NEW JERSEY POLICY PERSPECTIVE

WAS IT WORTH IT?

Looking Back on a Decade of Income Tax Cuts

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Except for the relative handful of households whose state income taxes went up with passage of the "millionaires" tax" last year, New Jerseyans today are paying a lower state income tax than they would have in 1993 on the same income. That is because the state income tax was reduced in three stages from 1994 to 1996. New Jersey is one of more than 40 states that cut income taxes, and other taxes, during an economic boom-time when revenues were rising beyond anyone's expectations.

In New Jersey, those tax cuts have now been in effect for a full decade. And it is time to ask an important question: was it worth it?

To help answer this question, New Jersey Policy Perspective analyzed the financial cost to the state of the major tax policy changes made in the past 10 years. According to this analysis, New Jersey lost about $14 billion from income tax rate cuts alone. If anything, this is a fairly conservative estimate, based in part on a 7 percent yearly growth rate of income tax revenue instead of the 30-year average of 9 percent.

In addition to cutting income tax rates, New Jersey also reduced the state sales tax in 1992 from 7 percent to 6 percent, returning the rate to its 1982-1990 level. The cost to the state from this was another $10.2 billion, bringing to $24.2 billion the amount of revenue the state has lost over this period.

During the same period as the income tax cut has been in effect, the average residential property tax in New Jersey rose by $1,886 (Part Two of this report shows the difference between the average property taxes paid in 1993 and 2003 for every New Jersey municipality). While data cannot detail the exact experience of every New Jersey taxpayer, an analysis of the tax cuts at various income levels indicates that only for households whose yearly income approaches $200,000 did the income tax cut exceed the average state increase in property taxes. Indeed, for more than 90 percent of households, the income tax cut has been less than the average increase in property taxes. In other words, the lower a household's income, the more likely that its property tax *increase* is greater than its state income tax *decrease*. The table below compares pre-1994 and current state income tax levies at various income levels.

Table 1
CHANGES IN INCOME TAX OWED

INCOME	PRE-1994 TAX	CURRENT TAX	TAX CUT
$22,000	$450	$315	$135
$30,000	650	455	195
$60,000	1,500	1,050	450
$100,000	3,650	2,750	900
$150,000	6,900	5,512	1,388
$250,000	13,900	11,523	2,377
$500,000	31,400	27,448	3,953
$1 million *	66,400	59,298	7,102

* For a household with $1 million in income, these figures reflect the rate in effect through the end of 2003. As of January 1, 2004 the state income tax rate was raised on incomes over $500,000. So the current tax on a household with $1 million in income is $72,658, an increase of $13,360 over the tax that would have been paid in 2003 and of $6,258 over the pre-1994 tax.

Income tax rates were reduced in three stages from 1994 to 1996. In 1994 rates were reduced by 5 percent across the board. These reductions were followed by cuts of up to 10.5 percent and 17.6 percent in 1995 and 1996 for incomes under $80,000, with smaller amounts on incomes above $80,000. Table 2 illustrates the changes in these rates.

Table 2
CHANGES IN NEW JERSEY INCOME TAX RATES

INCOME	1991-1993	1994	1995	1996-2003	CURRENT
Under $20,000	2.0%	1.9%	1.4%	1.4%	1.4%
$20,001-$50,000	2.5	2.375	2.125	1.75	1.75
$50,001-$70,000	3.5	3.325	2.975	2.45	2.45
$70,001-$80,000	5.0	4.75	4.25	3.5	3.5
$80,001-$150,000	6.5	6.175	6.013	5.525	5.525
$150,001-$500,000	7.0	6.65	6.58	6.37	6.37
$500,000-plus	7.0	6.65	6.58	6.37	8.97

When New Jersey adopted a state income tax in 1976, it was written into the state constitution that the revenue it brought in could only be used to relieve the burden of local property taxes. That direct connection is made annually in the state budget because gross income tax revenues are deposited into and spent from the Property Tax Relief Fund—not the General Fund where most expenditures are budgeted.

Over the years, then, income tax proceeds have gone for such state budget items as aid to municipalities, aid to schools and various programs that provide senior citizens, veterans, the disabled, homeowners and renters with property tax exemptions and rebates. Over the past decade, $14 billion less has been available to mitigate the burden of property taxes in the state that leads the nation in reliance on these taxes. Predictably, the rise in property taxes over this period has been pronounced.

Table 3 compares actual income taxes and property taxes collected over this period.

Table 3
AMOUNT COLLECTED IN STATE INCOME TAX
AND LOCAL PROPERTY TAX, 1993-2003

YEAR	INCOME TAX COLLECTED	PROPERTY TAX COLLECTED
1993	$4.35 billion	$10.8 billion
1994	4.49 billion	11.3 billion
1995	4.54 billion	11.7 billion
1996	4.73 billion	12.2 billion
1997	4.83 billion	12.6 billion
1998	5.59 billion	13.0 billion
1999	6.32 billion	13.6 billion
2000	7.21 billion	14.2 billion
2001	7.99 billion	15.0 billion
2002	6.84 billion	16.1 billion
2003	6.74 billion	17.3 billion

SOURCES: Various New Jersey State Budgets; Rutgers University Center for Government Services

It is estimated that the revenue loss in 2004 could come in as high as $1.8 billion—meaning that nearly half the $4 billion shortfall being faced in the upcoming budget year might have been avoidable had income tax rates not been reduced in the 1990s.

Almost every state enacted tax cuts starting in the mid-1990s, according to an analysis by the Center on Budget and Policy Priorities (CBPP). New Jersey's tax cuts were among the biggest—and now New Jersey's state fiscal problems are among the nation's worst. This might not be a coincidence.

"Those big tax cuts do not seem to have contributed to state fiscal and economic health," the CBPP analysis found.[1] Taking a look at the six states that cut taxes the most in the 1990s, CBPP found larger deficits and smaller reserves at the start of the current fiscal crisis than in other states. Calling New Jersey's fiscal crisis "one of the worst in the nation," the CBPP report notes that the 2004 shortfall was nearly 20 percent of the state budget, that three years ago the state's bond rating was downgraded and that between 2001 and 2003 New Jersey endured above average growth in unemployment and below average growth in personal income.[2]

The other states in the category of largest tax cuts were Colorado, Connecticut, Delaware, Massachusetts and New York.

The tax cuts of the 1990s were enacted at a time when soaring stock prices and the resulting record high capital gains were driving incomes higher, especially at the upper end. It became possible to cut income tax rates but still see an increase in the amount of money a state collected from income taxes. As the Center on Budget and Policy Priorities reported, "At the time they were enacted, the large tax cuts of 1994-2001 may have appeared affordable in many states because tax revenues were coming in at levels above expectations and many states were running record surpluses."[3]

Spending cuts were not made concurrent to the tax cuts. Indeed, "with this unusually high and rapidly growing revenue stream, states could cut taxes while maintaining spending growth at about the same level as in previous decades and also accumulating rainy day funds that, although insufficient to weather the current fiscal crisis, were quite large by historic standards."[4]

But the boom would not last. It came to an end in 2001. The amount of money coming in from income and sales taxes dropped. Programs that were created or expanded with boom-generated revenue would lack funding. To the extent that states spent their windfall on such programs, instead of using it on non-recurring items or putting it away for use in hard times, the fiscal crisis was worsened. In New Jersey this meant, for example, barring more low-income families from enrolling in a state healthcare plan and raising tuitions at state colleges by nearly 10 percent.

And states' structural deficits—a term that describes a situation in which states annually spend more than they take in—were exacerbated. "Unfortunately," CBPP reported, "to a large extent the trends that underlay the tax cuts of the 1990s have turned out to be unsustainable...In other words, the tax cuts of the 1990s were financed largely by *temporary* economic conditions that have now ceased. But the tax cuts themselves were designed to be *permanent*."[5]

New Jersey is slightly more fortunate than other states in that some taxes have been increased to help make up for the lost revenues. Most notable was the 2002 reform of the state's Corporate Business Tax, which enacted a new alternative tax on the largest corporations in the state, raised the alternative minimum tax and closed loopholes that had allowed many companies to avoid paying taxes. The amount of corporate business taxes collected by the state jumped from $1.2 billion in Fiscal Year 2002 to over $2.5 billion in Fiscal Year 2003 and $2.4 billion in Fiscal Year 2004.

Certainly tax cuts have their defenders. Reducing income tax rates, especially for the wealthiest taxpayers, are said by some to help create jobs. However, this proposition is even more debatable at the state level than when federal taxes are involved, because even if money saved in taxes is used to stimulate investment, that investment will not necessarily be confined to the state where the tax cuts took place.

But the more plausible take on the relationship between tax cuts and economic growth is the reverse of what tax-cutters argue. As the Center on Budget and Policy Priorities observed, "It is likely that the economic growth in tax-cutting states was a contributor to the budget surpluses that helped pay for the tax cuts more than it was a result of the tax cuts."[6]

In other words, New Jersey—like so many states—bought something it couldn't pay for over the long haul.

Now, as states attempt to deal with short-term budget shortfalls and long-term structural deficits, part of the solution should be to confront the question of whether the income tax cuts of the 1990s were worth it. Evidence strongly suggests that they were not. There are three main reasons.

1. In most cases, the drop in income tax was more than offset by an increase in local property taxes. So it was a net loss in citizens' wallets—a loss felt most by low- and middle-income households.

2. It was a shift away from a tax that is closely based on someone's ability to pay it and an increase in reliance on a tax that is based on home value—not a good indicator of ability to pay. New Jersey already is a state where lower income people pay a much higher share of their income in the form of state income tax, state sales tax and local property tax than higher income people. No tax in New Jersey is more progressive than the state income tax, which is to say that no tax is more closely tied to someone's ability to pay it. It could be argued that in cutting the state income tax, New Jersey fixed the only tax in the state that wasn't broken.

3. The tax-cutting trend has worsened New Jersey's fiscal situation, making the current financial hole deeper than it likely would have been and depriving the state—and ultimately its citizens—of money that could have been used to ease the property tax burden and allow state government to be more responsive to the needs of the most vulnerable people. Today that monetary loss from the reduction in income and sales taxes has reached $24 billion and is still climbing.

A decade's worth of lost revenue will not be recovered. But it is not too late to correct the problem for the future.

ENDNOTES

[1] Zahradnik, Robert. "Tax Cuts and Consequences: The States That Cut Taxes the Most During the 1990s Have Suffered Lately." Center on Budget and Policy Priorities. January 12, 2005
[2] Ibid.
[3] Johnson, Nicholas. "The State Tax Cuts of the 1990s, the Current Revenue Crisis and Implications for State Services." Center on Budget and Policy Priorities. November 18, 2002.
[4] Ibid.
[5] Ibid.
[6] Ibid.

For more on this and related issues from the Center on Budget and Policy Priorities, go to: http://www.cbpp.org.

For more on New Jersey's tax burden, see also, NJPP's report, *Upside Down & Backwards: Taxes in New Jersey,* January 2003.

New Jersey Policy Perspective is a nonpartisan, nonprofit organization established in 1997 to conduct research and analysis on state issues. Our goal is a state where everyone can achieve to his or her full potential in an economy that offers a widely shared, rising standard of living.

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