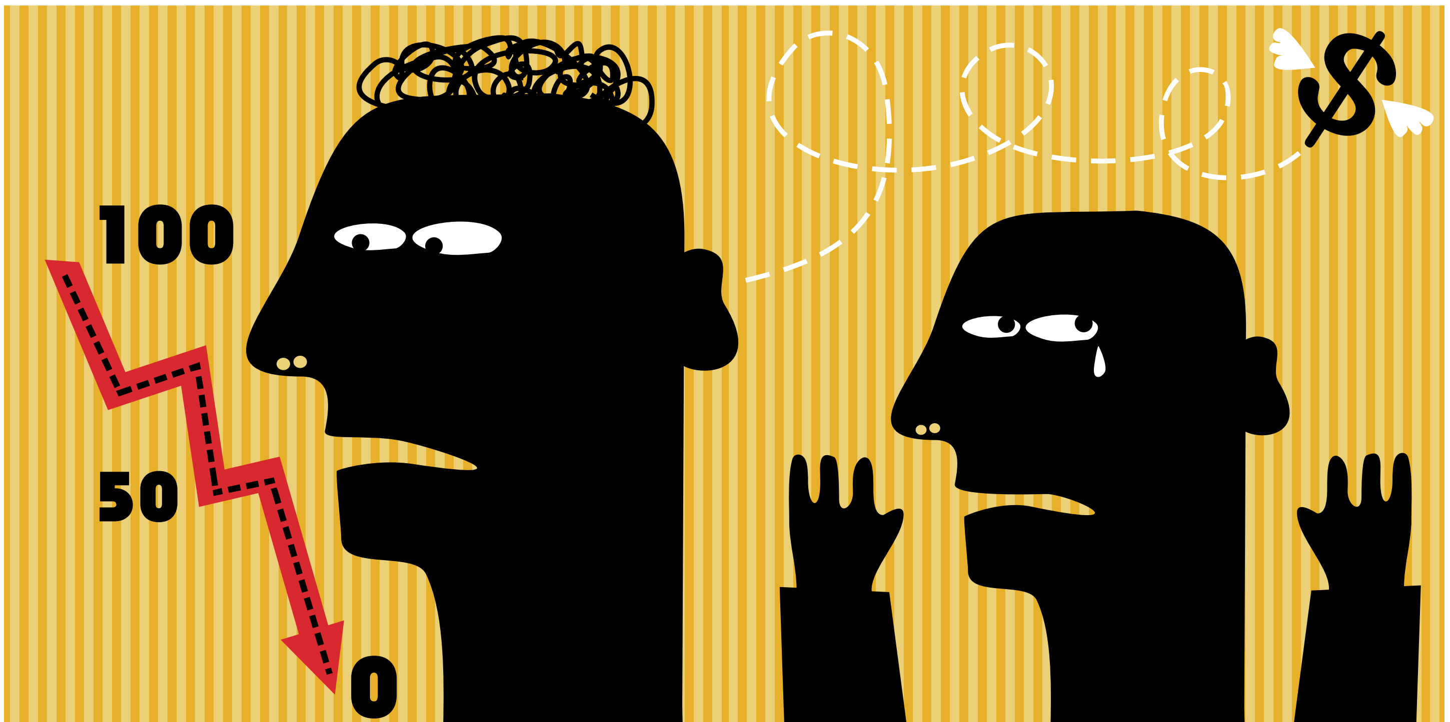
Tax Trends From the Recession

The Great Recession and slow recovery forced states to adjust their tax policies to survive the budget shortfalls.



BY MANDY RAFOOL

For state budgets, the fiscal challenges of the Great Recession have been enormous and widespread. And their effects linger today.

Although revenues began to dry up in 2008, the severe drought began in 2009 and continued into 2010. No matter how pessimistic forecasts were, actual revenue collections were even worse, over and over and over again. Lawmakers scrambled to address not only lower revenue growth rates, but also year-over-year declines in actual collections. The picture improved slightly in 2011 and 2012 as states reported slow but steady revenue grow.

Now, in most states, revenue growth has finally returned to the peak levels of 2008, eliciting a different emphasis in tax policy debates.

Mandy Rafool is a tax expert in the NCSL fiscal affairs program.

With all the tax talk swirling around state capitols, it's worth taking a look back at five tax trends that emerged from the economic downturn as lawmakers struggled to fill severe budget shortfalls. Many continue to have an impact today.

1. Targeting High-Income Earners

New Jersey lawmakers authorized the first "millionaire tax" back in 2004. But it wasn't until the Great Recession that the trend toward targeting higher incomes began in earnest.

Maryland, followed by California, kicked off the wave of income tax hikes on high earners in 2008. On incomes greater than $1 million, Maryland increased the tax rate and California applied a new surcharge. In 2009, nine more states (Connecticut, Delaware, Hawaii, Maine, New Jersey, New York, North Carolina, Oregon and Wisconsin) raised personal income tax rates on high earners, often for a limited time.

But a high-income resident in one state wasn't necessarily considered so in another. The definition of "high income" varied greatly. In Delaware, for example, tax rates were raised on anyone earning more than $60,000. For joint filers, the high-income range varied from $100,000 in North Carolina to $1 million in Connecticut. In Hawaii, lawmakers added a top tax bracket for incomes greater than $200,000 ($400,000 joint), and increased its rate, along with two other brackets.

The New York Legislature created two new temporary tax brackets on high-income earners and limited itemized deductions for taxpayers making more than $1 million. In 2012, the state targeted taxpayers earning more than $10 million by further limiting the itemized deductions for charitable donations they can claim.

In 2012, Maryland again raised tax rates on high-income residents in addition to reducing personal exemptions. Also in 2012, California voters approved a ballot measure to raise taxes on the wealthy for seven years by creating four new high-income brackets, starting at $250,000.

2.
Taking the Temporary Tack

During these tough years, state lawmakers often chose to levy tax increases on a temporary basis—just long enough for the economy to grow and revenue collections to recover. In addition to all the temporary taxes on high-income earners, states enacted other short-term increases on personal and corporate income, sales and other business taxes.

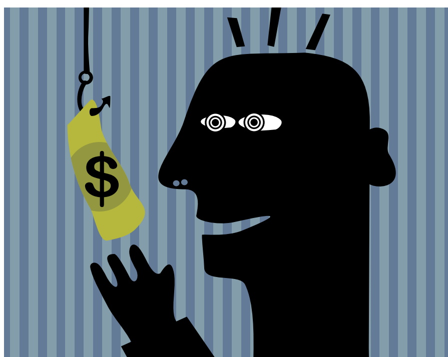
Delaware and Nevada, for example, temporarily raised business taxes in 2009. Lawmakers in Delaware let them expire early, while Nevada extended its increases.

Legislators in Kansas and North Carolina chose to increase sales tax rates temporarily—three years in Kansas and two years in North Carolina.

California raised nearly $1 billion in 2008 when it suspended for two years the net operating loss corporations were allowed to carry forward. In 2009, the state raised both personal income and sales tax rates for two years. Although both rate increases expired as planned in 2011, voters last November approved raising the sales tax rate again for four years.

In Arizona, voters approved a three-year hike in the state sales tax rate in 2010, but rejected a measure to extend it in 2012.

3.
Focusing on Businesses



Between 2008 and 2012, as unemployment rates around the country reached double digits, lawmakers in several states—Arizona, Florida, Indiana, Kansas, Massachusetts, Michigan, Missouri, New York, North Dakota, Texas and West Virginia—concentrated on adjusting business taxes to help sustain jobs.

Michigan—no stranger to reforming business taxes—was one of a few states that made comprehensive changes. Its rather interesting business tax history starts in 1975, when the state adopted the Single Business Tax. Essentially a value-added tax, it lasted more than 30 years until deductions, exemptions and credits eroded the tax base so much that it lost its original value-added intent. It became so complicated and unpopular with the business community that lawmakers replaced it with the Michigan Business Tax, a modified gross receipts tax, in 2007. But it turned out to be just as complicated and even more unpopular than its predecessor. So in 2011, during the slow economic recovery, the Michigan Legislature replaced it with a simple, flat, 6 percent corporate income tax rate and kept only one small business credit.

Elsewhere, states continued the decade-long trend to change corporate income tax formulas to weigh sales more heavily. Business income traditionally has been calculated based on the percentage of sales, tangible property and payroll the business had in the state compared to other locations. In recent years, there has been a shift away from this formula to one that weighs sales more heavily. This provides a benefit to in-state companies that have large investments in payroll and property, and increases the amount of income apportioned from out-of-state companies that sell within the state.

4.
Turning to Health Care Providers

A number of states also considered taxes and fees on health care providers and the health care industry. Because the federal government matches Medicaid spending, most states raised these taxes and fees to cover higher costs caused by an increasing demand for services, as well as to maximize the federal match. In addition, the 2009 federal stimulus bill temporarily made the federal match rate more generous, providing even more incentive.

The new health care taxes ranged from nursing facility taxes to hospital assessments to health provider taxes. In 2008, health care provider taxes brought $237 million more to states. One year later, that number jumped to $2.5 billion, and in 2010 and 2011, remained around $1 billion.

5.
Cutting Back on Exemptions and Credits

Lawmakers in many states also examined tax breaks already on the books and chose to close some loopholes.

For example, Colorado eliminated sales tax exemptions on cigarettes, candy, soda, carry-out

containers and condiments used to serve food at restaurants. Lawmakers also suspended, for up to three years, several additional sales tax exemptions and the senior homestead property tax exemption.

Connecticut expanded its sales tax to several previously exempt services, including pet grooming, spa treatments, cosmetic surgery, motor vehicle towing and yoga classes. Illinois also expanded its sales tax, adding sweetened tea, candy, and grooming and hygiene products to the taxable list.

In 2011, Rhode Island extended its sales tax to nonprescription drugs, travel and tour company products, and prewritten downloaded software. This followed a major income tax reform measure a year earlier that reduced 20 income brackets to three, eliminated itemized deductions, increased the standard deduction, and reduced the number of income tax credits.

What's Ahead?

States, buffeted by the most severe economic storm in generations, found ways to survive while revenues shriveled up. Today, as the fiscal drought clears, tax reform is high on lawmakers' agendas across the country. Numerous tax reform proposals have been introduced in at least 35 states, ranging from eliminating income taxes altogether to replacing the gas tax. Yet to date, only three states—Alaska, New Mexico and Virginia—have passed reforms.

But the year's not yet over. With around 20 states still in session, tax policy will continue to be debated, and perhaps enacted, in more states before the end of the year.

For tax preparers, it's simply job security.

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