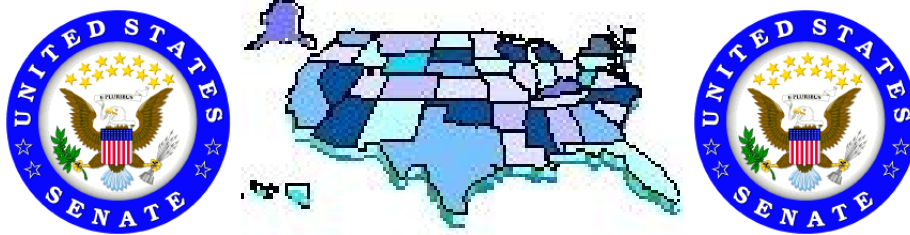


CORD

Tax Cuts at the State Level: Lessons for Washington?

Item Type	Bicameral Majority Staff Report
Download date	2026-03-15 01:27:46
Link to Item	https://hdl.handle.net/20.500.14300/3099

Tax Cuts at the State Level: Lessons for Washington?



Joint Economic Committee Staff Report Office of the Chairman, U.S. Senator Connie Mack March 1999

This staff report expresses the views of the author only. These views do not necessarily reflect those of the Joint Economic Committee, its Chairman, or any of its Members.

Tax Cuts at the State Level: Lessons for Washington?

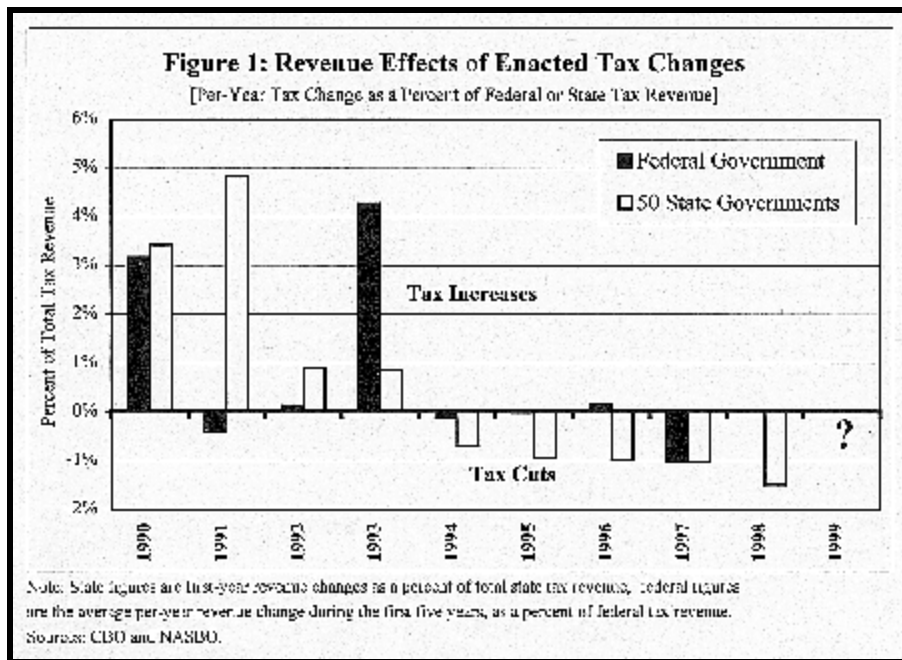
As the President and Congress consider options for the fiscal 2000 budget, they face the unusual situation of deciding what to do with large and growing budget surpluses. Federal legislators may wish to follow the lead of state legislators who have been handing back a portion of surplus state funds to taxpayers each year since 1994. The states have delivered a net tax cut of over \$22 billion during the past five years (1994-1998), and many are considering further cuts in 1999.

Both federal and state budgets have benefited from strong economic growth as tax revenues have risen along with growth in personal income, consumption, and business profits. Federal revenues have grown particularly quickly because the largest federal revenue source—the income tax—tends to grow faster during economic expansions than the largest state revenue source—the sales tax. As such, it is striking that states have provided larger tax cuts recently than the federal government, despite receiving a smaller revenue windfall from economic growth.

Five Years of Tax Cuts at the State Level

During the early 1990s, the federal government and many state governments raised tax rates in an attempt to close large budget gaps. But since 1994, state governments have reversed course and enacted net tax cuts five years in a row (1994-98), according to figures from the National Association of State Budget Officers.

(1) See Figure 1.



In order to compare federal and state tax changes, tax increases and cuts in Figure 1 are scaled to the size of total federal or state tax revenues, respectively. Note that these are changes in tax revenue due only to legislated changes in tax law, not changes in tax revenue due to economic growth or other factors.(2)

The 1998 state tax cut (effective for fiscal 1999) totaled over \$7 billion, or 1.5 percent of total state tax revenue. If the federal government were to enact a tax cut of a similar relative size (1.5 percent of federal tax revenue) it would total about \$25 billion per year, or about \$125 billion over five years.

Congress did enact a significant tax cut package in 1997 which included the \$500 per-child tax credit. The 1997 tax cut was estimated by the Joint Committee on Taxation to reduce taxes by an average of \$16 billion per year during 1998-2002.(3) The tax cut represented about one percent of annual federal tax revenues. In contrast, the states have cut taxes by about one percent of total state revenue - every year during the past four years, and yet they are still running large budget surpluses.

States Consider Further Tax Cuts in 1999

More tax cuts may be on the way for state taxpayers in 1999. The Center for the Study of the States noted in a recent report that states will likely continue the "pattern of widespread tax cutting" in 1999.(4) While substantial budget surpluses in many states are being kept in "rainy day" funds, many states think that there is room for both a prudent build-up of state surpluses and the return of a portion of excess revenues to taxpayers.

The National Conference of State Legislatures (NCSL) notes that tax cuts are being considered in over 30 states this year.(5) One state fiscal expert estimates that state tax cuts being considered this year have a combined value of at least \$5 billion.(6) Such cuts would come on top of last year's tax cuts in 36 states amounting to over \$7 billion per-year of net tax relief.(7)

State tax cuts in recent years have been primarily aimed at reducing personal income taxes. Personal income tax cuts have come in a variety of forms including increasing deductions and personal exemptions, and lowering tax rates. For example, the average top state personal income tax rate has fallen slightly from 6.2 percent in 1993 to 5.9 percent in 1999.(8)

Here are some of the largest state tax cuts currently being proposed by Governors across the country:

Colorado: In his State of the State address, freshman Governor Bill Owens proposed reducing the individual income tax rate from 5.0 percent to 4.75 percent, exempting a portion of investment income from the income tax, and other tax reductions to save Colorado taxpayers \$575 million.

Florida: Governor Jeb Bush has introduced a \$1.2 billion tax cut package for the Florida legislature to consider in 1999. His proposals include a \$480 million reduction in property taxes, a \$376 million one-time rebate to utility customers, a \$182 million cut in unemployment insurance premiums, and a \$178 million tax cut for investment income.

Massachusetts: Governor Paul Cellucci will try this year to pass an individual income tax cut that will drop the tax rate from 5.95 percent to 5.0 percent. This reduction would come on top of substantial prior year cuts including last year's record \$1 billion tax reduction.

Michigan: Governor John Engler has introduced a plan to reduce the state's individual income tax rate from 4.4 percent to 3.9 percent phased in over five years, eventually saving Michigan taxpayers about \$1 billion per year. The tax cut would be the largest reduction to date under Governor Engler.

Minnesota: Governor Jesse Ventura has proposed a \$1.1 billion sales tax cut under which the average family would receive a \$775 sales tax rebate in 1999. He has also proposed a \$1.6 billion phased-in income tax reduction which includes elimination of the marriage penalty and cutting the bottom individual income tax rate.

New Jersey: Governor Christine Todd Whitman has proposed that state money be used to reduce local property taxes over the next five years. When fully phased-in, the tax reduction for New Jersey property owners will be about \$1 billion per year. Whitman has gained a tax-cutting reputation by cutting individual income taxes 30 percent during her first few years in office.

Pennsylvania: Governor Tom Ridge has proposed the largest tax cut ever by a Pennsylvania Governor. His budget plan calls for \$273 million of reductions, including cuts to the business stock and franchise tax, and the corporate income tax. There is support in the state legislature to provide cuts to the personal income tax as well.

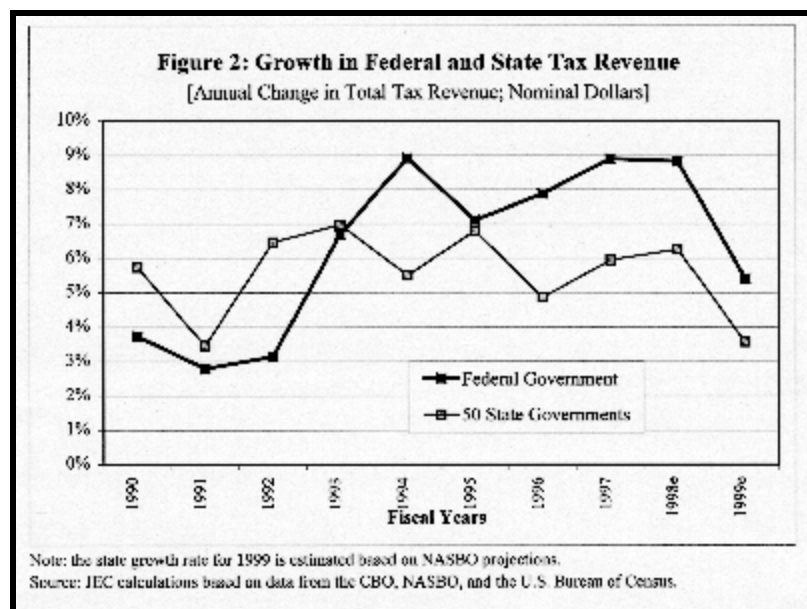
Texas: In his 1999 State of the State speech, Governor George W. Bush has proposed the largest tax cut in state history. The plan would cut property taxes by \$2 billion, sales taxes by \$330 million, and various business taxes by \$307 million.

Wisconsin: Governor Tommy Thompson has proposed cutting state personal income taxes 10 percent over five years and providing state taxpayers with property tax relief. The income tax cut would increase the standard deduction and personal exemptions, and adjust personal income tax rates.

Federal Tax Revenue Growth Outpaces the States During the 1990s

Widespread state tax cuts have been facilitated by the strong economic growth experienced by most states during the late 1990s. Economic growth tends to push up taxpayers' incomes, thus boosting income tax collections. Higher incomes also increase consumption spending, thus filling state government coffers with higher sales and excise tax revenues.

Strong economic growth has resulted in high federal tax revenue growth as well. In fact, federal tax revenue growth has exceeded state tax revenue growth every year since 1994, as shown in Figure 2. Federal tax revenues have grown at an annual average rate of 7.8 percent during fiscal 1994-1999, compared to 5.5 percent for the 50 state governments considered together.⁽⁹⁾



Considering the large windfall of tax revenue that has swelled the federal budget in recent years, it is striking that larger federal tax cuts have not been enacted. State governments have received a smaller revenue windfall from strong economic growth, but have managed

to provide relatively larger tax cuts than the federal government since 1994.

Income and Sales Tax Growth

The divergence in tax revenue growth rates between the federal and state governments is partly explained by the relatively larger tax cuts enacted at the state level, as discussed above.⁽¹⁰⁾ The differing revenue growth rates are also attributed to the different mix of tax sources that fund the federal and state governments. Put simply, the largest federal revenue source—income taxes—have grown much faster since 1994 than the largest state government revenue source—sales taxes.

Table 1 compares the federal and state governments with respect to the relative reliance on various tax sources. Personal and corporate income taxes represent 59 percent of federal tax revenues, but 40 percent of state tax revenues. Sales taxes provide 49 percent of state tax revenues, but just 4 percent of federal tax revenues.

**Table 1: Sources of
Federal and State Tax Revenue, 1997**

Tax Source	Federal	State
Income Taxes	59%	40%
Sales and Excise Taxes	4%	49%
Payroll Taxes (OASDI and HI)	34%	0%
Other	3%	12%
Total	100%	100%

Source: OMB and the Bureau of Census.

Sales and excise taxes tend to grow at about the same rate as growth in economic output, whereas income taxes tend to grow faster than economic output during expansions. For example, federal income taxes grew at an average annual 9 percent rate between 1994 and 1999, compared to federal excise taxes which grew at 6 percent.⁽¹¹⁾ ⁽¹²⁾

One important implication of this tendency is that governments which rely heavily on a progressive income tax system will tend to grow larger over time, relative to the size of the economy. As a consequence, recent economic growth has contributed to pushing federal revenues up to 20.7 percent of GDP in fiscal 1999, the highest level since World War II.

The tendency for federal tax revenues to run ahead of underlying economic growth suggests that a budgetary mechanism to return excess revenues to taxpayers should be considered at the federal level. Two dozen state governments have either statutory or constitutional tax and/or expenditure limitations (TELS) that could be examined as models to solve this federal budgetary problem.

Is It Time For a Federal Tax or Expenditure Limitation?

There has been continued interest in recent years in creating new mechanisms to ensure fiscal discipline in federal budget-making. For example, there have been a number of recent drives to enact a federal Balanced Budget Amendment (BBA), most recently an unsuccessful Senate vote in 1997. Implementation of a federal BBA would follow the practice of 48 state governments which currently operate under either statutory or constitutional requirements to balance their budgets.⁽¹³⁾

With the federal budget now in balance and tax revenues growing quickly, the focus could shift instead towards limiting the overall size or growth of the federal government through a tax or expenditure limitation (TEL). After all, it is the overall level of government expenditures which indicates the total resources being drained from the private sector, regardless of whether or not the resources come from taxation or borrowing.

Currently, over two dozen state governments operate under some form of TEL. Table 2 shows that TELs come under a variety of forms.

Table 2: States With Revenue or Expenditure Limitations

Revenue Limits	Florida, Massachusetts, Michigan, and Missouri
Expenditure Limits	Alaska, Arizona, California, Connecticut, Hawaii, Idaho, Montana, Nevada, New Jersey, North Carolina, Oregon, South Carolina, Tennessee, Texas, Utah, and Washington
Revenue and Expenditure Limits	Colorado and Louisiana
Appropriations Limited to Revenue Projections	Delaware, Iowa, Mississippi, Oklahoma, and Rhode Island

Source: National Conference of State Legislatures.

Four states have revenue-based TELs which limit annual increases in state revenue to personal income, population growth, inflation, or some combination of these factors. Sixteen states have expenditure-based TELs which are similarly linked to growth in either personal income or other factors. Two states have both revenue and expenditure-based TELs. Five states have TELs which link appropriations to prior state projections of revenue.

In addition to employing various methods for measuring budget limits, the states with TELs have a variety of different mechanisms which come into play once a limit is reached.⁽¹⁴⁾ In a number of states, including Connecticut, Rhode Island, and Washington, all or part of surplus revenues are directed into rainy day funds or used to pay down state debt. But in many states, excess revenues above TEL limits are fully or partially refunded to taxpayers. These states include California, Colorado, Florida, Hawaii, Louisiana, Massachusetts, Michigan, Missouri, Oregon, and South Carolina.

Colorado provides an interesting case study showing how the booming economy in the 1990s can trigger refunds to taxpayers. Under the 1992 Taxpayers Bill of Rights Amendment (TABOR), growth in state expenditures is limited to the growth in state population plus inflation. In years with excess revenues above the amount required to fund expenditures under the limit, refunds must be made to state taxpayers.

Limits under TABOR required that the state government return \$139 million to taxpayers in 1997 and \$563 million in 1998. The refunds are claimed when filing state income taxes and are based loosely on taxpayers' federal adjusted gross income. This year, taxpayers can expect another tax cut under TABOR. Governor Owens has proposed a \$575 million cut which includes a lowering of the income tax rate from 5.0 percent to 4.75 percent. Barry Poulson, an economics professor at the University of Colorado has called TABOR one of the most stringent budget limits in the country and recently noted that, "I think TABOR is the only reason Colorado has not gone on a spending binge."⁽¹⁵⁾

Despite successful TELs in a number of states such as Colorado, TEL's in many states have not been particularly effective.⁽¹⁶⁾ The NCSL notes that because of the mixed effectiveness of these traditional TELs, a movement towards requiring supermajority votes to raise state taxes has gained steam.⁽¹⁷⁾ Fourteen states now require supermajority votes in both state chambers for tax rate increases - half of these states implemented the supermajority requirement during the 1990s.

Supermajority vote requirements may be either three-fifths, two-thirds, or three-quarters, as summarized in Table 3. In 10 of the 14 states, the supermajority requirement applies to all tax increases. The exceptions are Arkansas (which excludes sales and alcohol taxes), Florida (applies only to the corporate income tax), Michigan (applies only to the state property tax), and South Dakota (applies only to sales and income taxes). Governors in New Jersey, New York, and Pennsylvania have proposed adding their states to the list of jurisdictions that require supermajority votes to raise taxes.

Table 3: States Which Require Supermajorities for Tax Increases

Supermajority Vote Required	States
Three-Fifths	Delaware, Florida, Mississippi, and Oregon
Two-Thirds	Arizona, California, Colorado, Louisiana, Nevada, South Dakota, and Washington
Three-Quarters	Arkansas, Michigan, and Oklahoma

Source: National Conference of State Legislatures.

At the federal level, there has been substantial interest in recent years in enacting some type of supermajority requirement for tax increases. Last year, Representative Joe Barton proposed a Tax Limitation Constitutional Amendment which would have required a two-thirds supermajority vote in both the House and the Senate to raise taxes. House Speaker Hastert has been a strong supporter of a supermajority requirement and plans for a vote on such an amendment early in 1999.

Federal Tax Cut Options for 1999

As many states offer one-time taxpayer refunds and various permanent tax cuts in 1999, federal policymakers have the chance to make up for lost time. Unfortunately, the Administration has not provided a good starting point for tax cuts with its fiscal 2000 budget. Although the budget does include a variety of very narrowly targeted tax breaks, such as a new long-term care credit, it includes a greater amount of tax increases. On net, the budget would raise taxes \$89 billion over the next ten years, according to the Joint Committee on Taxation.[\(18\)](#)

Americans might wonder why taxes need to be increased at a time when tax revenue growth is already strong due to the growing economy. The unexpected strong tax revenue growth has been the primary factor creating the large and growing federal budget surpluses. In effect, taxpayers have "overpaid" on their contributions to support federal spending. The Congressional Budget Office currently projects that the baseline fiscal 2000 unified budget surplus will grow to \$131 billion, from \$107 billion in fiscal 1999.

Congressional leaders have proposed a variety of tax cut plans in order to return some of the budget surpluses to individuals.

Some of the proposals being considered are the following:

Ten-Percent Across-the-Board Tax Cut: A ten-percent across-the-board reduction in statutory personal income tax rates would be a straightforward method of reducing income taxes for most federal taxpayers. The proposal would return about \$80 billion per year to taxpayers, or \$776 billion during the first ten years, according to the Joint Committee on Taxation.[\(19\)](#)

Alternative Across-the-Board Tax Cut: As an alternative to the ten-percent tax cut, other plans have been proposed to provide broad-based income tax cuts. One idea is to substantially raise the income threshold for the 28-percent tax bracket. This approach would reduce taxes for most federal taxpayers, but would not have the advantage of reducing top marginal tax rates which have important growth effects on the economy.

Targeted Tax Cuts: A number of proposals have been introduced to fix a number of widely-recognized problems with the individual income tax. These include:

Eliminate the "marriage penalty" which results in married taxpayers in some circumstances paying more tax than two single taxpayers with the same combined income as the married couple;

Provide an exclusion for interest income of \$200 and dividend income of \$400 in order to encourage greater savings;

Expand the income limit on the current estate tax exemption in order to reduce the burden of the "death tax;"

Index the alternative minimum tax (AMT) for inflation to avoid increasing numbers of middle-income taxpayers being hit by this complicated tax;

Further reduce the capital gains tax rate to encourage greater savings and investment.

Conclusion

With the disappearance of budget deficits from current federal projections, federal policymakers are now considering various tax cut options. State governments are also enjoying large budget surpluses, and a majority of them are considering additional tax cuts this year after five years in a row of net tax cuts for state taxpayers.

A growing number of state governments operate under budget constraints that make tax increases more difficult, and tax cuts more likely, for state taxpayers. If federal budget surpluses persist for a number of years as currently forecasted, federal legislators should consider some of the budget rules now in place at the state level such as balanced budget requirements, tax and expenditure limitations, and supermajority voting requirements for tax increases.

This staff report expresses the views of the author only. These views do not necessarily reflect those of the Joint Economic Committee, its Chairman, or any of its Members.

1. *The Fiscal Survey of the States*, National Association of State Budget Officers (NASBO), December 1998.
2. Note also that federal and state figures are projections of revenue effects before changes in tax law go into effect, since government estimators generally do not revise prior projections of tax law changes.
3. *Projecting Federal Tax Revenues and the Effect of Changes in Tax Law*, Congressional Budget Office, December 1998. CBO generally utilizes Joint Committee on Taxation estimates for revenue effects of changes in tax law.
4. *State Revenue Report*, Center for the Study of the States, December 1998.
5. National Conference of State Legislatures (NCSL) analyst quoted in the *Investors Business Daily*, February 22, 1999.
6. "Thinking About Principles This Legislative Season," David Brunori, *State Tax Notes*, February 1999.
7. NCSL estimates that 36 states cut taxes in fiscal 1998. A separate survey by NASBO estimates that 32 states provided net tax cuts in fiscal 1998. Both surveys estimate that the net state tax cut was about \$7 billion.
8. Author's calculation of the average top statutory personal income tax rate across the 43 states and D.C. that have personal income taxes, based on data from the Federation of Tax Administrators.
9. Growth in state tax revenues 1990-98 are based on Bureau of Census figures. Growth in state tax revenues for 1999 is based on NASBO estimates for fiscal 1999 general fund revenues.
10. The larger state tax cuts may also have a small positive effect on federal revenues as a result of positive growth effects.
11. See *State Revenue Report*, December 1998, from the Center for the Study of the States for a discussion regarding why income taxes have tended to grow faster than sales taxes in recent years.
12. See *The Fiscal Letter*, NCSL, Autumn 1997, for a discussion of tax revenue growth rates.
13. *The Book of the States*, The Council of State Governments, 1998-1999 Edition.
14. *State Tax and Expenditure Limits*, NCSL, 1998.
15. "States Divvy Up Surplus Money," *Investors Business Daily*, February 22, 1999.
16. See *Taming Leviathan: Are Tax and Spending Limits the Answer*, Cato Institute, 1994. Also see *State Tax and Expenditure Limits*, NCSL, 1996.
17. *State Tax and Expenditure Limits*, NCSL, 1996.
18. As reported by *Tax Notes*, March 1, 1999.
19. As reported by the Bureau of National Affairs *Daily Tax Report*, February 22, 1999. The estimate may be higher or lower depending on whether changes to the Alternative Minimum Tax are included in the tax package.