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State Revenue Boom Paves Way for Tax Cuts

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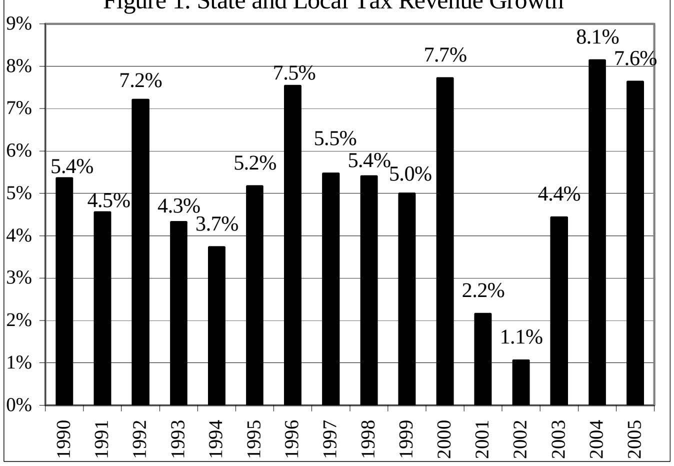
The nation's strong economic growth is creating a revenue boom for state and local governments. Figure 1 shows that state and local tax revenues soared 8.1 percent in 2004 and an estimated 7.6 percent in 2005, based on data for the first three quarters of the year.[1]

Both state and local governments are enjoying the surge in revenues. Table 1 shows that state taxes increased 8.7 percent in 2004 and an estimated 8.0 percent in 2005. Local taxes increased 7.3 percent in 2004 and an estimated 7.1 percent in 2005.

At the local level, taxes have been rising rapidly for years. As property values have soared, cities and counties have received a windfall because they derive about three-quarters of their tax revenues from property taxes.

At the state level, the economic downturn earlier this decade caused revenue growth to slow and briefly turn negative. But the revenue "crisis" that states complained about was exaggerated, and it is now long gone. By 2005, tax revenues for the 50 states were up 18 percent over the pre-recession peak of 2001. Also note that federal aid to the states has grown at more than 7 percent annually since 2000.[2]

Figure 1. State and Local Tax Revenue Growth



Source: U.S. Bureau of the Census. Calendar years. 2005 is estimated.

With today's rising revenues, states that had increased taxes to fill budget gaps—such as Virginia—can return the money to taxpayers now that budgets are in surplus. The 50 states enacted net tax increases of $24 billion during the past five years, but now they can reverse course and provide major tax relief in 2006.[3]

Unfortunately, some states are using the revenue boom to expand their budgets beyond sustainable levels, as many states did during the 1990s. In California, Governor Arnold Schwarzenegger has proposed a general fund budget increase for fiscal 2007 of 8.4 percent, which follows a 9.7 percent increase for 2006. In Maryland, Governor Robert Ehrlich has proposed a general fund (apart from reserve fund) increase for fiscal 2007 of 11.4 percent, which follows a 7.6 percent increase for 2006.

Table 1. State and Local Tax Revenue Growth

	2000	2001	2002	2003	2004	2005
State	8.8%	0.9%	-3.2%	4.2%	8.7%	8.0%
Local	5.9%	4.4%	8.0%	4.8%	7.3%	7.1%
State and local	7.7%	2.2%	1.1%	4.4%	8.1%	7.6%

Source: U.S. Bureau of the Census. Calendar years. 2005 is estimated.

Which States Are Most in Need of Tax Cuts?

Rather than expand their budgets, states should use current surpluses to reform their tax codes in order to boost long-run economic growth. Most states have the budget room to make substantial tax cuts and tax reforms—three-quarters of the states had tax revenue growth of 6 percent or more in 2005.[4]

Table 2 identifies states that are most in need of tax relief. Those are states that have rapid revenue growth, a high overall tax burden, and high income tax rates. States that measure above average on those criteria are marked with an asterisk (*).

Table 2. States Most in Need of Tax Cuts

	State Tax Revenue Increase 2002-2005	State and Local Tax Burden, % of Income 2004	Top Individual Tax Rate 2005	Top Corporate Tax Rate 2005
All States	22%	10.5%	5.5%	6.9%
Alabama	25% *	8.5%	5.0%	6.5%
Alaska	115% *	11.3% *	0.0%	9.4% *
Arizona	22%	9.8%	5.0%	7.0% *
Arkansas	29% *	10.4%	7.0% *	6.5%
California	16%	10.9% *	9.3% *	8.8% *
Colorado	16%	8.9%	4.6%	4.6%
Connecticut	30% *	10.8% *	5.0%	7.5% *
D.C.	39% *	13.6% *	9.0% *	10.0% *
Delaware	33% *	10.5%	6.0% *	8.7% *
Florida	49% *	9.8%	0.0%	5.5%
Georgia	20%	9.9%	6.0% *	6.0%
Hawaii	33% *	12.1% *	8.3% *	6.4%
Idaho	6%	10.0%	7.8% *	7.6% *
Illinois	30% *	10.2%	3.0%	7.3% *
Indiana	26% *	10.5%	3.4%	8.5% *
Iowa	6%	9.8%	9.0% *	12.0% *
Kansas	10%	10.3%	6.5% *	4.0%
Kentucky	12%	10.0%	6.0% *	8.3% *
Louisiana	4%	10.6% *	6.0% *	8.0% *
Maine	20%	12.8% *	8.5% *	8.9% *
Maryland	31% *	10.5%	4.8%	7.0% *
Massachusetts	22%	10.0%	5.3%	9.5% *
Michigan	-3%	9.6%	3.9%	0.0%
Minnesota	21%	11.3% *	7.9% *	9.8% *
Mississippi	12%	10.2%	5.0%	5.0%
Missouri	10%	9.2%	6.0% *	6.3%
Montana	24% *	9.3%	6.9% *	6.8%
Nebraska	24% *	11.3% *	6.8% *	7.8% *
Nevada	56% *	9.4%	0.0%	0.0%
New Hampshire	8%	8.3%	0.0%	8.5% *
New Jersey	26% *	11.0% *	9.0% *	9.0% *
New Mexico	8%	10.6% *	6.0% *	7.6% *
New York	33% *	13.4% *	12.2% *	17.6% *
North Carolina	23% *	10.0%	8.3% *	6.9%
North Dakota	31% *	10.6% *	5.5%	7.0% *
Ohio	12%	11.5% *	7.5% *	8.5% *
Oklahoma	22%	9.7%	6.7% *	6.0%
Oregon	25% *	9.4%	9.0% *	6.6%
Pennsylvania	23% *	10.4%	3.1%	10.0% *
Rhode Island	22%	11.2% *	8.8% *	9.0% *
South Carolina	41%	9.7%	7.0% *	5.0%
South Dakota	16%	8.9%	0.0%	0.0%
Tennessee	26% *	8.8%	0.0%	6.5%
Texas	18%	9.4%	0.0%	0.0%
Utah	27% *	10.4%	7.0% *	5.0%
Vermont	39% *	11.4% *	9.5% *	9.8% *
Virginia	26% *	9.4%	5.8% *	6.0%
Washington	18%	10.1%	0.0%	0.0%
West Virginia	18%	10.7% *	6.5% *	9.0% *
Wisconsin	17%	11.4% *	6.8% *	7.9% *
Wyoming	74% *	13.7% *	0.0%	0.0%

Sources: The first two columns are calendar year estimates based on data from the U.S. Bureau of the Census. The second two columns are from the Federation of Tax Administrators. New York income tax rates include New York City taxes. Above-average data items are marked with *.

The first column in Table 2 shows increases in state tax revenues between 2002 and 2005. Total tax revenue for the 50 states and the District of Columbia increased 22 percent. The fastest growth was in Alaska, Wyoming, Nevada, Florida, South Carolina, Vermont, and D.C.

The second column shows the overall burdens of state and local taxes as a percentage of personal income. For 2004, the U.S. average was 10.5 percent.[5] The other columns show the top state income tax rates. For 2005, the average top individual and corporate rates were 5.5 and 6.9 percent, respectively.

States that combine high income tax rates with high overall tax burdens include California, Louisiana, Maine, Minnesota, Nebraska, New Jersey, New Mexico, New York, Ohio, Rhode Island, Vermont, West Virginia, and Wisconsin. New York, New Jersey, Nebraska, Vermont, and D.C. ranked high on all four tax measures. All those jurisdictions are ripe candidates for tax relief in 2006.

The most important goal of tax reform is to cut top income tax rates. In today's competitive economy, capital, skilled labor, and retirees are increasingly mobile and will gravitate to lower-tax jurisdictions. With the coming retirement of the large baby-boom generation, high-tax states such as New York will shoot themselves in the foot if their tax policies prompt retirees to pull up stakes and head to sunny and low-tax locations such as Florida.

High corporate income taxes are similarly counter-productive. State corporate taxes have a high ratio of compliance costs to revenue collected, and they induce businesses to shift real investments and paper profits to low-tax states and foreign countries.

In sum, rather than expand their budgets and induce another budget crunch, states should use today's surpluses to make lasting reforms to their tax systems. After all, competition for jobs and investment will only increase in the years ahead. By restraining spending and pursuing tax reforms, states will be better prepared for the next downturn and better able to sustain long-run growth.

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[1] U.S. Bureau of the Census, "Quarterly Summary of State and Local Tax Revenue," December 15, 2005, www.census.gov/govs/www/qtax.html.

[2] *Budget of the United States Government, Fiscal Year 2006: Analytical Perspectives*, p. 131. Measured from 2000 to 2006.

[3] National Association of State Budget Officers, "Fiscal Survey of the States," December 2005, p. 8.

[4] U.S. Bureau of the Census. Estimated based on the first three quarters of data for calendar 2005.

[5] The state and local tax burden was estimated using state tax data for 2004 and local tax data for 2002, the most recent available from the U.S. Bureau of the Census.