Tax Revenue is Recovering, but Fiscal Stress Continues

By William F. Fox

The state fiscal environment remains very weak despite the turnaround in revenue growth. It will be at least several years before many states see revenues return to their previous peak levels and several years more before revenues reach similar proportions of the economy. Though states may be less inclined to seek the tax rate increases that occurred after previous recessions, many are examining ways to tax cross-border activity more effectively.

Fiscal Conditions in the States

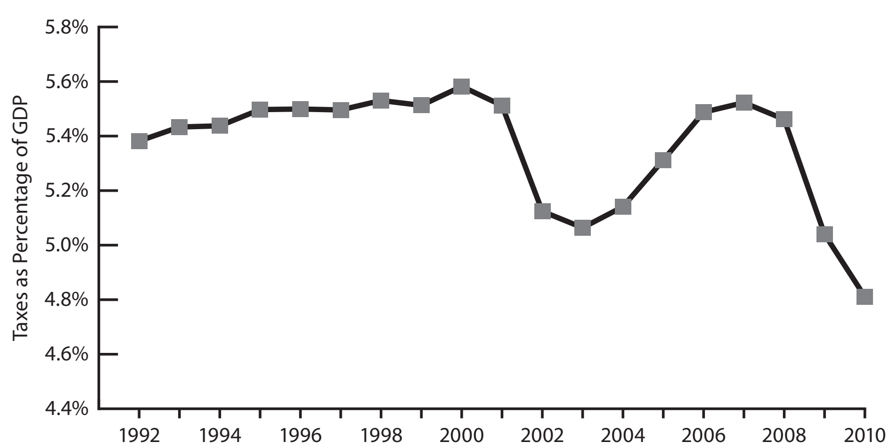
Almost every state experienced a dramatic drop in tax revenues during the Great Recession of 2008–09. State tax revenues declined more rapidly than the gross domestic product and other broad measures of economic activity resulting in taxes being historically low relative to the economy (see Figure A). State taxes fell from 5.5 percent of GDP in 2008 to 4.8 percent in 2010.[1] Taxpayers, government officials and service providers should not anticipate a quick return of service levels and expenditures (should these be goals) to their pre-recession peaks.

Taxes returned close to their pre-recession share of GDP through a combination of natural growth and policy changes—such as tax rate increases—after previous recessions. This can be seen by the 2007 peak in revenues being a little higher than in 1995 taxes. But, the rebound took approximately three years once revenues began growing again, meaning the overall cycle from one revenue peak to the next can easily be seven to eight years.

Most States Are Seeing a Rebound in Revenues

Tax revenues have begun to grow again in many states after the sharp contraction in 2009 and 2010. The average state saw tax revenues decline by 11.1 percent between 2008 and 2010, including the effects of any tax policy changes. Personal income taxes were off 17.3 percent across the two years, compared to a 7.3 percent decline in the sales tax. Tax revenues have now risen three consecutive

Figure A: State Taxes as a Share of GDP, 1992–2010



Source: U.S. Census Bureau and Bureau of Economic Analysis.

quarters following five quarters of decline. On average, revenues were 3.9 percent higher in the third quarter of 2010 compared to the same period a year earlier, but were still 7 percent lower than 2008.[2] Revenues increased in 42 of the 48 reporting states during the third quarter, and fell in only six. Personal income taxes rose the fastest at 4.7 percent, followed by sales taxes at 4.1 percent. Corporate income taxes, which have fallen 12 of the past 13 quarters, continued to decline and were down 2.5 percent.

The role that policy changes will play in raising or lowering taxes during the current expansion is difficult to anticipate given the significant turnover in state legislatures and governor's offices. The focus on limiting or reducing taxes during the recent election cycle could mean states are less willing to use policy increases to return taxes to previous levels. However, voters sent mixed messages on direct ballot initiatives. For example, Colorado and Massachusetts rejected significant tax cuts, while Washington voters opposed introduction of a personal income tax. Also, voters approved property tax caps and exemptions in a number of states. No effort is made here to anticipate how these various political forces will influence tax patterns in coming years, but instead the discussion is placed in the context of current trends in tax policy and revenue growth.

Fiscal Problems Remain as the Economy Rebounds

Many state budgets will remain under pressure during the 2012 fiscal year as the end of the American Recovery and Reinvestment Act funds offsets much of the growth in tax revenues. In fact, aggregate tax revenues will only return to 2008 peaks in 2013, meaning taxes will remain well below previous peaks relative to GDP for several more years. Taxes will grow rapidly relative to the economy in many states as the expansion improves because of the rapid increase of the non-labor income component of the personal income tax, such as dividends and interest, and significant increases in housing and vehicle sales, even though the levels of housing and vehicles purchased will be much lower than the peaks achieved in the 2005–06 time period.

The opportunity to right-size government is an obvious silver lining of the tight fiscal conditions, particularly the chance to readjust the distribution of spending across programs. But the severity of ongoing fiscal problems differs across states depending on such factors as the degree to which recurring expenditure cuts were enacted over the past several years, the extent to which tax revenues have fallen, and the revenue rebound that will occur this year and next. States with large structural economic changes, such as long-term reductions in housing and other construction, will continue to have significant fiscal difficulties over the next several years. States that made significant cuts in recurring spending and did not see the greatest revenue losses will be best able to accommodate the loss of federal dollars. Forty-five states reported to the National Association of State Budget Officers that they had cut their budgets in the 2010 fiscal year, though the amount cut varied widely.[3] Texas reported reducing its general fund budget by 22.8 percent, while New Hampshire lowered spending by only 0.7 percent.

Even the states least affected by the recession will continue experiencing fiscal difficulties in the sense that tax revenues declined relative to the economy and will not return to the pre-recession share for several more years, depending on the state. This can mean lower service levels compared with pre-recession levels, though the specific areas where cuts are made differ by state. Public service expenditures could return to their earlier levels as revenues continue to rise through the expansion.

State Policy Actions

Rate Changes

States appear to have relied less frequently on tax rate increases to moderate budget problems during this economic downturn than earlier ones. Ten states increased their sales tax rate and nine raised their personal income tax rate during 2009 and 2010. At the same time, five states lowered their income tax rate. In addition, 12 states raised their tobacco tax rate.

Sales tax rate increases were more common during the recessions of the 1980s and 1990s,with more than 30 increases in the first half of the 1980s and about 25 in the first half of the 1990s. More than 20 states increased their tobacco tax rates in 2001 and 2002, during and around the recession. More rate changes may occur over the next several years, but they seem less likely during the next several years than in the years following the previous recessions. Nonetheless, the dollar value of tax revenues generated by rate increases in 2010 was the highest in history; of course, this is, in part, the result of inflation.

Sales Taxes

Many states are focusing on ways to better tax cross-state or multi-state economic activity. Fiscal pressure is only one of the reasons for these policy initiatives. Expanding globalization emphasizes the imperative for tax policies that support rising cross-border trade and factor flows. Tax systems should support better and more consistent economic growth while protecting state revenue bases. Solutions to cross-border taxation are complicated, so the intent here is to provide a thumbnail sketch of some recent actions. We discuss two taxes here, the sales and corporate income taxes, but similar issues are being addressed for other taxes, such as the individual income tax.

Many efforts are underway to allow states to collect the sales tax more effectively on in-state purchases from out-of-state vendors. The U.S. economy is hampered when taxes are not collected evenly on in-state and cross-state transactions, because vendors have an incentive to arrange their affairs to avoid establishing a taxable presence, thereby giving consumers a tax incentive to purchase from out-of-state vendors. The economy suffers as firms incur higher costs to avoid creating taxable presence and states lose tax revenues. For example, Bruce, Fox and Luna estimate that state and local governments will lose about $12 billion in 2012 due to the inability to collect sales taxes due on e-commerce.[4]

Among state efforts to improve their ability to collect the tax, the Streamlined Sales Tax Governing Board continues to move forward, with Georgia becoming the 24th member. More states have recently been found out of compliance with the Streamlined Agreement, as states are being required to comply more stringently with every detail of the agreement. The Governing Board is seeking agreement on a number of remaining elements in a simplified sales tax structure. Vendor compensation for collecting the sales tax has proved one of the most difficult issues, perhaps because vendor compensation can significantly reduce net state revenues obtained from establishing a collection responsibility for remote vendors. The Governing Board also has discussed seeking to overturn the *Quill v. North Dakota* Supreme Court decision, which limits states to only requiring firms with a physical presence to collect sales tax.

Other state efforts to tax remote sales also appear to be increasing, perhaps reflecting frustration with slow congressional movement in areas such as the Main Street Fairness Act. Twenty-three states include a line on their personal income tax return allowing taxpayers to report use tax obligations. Most states report modest collections as a result, but the approach represents a step in the right direction.

Disagreement exists regarding whether some of the other new state approaches are helpful in enhancing states' ability to require remote vendors to collect sales and use taxes. Several states have enacted so-called "Amazon Laws." For example, New York enacted legislation asserting that a vendor must collect taxes on behalf of the state if in-state affiliates solicit sales and direct customers to the site.[5] Several other states passed similar legislation, which in some cases has been vetoed or cancelled. Amazon is challenging New York's authority to require collection of the sales tax and lost the first round in New York courts.

Colorado enacted reporting requirements for firms that do not collect state sales taxes. Firms with more than $100,000 in sales to Colorado buyers are required to report the buyer and the dollar amount to the state Department of Revenue. The vendors are also required to send letters to buyers of more than $500 in purchases to alert them that use tax may be due to Colorado. The Direct Marketers' Association is challenging the legislation in court. Oklahoma also has enacted legislation requiring firms to say that tax may be due on their purchases. Further, North Carolina has asked online vendors who are affiliates of sites such as Amazon and that operate in North Carolina to collect and report sales taxes. Amazon has gone to court questioning North Carolina's ability to require the information, with some initial success. Finally, Texas is auditing Amazon and arguing that the firm owes four years worth of back sales taxes because it operates a distribution center in the state.

Corporate Income Taxes

States continue to focus on the best means to tax corporations and businesses. State business tax policy goals seem somewhat schizophrenic as states are torn between economic development and tax revenues. One issue is how to determine the taxable income of related corporations. The options include separate reporting, elective consolidated reporting and mandatory combined reporting. Combined reporting requires certain related companies to file a single return as if related entities were collapsed into one entity. Six additional states have adopted required combined reporting in recent years, including Vermont (2006), New York (2007), West

Virginia (2009), Michigan (2009), Wisconsin (2009) and Massachusetts (2009), raising the number of states with combined reporting to 22. Combined reporting is intended to reduce tax planning, increase corporate tax revenues and develop a more accurate measure of profits earned in a state. Combined reporting may help achieve some of these goals, but does not measure up to the expectations that many have placed on it.[6] It can close some tax planning opportunities, but will not close them all since the combined group normally excludes some affiliates.[7]

Our research suggests that combined reporting likely raises a small amount of revenue, but should not be counted on for significant new revenue. Thus far, statutes requiring addbacks of related company deductions appear to be more effective at generating revenues. Further, our research and that conducted by others over the years suggests any increase in the effective tax rate, including increases resulting from combined reporting and addbacks, could have a small negative effect on the state's economy. It should also be noted that states have a series of options besides combined reporting, such as addbacks, to reduce tax planning. States should also consider these other options in efforts to reduce abusive tax planning.

States also continue to increase the weight on the sales factor in the corporate income tax formula with the apparent goals of lessening the tax implicit on production without significant tax revenue losses. A single weighted sales factor apportionment formula distributes the tax burden much like a gross receipts or sales tax because the receipts are sitused at the destination of goods. Effectively, a single factor sales apportioned corporate income tax operates like a sales tax on profitable corporations. At the same time, the tax on capital or labor used in a state is lessened. But, most states have not recognized that this logic only works for goods. The sales factor in most state formulas locates sales of services where production takes place. The result is that moving to 100 percent weight on the sales factor may actually increase the tax imposed on production of services in a state. In recent years 11 states have moved the sales factor for services so that both goods and services are sitused where the purchase is to be enjoyed and attributes the service where the customer is located.

This remains an important issue for other states to consider. As a general rule, moving to destination situsing of sales of services is good policy, though this issue has not been widely researched to date.

Notes

[1] Local taxes, on the other hand, rose from 3.6 percent to 4 percent of GDP in the same time period, so that the overall decline in state and local taxes is modest.

[2] See Lucy Dadayan and Donald Boyd, "State Tax Revenues Rebound Further, Growing for the Third Straight Quarter," *State Revenue Flash Report*, Nelson A. Rockefeller Institute of Government, SUNY Albany November 30, 2010.

[3] See NGA/NASBO Fall 2010 Fiscal Survey of States at *http://nasbo.org/LinkClick.aspx?fileticket=wJKroFj6QDA%3d&tabid=38*.

[4] See Bruce, Fox and Luna, "State and Local Government Sales Tax Revenue Losses from E-commerce," *State Tax Notes*, May 18, 2009.

[5] The term affiliates is used in a different context in the discussion of Amazon Laws than with the corporate income tax. These affiliates are normally not owned or controlled by the vendor.

[6] See William F. Fox and LeAnn Luna, "Combined Reporting with the Corporate Income Tax: Issues for State Legislators," *State Tax Notes*, January, 17, 2011.

[7] States may exclude certain affiliates, such as insurance or banking firms, and often some foreign businesses.

About the Author

Bill Fox is the William B. Stokely Distinguished Professor of Business and the director of the Center for Business and Economic Research at the University of Tennessee. He is a past president and recipient of the Steven D. Gold Award from the National Tax Association and former chairman of the Economics Department at the University of Tennessee. He has held visiting appointments as professor at the University of Hawaii, scholar at the Federal Reserve Bank of Kansas City, and Distinguished Fulbright Chair at the University of Frankfurt, Germany. Fox has served as a consultant in more than 25 countries and 10 U.S. states on a wide range of public policy issues.