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BTC Brief

NC BUDGET & TAX CENTER

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Timely, accessible, and credible analysis of state and local budget and tax issues

PEER PRESSURE: Most states have increased taxes since the start of the recession

Key Findings:

- **As North Carolina's lawmakers debate how to deal with the $4.6 billion state budget gap, it may be helpful to look at the choices made in states with similar fiscal situations. Twenty-five states have raised taxes since the beginning of 2009, and 13 more are considering tax proposals (Figure 1). Some states have taken either progressive or reform-minded approaches by adding top income tax brackets, closing corporate tax loopholes or broadening the base of their sales taxes**

A Balanced Approach

The current recession presented serious challenges to state legislators across the country as they attempted to balance budgets for the fiscal year that started July 1. Compared to the last recession in late 2001, this recession is already deeper and projected to be longer. In the current recession, national unemployment has reached 9.5%, compared to 6.3% in the last recession.

North Carolina's economy has taken a substantial hit in the recession. The state's unemployment rate is 11.1%, well above the national average. In addition, North Carolina faced the third-largest revenue shortfall in the country, as measured as a share of the original budget, during the fiscal year that just ended (FY 2008-09). It is currently wrestling with a $4.6 billion gap between the funding level needed to maintain current services and the projected tax revenues for FY2009-10.

Raising Revenues – A smart and balanced approach

Sound economic policy calls for states to use a balanced approach to closing budget gaps. Renowned economists Joseph Stiglitz and Peter Orzag concluded in a paper written at the outset of the previous recession that tax increases on higher-income taxpayers are preferable to cutting spending for closing state fiscal deficits in the short run.[1] State spending cuts decrease overall demand for goods and services, which can deepen the recession. For instance, if a state lays-off employees, reduces social services, or terminates contracts, all directly translate to less consumption on the part of the laid-off worker, individual paying more out of pocket, or out-of-work contractor. However, placing an additional tax on upper income earners has less of an effect on consumption, because some of the additional taxes will be paid out of savings instead of reduced spending.

The federal government made funds available to offset the need for spending cuts or tax increases, but recovery dollars on average closed between 30% and 40% of state budget gaps.

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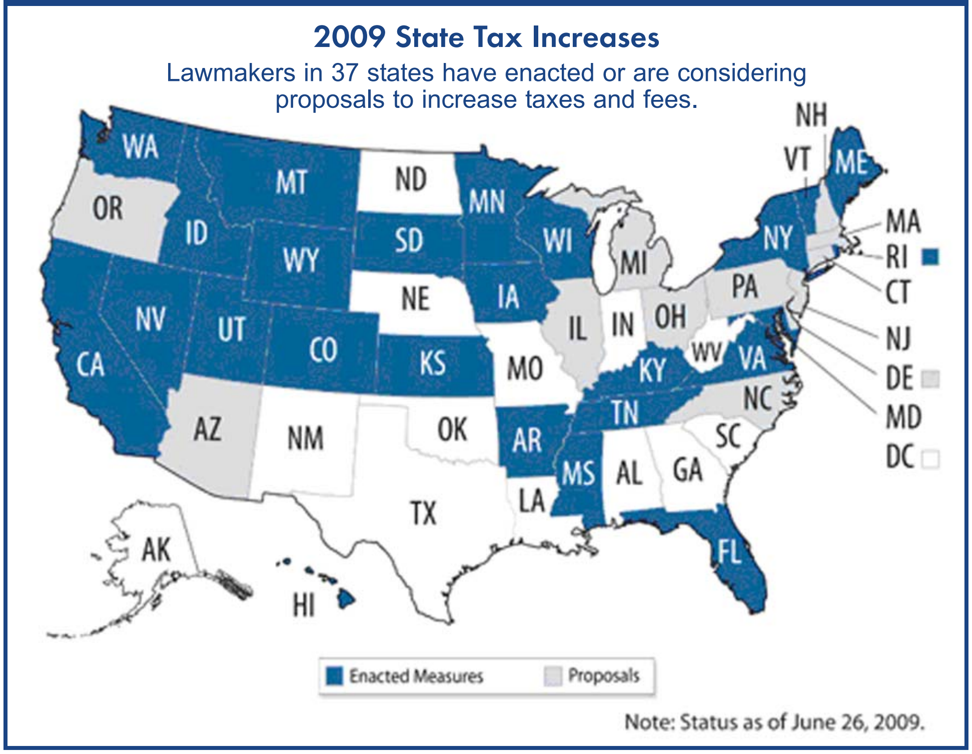
Legislators should first look to use the federal funds to balance the budget, and the remaining gap should be addressed through a combination of thoughtful spending reductions and well designed tax increases in order to prevent devastating cuts to important public investments.

Most states have passed budgets for the fiscal year that started July 1. Twenty-five states have already enacted tax increases, and 13 more are considering doing so. North Carolina is not the only southern state that recognizes the need for tax increases. Virginia, Florida, Mississippi, Tennessee and Kentucky have all increased taxes since the start of 2009.

FIGURE 1



SOURCE: http://www.cbpp.org/cms/index.cfm?fa=view&id=2815. Center on Budget Policy and Priorities.

Several states have added at least one top income tax bracket. Hawaii and New York added three and two top brackets, respectively. California passed a 25% increase on all tax brackets. Several other states, including Virginia, increased income tax revenue by removing exemptions. More popular among states is using the sales tax. Several states raised rates, removed exemptions, added to the tax base, or enacted a combination of the three. Excise taxes and business taxes have also been widely raised. Wisconsin became the 23rd state to close major corporate tax loopholes through enacting mandatory combined reporting. Virginia expanded its corporate income tax to include Real Estate Investment Trusts.

Proven by history

Raising taxes was a common approach to balancing budgets in the past two recessions. In the recession of the early 1990s, 44 states raised taxes, and 30 states took that approach in 2001. Furthermore, the states that raised taxes recovered as quickly from the recession as states that did not raise taxes.[2] However, it is likely that the impact of the recession was more severe in the states that raised revenues, which may indicate that they rebounded more quickly. For instance, North Carolina raised taxes during the 2001 recession, and both personal income and employment growth outpaced national averages in the period 2002-2004.[2]

Implications for North Carolina

The recession—and with it, state budget gaps—are projected to worsen in the coming months. Twelve states with adopted budgets for FY09-10 have already been forced to go back to the drawing board to make unusual early year adjustments. Legislators in North Carolina need to focus on raising a sufficient amount of revenue that will also make the tax system fairer and more stable in the long run. North Carolinians support raising revenue to offset damaging cuts to public investments.[3] A recent public opinion poll shows that residents support adding an upper income tax bracket and closing corporate tax loopholes to balance the budget. State leaders need to heed the call to raise revenues in a fair and smart way.

SOURCES:

1 Raising State Income Taxes on High-Income Tax Payers, Elizabeth McNichol *et al*: Center on Budget Policy and Priorities. http://www.cbpp.org/cms/index.cfm?fa=view&id=2792

2 Tax Measures Help State Balance Budgets, Nicholas Johnson: Center on Budget Policy and Priorities. http://www.cbpp.org/cms/index.cfm?fa=view&id=2815

3 http://www.ncae.org/News.asp?nid=105

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