The Good, the Bad and the Ugly:

2010 State Tax Policy Changes

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ITEP
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About ITEP

Founded in 1980, the Institute on Taxation and Economic Policy (ITEP) is a non-profit, non-partisan research organization, based in Washington, DC, that focuses on federal and state tax policy. ITEP's mission is to inform policymakers and the public of the effects of current and proposed tax policies on tax fairness, government budgets, and sound economic policy. Among its many publications on state and local tax policy are *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States* and *The ITEP Guide to Fair State and Local Taxes.* ITEP's full body of research is available at www.itepnet.org.

Introduction

Compared to previous years, the budget outlook for the states improved only slightly in 2010 and virtually every state continued to face a budget shortfall. As a result, the overwhelming majority of state policymakers were put in the unenviable position of having to address some very difficult budgetary issues. Lawmakers were forced to make the difficult choice between painful spending cuts and tax increases or a combination of both. State legislatures handled this quandary in a variety of ways.

This report takes a close look at the significant tax law changes enacted by state governments across the country from Hawaii to Maine in 2010. Most of these changes were designed to close state budget gaps, though some states inexplicably chose to enact costly tax cuts despite lagging revenues. 2010 was an especially challenging year for lawmakers seeking to enact sensible tax reforms, both because of the difficult political environment surrounding an election year and the fact that many states had just emerged from bruising tax reform debates in 2009.

This report presents the good, bad, and ugly major tax policy actions that were taken in 2010. Most "good" changes were designed to mitigate big cuts in vital state services, while the majority of "bad" changes actually worsened states' already bleak fiscal outlook. "Ugly" changes raised taxes on the low-income families most affected by the economic downturn, drastically reduced state revenues in a poorly targeted manner, or handcuffed the ability of states and localities to raise needed revenues in the future. In addition to highlighting some of the more controversial issues discussed in 2010, this report also looks ahead to the issues that will likely be in the forefront of state lawmakers' minds in 2011.

The "Good"

Eliminating Personal Income Tax Giveaways

Unlike in past years, states achieving revenue-raising through the income tax in 2010 typically did not choose to increase tax rates on "millionaires," but instead chose to make income taxes fairer by closing unwarranted tax loopholes.

Rhode Island lawmakers significantly reformed their state's personal income tax structure this year. The most significant aspects of Rhode Island's personal income tax reform include the full repeal of all itemized deductions, a substantial increase in the standard deduction, the elimination of most credits and the alternative flat tax, and a new rate structure with a substantially lower top marginal rate (5.99%, as opposed to the previous 9.9% rate). Repealing itemized deductions is an important step because these deductions sharply reduce the yield--and the fairness-- of state income taxes in more than 30 states.

Other major changes to states' personal income taxes also involved reforming the treatment of itemized deductions. **New Mexico** lawmakers repealed the state income tax deduction for state income taxes paid. **New York** capped the maximum amount of the charitable contribution deduction at 25 percent of total contributions for taxpayers with adjusted gross income of $10 million or more.

Expansion of Low-Income Credits

Low-income tax credits are targeted, effective, and time-tested tools to alleviate poverty and provide income assistance to families. Refundability is an especially important component of low-income tax credits because it allows the credits to be used by taxpayers who have little or no income tax liability but who pay a substantial amount of their income in sales taxes. Thus, refundable credits are useful in offseting the regressive nature of sales and property taxes, and can provide a much needed income boost to help families pay for basic necessities.

Kansas lawmakers made modest expansions to two refundable low-income tax credits- the state Earned Income Tax Credit (EITC) and the Food Sales Tax Rebate- to mitigate the impact of increasing the state's sales tax rate on low-income families. The state EITC, a powerful anti-poverty tool, was temporarily increased from 17 to 18 percent of the federal credit. The Food Sales Tax Rebate was permanently expanded. The rebate was specifically designed to help offset the regressive impact of the portion of the sales tax levied on groceries.

Bringing Back the Estate Tax

While estate taxes typically represent only a small part of overall state tax collections, they play an important role in reducing the transmission of concentrated wealth from one generation to the next. **Hawaii**'s estate tax, like many others around the country, disappeared in 2005 when the state estate tax credit was eliminated as part of the Bush tax cuts. This year, Hawaii legislators finally re-enacted their estate tax.

Sales Tax Base Broadening

Virtually every state's sales tax laws are riddled with tax breaks for everything from haircuts to helicopter repair. This forces the tax rate to be higher on the remaining items subject to tax. Despite the strong policy merits and enormous revenue potential of expanding states' sales tax bases, very little in the way of principled base expansion occurred in 2010. Only two states—**Colorado** and **New York**—enacted notable expansions to their sales tax bases, though even these changes were incremental and confined mostly to "low-hanging fruit." Colorado extended its sales tax to include, among other things, sugared beverages, candy, and software delivered online or installed on a computer. New York temporarily eliminated its sales tax exemption for items of clothing valued at under $110. Colorado also enacted a requirement that Internet retailers disclose information about their customers in order to assist the state in enforcing its existing sales tax laws.

Business Tax Changes

Business tax reforms were few and far between in 2010. **Colorado** capped the amount of net operating loss a company can take in any particular year, which will enhance the stability (and predictability) of its revenue collections by preventing companies from suddenly writing off huge losses when their profits plummet.

Tax Credit Reform

Both **New Jersey** and **Iowa** suspended generous tax credits designed to entice filmmakers to film movies and TV shows within their borders. A growing body of evidence suggests that the limited economic boost these credits provide ultimately pales in comparison to their immense cost. Iowa's suspension was accompanied by reductions in various other so-called "economic development" tax credits. Iowa also created a panel of legislators tasked with reviewing the effectiveness of tax credits in achieving their original goals.

Sales and Excise Tax Rate Increases

Sales and excise taxes are an important revenue source for states. But these consumption taxes are regressive, falling far more heavily on low- and middle income taxpayers than on the wealthy. Consumption taxes also face structural problems that threaten their future viability. For example, sales taxes are normally levied on a narrow base that excludes most consumer services, instead just taxing most goods. But aside from the small changes mentioned above, lawmakers mostly shied away from base broadening this year, and instead turned to sales and excise tax rate increases. Raising taxes to ensure the continuation of important state services is good public policy, but it's unfortunate that lawmakers chose to rely on regressive revenue sources, and that they opted to raise tax rates rather than broaden tax bases. Ultimately, many of these changes just barely manage to qualify as "good." Each of the states enacting these rate increases had much better revenue-raising options at their disposal. In these difficult times, however, the need to maintain state services was the overriding concern.

Sales Tax

In **Kansas**, lawmakers were faced with more than a billion dollar shortfall. In response to this situation, Governor Mark Parkinson pushed for, and the legislature approved, a three year increase in the sales tax rate from 5.3 to 6.3 percent. In a nod toward tax fairness, lawmakers coupled the sales tax rate increase with an expansion of the Earned Income Tax Credit and the Food Sales Tax Rebate. Other sales tax rate increases include:

- **Arizona**'s Proposition 100—approved by the state's voters in May—temporarily increased sales tax rate from 5.6% to 6.6% for three years.
- **New Mexico** lawmakers passed a budget that included a one-eighth cent increase in the state's 5 percent gross-receipts tax on goods and services.

Excise Taxes

This year raising excise taxes on cigarettes and other tobacco products was a fairly popular option for lawmakers. **South Carolina** lawmakers raised their cigarette tax for the first time since 1977, from seven cents to 57 cents a pack. Relying on regressive revenue sources such as the cigarette tax obviously isn't an ideal way to fund needed government services, but in some of the states that increased these taxes, progressive revenue options were unable to gather serious political support. Hawaii, New Mexico, New

York, Utah and Washington also increased their cigarette taxes and New Hampshire and New York raised their tax on other tobacco products.

The "Bad"

Ballot Measures Repealing Needed Tax Increases

This year voters were busy in **Maine, Massachusetts, and Washington** actually overturning tax legislation that had been previously passed by state lawmakers. Early in 2010, Maine voters approved a ballot measure that repealed an ambitious tax reform enacted in 2009 by the state legislature. The legislature's plan would have reduced the state's reliance on income taxes and increased its reliance on sales taxes in a way that was carefully calibrated to leave total tax collections unchanged (while cutting taxes on Maine residents and hiking taxes on tourists).

Voters in Massachusetts and Washington delivered a blow to already large and unresolved budget gaps by repealing recently enacted tax increases in November. Massachusetts voters removed the sales tax on alcohol, which was just added last year in order to raise $80 million for substance abuse programs. In Washington, voters repealed a recently enacted sales tax increase on a variety of goods including soda, bottled water, and candy adding $250-$300 million to the state's three-year budget gap. After the election, Washington Governor Chris Gregoire issued a statement saying "the additional cuts we will have to make due to this loss of revenue will have significant consequences."

Suspending Middle-Income Property Tax Breaks

Two states—**Colorado** and **New Jersey**—temporarily suspended property tax relief programs in order to help bring their budgets into balance. Colorado suspended the senior homestead property tax exemption until 2012, and New Jersey suspended property tax rebates for 2010. These suspensions had a significant impact on lower- and middle-income taxpayers, and could have been avoided had better targeted revenue-raising options been enacted.

Expanding Capital Gains Tax Breaks

Capital gains preferences are costly, inequitable, and ineffective, depriving states of millions of dollars in needed funds, benefitting almost exclusively the very wealthiest members of society, and failing to promote economic growth in the manner their proponents claim. Yet, lawmakers in **Vermont** and **Massachusetts** enacted changes to their state's tax treatment of capital gains income this year. Vermont lawmakers partially backtracked on last year's decision to reduce the state's existing exclusion for capital gains income. Taxpayers with capital gains from the sale of certain business assets held for more than three years are now allowed to exclude 40 percent of their net gain from income. Massachusetts introduced a new small capital gains break that reduces the tax rate to 3 percent (from 5.3 percent) on investments, held at least three years, in Massachusetts companies that are less than five years old and have less than $50 million in assets at the time of the investment.

Film Tax Credits

Some states inexplicably decided to shower filmmakers with lavish tax breaks despite lagging state revenues and a growing body of evidence that film credits are ineffective at spurring economic growth. **Florida** and **Virginia** each chose to enact a film tax credit for the first time while **New York** decided to extend its existing film credit for at least five more years.

The "Ugly"

Reductions to Low-Income Credits

The ongoing recession has had an unrelenting impact on families and communities in every state across the country, and has been particularly hard on the millions of lower-income Americans struggling to make ends meet. Yet, several states chose to close budget gaps this year by cutting proven and effective refundable tax credits, such as the Earned Income Tax Credit (EITC). These reductions barely made dents in solving states' budget dilemmas and raised taxes on those families hit hardest by the economic downturn who count on the additional income provided by these credits to help pay for food, housing, transportation and other necessities.

Perhaps the most egregious example was **Georgia's** move to make its low-income credit nonrefundable harming the state's poorest taxpayers—those with incomes below $20,000. The already small credit was made virtually meaningless by this change and only raised $22 million to close the state's $5 billion budget gap (less than 0.5 percent of the gap). Other reductions to low-income credits include:

- **New Jersey** reduced its state EITC credit to 20 percent from 25 percent of the federal credit.
- **Virginia** and **Iowa** held down EITC benefits by not conforming to expansions of the federal EITC enacted under the American Recovery and Reinvestment Act, which included an additional benefit for families with three or more children and a reduction in the marriage penalty.
- **Minnesota** repealed its lower income motor fuels tax credit, which was enacted in 2008 to offset the impact of an increase in the state's gas tax on low-income households. Lawmakers also made a substantial funding cut to the state's Renter Credit program which harms close to 300,000 households.

Personal Income Tax Base Narrowing

One tax policy principle that most any economist can agree with is that taxes should have a broad base and a low rate. Narrowing the base of any income, sales, or property tax base is counterproductive from both a revenue raising and fairness perspective. Clearly, **Georgia** Governor Sonny Perdue wasn't interested in promoting principled tax policy which he sought and ultimately signed legislation that removed most retirement income from the income tax base. Georgia seniors already enjoyed some of the highest exemptions in the country on retirement income. Fully exempting this income, especially as the boomer population ages, means that the cost of this legislation will grow rapidly in the future.

New Restrictions on Property Taxes

The push for property tax caps has fortunately slowed somewhat since housing prices plummeted beginning in late 2008. Nonetheless, **New Jersey**'s new governor, Chris Christie, successfully pushed through a plan that capped property tax revenue increases at 2% per year. The cap will greatly reduce localities' ability to provide vital public services for years to come, though a handful of exemptions to the cap will help avert some of its most disastrous potential effects.

In **Indiana**, voters chose to enshrine an existing property tax cap in the state's constitution. Specifically, the cap limits property tax rates to 1% of assessed value for residences, 2% for rental property, and 3% for businesses. The cap was originally enacted in 2008, and was already permanent state law. Now that the cap is protected within Indiana's constitution, the options for reforming or repealing this new and relatively untested part of Indiana's property tax system will be severely limited.

Some Things Stay the Same (for Better or for Worse)

In many states, the failure of high-profile tax proposals was just as important, if not more so, than the tax policy changes actually enacted. Some of these changes would have significantly improved the fairness and adequacy of state tax systems, and will hopefully be given another chance at some point in the future. In Washington, for example, voters rejected a proposal to enact a limited personal income tax on the best off Washingtonians. Enacting the tax would have allowed the state to provide additional funding for education and health, and to reduce property taxes and business taxes. In a similar vein, both Maryland and New Jersey failed to enact proposals to extend temporary income tax increases targeted toward their best off residents. In Hawaii, the legislature passed a plan that would have limited the size of itemized deductions for high-income earners, only to later see it vetoed by Governor Linda Lingle. Alabama lawmakers once again failed to enact a plan to eliminate the state's grocery tax and pay for it by scrapping the state's regressive and costly deduction for federal income taxes paid. And in California, voters chose not to repeal several costly business tax breaks enacted in 2008 and 2009.

But not all of the failed proposals that surfaced during 2010 would have improved state tax systems. Indeed, many failed proposals would have decimated state budgets and/or made state tax systems more regressive. Missouri taxpayers, for example, scored a great victory when lawmakers rejected the so-called "Fair Tax." ITEP's analysis of the Missouri "Fair Tax" plan showed that the proposed tax rate was far too low to be revenue neutral, and that the poorest 95% of Missourians would effectively pay more in taxes under the "Fair Tax" in order to finance tax cuts for the richest 5% of residents. In Georgia, the Governor vetoed a capital gains tax cut that would have overwhelmingly benefited the richest 1% of taxpayers while digging the state's budget hole much deeper. And in Massachusetts, voters wisely rejected a proposal to cut the state's sales tax rate by more than half—a move that would have left the state's budget in tatters. Colorado voters also made the right call in rejecting multiple tax proposals in their state. Among the many unwise proposals put before Coloradoans were reductions in the state's income tax, cuts in school district property taxes, the elimination of various fees, and the removal of Coloradans ability to vote to opt out of the state's "TABOR" limitations on property taxes.

Looking Ahead to 2011

Tax policy will be at the forefront of state lawmakers' minds in 2011 as they continue to grapple with historic budget shortfalls due to lagging revenue recovery and a high demand for public services. In 2009 and 2010, most states balanced their budgets with a mix of large spending cuts, temporary tax increases, and significant aid from federal policymakers. In 2011, many of the temporary tax increases are set to expire and there will be no more federal assistance, leaving lawmakers to make tough choices about whether to increase taxes or reduce spending or both to close budget gaps. Moreover, recent seismic shifts in the political balance of power in most states threaten to usher in a host of unsustainable and regressive tax changes over the next two years.

A handful of states are in a position to enact progressive, reform-minded tax changes that would improve the overall fairness of the states' tax systems and in some cases raise sorely needed revenue. Broadening the sales tax base to include services and removing other sales tax exemptions will be on the agenda in Rhode Island, Georgia, Idaho, and other states. Connecticut has a good chance of becoming the 25th state to enact an Earned Income Tax Credit.

Special interest tax breaks, or "tax expenditures," will likely come under increased scrutiny in 2011. Many states will be examining this type of "spending through the tax code" with the objective of eliminating ineffective tax expenditures. In particular, lawmakers in Georgia, Iowa, Maine, Missouri, New Mexico, Oregon, and South Dakota have demonstrated an interest in taking this route.

But anti-tax lawmakers, who have shown no interest in these sustainable, progressive, revenue enhancing reforms, ascended into power in more than a dozen states. Many are poised to enact harmful cuts in existing state taxes that could weaken states' ability to provide core public services for years to come. From cutting the capital gains tax to eliminating corporate and personal income taxes, the threats to state tax fairness and adequacy are mounting by the day.

Lawmakers in at least a dozen states including North Carolina, Minnesota, and Georgia are likely to consider new Tax and Expenditure Limits (known as TELs) modeled on Colorado's Taxpayer Bill of Rights (TABOR). New TABOR legislation in those states would limit their annual growth in state revenues to the sum of inflation and population growth, which would seriously hinder these states' ability to fully recover from the current economic downturn.

Ohio's new governor is calling for the elimination of the personal income tax while lawmakers in Missouri and Kentucky will both be debating the so-called "Fair Tax," which would eliminate state personal income taxes and replace the revenue with regressive sales taxes. Regrettably, passing the "Fair Tax" is apparently a top priority for Missouri's new Speaker of the House.

Corporate tax breaks are also on the agenda in at least six states ranging from proposals to entirely eliminate corporate income taxes (South Carolina, Florida, and Wisconsin) to massive reductions in corporate tax rates (Pennsylvania, Georgia, and Iowa). Substantial capital gains tax breaks will also be considered in many states including Arkansas, Georgia, and Oregon.

Certainly, 2011 will be an interesting year in terms of state tax policy. Though the year ahead will not be without its challenges, there are a wide range of policy options available to lawmakers interested in achieving greater tax fairness. Even in those states where prospects for positive tax developments seem bleak, broad coalitions of advocates, researchers, and activists are working together to build support for progressive tax policy and balanced approaches to addressing their states' continued budget constraints.