Economic Conditions and State Tax Policy: Experience over the Last Decade and Implications for the Future

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Over the last decade or so, state governments have taken on more responsibility for administering social welfare programs. Thanks to abundant federal aid, a robust national economy, and a decline in the number of participants in some social programs, most states have had the resources to fund social programs at or above historical levels. But what will states do when the economy inevitably slows down?

Much can be learned from studying the past. Despite many important changes, the political, economic, and social forces that have shaped state policymaking for decades persist. In fact, the best predictors of states’ future policy choices are those they have made in the past.

This brief reviews a decade’s worth of data on changes in state income and sales taxes, investigating how state tax policy has responded to the business cycle and discussing long-term trends in the relative use of the sales and income taxes from 1988 through 1998.

Before this research, Dye and McGuire (1999) investigated the relationship between states’ real tax revenues and gross state products (GSP) from 1977 to 1996. They found that tax revenues increased and decreased less than proportionately with economic growth. On average, for the United States as a whole, a 1 percent increase in GSP was associated with only a 0.27 percent increase in sales tax revenues and only a 0.66 percent increase in income tax revenues. Dye and McGuire (1999)

“infer from these results that the positive relationship between the bases of the various taxes and GSP . . . is greatly muted [by policy changes].” Inference is necessary because Dye and McGuire did not have access to direct evidence about tax policy changes.

Tax Policy Data Sources

The complete, though still imperfect, data set assembled for this study contains direct information about state tax policy changes from 1988 to 1998. The data come from publications of the National Conference of State Legislatures (NCSL) and the National Association of State Budget Officers (NASBO). Both organizations track legislated changes in tax policy on a regular basis. The NCSL gains information from regular surveys of legislative staff in each state capital, while NASBO utilizes its contacts with state budget officers to get reports of tax changes. Both sources provide a brief description of each tax change and an estimate of its revenue implications.

Because tax changes are numerous and complex, and because revenue can be quite difficult to forecast, both data sources are imperfect. Tax changes reported in one source may appear in a different year, or not at all, in the other. Even when both sources record the same policy change in the same year, they sometimes give different descriptions of the change and may present revenue estimates that
differ by millions of dollars. Despite these differences, the two sources present a very compatible picture of tax policy changes over this particular business cycle.

**Economic Growth and Tax Revenue**

Before examining recent tax policy changes, it is important to briefly review data about recent economic growth and tax revenue changes. Figure 1a shows the rate of change in real per capita general sales tax revenues and personal income in the 50 states for each calendar year from 1989 through 1998. The decade started off poorly, with a very low rate of change in 1990 and a decline in average per capita income in 1991. After a brief respite in 1992, income growth dipped again in 1993; from 1993 through the end of the decade, however, income growth accelerated.


A comparison of figures 1a and 1b reveals that from 1989 through about 1994, the relationship between the growth in income tax revenue and income is similar to the relationship between the growth in sales tax revenue and income. Income tax revenue growth tracked with income growth early in the decade. In 1993, however, income tax revenue surged while income growth lagged. Furthermore, while sales tax revenue grew at about the same rate as income after 1994, income tax revenue grew much more rapidly.

**Tax Change Patterns**

The relationship between income and tax revenues depends, in part, on the design of the tax system and changes in tax policy undertaken in response to changing economic conditions. The changing relationship between income and sales and income tax revenues can be better understood by scrutinizing the timing and magnitude of states’ legislated tax policy changes. Figures 2a through 2d show the number of states enacting sales and income tax increases and decreases in each year from 1988 through 1998. Regardless of whether the NCSL or the NASBO data are used, the pattern of tax changes is similar. During the slow-growth years of 1988 through 1993, many states enacted sales and income tax increases. The NASBO data show that of the 45 states with a sales tax, the number enacting increases peaked at 20 in 1990; the NCSL data show that the number peaked at 22 in 1992 (figure 2a). Both data sets show a rapid decline in the number of states with sales tax increases later in the decade and not a single state enacting an increase in 1998.

The pattern of sales tax cuts for this decade (figure 2b) is virtually a mirror image of the sales tax increases (figure 2a). Very few states enact-
ed sales tax cuts during the slow-growth years prior to 1993. As the economy picked up speed in the late 1990s, however, many more states cut sales taxes. The peak was apparently reached in 1997, when between 16 and 21 states enacted measures to reduce sales taxes.

The income tax story is similar, as shown in figures 2c and 2d. Both NASBO and NCSL data show a dramatic increase in the number of states enacting income tax increases early in the decade, with increases peaking in 1992 and declining steeply thereafter. Fewer than 14 states a year lowered income taxes through 1994, but in the latter half of the decade income tax cuts were widespread. The peak was reached in 1998, when at least 27 of the 43 states with income taxes enacted tax reductions.

These data confirm Dye and McGuire's (1999) conclusions. During difficult economic times, states often legislate tax increases to create additional revenues, even through standard macroeconomic theory suggests that to do so will dampen economic activity and prolong the economic doldrums. So when the rate of economic growth increased after 1993, states increased their frequency of tax cuts. These state tax cuts could be expected to further ignite economic activity, potentially leading to an inflationary spiral.

Although the general patterns of legislated income and sales tax changes were parallel, there are very important differences in the way states behaved vis-a-vis these two taxes. The income tax cuts of the late 1990s effectively rolled back most of the increases imposed early in the decade, but legislated sales tax cuts were much smaller than earlier sales tax increases. Despite this legislative pattern, shown in figures 1a and 1b, income tax revenue growth greatly exceeded sales tax revenue growth. In fact, income tax revenues in 1998 exceeded sales tax revenues. This was the first year since 1947 that sales taxes were not the top state revenue producer (Mikesell 2000).

The dollar values of state sales and income tax increases and cuts are shown in figures 3a through 3d. Again, our two data sources show

**FIGURES 2A–2D.**
similar trends, although they certainly differ in the details. In most years, NASBO data show smaller increases and cuts than NCSL data. Regardless of which source is used, however, the value of reported legislated sales tax increases was significantly more than $1 billion in each year from 1990 through 1995. This greatly exceeds the value of sales tax cuts, which were less than $1 billion in every year of the decade. In contrast, the value of legislated income tax increases, which peaked at more than $5 billion (using either data set) in 1992, exceeded $1 billion in 6 of 11 years according to NCSL data and 4 of 11 years according to NASBO data. However, legislated income tax cuts were also quite large, averaging more than $2 billion per year from 1996 through 1998 (both data sets).

Overall, legislated changes over the entire decade increased real per capita income tax revenues about 4 percent and real per capita sales tax revenues about 10 percent. Yet sales tax revenues continued to slide as a share of state revenue, despite these large legislated increases. The reason for this is the long-term decline in the sales tax base due to changes in the nature of economic activity, particularly the increase in purchases of services (which usually are not taxed) and interstate sales that are technically taxable but often go untaxed in practice. Future growth of e-commerce is likely to further accelerate the decline of the sales tax base (Bruce and Fox 2000).

Conclusions
Over this 10-year period, states responded to economic doldrums by legislating both sales and income tax increases. When the economy improved, income tax increases were largely rolled back while many of the sales tax increases were left in place. Despite this pattern, sales tax revenues grew less than income tax revenues because of long-term declines in the sales tax base (see Merriman 2000 for further details).

As states gain more flexibility in how they design their social programs and take on greater responsi-

**FIGURES 3A–3D.**
bility for financing them, options expand. States may raise taxes when needs increase, or states may use their flexibility to scale back their funding commitments. While the course states will take cannot be known, many states have demonstrated a widespread willingness to take legislative action to increase income and sales tax revenues when economic growth slows. They also have been willing to cut taxes when conditions improve. In the past, states have been able to spread tax changes between their two major revenue sources: the income and the sales tax. In the future, pressure on the income tax may increase, since the sales tax’s importance is diminishing as a source of revenue. Furthermore, sales tax rates have now been pushed so high that further increases may have significant deleterious effects. Thus, in the next recession, states wishing to enhance tax revenue may find their legislative options limited to income tax increases.

Endnotes
1. The data on legislated sales and income tax changes reported in this brief were taken from The Fiscal Survey of the States (National Governors’ Association and NASBO) (1987–1997) and NCSL’s Legislative Finance Papers (1987–1989), State Budget and Tax Actions (1990–1991), and State Tax Actions (1992–1997). The revenue effect of each change was taken directly from these reports. Legislated changes that canceled planned policy changes were included only if they represented a change relative to 1988 tax policies. Changes enacted over a period of years were recorded as a series of changes in each year of the period. State tax changes due to federal tax reform (i.e., to comply with federal tax code) were treated in the same manner as other state policy changes. Retroactive changes were included only when a specific dollar amount was given for previous years. Tax changes subject to voter approval were not recorded unless later books confirmed enactment.

2. We use per capita income rather than GSP because the most recent GSP data available, as of May 2000, are for calendar year 1997. In general, there is a close correlation between GSP and per capita income.

3. This pattern is apparently not unique to the current business cycle. Kee and Shannon (1992) argue that the state and local sectors always grow during recessions.

4. More details on this calculation are given in Merriman (2000).

References


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This series is dedicated to the memory of Steven D. Gold, who was codirector of Assessing the New Federalism until his death in August 1996.

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