Temporary Taxes

States' Response to the Great Recession

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There's nothing more permanent than a temporary tax.
—Minnesota House Minority Leader Kurt Daudt[1]

When the Great Recession created unexpected budget deficits, many states used temporary tax increases to maintain revenues for vital government services. Because they are generally less disruptive than immediate spending cuts, temporary tax increases can be a useful tool for overcoming short-term deficits. Mr. Daudt's statement, however, reflects a common concern: temporary taxes may end up permanent.[2]

But the evidence on this point is mixed. States often allow temporary taxes to expire after the taxes have met their short-term revenue needs. In this brief, we look at 14 states and the District of Columbia (DC) that together enacted 25 temporary tax increase measures between 2008 and 2011. Among the temporary taxes that have passed their expiration date, about half were allowed to expire on schedule. The remaining measures were made permanent, modified and made permanent, or replaced with alternatives.

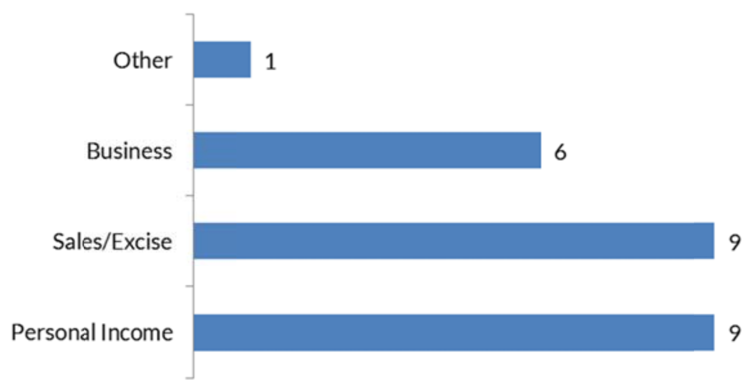
Temporary Taxes and Balanced Budget Requirements

Unlike the federal government, states have to balance their budget every fiscal year. So, when revenue declines unexpectedly, states must scramble to keep spending and revenues in line for the rest of the year. States usually manage these midyear shortfalls with quick fixes, such as spending controls (e.g., hiring freezes and program delays) or one-time revenue measures like acceleration of tax payments or delayed refunds. Another option for states is using built-up reserves like rainy-day funds (Maag and Merriman 2007). However, when the decline is severe and extends into the next fiscal year, states must consider other measures, including raising taxes. While increasing taxes is always controversial, policymakers can make it more palatable by adding a sunset date when the tax hike will expire.

States faced enormous deficits following the Great Recession, and most responded with both taxes and significant budget reductions to balance the budgets.[3] According to Johnson, Collins, and Singham (2010), 33 states increased taxes in response to the Great Recession. Most enacted these increases without sunset dates. But the states discussed here passed temporary tax measures with statutory durations ranging from a single year in New Jersey to six years in Hawaii. The increases fell into three main categories: personal income, business, and sales and excise (figure 1). The personal income tax changes were almost all targeted at high-income earners (table 1).

FIGURE 1

Temporary Tax by Type



Source: Urban Institute.
Note: See table 1 for details.

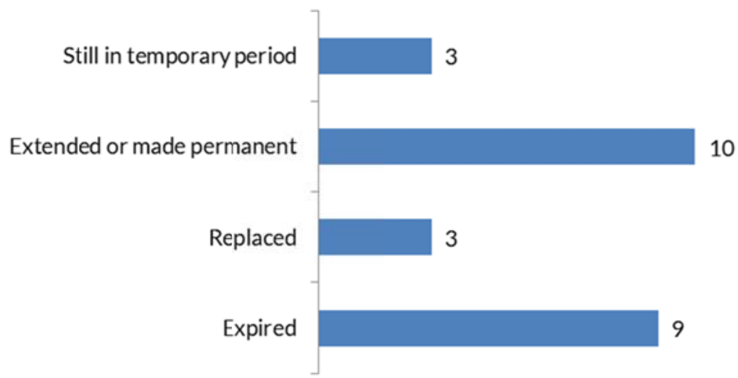
Temporary tax measures can be classified based on some common features (figure 2):

- **Expired:** Temporary tax measures are typically used to plug a one-time budget shortfall and allowed to sunset once the crisis appears to be averted. States using these taxes included Arizona, California, DC, Maryland, North Carolina, and Oregon (personal and business income tax).

- **Replaced:** Scheduled expiration can also be an opportunity to enact other tax policy preferences. For example, Kansas replaced a temporary increase in its sales tax with a smaller but permanent increase. It also sharply cut personal and corporate income taxes. New York allowed its temporary income tax increase to expire but replaced it with another temporary top rate.
- **Extended or made permanent:** Temporary taxes can also be extended. For some states—Colorado, Connecticut, Delaware, Nevada, and Oregon (alcohol tax)—the temporary period was not long enough to resolve budget problems and the taxes were either extended or made permanent. Connecticut and Nevada have now each extended their temporary taxes twice.
- **Still in temporary period:** Temporary increases in Hawaii and Illinois are still in the original period.

FIGURE 2

Status of Temporary Taxes



Source: Urban Institute.
Note: See table 1 for details.

Do Temporary Taxes Work?

The evidence is mixed on whether temporary tax increases can respond to a fiscal crisis without becoming a permanent feature of the tax system. The length and severity of the Great Recession forced state lawmakers to make tough tax and spending decisions. Most states went into the recession with what was thought to be adequate reserves, having built them up from the 2001 recession (NASBO 2009). But in many states the reserve only softened the fiscal damage. General fund spending in the states fell 3 percent in 2009 and almost 6 percent in 2010, the first nominal back-to-back decline in NASBO's survey going back to 1979.[4] (Federal stimulus kept total spending from falling.)

In 2013, while total state general fund spending had nominally recovered from 2008, 20 states still spent less than in 2008. Whether revenue policy was temporary or not, virtually every state had to take actions to cut spending, increase revenues, and deplete its fund balance—in some combination—from 2009 to 2011. The states that passed temporary taxes are no different.

Description of Temporary Taxes, by State

Arizona

Arizona had approximately $700 million in its reserves, about 7 percent of general fund expenditures, going into the 2007–09 recession, also called the Great Recession. But when revenue dropped by over $750 million in 2008 and $1.8 billion in 2009, the state drained those reserves. Entering 2010, the state still faced a budget shortfall of close to $5 billion over the next two years.[5] To reduce the deficit, Arizona Governor Jan Brewer (R) had already cut spending by $1.5 billion in fiscal years (FYs) 2009 and 2010. But more revenue was needed for FY 2011, and Brewer campaigned for a temporary 1 percentage-point increase in the sales tax for 2010–13. The increase, on the ballot as Proposition 100 and passed by the voters in April 2010, went into effect July 1, 2010, and expired on schedule.

California

Halfway through FY 2009, California lowered its revenue forecast by 18 percent, creating a significant fiscal gap. The FY 2010 budget package revised FY 2009 estimates and included additional spending cuts. According to the Legislative Analyst's Office (2009), spending cuts accounted for 55 percent of the FY 2010 balanced-budget solution, tax increases accounted for 21 percent, and borrowing accounted for the remainder. Tax increases included a sales tax hike from 7.25 to 8.25 percent and raising all income tax rates by a quarter of a percentage point. The temporary tax increases expired on schedule, but the voters approved other temporary tax hikes in 2012.

Colorado

Colorado's revenues fell $1 billion short of projections in FY 2009. The difficult budget situation was addressed by using cash and reserve funds, furloughing workers, and reducing circuit-breaker payouts for seniors, among other measures. Still faced with a shortfall, lawmakers agreed to include tobacco products, including cigarettes, in the sales tax base.[6] The measure, signed into law by then-Governor Bill Ritter (R), was initially set to expire after two years. In 2011 lawmakers extended the tax increase for an additional two years. As the tax was nearing expiration again in 2013, state lawmakers and Governor John Hickenlooper (D) made the sales tax on tobacco permanent, citing health benefits due to the higher tax. The policy raises about $30 million a year.

TABLE 1

Temporary Tax Measures Enacted from 2008 to 2011

State	Original period	Type	Policy	Status
Arizona	2010–13	Sales/Excise	Increased general sales tax rate from 5.6% to 6.6%	Expired on schedule
California	2009–10	Personal income	Increased all rates by 0.25 percentage points	Expired on schedule but replaced in 2012 by referendum with a temporary increase in the top rate
	2010–13	Sales/Excise	Increased general sales tax rate from 7.25% to 8.25%	Expired on schedule but replaced in 2012 by referendum with a quarter-point increase to 7.5%
Colorado	2009–11	Sales/Excise	Increased tobacco products tax	Made permanent
Connecticut	2009–11	Business	Added 10% corporate income tax surtax	Extended twice and increased to 20%; expires in 2016
Delaware	2010–11	Personal income	Increased top rate ($60,000) from 5.95% to 6.95%	Rate was reduced to 6.75% in 2012 and again to 6.6% in 2014 and made permanent
	2010–13	Business	Increased minimum tax for four years	Made permanent
	2010–13	Estate	Calculated estate tax based on 2001 federal law	Made permanent
District of Columbia	2010–13	Sales/Excise	Increased general sales tax rate from 5.75% to 6%	Expired on schedule
Hawaii	2010–15	Sales/Excise	Increased lodging tax from 7.25% to 9.25%	Made permanent
	2010–15	Personal income	Created new top rates plus exemption phaseout	Still in temporary period
Illinois	2011–15 2011–25	Business	Increased corporate income tax rate from 4.8% to 7% through 2014 and 5.25% through 2024	Still in temporary period
	2011–15 2011–25	Personal income	Increased flat income tax rate from 3% to 5% through 2014, 3.75% through 2024. Permanent increase to 3.25%.	Still in temporary period
Kansas	2010–13	Sales/Excise	Increased sales tax rate from 5.7% to 6.3%	Reduced to 6.15% and made permanent
Maryland	2008–10	Personal income	Created top rate of 6.25% on income over $1 million	Expired on schedule
Nevada	2009–11	Business	Created additional tax on wages above $62,500	Extended twice; expires 2015
	2009–11	Sales/Excise	Increased sales tax from 6.5% to 6.85%	Extended twice; expires 2015

TABLE 1

Temporary Tax Measures Enacted from 2008 to 2011

State	Original period	Type	Policy	Status
New Jersey	2010	Personal income	Increased taxes for earners over $400,000 and created a new top bracket for earners over $1 million	Expired on schedule
New York	2009–11	Personal income	Taxed all $500,000+ earners at 8.97% and taxed married filing jointly above $300,000 at 7.85%. Limited itemized deductions for $1 million + earners.	Replaced with new temporary tax: top rate on income over $2 million of 8.82% through tax year 2017
North Carolina	2009–12	Business	Created temporary corporate tax surcharge and expanded business tax credits	Expired on schedule
	2009–11	Personal income	Added a 3 % surcharge for high earners	Expired on schedule
	2009–12	Sales/Excise	Increased sales tax 1 percentage point (from 6.75% to 7.75%)	Expired on schedule
Oregon	2009–11	Business	Increased corporate tax rate for businesses with taxable income over $250,000	Expired on schedule
	2009–11	Personal income	Increased rate for high earners to 10.8% on $250,000–$500,000 and 11% above $500,000	Expired on schedule
	2009–11	Sales/Excise	Added a 50 cent surcharge on bottles of distilled liquor	Extended through June 30, 2015, by the Oregon Liquor Control Commission

Connecticut

Addressing a $2.7 billion shortfall in FY 2010, Connecticut Governor Jodi Rell (R) and the Democratic legislature compromised on a mixture of spending cuts and tax increases. On the spending side, a union contract agreement froze wages, increased employee contributions to health care, deferred state contributions to retirement, and furloughed employees. On taxes, they increased the personal income tax permanently and enacted a three year 10 percent surcharge on corporate tax. The surcharge was increased to 20 percent and extended in 2011 and extended again in 2013.

Delaware

In FY 2010, Delaware lawmakers faced an $800 million shortfall. They cut the budget by 8 percent and passed several tax increases including an increase in the income tax rate from 5.95 percent to 6.95 percent for taxpayers earning more than $60,000, expiring in 2014.[7] Before the temporary period was over, the rate was reduced to 6.75 percent. The personal income tax rate is now permanently 6.6 percent.

District of Columbia

Facing rapidly declining revenue projections, DC passed several tax increases and spending cuts over multiple iterations of the FY 2010 budget. The final budget was 7.4 percent below the FY 2009 budget level and included a temporary increase in the general sales tax from 5.75 percent to 6 percent.[8]

Hawaii

In 2009, Hawaii faced a $2 billion revenue deficit over the previous year. The state had only $74 million in reserves, which Governor Linda Lingle (R) wanted to preserve, opting for deep cuts to balance the budget. State lawmakers rejected the governor's austerity budget, especially cuts to employee benefits, but left the reserves mostly intact. Instead, Hawaii passed a temporary tax measure to create three new income tax brackets for high earners. For married couples filing jointly, a 9 percent rate would apply to income from $300,000 up to $350,000, a 10 percent rate for income from $350,000 up to $400,000, and an 11 percent rate for income above $400,000 (McNichol, Nicholas, and Shure 2009). The measures remain in effect through 2015, so it is too early to tell if they will sunset as scheduled.

Illinois

The Great Recession exacerbated Illinois's ongoing budget crisis due to underfunded state employee pension liabilities and unpaid bills to vendors. While still recovering from the downturn in 2011, Governor Pat Quinn (D) proposed a temporary increase in revenues to improve the budget situation. With the governor's backing, the state passed temporary personal income tax and corporate income tax increases set to expire in 2015.[10] The state raised its flat personal income tax rate from 3 percent to 5 percent and its corporate income tax rate from 4.8 percent to 7 percent. Combined, these provisions are expected to increase revenue by $7 billion annually.

Kansas

Governor Mark Parkinson (D) initially responded to declining revenues during the recession by cutting the state budget by close to $1 billion in both 2008 and 2009. The state still faced a $400 million shortfall entering 2010. Governor Parkinson felt there was no further room for budget cuts and proposed a permanent 0.4 percentage-point increase and a temporary 0.6 percentage point-increase in the sales tax rate for three years, raising the tax rate from 5.3 percent to 6.3 percent. In 2012, newly elected Governor Sam Brownback (R) proposed a major redesign of the state tax system, including steep cuts to the corporate and personal income taxes paid for by permanently setting the sales tax rate at 6.3 percent. The legislature adopted the income tax cuts but did not extend the temporary sales tax increase, creating an instant hole in the budget.[11] In 2013, the governor and legislature agreed to a 6.15 percent sales tax rate rather than letting it revert to 5.7 percent.

Maryland

In 2008, Maryland exempted select computer services from the sales tax. In order to smooth the transition to decreased revenues, the state enacted a temporary tax for millionaires during 2008–10. Although not designed for a revenue shortfall, the temporary tax helped Maryland's finances when revenue did fall as a result of the recession.[12] The tax created a new bracket for millionaires with a tax rate of 6.25 percent. Despite a budget shortfall in 2010, Governor Martin O'Malley (D) did not include an extension in his budget and instead proposed cuts to government services. There was a short-lived attempt by some lawmakers to extend the surcharge until 2016, but the bill did not pass.

Nevada

The Nevada economy was hit hard by the recession. The state faced a $2.26 billion deficit going into the 2009–11 biennium. Rejecting Governor Jim Gibbon's (R) executive budget that relied heavily on budget cuts, state lawmakers put forward their own plan that used tax increases to close the deficit. The governor and Republican lawmakers agreed to increases in taxes and fees on the condition that those increases expire at the end of the biennium. With this condition, the compromise plan passed. The state increased the sales tax by 0.35 percentage points, increased the business payroll tax, and increased several licensing and registration fees for both consumers and businesses. In 2011, newly elected Governor Brian Sandoval (R) initially proposed a budget that clawed back previously allocated funds for capital improvements to schools and infrastructure projects. A judge ruled the state could not reclaim the as-yet-unspent portion of the funds, leaving a budget hole. Governor Sandoval decided to extend the temporary tax measures for an additional biennium through 2013. In his 2014–15 budget recommendation, Governor Sandoval proposed extending the tax increases again to pay for education, and those increases were adopted by the legislature. Some legislators have argued that the revenue measures should be made permanent.

New Jersey

New Jersey faced sharply declining revenues in 2008 and 2009. To cover these shortfalls, the state used its reserves and cut discretionary spending. In 2009, having exhausted reserves, Governor John Corzine

(D) and the Democratic legislature had to close a $7 billion budget gap. In addition to $4 billion of cuts, policymakers increased income tax rates for high earners for one year. The tax hike expired at the end of 2010 after an election that focused on taxes. The Democratic-controlled legislature passed measures to extend these tax increases twice during the 2010 legislative session; however, Governor Chris Christie (R) vetoed the extensions both times.

New York

In December 2008, New York Governor David Patterson (D), facing a deficit of about $15 billion, proposed a budget with modest spending cuts and tax increases. During the 2009 spring legislative session, budget projections were revised to show a $3.2 billion decrease over the earlier revenue estimates, widening the gap significantly. In addition to significant spending reductions, lawmakers agreed on a temporary high-earners tax, creating two new brackets to tax income over $300,000 at a 7.85 percent rate and income over $500,000 at 8.97 percent rate—up from a rate of 6.85 percent that previously applied to all income greater than $40,000. The higher rates were scheduled to sunset in three years at the end of 2011, and thus became an issue during the 2010 gubernatorial campaign. As a candidate, future Governor Andrew Cuomo (D) argued for allowing the temporary tax increase to expire. However, the looming sunset deadline provided an opportunity to enact other tax legislation that was a priority for Democratic legislators. In a special session in 2011, the governor and state legislators made a deal to revise the income tax brackets, lowering rates for married taxpayers filing joint returns and earning less than $300,000 but also creating new temporary rates on high earners, 8.82 percent for taxpayers earning more than $2 million through 2016.

North Carolina

North Carolina enacted several temporary tax measures to overcome a substantial budget shortfall. These measures included a surcharge on high-income earners (expired in 2010), a surcharge on the corporate income tax (expired in 2011), and a 1 percentage-point increase in the sales tax (expired in 2012). Governor Beverly Perdue (D) proposed extending the sales tax increase but was rebuffed by the Republican legislature, and all the temporary taxes expired on schedule.

Oregon

Facing a budget shortfall in 2010 after using reserves to help close budget gaps in 2008 and 2009, Oregon Governor John Kitzhaber (D) proposed a temporary increase in the state's personal and corporate income taxes as well as a the diversion of a temporary surcharge on distilled liquor to the state general fund. Skittish lawmakers did not want to vote on the income tax measures, so instead put it before the voters as ballot measures 66 and 67. With the backing of many state political leaders, including the governor, the measures passed. The temporary measures imposed higher rates on the two highest income tax brackets, taxing income between $250,000 and $500,000 at a 10.8 percent rate and income above $500,000 at an 11 percent rate. Both rates fell to 9.9 percent in 2011. The measures also included a temporary increase in tax rates for business income over $500,000, with a permanently higher rate on business income over $10 million after the temporary provisions expired in 2012. Both the personal and corporate income tax increases sunset in 2012 as scheduled, but the Oregon Liquor Control Commission extend the 50 cent per bottle surcharge on distilled spirits twice. It now expires on June 30, 2015.

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Notes

1. Quoted in James Nord, " 'Temporary' Taxes Become Permanent? Minnesota Has Mixed Experience," MinnPost.com, March 22, 2013.
2. Minnesota ended up passing permanent income tax increases in 2014.
3. Maryland originally enacted the temporary tax to pay for a sales tax exemption.
4. See NASBO's *The Fiscal Survey of States,* fall edition, various years (available at http://www.nasbo.org/publications-data/fiscal-survey-of-the-states/archives). Although 2010 was the first nominal two-year consecutive decline, the 1981–83 recessions and the 2001 recession brought about real state general fund spending declines lasting longer than one year.
5. See the governor's State of the State address, available at http://azgovernor.gov/dms/upload/GS_011410_StateoftheStateYUMA.pdf.
6. The sales tax was to be paid on top of the existing tobacco tax.
7. See "Overcoming Historic Challenges: A Balanced Budget for the 2010 Fiscal Year," Delaware Office of Budget, Planning, and Administration, http://budget.delaware.gov/fy2010/session_overview_070109.pdf.
8. See "Annual Operating Budget and Capital Plan Archives," D.C. Office of the Chief Financial Officer, http://cfo.dc.gov/node/292242.
9. Beginning in 2015, the individual rate goes down to 3.75 percent, maintaining an increase of 0.75 percent. Similarly, the corporate rate goes down to 5.25 percent rather than the pre-2011 4.8 percent rate.
10. Norton Francis, "Kansas Sets the Stage for Perpetual Budget Crisis," *TaxVox* (blog), Urban-Brookings Tax Policy Center, June 10, 2013.
11. See Office of Revenue projections, available at http://finances.marylandtaxes.com/static_files/revenue/closeout/FY2009_closeout.pdf.

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