



Governing with Tight Budgets

Long-Term Trends in State Finances

Norton Francis and Frank Sammartino

September 2015

The tenuous balance between revenues and outlays in state finances is becoming more precarious. On one side of the ledger, the growth in the traditional sources of state revenue is slowing down; on the other, expenditure growth is poised to accelerate. As a result, states will increasingly face more difficult annual budget challenges as they attempt to satisfy balanced-budget requirements.

Changing demographics, technology, and inflation are driving these divergent fiscal trends. An aging population puts more pressure on spending programs while reducing tax revenues from some sources. State sales tax revenue systems have not kept up as technology has changed the marketplace. Costs of government programs keep rising, particularly health care, while inflation erodes excise tax revenue. States must face these emerging pressures as they continue to recover from the Great Recession. To keep a functioning government, legislators will need to make difficult tradeoffs between revenue increases and spending cuts.

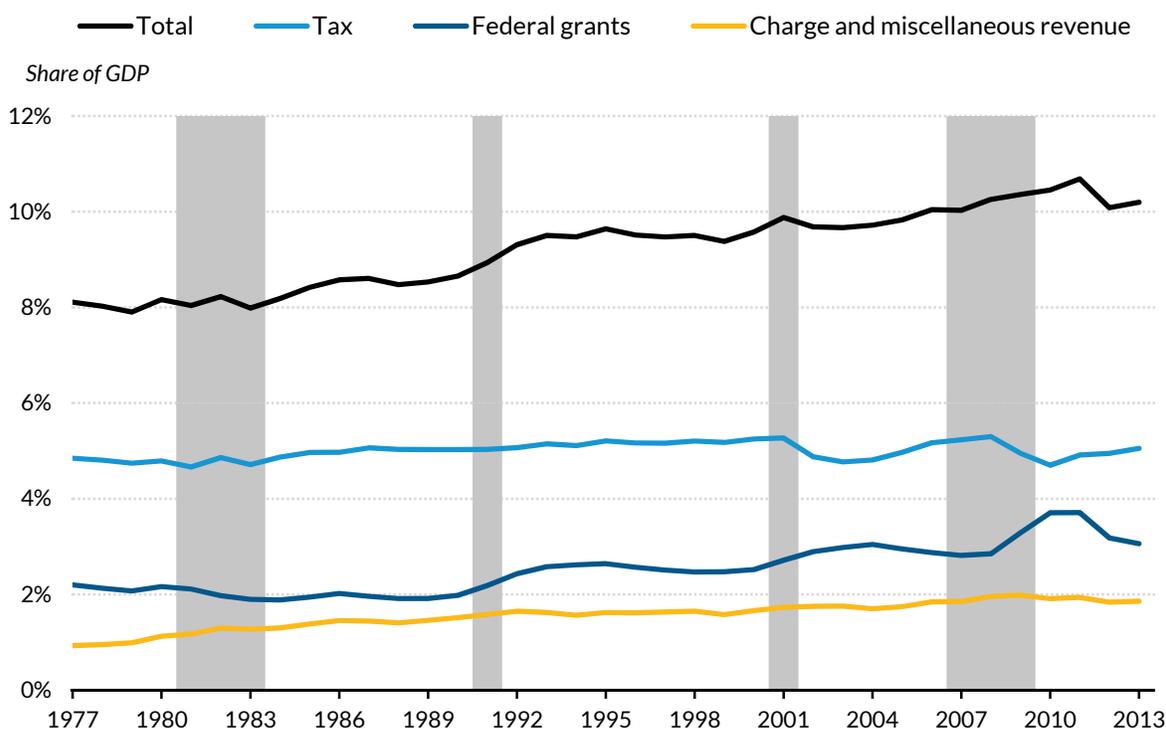
This brief examines the history and outlook of state revenues and expenditures with particular attention to the effects of the last recession on state fiscal policy. The first section discusses trends in state revenues and the second focuses on trends in state expenditures. The final section examines the outlook for state finances. Data for the analysis come from the US Census Survey of State and Local Finances, augmented with data from other federally collected sources as noted.¹ Only state-level finances were analyzed.²

Revenues

State general revenues grew over the past 35 years from 8 percent of national gross domestic product (GDP) in 1977 to 11 percent in 2011 before dipping to just over 10 percent in 2013 (figure 1).³ State tax revenues have remained reasonably stable at 5 percent of GDP throughout the period, although they temporarily dipped below that level in the 2001 and 2007–09 recessions. Charges and miscellaneous revenue doubled from 1 percent of GDP to 2 percent. The rest comes from federal transfer payments, which were about 2 percent of GDP through the 1980s, climbed to about 3 percent of GDP during the 1990s and early 2000s, and now provide about 30 percent of all state revenues.

FIGURE 1

State General Revenue Trends



Sources: Census Survey of State Government Finances; Bureau of Economic Analysis.

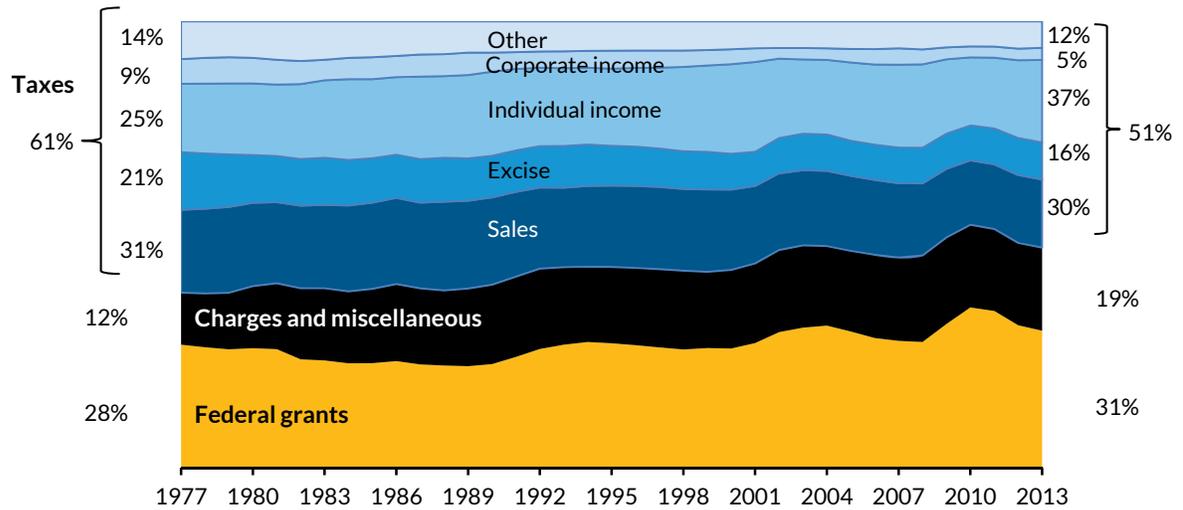
Notes: Shaded areas indicate recessions.

The composition of state general revenue has changed over the past three decades as states have become more reliant on federal grants and nontax revenue. The share of state revenue coming from taxes dropped from 61 percent in 1977 to 51 percent in 2013, while the share coming from federal grants climbed from 28 percent to 31 percent (figure 2). About three-quarters of federal grants to the states are for education and welfare. Among taxes, states are increasingly reliant on the individual

income tax. From 1977 to 2013, the share of individual income tax revenue rose from 25 percent to 37 percent.

FIGURE 2

Share of State Revenues 1977-2013



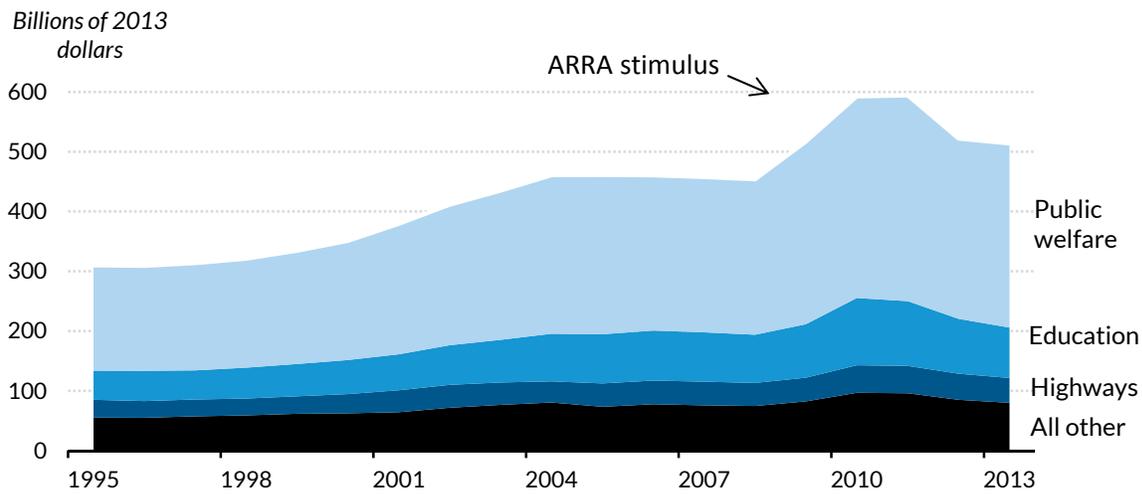
Source: Census Survey of State Government Finances.

Federal Grants to States

Federal grants crept up over the last few decades, with much of the growth in social programs (figure 3). The American Recovery and Reinvestment Act of 2009 dramatically increased federal grants to states using Medicaid education and infrastructure programs as primary vehicles for distributing economic stimulus to the states. Federal spending accounted for one-third of state revenue from 2009 to 2013, when states were receiving stimulus grants.

FIGURE 3

Federal Transfers to State Governments, 1995–2013



Sources: Census Survey of State Government Finances (public use data file); Bureau of Labor Statistics (Consumer Price Index).

Charges and Miscellaneous Revenues

Charges and miscellaneous revenues climbed from 12 percent of state revenues in 1977 to 19 percent in 2013. From 1995 to 2013, charges grew 6 percent annually. College tuition and fees accounted for half of charges in 2012 and has been growing about 6 percent annually. The next-largest component, public hospital charges, which accounts for 30 percent of charges, has grown 7 percent annually.⁴ The share of miscellaneous revenue rose in 2000, when states began receiving payments from the tobacco company master settlement agreement.⁵ In recent years, interest earnings, historically the largest share of miscellaneous revenue, has suffered because states spent down fund balances to shore up government services during the recession and because interest rates have been at historic lows. Peaking at \$48 million in 2008, interest earnings were \$32 million in 2013, a 32 percent decline.

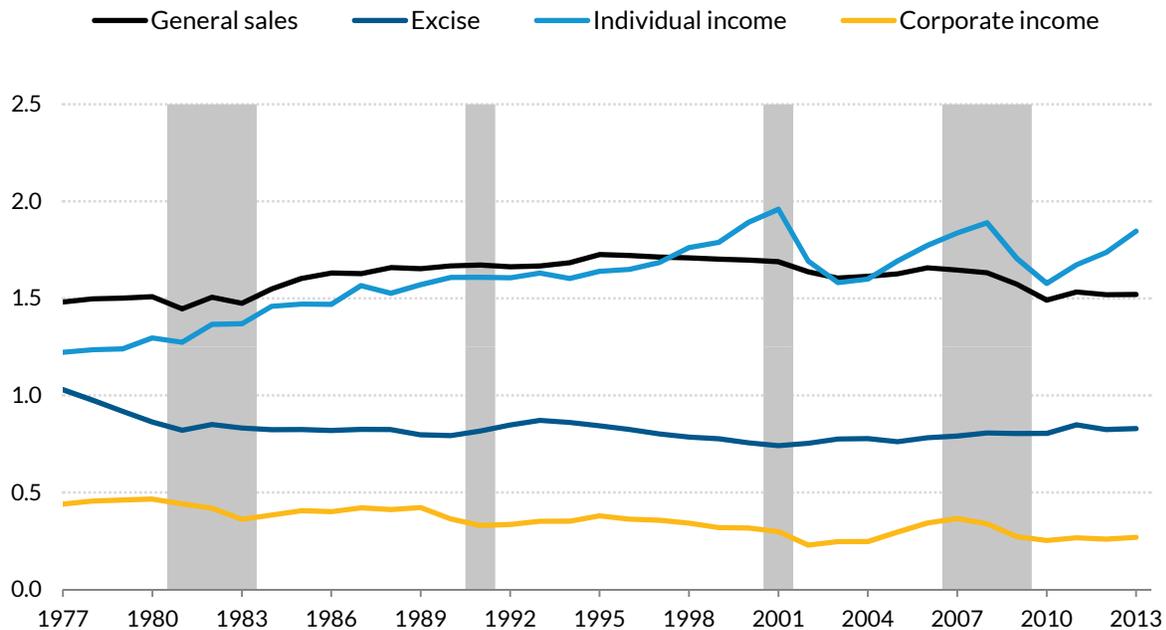
Taxes

Taxes are the largest source of state revenues, accounting for 51 percent of general revenues in 2013. This share is down from 61 percent in 1977, reflecting states' growing reliance on federal revenue and charges and miscellaneous revenues in place of tax revenues. As a share of the economy, state tax revenue has been consistently about 5 percent since 1977, but the mix of tax revenue has changed subtly.

As a share of the national economy, state individual income tax revenue grew from about 1 percent of GDP in 1977 to a peak of 2 percent in 2001 (figure 4). Corporate income tax, always the smallest source of tax revenue, declined as a share of GDP throughout the 1980s and 1990s. General sales taxes

rose as a share of GDP until about 1995 and have drifted downward since then. Excise taxes have remained relatively constant after falling during the late 1970s and early 1980s.

FIGURE 4
Major Sources of Tax Revenue as Share of GDP



Source: Census Survey of State Government Finances.

Notes: Shaded areas indicate recessions.

Individual Income Tax

Individual income tax revenues account for 37 percent of state tax revenue, up from 25 percent in 1977. Individual income tax collections were mostly responsible for the two periods of noticeable tax revenue volatility—after the 2001 recession and during the Great Recession—reflecting the volatility of investment income and the recently tepid growth of wages and salaries. Income tax revenue grew from just over 1 percent of GDP in 1977 to just under 2 percent in 2001. Volatile capital gains and other stock market-related income during and after the dot-com bubble in the late 1990s led first to a rapid increase in income tax revenue and then to a rapid decline in 2001, when the bubble popped.⁶

The individual income tax is a popular target for cuts when revenue is strong. States typically make small changes, such as exempting active-duty military pay or allowing a new or larger deduction. Until recently, few states attempted major individual income tax cuts. Alaska, with revenue gushing from its oil fields, repealed its income tax in the 1970s. A handful of states cut rates significantly in the 2000s. New Mexico cut its top rate from 8.2 percent to 4.9 percent over six years. Oklahoma cut its top rate

from 7.0 percent to 5.5 percent. And since the Great Recession, Idaho, Kansas, Louisiana, North Carolina, Rhode Island, and Wisconsin have all enacted significant individual income tax reductions, and Oklahoma has cut its rate even more to 5.0 percent. The zeal for income tax cuts in particular comes from a belief that cutting taxes on income will grow the economy (Gale, Krupkin, and Rueben 2015).

General Sales Tax

Sales taxes account for about 30 percent of state tax revenue, about the same as in 1977. Though general sales taxes were the largest source of state revenue 30 years ago, they are now eclipsed by individual income tax revenue. General sales taxes grew slightly faster than the national economy from 1977 to the mid-1990s, but they have declined as a percentage of GDP since then. That decline came as consumption moved toward transactions that often escape taxation in most states. Individuals shifted consumption from goods to services, and they increased their consumption at Internet retailers, many of whom do not collect sales taxes. From 1984 to 2012, consumer expenditures on generally tax-exempt items increased from 34 percent to 40 percent.⁷ In 1998, nonstore retailers, which includes electronic commerce and mail order retailers (e.g., Amazon or the J. Crew mail order catalog), accounted for about 10 percent of commonly taxable retail trade, and online commerce accounted for just 3 percent of the sector's sales.⁸ By 2013, nonstore retailers accounted for just under 20 percent of retail trade, 63 percent of which were online sales.

To mitigate the erosion of the tax base, 38 of the 45 states with a general state sales tax increased their tax rates between 1984 and 2014. Only Colorado, Connecticut, and South Dakota lowered their rates over that period. But the rate changes have not kept up with changing consumption. As a result, states have begun aggressively going after industries most affected by technology, like online travel companies and Internet retail companies that use local affiliates to market websites. The Streamlined Sales and Use Tax Agreement, a cooperative effort to simplify state and local sales tax collection and administration, is another strategy states are using to collect sales tax owed. The agreement, with 24 full-member states participating, is voluntary on the part of retailers unless Congress enacts legislation that allows states to require remote vendors collect the tax.⁹

Excise Taxes

Excise taxes account for 16 percent of state revenue, down from 21 percent in 1977. State excise tax revenue dropped below 1 percent of GDP in the late 1970s and has claimed a roughly constant share of GDP since then. Motor fuel and tobacco taxes account for more than half of state excise tax revenue. In most states, motor fuel taxes have failed to keep up with inflation and have lost significant value (Auxier 2014). The recent decline in vehicle miles traveled has further eroded revenues, but, in the last few years, several states have raised or seriously considered raising their motor fuel taxes.

Tobacco tax revenues have declined in recent years, even as all states have raised their cigarette tax rates since 1990 and all but California, Missouri, and North Dakota have raised them again since 2000.¹⁰ The tax hikes increased the price of taxable cigarettes. Thus, the demand for taxable cigarettes has decreased as price-sensitive smokers gave up or reduced consumption and others shifted

consumption of nontaxable cigarettes found on the Internet, the black market, or in lower-tax areas (particularly tribal stores and neighboring states) (Goolsbee, Lovenheim, and Slemrod 2010). Other changes, such as bans on indoor smoking and marketing restrictions, have also reduced demand for cigarettes. More recently, technology has contributed to the erosion of cigarette tax revenue, with e-cigarettes or vaporizers becoming more popular. States have hesitated to include these new products in their tax bases while they debate whether these devices are cigarette-cessation devices or long-run substitutes.

Corporate Income Tax

Levied by 45 states, corporate income taxes provide only 5 percent of state tax revenue. A combination of sophisticated tax planning by corporations, opportunities to take advantage of differing tax laws across states to minimize taxes, and state efforts to attract corporations through tax incentives has led to a reduction in corporate income tax collections relative to the economy since 1977 (Brunori 2012).

The Great Recession and Its Aftermath

The recessions in 2001 and 2007–09 were devastating for state finances. Unlike previous recessions, the decline in tax revenue was steep in both periods and did not recover quickly. This in part was related to high growth in revenue during the boom periods immediately preceding the economic downturns. State tax revenue dropped 0.5 a percentage point of GDP between 2001 and 2003, or \$24 billion, and 0.6 percentage points between 2008 and 2010, or \$76 billion. Even though the revenue share of GDP was unchanged between 2000 and 2013, volatility roiled state finances.

The anemic economic recovery from the Great Recession was matched by slow growth of state tax revenue. Tax revenue nevertheless rose substantially in 2013, but this was largely a temporary phenomenon resulting from a surge in capital gains realizations at the end of 2012 and general strength in equities (Francis and Gault 2015). Real tax revenue grew nearly 4.5 percent, buoyed by a strong almost 9 percent growth in individual income tax revenues.

Even though 42 states had recovered their nominal 2008 tax revenue levels by 2013, only 24 experienced real revenue growth. Plus the aggregate trends were driven by a few large states. The five largest states by size of economy—California, Florida, Illinois, New York, and Texas—increased their share of both tax revenue and GDP. Between 2000 and 2013, the combined share of GDP for these states rose from 38 to 40 percent, while their share of tax revenue increased from 37 to 40 percent. The three big states with individual income taxes—California, Illinois, and New York—had either permanent or temporary rate increases during the period, further driving up tax revenue. Texas had a surge in oil and natural gas production, driving the increase in that state’s revenue, but the decline in oil prices will reduce Texas revenue growth in the future. Among these large economic states, only Florida still has not surpassed its 2008 revenue level, primarily because of lower sales tax revenue following the housing market collapse in that state.

Nationally, retail sales and individual income tax collections make up about two-thirds of state own-source general revenue. The outlook for growth in personal income, a key driver of tax revenue, is tepid at best. The Congressional Budget Office (CBO) projects inflation-adjusted personal income to grow just under 3 percent annually over the next 10 years, higher than the annual growth from 2000 to 2014 but not nearly a return to the higher growth rates before 2000 (table 1).

Though growth of both sales and individual income tax revenue depends on growth in personal income, income tax revenue has historically grown faster than income, and sales taxes have grown more slowly. Graduated tax rates, a feature of most state income taxes, play a role, particularly if most of the income growth is concentrated at high incomes. However, in many states the highest tax rate starts at a modest income level, making the tax structure similar to a flat tax. For example, Missouri has a progressive tax structure with rates rising from under 2 percent of income to 6 percent of income, but the top rate applies to taxable income above \$9,000. However, three states—California, New York, and Minnesota—have made their income tax structures more progressive since 2008 by introducing higher top marginal tax rates.

General sales tax revenue tends to grow more slowly than personal income because households typically save a greater portion of their income as it increases. Erosion of the sales tax base has exacerbated that lag. Even though consumption has grown as a share of the economy, the sales tax base has declined (Fox 2012). In many states, the sales tax base excludes a large share of consumption, typically including services and groceries. Few states have made any progress in broadening their tax bases to include services, and only 19 states tax groceries (6 of them tax groceries at rates lower than the general rate). And finally, electronic commerce, which grew from almost nothing in 1998 to about 6 percent of retail sales in 2013, is more difficult to tax at the state level because of interstate commerce issues (Fox 2012).¹¹ There has been some progress but states are waiting on Congress to act to be able to capture sales taxes owed on remote transactions.¹²

A narrower base from new technology also affects excise taxes (e.g., e-cigarettes, electric cars) reducing the demand for taxable goods. Most states do not adjust excise tax rates for inflation, so compounding the drop in demand is a reduction in the real value of the tax (Felix 2008). The wide variation in cigarette tax rates across states adds tax avoidance behavior to the equation. For some states, however, taxes on legalized marijuana sales will bring in new revenue. (Colorado projects that the state will collect \$85 million from marijuana taxes in 2015; see Colorado Legislative Council Staff 2015).

TABLE 1

Real Wages and Personal Income

Average annual growth rates

Date range	Wages (%)	Personal income (%)
1960–1980	3.0	3.4
1980–2000	2.6	2.9
2000–2014	0.8	1.6
2014–2024 (forecast)	2.4	2.6

Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; Congressional Budget Office, 2015.

Note: Inflation adjusted using Consumer Price Index.

Historically, the sales tax has been the workhorse of state finances, with revenue roughly equal to that of the income tax but with much less volatility. Because a large part of the tax base is basic consumption, usually sustained during recessions, the sales tax is not affected as much by business cycles as income taxes. However, the last decade was a challenge for sales taxes. Not only did the growth slow, but volatility increased. Part of the reason is the housing crisis: construction and sales of home furnishings and appliances dropped significantly. Felix (2008) shows that these items are volatile. For example, Arizona relies on its sales tax (called the “transaction privilege tax”) for over half of its revenue. When the housing collapse began, the state was one of the hardest hit. The contracting category dropped from 20 percent of sales tax revenue in 2007 base to 10 percent in 2013, declining almost \$600 million.

A number of economic studies have measured the growth potential of income and sales taxes by estimating how responsive tax revenue is to changes in personal income. Those studies have generally found that individual income tax revenue is more responsive and sales tax revenue is less responsive (Bruce, Fox, and Tuttle 2006; Felix 2008; GAO 2014; Sobel and Holcombe 1996). That means that when personal income is growing, income tax revenue will grow faster—but the reverse is true, too: income tax revenue declines faster when income declines.

Though income tax revenue generally grows faster than sales tax revenue when the economy is expanding, it also tends to be more volatile. The uncertainty of business and investment income contributes, but tax policy has also played a role (Mattoon and McGranahan 2012). Between lowering rates, expanding and adding credits, and exempting types of income, states have made the income tax more complicated and less robust.

A recent trend of states shifting, or proposing to shift, from reliance on the income tax to the sales tax is worrisome for budget outlooks. Proponents of the change argue that states should reduce their reliance on the income tax because its revenue stream is too volatile. For example, the Show Me Institute highlighted volatility as a reason to repeal the Missouri income tax and replace it with increased sales taxes.¹³ In New Jersey, the Chamber of Commerce issued a comprehensive report on tax revenue volatility that recommended reducing the progressivity and/or the tax rate on capital gains,

the most volatile component of the income tax base, as a way to reduce volatility (Capitol Matrix Consulting 2012).

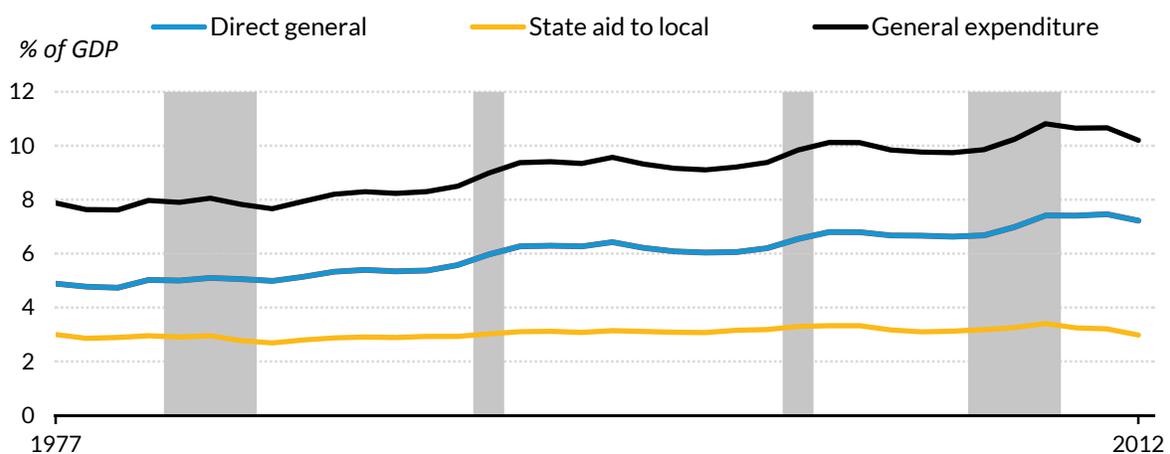
Overall, however, the income tax is a more powerful tax than the sales tax and faces less erosion over time. The sales tax has become less efficient because of consumer patterns shifting more toward services, eroding the tax base. Replacing income taxes with sales taxes would risk even more anemic revenue growth. A better solution to the volatility of the income tax might be to increase rainy-day funds or smooth spending growth during boom periods. California, for example, has dedicated any additional tax revenue from capital gains above 8.5 percent growth to a stabilization fund, mitigating the volatility on general revenue sources but not sacrificing the revenue.

Expenditures

States spend money directly on services and programs and also distribute money to local governments, primarily for public education. State general expenditures have been trending upward over the past 25 years, rising from about 8 percent of GDP in 1977 to 10 percent in 2013 (figure 5). State aid to local governments have hovered around 3 percent of GDP, declining in recent years following the Great Recession.¹⁴ The direct spending is supported by either state revenues or federal grants. Increased state-funded expenditures account for most of the early growth, rising from under 3 percent to about 4 percent in 2012.¹⁵ Federally funded expenditures have been the driver since 1992, growing from about 2 percent of GDP from 1977 to 1992 to 3 percent before the Great Recession. The federal stimulus the American Recovery and Reinvestment Act provided temporarily boosted federally funded expenditures to almost 4 percent of GDP, but they have since declined to 3 percent.

FIGURE 5

State General Expenditures



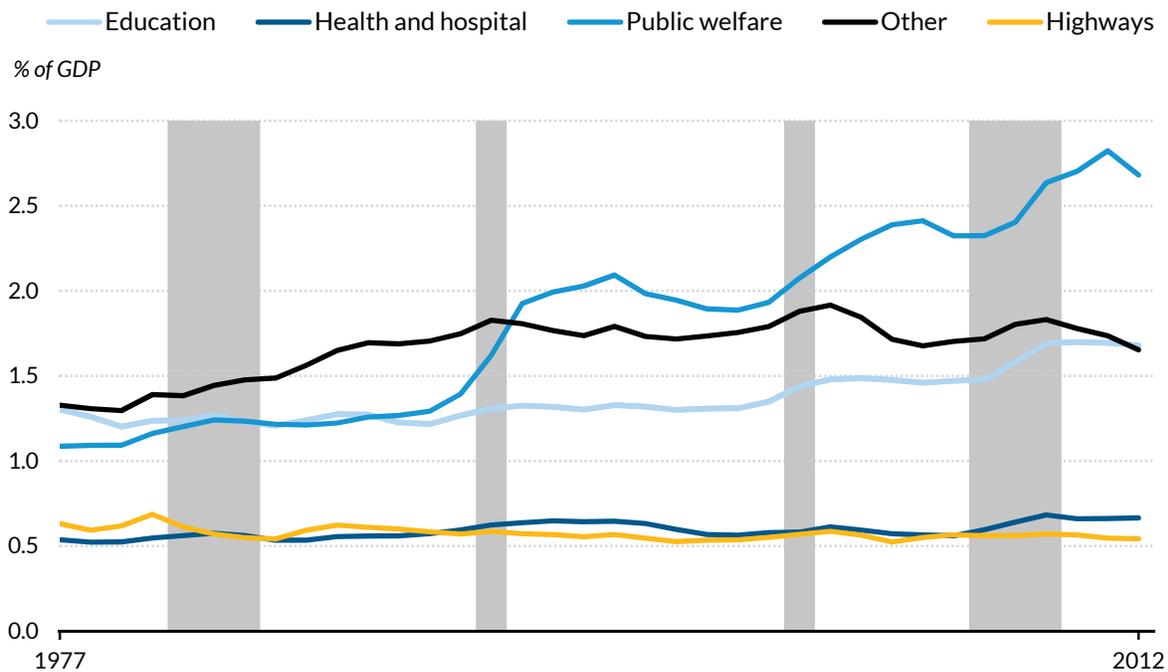
Source: Census Survey of State Government Finances .

Note: Shaded areas indicate recessions.

The composition of direct general expenditures has changed over the past 35 years. Public welfare spending increased rapidly beginning in the late 1980s, more than doubling from 1.1 percent of GDP in 1977 to 2.7 percent in 2012 (figure 6). That spending, primarily for Medicaid, has been the fastest-growing component of direct general expenditures. Direct education spending, which, at the state level, mostly goes for higher education, also increased, though much less rapidly, from 1.3 percent of GDP in 1977 to 1.7 percent in 2012.¹⁶ In contrast, spending on highways and on health and hospitals changed little over the period, with both hovering around 0.5 percent of GDP.

FIGURE 6

Components of Direct General State Expenditures



Source: Census Survey of State Government Finances.

Notes: Shaded areas indicate recessions. Data include state-funded and federal-funded direct general expenditures.

When state aid to local governments is considered, education claimed the largest share of state spending in 2012 (table 2). Most state education spending goes to local governments, typically school districts. The next-largest category, public welfare, is mostly funded by federal grants and accounts for most of the federal transfers to states. Other expenditures include government operations, corrections, and natural resource programs.

TABLE 2

Components of State Expenditures, 2012*Billions of dollars*

	Direct Expenditures			State aid to local	Total
	State funded	Federally funded	Subtotal		
Education	181	90	271	318	589
Public welfare	136	297	433	43	476
Health and hospitals	82	26	108	21	128
Highways	54	43	98	16	114
Other	201	57	258	46	341
Total	654	513	1,167	444	1,649

Source: Urban Institute analysis of Census Survey of State Finance Data

Spending Pressures

State general expenditures have risen for many years as a share of GDP, but they may grow even faster over the next decade. Five factors will exert the largest pressures on state budgets: education, health care infrastructure, pensions, and population.

EDUCATION

Both K-12 education and higher education face headwinds. Even though most education dollars are spent on K-12 education at the local level, more than half the funding comes from state transfers to local school districts. Since the 1970s, many lawsuits have alleged unequal or inadequate access to a level of public education as guaranteed in state constitutions, leading to states picking up a larger share of the costs for K-12 education and to higher spending levels (Fischel 1998; Murray and Rueben 2007).

HEALTH CARE

Health care costs have grown faster than the economy for decades and, despite a recent deceleration, are expected to continue to outpace GDP. The Government Accountability Office, or GAO, (2014) projects that health care costs, which include Medicaid and employee and retiree health care, will almost double as a share of GDP between 2014 and 2060.

The Centers for Medicare and Medicaid Services project that state Medicaid expenditures, jointly financed by federal and state sources, will increase over 6 percent annually over the next decade (CMS 2014). Higher Medicaid spending affects more than just federal spending: state own-source Medicaid expenditures have increased from less than 13 percent of general fund budgets in 1993 to 19 percent in 2012 (NASBO 2015). As noted above, most of the growth in state expenditures has been for public welfare, primarily for Medicaid (figure 6).

Growing costs of health care for retired public-sector employees are also putting pressure on state budgets. Lutz and Sheiner (2014) estimate that fully funding retiree health care at the state and local level would require increasing total revenue between 0.7 percent and 1.5 percent.

INFRASTRUCTURE

State investment in infrastructure has languished, particularly for roads but also for buildings and other structures (Boyd and Dadayan 2015). Funding for roads and highways has fallen in real terms, in large part because the federal excise taxes on gasoline and diesel fuel have gone unchanged since 1993. States are slowly beginning to increase their own gas taxes, but, absent an increase in motor fuels taxes, states will need funding from other sources to ensure adequate investment in roads and highways.

Infrastructure is, of course, much more than just roads. Real state and local investments in office buildings is down 23 percent since it peaked in 2008, and education infrastructure is down 38 percent since its 2007 peak.¹⁷ Transit, water, wastewater, and electrical transmission infrastructure have also declined and all require maintenance and improvement.

PENSIONS

Already causing fiscal chaos in many local governments, the underfunding of pensions has spread to state plans like Illinois and New Jersey. As more state workers retire and retiree health care costs increase, states will struggle to meet their obligations. Novy-Marx and Rauh (2014) estimate that state and local governments need to increase funding by 1.2 percent of GDP by state over the next 30 years to be able to fully fund obligations. In addition, underfunded pensions have been a factor in lower bond ratings in several states, increasing the costs of capital investments and hence adding budget pressure.¹⁸

Cost pressures on higher education come from increasing attendance and per pupil costs, competition from the private sector, and politically constrained tuition. Though federal support increased during and after the Great Recession, the current state of the federal budget puts pressure on federal higher education programs.

POPULATION

The population is aging, putting more pressure on health care spending and reducing the ratio of the working-age population to older people. The Urban Institute's Mapping America's Futures project reports that, although working-age people will still outnumber those over 60 years old in 2030, the largest population growth will come from the latter group (Nichols et al. 2015). The 65 and older demographic will grow on average 2.7 percent annually for the next 20 years, three times faster than the overall population.¹⁹

Prognosis

Rapid growth in spending projected for Medicaid and education will put pressure on states to increase revenue or hold down other spending. States project nominal general revenue growth of about 3.5 percent in the near term. The Centers for Medicare and Medicaid Services projects that Medicaid

spending will grow 6.6 percent annually, and the National Center for Education Statistics projects 4.0 percent annual growth in elementary and secondary education spending. If those projections hold, states will have to hold the annual growth in spending on all other operations to just 1.9 percent to maintain balanced budgets. And this ignores increases needed for underfunded state pensions and retiree health care benefits (Lutz and Sheiner 2014; Novy-Marx and Rauh 2014). For example, the long-term revenue and expenditures forecast in Georgia Governor Nathan Deal's proposed 2016 budget and the 5.5 percent growth projected for Medicaid require that the rest of the budget grows less than 3 percent a year (Deal 2015).

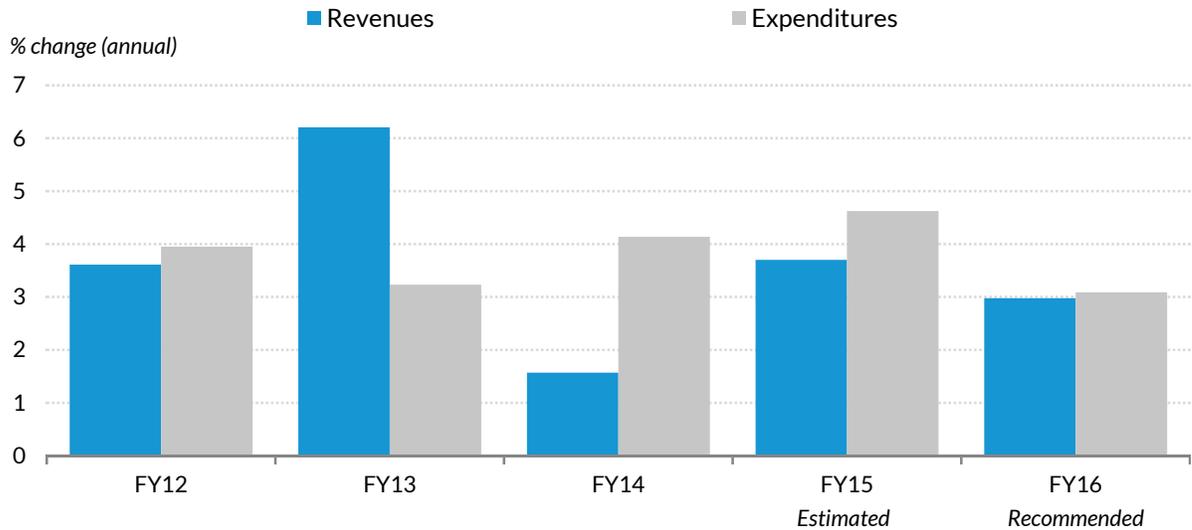
GAO (2014) draws similar conclusions. In its scenario, which includes both state and local finances, a gap opens up between revenues and expenditures because the underlying drivers of revenue grow more slowly than the drivers underlying expenditures. GAO calculates an 18 percent "fiscal gap"—the amount of expenditure reductions or revenue increases required to maintain balanced budgets. The primary driver is health care, principally Medicaid but also state employee and retiree health care.²⁰ But states are unlikely to be able to control growth in health care costs independent of the federal and private sectors, meaning health care costs will continue to squeeze out other spending.

On the revenue side, similar to other studies, the GAO report uses elasticities (the responsiveness of one variable to changes in another) for different components of tax revenue and CBO's (2015) national economic forecast to construct a forecast of state and local revenue. Accepting CBO's projection that income will grow more slowly than historic trends (table 1), the GAO simulation finds that revenues will not keep up with spending.

And this imbalance is coming soon. Projections of state general fund spending and revenue over the next few years indicate that recent patterns of anemic growth will continue. State budgets for 2016 already appear to be out of balance, a major reason many states had trouble enacting budgets.²¹ Based on its spring survey, NASBO (2015) reported that 24 states will have a general fund budget gap (that is, expenditures exceed revenues) in fiscal year 2016. And rather than building up fund balances, states have seen balances decline in the last two years; NASBO reports that 19 states have less than 5 percent in fund balance.

FIGURE 7

General Fund Revenues and Expenditures, 2012–16



Sources: National Association of State Budget Officers, Spring Fiscal Survey 2012, 2014, 2015.

Conclusion

The Great Recession shed light on the inadequacy of state finance structures. The deterioration of the sales tax base, the reduction in personal income tax rates, and the chaos caused by federal tax and spending policy all contributed to the worst fiscal period for states since data became available in 1977. The federal stimulus shored up Medicaid and education spending and protected state budgets from a larger fiscal crisis, but states’ expenses went up, as they do during every recession. States cut spending significantly and raised revenues. A few enacted temporary tax increases, staving off larger budgetary issues for a time. And a handful of states took the completely opposite tack, cutting income taxes after suspending their implementation during the recession or by enacting new income tax cuts (Francis and Moore 2014).

Seven states enacted laws swapping individual income tax cuts for sales tax increases (table 3). Some states enacted the swap in a single tax bill (Ohio and North Carolina), and others increased sales taxes after income tax cuts resulted in too little revenue (Kansas, Maine, and New Mexico).²² Arkansas and Indiana increased sales taxes during the recession and then cut income taxes when revenue stabilized.²³ Switching from income taxes to sales taxes could slow revenue growth but also reduce volatility. Sales taxes correlate more closely with wages, which have been growing slower than personal income and are subject to long-run erosion. In exchange for a less volatile tax system, these states have given up the surpluses that come from April surprises during boom periods, when taxpayers realize investment income and pay more tax. States often used the surge in revenue to shore up exhausted

reserve funds.²⁴ In other words, by shifting to sales taxes, states set a slower growth path and likely lose opportunities to fill up reserve funds.

A few states increased both income and sales taxes during the recession and retained the increases after the economy improved. California, Connecticut, and Minnesota have all raised both individual income and sales taxes since 2008. But the tax increases are only temporary in California and were passed by voters who will likely be asked again to set tax policy when the increases expire in 2016.

TABLE 3

State Tax Actions, 2008–15

Tax rate action	States
Raised sales	AR, CA, CT, IA, IN, KS, MA, ME, MN, NC, NM, NV, OH, VA
Raised income	CA, CT, DE, HI, IL, MD, MN, NY, OR, WI
Reduced sales	None
Reduced income	AR, ID, IN, KS, ME, MI, NC, ND, NM, OH,^a OK, RI, VT, WI^b

Source: Urban Institute State and Local Finance Initiative tax rate data.

Notes: States in bold raised sales taxes and reduced income taxes.

^a New Mexico and Ohio income tax cuts, passed before 2008, were being phased in.

^b Wisconsin added a new top rate in 2009, increasing individual income tax rates, and reduced the new top rate in 2013.

Contrary to popular sentiment, taxes are not growing uncontrollably. Total state tax revenue has barely budged as a share of personal income. In 1977, state taxes were just over 6 percent of personal income. That share was 6.3 percent in 2008 and had dropped to 5.8 percent four years later. Only 19 states had higher effective tax rates in 2012 than in 1977, and only 7 states had higher rates than in 2008. Meanwhile, general own-source revenue (taxes plus charges and miscellaneous revenue) increased from 7.4 percent of personal income in 1977 to 7.9 percent in 2012. Thirty-nine states had higher effective rates on general own-source revenue in 2012 than in 1977. States may be taking in less in taxes but still maintaining or increasing overall revenues by increasing fees and charges.

On the expenditure side, every state has cut expenditure growth to below historic levels. A few states have rebounded to 2008 inflation-adjusted expenditure levels, but none have restored expenditures to what they would have reached if they kept on the same growth trajectory. Most expenditure growth has been for Medicaid, which will continue to put pressure on other spending. One indicator is state non-education employment, which, across all states in 2013, was 6 percent below the 2008 peak. Natural resource protection and corrections staffing were the hardest hit, declining 28 percent and 10 percent, respectively.²⁵

Some underlying problems facing states may be beyond their control, including growing costs for Medicaid, aging of the population, and stagnant incomes for most of their citizens. If personal income, particularly wages, continues to grow at below historical rates, tax revenue will likely fail to keep pace with spending, especially if more states choose to substitute sales taxes for income taxes.

Unfortunately, there are no easy solutions. Every state has to identify the resources it needs to pay for

the desired level of services. Each state has a unique fiscal history that may drive this decision process. Some states simply refuse to have an income tax (Texas) and others will not have a sales tax (Montana). Other states have constitutional restrictions that limit tax rates or spending levels. But states can take action. McNichol, Palacios, and Johnson (2014) point to a number of ways to guard against budget crises including building up reserves and forecasting revenues and expenditures out over a long period.

This challenge is not new. What is new is the unwillingness to acknowledge the dilemma that leads to recurring budget showdowns even as the economy recovers. Eight states could not agree on a budget by the time their fiscal year started in July 2015. Many of them were in the same position last year and are likely to be in the same position next year.

Notes

1. Data for 1977 to 2012 are available on the Tax Policy Center State and Local Finance Data Query System. Data for 2013 are only available for state finances.
2. Cross-state comparisons of total revenues and expenditures would require including local government finances to account for different governance structures. This brief focuses on trends in major state-level revenues and fiscal actions, however, and so uses only state data.
3. Census “general revenue” excludes revenue from utilities, state-run liquor stores, and social insurance trusts.
4. The public hospital category includes payments by patients, insurance, and public programs like Medicare (but not Medicaid) for care at state-operated hospitals. It also includes charges for amenities, such as food service and sundries.
5. In 1998, major tobacco companies settled with states over health costs arising from tobacco use. The first annual payments were made in 2000.
6. Capital gains income rose 89 percent from 1995 to 2000 and then fell 49 percent over the next two years.
7. Analysis was based on average annual expenditures from the Bureau of Labor Statistics Consumer Expenditure Survey September 2014. The following were included as generally tax exempt: food at home, shelter, personal services, other vehicle expenses, public and other transportation, medical services, drugs, medical supplies, reading, and education. Some items (e.g., health insurance, motor vehicles) are subject to taxes other than general sales taxes.
8. Commonly taxable excludes motor vehicles and gasoline, which are taxed separately, and food stores, which are commonly not taxed. Data are from the US Census Bureau’s annual Retail Trade Survey (May 2015). *Revised from earlier draft on 9/17/2015 to clarify that nonstore retailers’ share of taxable retail sales is just under 20 percent.*
9. An example of congressional action is the Marketplace Fairness Act, which has been introduced in the last two sessions.
10. The median per pack tax rate on cigarettes was 31.5 cents in 1998 and \$1.36 in 2015.
11. Data from Census Annual Retail Trade Survey.
12. The Streamlined Sales and Use Tax Agreement includes 23 participating states. The Marketplace Fairness Act in front of Congress would allow states to require out-of-state sellers to collect sales and use tax.
13. Joseph Haslag, “Replacing Missouri’s Income Tax Would Reduce Revenue Volatility,” Show Me Institute blog, December 30, 2008.
14. The Census public use data file allows the direct general category to be parsed between state expenditures and intergovernmental transfers from the federal government.

15. The Census variable is “Direct General Expenditures,” which excludes enterprise- and insurance-trust expenditures like utilities, state-controlled liquor stores, pensions, and unemployment.
16. The state provides aid to local governments and school districts for public K–12 education, which is part of intergovernmental transfers to local governments (called “state aid to local governments” in figure 5).
17. Data from Bureau of Economic Analysis National Income and Products Account (table 5.9.6B), August 2015. Data include local government spending.
18. Illinois, Kansas, New Jersey, and Pennsylvania have had credit ratings downgraded with pensions described as a major factor.
19. This is an issue for revenue growth too. Many states have exemptions for all or part of a resident’s social security, pension, or other retirement income.
20. Zhao and Coyne (2013) have a different measure (trend gap) that shows retirement benefits like health care and pensions as contributors to the long-run trend gap.
21. Richard Auxier, “Recovery Cannot Save State Budgets from Politics,” *TaxVox* (blog), Urban-Brookings Tax Policy Center, August 4, 2015.
22. Ohio passed legislation in 2005 with a multiyear transition to immediately increase the sales tax rate and phase in an income tax cut.
23. Kansas also enacted a temporary sales tax rate increase.
24. Norton Francis, “State Revenue Growth Will Remain Sluggish,” *TaxVox* (blog), Urban-Brookings Tax Policy Center, February 16, 2015, <http://taxvox.taxpolicycenter.org/2015/02/16/state-revenue-growth-will-remain-sluggish/>.
25. Data on full-time-equivalent from the US Census Annual Survey of Public Employment and Payroll shows total state government employment decreased by 2 percent from 2008 to 2013 (US Census Bureau 2009, 2014).

References

- Auxier, Richard. 2014. “How States Are (and Are Not) Addressing an Eroding Tax Base.” Washington DC: Urban Institute.
- Boyd, Donald, and Lucy Dadayan. 2015. “The Economy Recovers While State Finances Lag.” *The Blinken Report*. New York: Rockefeller Institute.
- Bruce, Donald, William F. Fox, and M. H. Tuttle. 2006. “Tax Base Elasticities: A Multi-State Analysis of Long-Run and Short-Run Dynamics.” *Southern Economic Journal* 73 (2): 315–41. <http://web.utk.edu/~dbruce/sej06.pdf>.
- Brunori, David. 2012. “State Corporate Income Taxes.” In *The Oxford Handbook of State and Local Government Finance*, edited by Robert D. Ebel and John E. Petersen, 333–51. New York: Oxford University Press.
- US Census Bureau. 2009. “State Government Employment and Payroll Data: March 2008.” Washington, DC: US Census Bureau.
- . 2014. “State Government Employment and Payroll Data: March 2013.” Washington, DC: US Census Bureau.
- Capitol Matrix Consulting. 2012. “Revenue Volatility in New Jersey: Causes, Consequences, and Options.” Report for the New Jersey Chamber of Commerce. Sacramento, CA: Capitol Matrix Consulting.
- CBO (Congressional Budget Office). 2015. *The Budget and Economic Outlook: 2015 to 2025*. Washington, DC: CBO.
- CMS (Centers for Medicare and Medicaid Services). 2014. “2014 Actuarial Report on the Financial Outlook for Medicaid.” Washington DC: Department of Health and Human Services.
- Colorado Legislative Council Staff. 2015. “Focus Colorado: Economic and Revenue Forecast.” Denver: Colorado General Assembly. <https://www.colorado.gov/pacific/sites/default/files/15JuneForecast.pdf#page=5>.

- Deal, Nathan. 2015. *The Governor's Budget Report: Fiscal Year 2016*. Atlanta, GA: Governor's Office of Planning and Budget. https://opb.georgia.gov/sites/opb.georgia.gov/files/related_files/site_page/FY_2016_GovernorsBudgetReport.pdf.
- Felix, R. Alison. 2008. "The Growth and Volatility of State Tax Revenue Sources in the Tenth District." *Economic Review* Third Quarter: 63–88. St. Louis, MO: Federal Reserve Bank of St. Louis.
- Fischel, William A. 1998. "School Finance Litigation and Property Tax Revolts: How Undermining Local Control Turns Voters Away from Public Education." Working Paper WP98WF1. Washington, DC: Lincoln Institute of Land Policy.
- Fox, William F. 2012. "Retail Sales and Use Taxation." In *The Oxford Handbook of State and Local Government Finance*, edited by Robert D. Ebel and John E. Petersen, 406–28. New York: Oxford University Press.
- Francis, Norton, and Sarah Gault. 2015. "Federal Tax Policy Uncertainty and State Revenue Estimates." Washington, DC: Urban Institute.
- Francis, Norton, and Brian Moore. 2014. "State Economic Monitor: April 2014." Washington, DC: Urban Institute. <http://www.urban.org/research/publication/state-economic-monitor-april-2014>.
- Gale, William, Aaron Krupkin, and Kim Rueben. 2015. *The Relationship between Taxes and Growth at the State Level: New Evidence*. Washington, DC: Urban-Brookings Tax Policy Center.
- GAO (US Government Accountability Office). 2014. "State and Local Governments' Fiscal Outlook." Washington, DC: GAO. <http://www.gao.gov/assets/670/667623.pdf>.
- Goolsbee, Austan, Michael F. Lovenheim, and Joel Slemrod. 2010. "Playing with Fire: Cigarettes, Taxes, and Competition from the Internet." *American Economic Journal: Economic Policy* 2 (1): 131–54.
- Lutz, Byron, and Louise Sheiner. 2014. "The Fiscal Stress Arising from State and Local Retiree Health Obligations." Working Paper 19779. Cambridge, MA: National Bureau of Economic Research.
- Mattoon, Richard, and Leslie McGranahan. 2012. "State Tax Revenues over the Business Cycle: Patterns and Policy Responses." Chicago Fed Letter 999. Chicago: Federal Reserve Bank of Chicago.
- McNichol, Elizabeth, Vincent Palacios, and Nicholas Johnson. 2014. "Budgeting for the Future: Fiscal Planning Tools Can Show The Way." Washington, DC: Center on Budget and Policy Priorities.
- Murray, Sheila, and Kim Rueben. 2007. "School Finance Over Time: How Changing Structures Affect Support for K–12 Education." Policy Working Paper WP07SM1. Cambridge, MA: Lincoln Institute of Land Policy.
- NASBO (National Association of State Budget Officers). 2012. Spring. *Fiscal Survey of the States*. Washington, DC: NASBO.
- . 2014. Spring. *Fiscal Survey of the States*. Washington, DC: NASBO.
- . 2015. Spring. *Fiscal Survey of the States*. Washington, DC: NASBO.
- Novy-Marx, Robert, and Joshua Rauh. 2014. "The Revenue Demands of Public Employee Pension Promises." *American Economic Journal: Economic Policy* 6 (1): 193–229.
- Sobel, Russell S., and Randall G. Holcombe, 1996. "Measuring the Growth and Variability of Tax Bases Over the Business Cycle." *National Tax Journal* 49 (4): 535–52.
- Zhao, Bo, and David Coyne. 2013. "Walking a Tightrope: Are U.S. State and Local Governments on a Fiscally Sustainable Path?" Working Paper 13-18. Boston, MA: Federal Reserve Bank of Boston. <http://www.bostonfed.org/economic/wp/index.htm>.

About the Authors

Norton Francis is a senior research associate in the Urban-Brookings Tax Policy Center at the Urban Institute, where he works on the State and Local Finance Initiative. His current work focuses on state finances, tax policy, and revenue forecasting.

Frank Sammartino is a senior fellow at the Urban-Brookings Tax Policy Center and an affiliate of Urban's State and Local Finance Initiative. His current work focuses on the interaction among federal, state, and local tax policies and on the influence of tax and transfer policies on income inequality.

Acknowledgments

This report was funded by the John D. and Catherine T. MacArthur Foundation and an anonymous donor. The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders.

The authors thank Richard Auxier, Kim Rueben, and Robertson Williams for their helpful comments and suggestions as well as Urban's communications team who provided design and editing support.



ABOUT THE STATE AND LOCAL FINANCE INITIATIVE

State and local governments provide important services, but finding information about them—and the way they are paid for—is often difficult. The State and Local Finance Initiative provides state and local officials, journalists, and citizens with reliable, unbiased data and analysis about the challenges state and local governments face, potential solutions, and the consequences of competing options. We gather and analyze relevant data and research, making it easier for others to find the data they need to think about state and local finances. A core aim is to integrate knowledge and action across different levels of government and across policy domains that too often operate in isolation from one another.



ABOUT THE URBAN INSTITUTE

The nonprofit Urban Institute is dedicated to elevating the debate on social and economic policy. For nearly five decades, Urban scholars have conducted research and offered evidence-based solutions that improve lives and strengthen communities across a rapidly urbanizing world. Their objective research helps expand opportunities for all, reduce hardship among the most vulnerable, and strengthen the effectiveness of the public sector.

2100 M Street NW
Washington, DC 20037

www.urban.org

Copyright © September 2015. Urban Institute. Permission is granted for reproduction of this file, with attribution to the Urban Institute.