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Time Bandits? State Income Taxes Surge in April

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This time of year can bring great joy or sorrow to state budget negotiators, and uncertainty, too. This year, a 37 percent surge in "nonwithheld" *federal* income tax payments in April and May, along with early reports of surging income tax revenue in several states, suggest that states with income taxes will have a little joy, perhaps a little sorrow, and an abundance of uncertainty.

Federal income tax returns were due on April 15, and most state income tax returns were due then as well. Most of us dutifully pay our taxes through withholding as the year progresses, and face only a small payment or refund when we file our returns. However, a small number of taxpayers with large, volatile, uncertain, and sometimes movable nonwage income can dominate April income tax collections. When this kind of income spikes or falls, taxpayers often adjust their payments of estimated tax in September or January, and "settle up" when they file their returns in April.

Capital gains from stocks and other assets are the most striking example of this, although some other forms of nonwage income are concentrated and relatively movable. In 2010, two one-hundredths of a percent of taxpayers accounted for 50 percent of all taxable net capital gains, and 0.9 percent of taxpayers (less than one percent) accounted for 86 percent of taxable gains.[1] Because capital gains invariably are taxed at the highest rates, the revenue impact of changes in this income for a relative few taxpayers is even more concentrated.

This is hot money that can rise or fall rapidly from one year to the next, reflecting sharp movements in financial markets and individual taxpayer choices. The stock market was up about 9 percent in 2012, setting the stage for some growth.[2] The income is taxable when "realized" — after assets are sold. Taxpayers decide when to sell assets, taking into account personal circumstances, current tax rates, *expected future tax rates*, and other factors. Throughout 2012, taxpayers knew that federal income tax rates were scheduled to rise in 2013, and after Congressional action on the "fiscal cliff" those fears largely were realized: The top rate on ordinary income rose from 35 to 39.6 percent, and the top rate on capital gains rose from 15 to 20 percent. Taxpayers had an incentive to accelerate income into 2012 from 2013 and later years, to lower their overall tax liability. Capital gains are the easiest form of income to move, but the incentive was there for other income as well. Income tax revenue for the 2012 tax year likely would rise, but at the expense of 2013 and beyond. Because most states tax largely the same income as the federal government, the acceleration would affect state income tax revenue in a similar fashion.

One early sign that taxpayers accelerated income is that the fourth and final payment of estimated taxes to states rose by 25.2 percent, up from the 6.7 percent median increase for the first three payments, as noted in our April *State Revenue Report*. As we said in that report, "The strong growth in the December- January estimated payments is a significant indicator that income was accelerated into tax year 2012. The uncertain implications of this acceleration for payments in April and in later years creates a further burden for states trying to make accurate projections of personal income taxes in the coming quarters."

A second and related sign was that early data on personal income taxes for January and February was strong, suggesting that some revenue from the final estimated tax payment, which generally was due in January, and from bonuses accelerated into December, affected those months.

Now, we have further indications: The federal government reports its tax collections on a daily basis, and sooner than many states. Nonwithheld taxes for April and the first few days of May (which includes payments with tax returns) were up 37 percent from the same period last year.[3] By early May, the vast majority of revenue from tax returns is deposited and counted as revenue, so this is a fairly complete picture. Because federal tax changes in 2012 were minor, it likely reflects changes in underlying income (including income that taxpayers chose to accelerate), rather than legal changes.

Around the states, we're seeing some signs of a similar surge, coupled with appropriate concern that this is money drawn from the future, as well as caution about the weak state of the economy:

- California income tax revenue in April was about $4.5 billion more than expected, and analysts attributed it at least in part to acceleration.[4] Strong revenue growth also reflected California's recent tax increase.
- Connecticut's consensus revenue forecast group recently raised its estimate of revenue for fiscal year 2013 based primarily on strong but one-time income and gift tax collections, but cut its revenue forecasts for the upcoming two fiscal years. The secretary of the Office of Policy and Management noted that "OPM estimates that much of this additional revenue is due to one-time factors related to the partial expiration of the Bush tax cuts at the end of calendar year 2012. Those federal changes may be responsible for upwards of $400 million in additional revenue in FY 2013

from the Personal Income Tax and the Inheritance and Estate Tax. Sales tax collections remain weak.…"[5]

- A headline from the Illinois Commission on Governmental Forecasting and Accountability said it well: "April Surprise — Revenues Skyrocket But Are They One Time?" COGFA went on to note, "preliminary Commission assumptions are that gains are strongly related to final and estimated payments stemming from actions taken by taxpayers in efforts to minimize the tax consequences of the higher 2013 federal tax rates. As such, they are not repeatable in future fiscal years, and should be viewed more in terms of a 'one-time' event.… Illinois' employment situation is dominated by less than positive news, offering little in the way of argument for sustainable higher expectations." [6]
- Nebraska reported unanticipated revenue, and attributed it in part to acceleration.[7] In our previous discussions with state revenue analysts, they noted that estimated payments in 2012 were also strong, likely for the same reasons.
- Pennsylvania saw a jump in quarterly estimated payments in December and January. April tax collections were slightly ahead of projections, but their Independent Fiscal Office expressed caution about the outlook.[8]

Several other states have reported revenue surges, too. We expect more will as well. We will report more fully after we have more complete data for April and May of 2013.

What does this all mean? One of the complications that revenue analysts face when April tax-return revenue surges is that it could mean the economy in the previous year actually was stronger than previously believed. In that case, the longer term revenue outlook could be better than previously thought. Revenue analysts won't know whether this is a contributing factor until more economic data are available.

However, much of the available economic data suggests the underlying economy remains very weak, and there are well-known reasons to believe that federal tax incentives caused much of the increase. In that case, the temporary surge in revenue may mask underlying weakness in the economy. Over the longer term, this could be bad news — it could mean that accelerated money received now, used to pay current bills, will not be there to pay for services in the future. Fortunately, many revenue forecasters anticipated a surge and have been properly cautious in estimating that revenue has been borrowed from the future. Still, the temptation will be to treat it as recurring revenue available to support ongoing spending, or available for tax cuts. Caution is in order.

Endnotes

1 See http://www.irs.gov/file_source/PUP/taxstats/indtaxstats/10in14ar.xls.

2 As measured by the calendar-year average for the S&P 500 index. Capital gains do not move up or down in lockstep with the stock market, but increases in asset values, all else equal, create conditions for larger capital gains.

3 See Financial Management Service, "Daily Treasury Statements," http://www.fms.treas.gov/dts/index.html.

4 Chris Megerian, "California tax revenue yields multibillion-dollar surplus," *Los Angeles Times*, May 2, 2013, http://articles.latimes.com/2013/may/02/local/la-me-state-budget-20130503.

5 State of Connecticut, Office of Policy and Management, Letter to State Comptroller Kevin Lembo, April 30, 2013, http://www.ct.gov/opm/lib/opm/budget/comptrollerletter/fy2013/2013apr30comptrollersletter.pdf; "Connecticut revises down revenue forecasts for 2014, 2015," Reuters News Service, April 30, 2013, http://www.reuters.com/article/2013/04/30/connecticut-budget-revenue-idUSL2N0DH38J20130430.

6 Jim Muschinske, "REVENUE: APRIL SURPRISE — REVENUES SKYROCKET BUT ARE THEY ONE-TIME?" Commission on Government Forecasting and Accountability, April 2013 Monthly Briefing, http://cgfa.ilga.gov/.

7 Sen. Norm Wallman, "Income tax revenues brings additional funds," *Beatrice Daily Sun*, Beatrice, NE, May 6, 2013, http://beatricedailysun.com/news/opinion/mailbag/income-tax-revenues-brings-additional-funds/article_3e952dd0-e829-5373-9afd-87aac4f8f591.html.

8 Robert Swift, "Sluggish tax revenues spur jobs debate," *The Citizens' Voice*, Wilkes-Barre, PA, May 6, 2013, http://citizensvoice.com/news/sluggish-tax-revenues-spur-jobs-debate-1.1484559.