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HIGHLIGHTS

- State personal income tax collections fell by 7.1 percent in January-April of 2014, compared to the same period a year earlier for thirty-eight early reporting states. Thirty-three states had declines, with ten states reporting double-digit declines.
- Sharp personal income tax revenue declines were mostly due to the mirror-image impact of the federal “fiscal cliff” that led to a one-time surge in income tax collections last year and reversal of that effect this year. April collections represented the bulk of the decline, with states collecting \$7.9 billion less in April 2014 compared to April 2013.
- Declines in personal income tax collections were much anticipated but the size of the declines surprised officials in many states. It was extremely difficult for states to forecast personal income tax collections as it was hard to sort out the impact of income acceleration from tax year 2013 to tax year 2012 relative to the countervailing effect of the strong 2013 stock market. While many states tried to be cautious in their forecasts, early figures indicate that income tax collections are below the forecasts in many states.
- The income tax decline and associated shortfalls do not signal a fundamental weakening in the economy, but it is bad news for budgets nonetheless. States with revenue shortfalls in 2014 generally will reduce their forecasts for 2015 as well, causing a “double whammy” effect on budgets currently being finalized.

STATE REVENUE SPECIAL REPORT

WWW.ROCKINST.ORG

JUNE 2014, SPECIAL REPORT

April “Surprises” More Surprising Than Expected

Depressed Income Tax Collections Adding to Budget Pressures

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Introduction

The April 15th deadline for personal income tax returns brought bad news for nearly every state that has a broad-based income tax. While the direction of the April “surprise” was anticipated, the magnitude was underestimated in many states. The declines in income tax collections appear to have been driven mostly by behavior of taxpayers, who shifted income from tax year 2013 to tax year 2012 to minimize federal tax liability. The situation was further complicated in states that reduced income tax rates, including Kansas, Maine, Michigan, Nebraska, North Dakota, and Ohio, where it was difficult to sort out the effects of tax cuts from declines in underlying income. Minnesota was the only state to increase income tax rates in 2013.

As we predicted in previous reports, tax returns on 2013 income that were filed in April show large and widespread declines, likely due to declines in capital gains and other investment income as many taxpayers took actions to minimize their expected federal tax liability as certain federal income tax rates were set to rise on January 1, 2013. This behavior led to a one-time surge in income tax collections for the 2012 tax year, in fiscal year 2013, and left states with a dark cloud over revenue projections for fiscal year 2014.¹

To gain early information on personal income tax revenues, Rockefeller Institute staff collected statistics from thirty-eight of forty-one states that have a broad-based personal income tax.² The data cover different components of the personal income tax, including withholding, final returns, declarations of estimated taxes, and refunds.

Preliminary data for April 2014 show large and widespread declines in overall personal income tax revenues. While these declines do not necessarily signal weakening of the overall economy and the direction was much anticipated, they still created enormous challenges for states with resulting shortfalls, particularly for the states that rely most heavily on personal income taxes.

The April-June quarter is an important quarter for personal income tax revenue collections and can be very volatile. While we don’t have complete data for the April-June 2014 quarter, we can still look at the trends in the previous years to shed some light.

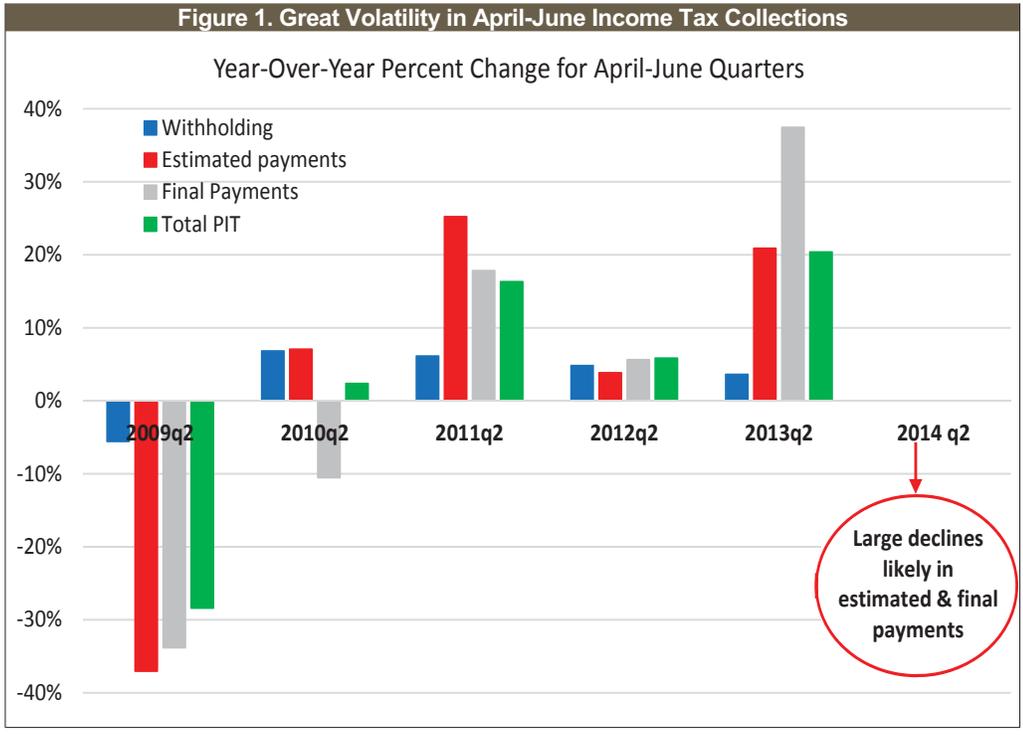


Figure 1 shows the year-over-year percent change in total personal income tax, withholding, estimated payments, and final payments for the April-June quarter in the last five years. Estimated and final payments are particularly volatile. In the April-June 2009 quarter, overall income tax collections showed a decline of 28.4 percent compared to a year earlier, mostly driven by large declines reported in estimated and final payments, at 37 and 33.8 percent,

respectively. The year-over-year growth rate for overall income tax collections was 16.3 percent in April-June 2011 and 20.4 percent in April-June 2013. There is far less volatility in withholding income tax collections. The largest decline in withholding in the last five years was 5.6 percent in April-June of 2009 and the greatest growth was 6.8 percent in April-June of 2010. Given the large declines in April 2014 personal income tax collections, we expect that the April-June 2014 quarter will be dramatically negative, particularly in terms of estimated and final payments.

April and May are critical months for personal income tax receipts as individual income tax returns are due and most income tax refunds are processed in these two months.³ In this report we mostly discuss revenue collections for the month of April 2014, as well as for the period January through April 2014. The figures for April alone should be viewed cautiously as the picture may be distorted due to various factors, including changes in processing times from one year to another. The final picture on personal income tax receipts will become clearer once we have complete data for the months of May and June.

The rest of this report is organized as follows. We first discuss trends in overall personal income tax collections as well as in different components of income tax collections, including withholding, estimated payments, final payments, and refunds. Next we discuss the impact of capital gains and the stock market on the April income tax returns. Finally, we discuss the impact of "bad" April surprises on state revenue forecasts as well as on state budget processes.

Personal Income Tax

Total personal income tax collections in January-April 2014 were 7.1 percent, or about \$8.4 billion below the level of a year ago in thirty-eight states for which we have data. In April 2014 alone (April being the month when many states receive the bulk of their balance due or final payments), personal income tax receipts fell by 15.8 percent, or \$7.9 billion.

Personal income tax receipts in the first four months of calendar year 2014 were greater than in 2013 in only five states — Delaware, Massachusetts, Oklahoma, Oregon, and Virginia. The growth in Delaware and Virginia is mostly due to the fact that in both states the income tax return due date is later than April 15th (April 30th in Delaware and May 1st in Virginia) and the April numbers do not reflect the potential declines in final payments. In Oregon, the growth is mostly attributable to the relatively strong growth in withholding, which was at least partially driven by the strong job growth in the second half of 2013 and first quarter of 2014.

Table 1 shows the percent change in state-by-state personal income tax revenues for January-April of 2014 compared to the same period of 2013. In FY 2013, personal income tax revenue made up over 50 percent of total tax collections in five states — California, Massachusetts, New York, Oregon, and Virginia. Among all thirty-eight early-reporting states, the largest declines were reported in Ohio, North Dakota, and Kansas at 31.1, 28.1, and 24 percent, respectively. In all three states the large declines are at least partially attributable to legislated tax changes, including income tax rate deductions. For example, in North Dakota legislators reduced the income tax rate for the highest earners from 3.99 percent in 2012 to 3.22 percent in 2013 and in Ohio the rates for the highest income tax bracket was reduced from 5.925 percent in 2012 to 5.421 percent in 2013. Finally, in 2012 Kansas enacted deep cuts in income tax rates, "the largest ever enacted by any state" according to the Center on Budget and Policy Priorities.⁴ Kansas reduced the income tax rate for the highest earners from 6.45 percent in 2012 to 4.9 percent. Moreover, rates are set to decrease further through 2018.

The large and widespread year-over-year declines in personal income tax collections in January-April are a troubling harbinger for many states for the rest of the year.

As Figure 2 shows, all regions but the Southwest saw declines in personal income tax revenues both in April and in January-April collections (for state-by-state patterns, see above). The Southwest region was the only region reporting growth for the first four months of tax year 2014, albeit insignificant. (Revenue receipts are missing for New Mexico, and the picture for the Southwest region might change slightly once its numbers become available.) The Great Lakes region saw the largest decline, followed by the Plains region.

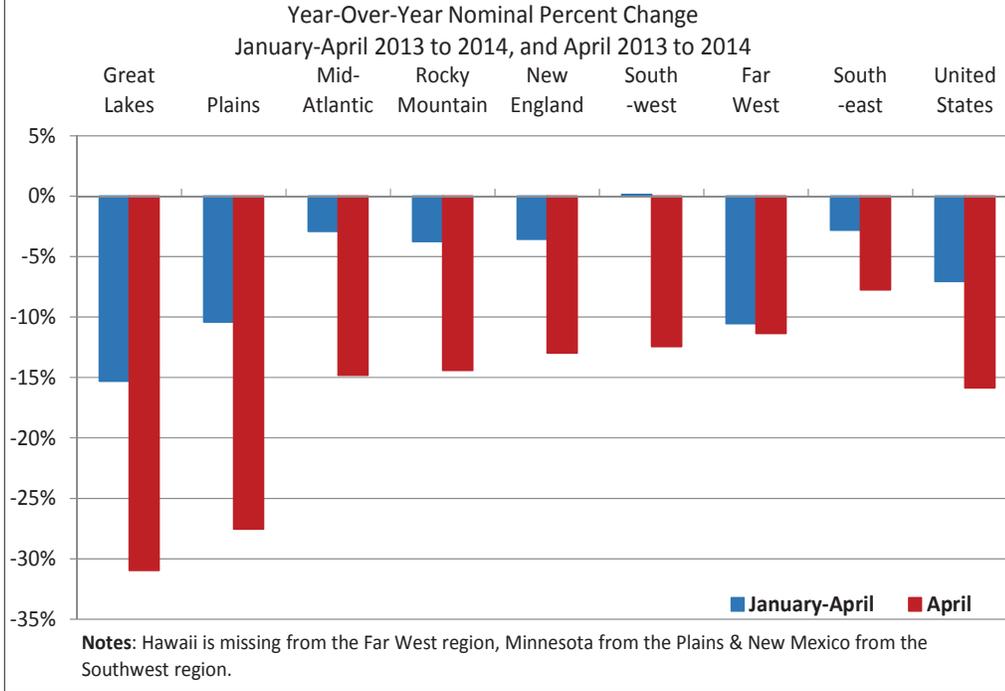
Figure 3 shows nominal percent change in cumulative collections for total income taxes as well as for withholding, estimated,

Table 1. Nominal Percent Change in State Personal Income Taxes					
Tax Revenue by Major Components of Personal Income Tax					
January-April 2013 to 2014, % change					
	Withholding	Estimated	Final Payments	Refunds	Total PIT
United States	5.4	(17.0)	(17.6)	4.8	(7.1)
Alabama	2.0	(17.9)	(14.9)	4.6	(4.4)
Arizona	5.5	(10.2)	(9.6)	5.7	(6.7)
Arkansas	3.5	(12.7)	(23.4)	4.6	(8.9)
California	10.5	(30.6)	(12.6)	3.3	(11.9)
Colorado	7.7	(19.2)	(11.8)	1.5	(3.9)
Connecticut	3.9	7.5	(22.2)	4.0	(6.9)
Delaware	13.5	(5.8)	11.8	32.3	5.9
Georgia	6.6	(1.1)	(12.9)	6.8	(1.0)
Hawaii	ND	ND	ND	ND	ND
Idaho	6.7	ND	(8.0)	6.1	(3.7)
Illinois	2.3	(12.1)	(26.6)	14.8	(10.3)
Indiana	3.0	(0.8)	(10.4)	8.1	(5.8)
Iowa	4.1	(11.8)	(10.1)	23.5	(13.1)
Kansas	(4.9)	(47.3)	(29.9)	(4.7)	(24.0)
Kentucky	0.9	(34.1)	(18.5)	ND	(1.6)
Louisiana	2.7	(10.3)	(26.7)	0.6	(5.6)
Maine	3.1	(19.5)	(20.1)	12.2	(15.1)
Maryland	4.1	(0.9)	(15.3)	2.7	(1.6)
Massachusetts	7.5	0.4	(12.4)	4.5	0.1
Michigan	2.8	4.5	(36.1)	5.7	(14.4)
Minnesota	ND	ND	ND	ND	ND
Mississippi	5.6	3.5	ND	17.1	(0.7)
Missouri	2.2	2.6	(20.3)	ND	(3.2)
Montana	5.5	10.6	(20.6)	6.4	(3.7)
Nebraska	3.9	(3.7)	(21.4)	(7.5)	(6.9)
New Jersey	9.1	5.2	(20.3)	19.2	(5.3)
New Mexico	ND	ND	ND	ND	ND
New York	7.8	(17.4)	(3.3)	1.3	(3.2)
North Carolina	(9.6)	(6.7)	(13.3)	(13.0)	(9.2)
North Dakota	2.4	(44.3)	(40.9)	1.2	(28.1)
Ohio	(2.9)	(22.0)	(47.7)	32.0	(31.1)
Oklahoma	7.4	(2.6)	6.8	2.5	7.3
Oregon	6.3	(0.3)	ND	(8.7)	8.8
Pennsylvania	6.8	(4.4)	(18.5)	(2.4)	(0.6)
Rhode Island	6.2	(8.7)	(15.9)	(0.0)	(3.1)
South Carolina	7.3	(8.7)	(23.0)	7.1	(10.6)
Utah	4.6	ND	(12.2)	(0.6)	(3.4)
Vermont	10.3	5.0	(21.6)	6.3	(4.9)
Virginia	3.1	11.7	6.7	(0.9)	6.7
West Virginia	1.2	(3.6)	(8.0)	2.3	(3.3)
Wisconsin	4.7	(19.6)	(30.7)	12.0	(14.1)

Source: Individual state data, analysis by Rockefeller Institute.

Notes: Detailed data is missing for Hawaii, Minnesota and New Mexico.
ND - no data.

Figure 2. Large Declines in Personal Income Taxes in Opening Months of 2014



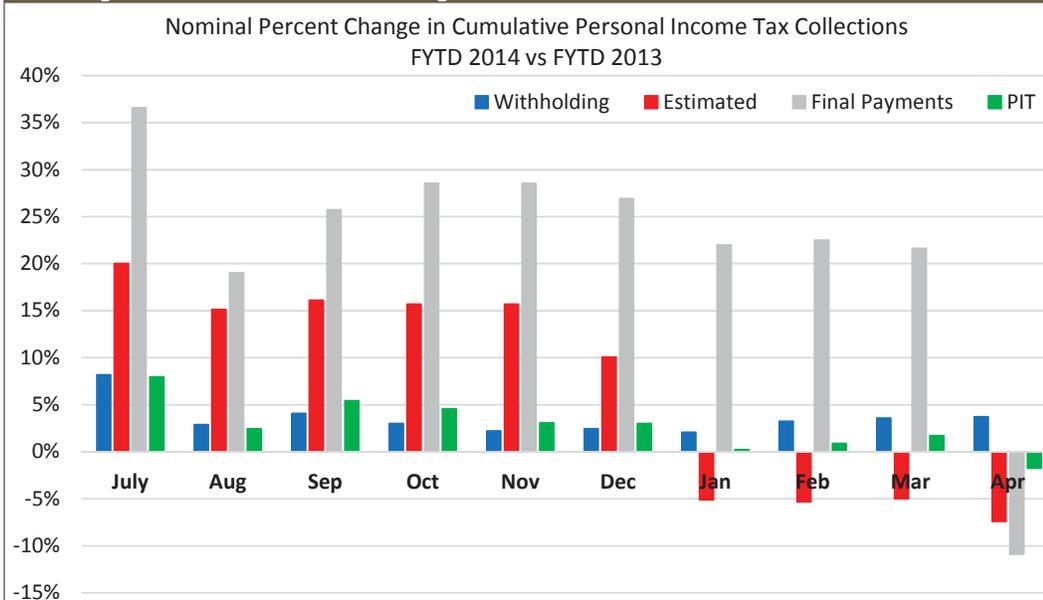
and final payments at several points in fiscal year 2014 compared to the same points in the prior fiscal year. Through March 2014, total personal income tax collections were 1.7 percent higher than the same period of last year. But with the addition of April 2014, states reported lower cumulative income tax collections than in the same period of last year. Growth slipped for estimated as well as final payments in the last four months, driving total personal in-

come tax collections down. The cumulative growth rate for withholding remained relatively stable throughout fiscal year 2014 and did not show any declines.

Withholding

Withholding is a good indicator of the current strength of personal income tax revenue because it comes largely from current wages and is much less volatile than estimated payments or final settlements. Withholding tax collections showed 5.4 percent

Figure 3. Fiscal-Year-To-Date Figures Show Declines in Income Tax Collections



growth during the first four months of tax year 2014. During April alone, withholding tax collections grew by 5 percent compared to April 2013. Only three of thirty-eight early reporting states showed declines in withholding for the January-April months. The three states reporting declines in withholding taxes for the first four months of

2013 are Kansas, North Carolina, and Ohio. The declines in all three states are mostly driven by the legislated tax changes that led to income tax rate reductions. In 2013, Kansas introduced various income tax measures including incremental income tax rate reductions from 2013 to 2018. In 2013, the income tax rate was reduced from 3.5 percent to 3.0 percent for the bottom individual income tax bracket and from the 6.45 percent to 4.9 percent for the top individual income tax bracket. The rates were reduced further in 2014, to 2.7 percent and 4.8 percent for the bottom and top income tax brackets, respectively. Before 2013, North Carolina had three income tax brackets, with tax rates of 6.0 percent, 7.0 percent, and 7.75 percent. The income tax brackets were reduced to a single tax bracket and the individual income tax rate was reduced to a flat 5.8 percent for tax year 2014 and is set to be reduced further to 5.75 percent for tax year 2015.

Collections in withholding were up more than 5 percent in seventeen of thirty-eight states reporting growth in the first four months of 2014. The relatively strong growth in withholding is a clear indication that the cause for overall income tax collections is not the underlying economy.

Estimated Payments

The highest-income taxpayers generally make estimated tax payments (also known as declarations) on their income not subject to withholding tax. This income often comes from investments, such as capital gains realized in the stock market. The first payment for each tax year is due in April in most states and the second, third, and fourth are generally due in June, September, and January. The early payments are often made on the basis of the previous year's tax liability and may offer little insight into income in the current year.

The first payment, in April, is a special case because in many states it will include two kinds of money. The first kind is an initial payment on taxes for the current year. For example, the payment in April 2014 includes taxpayers' initial payment on income for the 2014 tax year. But the April payment in some states also includes a second kind of money: taxpayers who have an April tax return due for the prior tax year, but have not yet completed their return, may file a request for an extension and pay an estimate of what they still owe on the prior year. In April 2014, this would be a near-settling-up payment on taxes for the 2013 tax year, akin to a final payment but based on an estimate. The two different tax years at work can have very different impacts on the April estimated payments. In a year in which final payments are subject to extreme volatility (as is often the case), the portion of the April estimated tax payment attributable to the prior tax year can swing wildly for the same reasons. Some states separate these two kinds of payments in data they report, and others do not.

It is not safe to extrapolate trends from the first payment. As shown in Figure 3, through December 2013 collections, estimated

payments were 10.1 percent higher compared to the same period of the previous year. However, states reported lower estimated tax payments through January at 5.1 percent, and through April estimated tax collections dropped 7.4 percent compared to the same period of last year.

In the thirty-six states for which we have complete data, these payments were down by \$5.4 billion, or 17 percent, for the January-April months of 2014, and by \$1.8 billion or 14.8 percent in the month of April 2014. The April decline probably is related, in part, to the same sort of income shifting from 2013 into 2012 that appears to have affected final payments. Among individual states, twenty-seven of thirty-six states reported declines in estimated payments in the months of January through April of 2014, with fifteen states reporting double digit declines. California, Kansas, Kentucky, and North Dakota had the largest drops in estimated payments, all declining more than 30 percent for the January-April period.

Final Payments

Final payments normally represent a smaller share of total personal income tax revenues in the first, third, and fourth quarters of the calendar year, and a much larger share in the second quarter due to the April 15th income tax return deadline. As already discussed above and illustrated in Figure 1, the second quarter is the most volatile quarter for final payments.

In the first four months of 2014, final payments accounted for \$22.6 billion, or roughly 20 percent of all personal income tax revenues. Final payments with personal income tax returns in the thirty-six early reporting states declined by \$4.8 billion, or 17.6 percent, in the months of January through April.

Payments with returns in January-April 2014 exceeded 2013 levels in only three of thirty-six states: Delaware, Oklahoma, and Virginia. The positive growth in Delaware and Virginia is mostly because their income tax returns are due later than April 15th; the picture likely will change in both states once data are available for May. Not only were declines widespread among the states, but twenty-nine states reported double-digit declines in final payments in the first four months of 2014. Michigan, North Dakota, Ohio, and Wisconsin all had declines of more than 30 percent for January-April of 2014.

Refunds

Personal income tax refunds processed by states increased by 4.8 percent through April 2014, and 3.1 percent in the month of April. In total, thirty-six reporting states have paid out about \$1.7 billion more in refunds in January-April of 2014 than in 2013. In April 2014 alone, the thirty-six reporting states paid about \$0.4 billion more than in April of 2013. Only eight of thirty-six reporting states returned less personal income tax refunds to taxpayers in the January-April months of 2014 than in the same period of 2013,

while another eight states returned over 10 percent more in personal income tax refunds for the same period. The picture will become clearer once data for May refunds become available.

Capital Gains, the Stock Market, and April Tax Returns

Taxpayers pay income tax throughout the tax year and shortly afterward mainly through regular withholding on wages. In addition, taxpayers with substantial nonwage income may make payments of estimated tax, usually in April, June, September, and December/January. Taxpayers who have paid more through these methods than they owe will receive a refund when they file their return in April, and those who have underpaid will make an additional payment with their return.⁵ Wages are fairly easy to determine and withholding can be quite an accurate estimate of taxes owed on wages, but nonwage income can be hard for taxpayers to determine during the year and estimated payments are a less-accurate reflection of taxes associated with nonwage income. As a result, the April "settling up" tends to be highly related to nonwage income, and quite variable.

In almost all years, the April-June quarter is the largest quarter for state government income tax revenue, and as a consequence it usually is the largest for total tax revenue as well. Furthermore, revenue in this quarter is volatile, as discussed above. Much of this volatility is related to nonwage income for several reasons. First, the underlying forces determining the potential magnitude of taxable income are quite volatile. The stock market can go up and down significantly, creating opportunity for taxpayers to take capital gains and losses. Interest income also can be volatile — for someone with a variable-rate asset, a fall in the interest rate from 4 percent to 3 percent represents a decline of 25 percent in interest income. (Most portfolio income does not respond as suddenly or fully to interest rate changes, but it certainly does happen.) The broader economy, too, can have a big influence on potential capital gains and losses and on other forms of nonwage income.

Second, in the case of capital gains, the decision to realize gains — whether to sell assets with accrued gains — is a discretionary one that reflects not just asset values, but also current and expected future tax rates, transaction costs, expected earnings on alternative investments, and a host of personal planning considerations. Gains realized for tax purposes, therefore, are more volatile than accrued gains.

Third, the timing of associated tax payments is volatile and variable. Taxpayers generally must make estimated payments related to expected taxable income — typically on April 15, June 15, September 15, and January 15 — but safe harbors, estimating uncertainties, behavioral stickiness, and considerations related to deductibility of state taxes against federal taxes all influence the timing and variability of estimated payments.

Because nonwage income is hard to estimate during the year and because estimated payments may be only loosely related to taxes owed on that income, payments with April 15th tax returns are volatile. Making matters worse, the magnitude of this volatility is large relative to state budgets. Furthermore, this heightened uncertainty comes right in the midst of peak budget negotiations.

The tax-return filing season is largely in April and May. Thus, if states are going to have a significant overage or shortfall in the April 15th tax returns, they are likely to discover it at the end of April or early May, after sufficient returns are processed and after they have a chance to analyze the data. Many states announced income tax surpluses in April of last year and income tax shortfalls in April of this year. Needless to say, a significant shortfall or overage announced in the months of April-May, when budget negotiations are down to their last few weeks and the time to develop and negotiate proposals is short, further complicates already complex political dynamics – and can make it difficult to close any new budget gaps that arise.

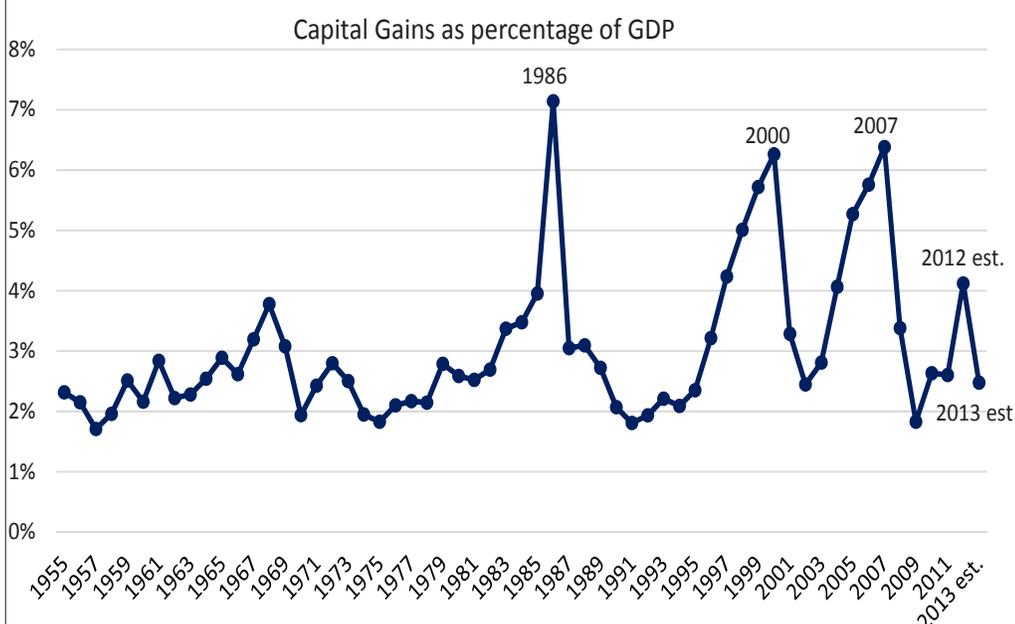
Forecasting Capital Gains

As we have noted in previous reports and presentations, capital gains play an important role. Figure 4 shows capital gains as a share of gross domestic product from 1955 through 2011 and provides Congressional Budget Office estimates for 2012 and 2013.⁶ Several points are noteworthy. First, the large spike in gains in 1986 reflected a behavioral response by taxpayers to the 1986 federal tax reform that increased effective tax rates on most capital gains in 1987 (and presumably beyond) by approximately 40 per-

cent, creating a dramatic incentive for taxpayers to accelerate gains into 1986.⁷ The near-doubling of gains in 1986 followed by a 55 percent decline in 1987 illustrate how sensitive taxable gains are to taxpayer choices, and how the choice to realize gains can be affected by actual and expected tax rates.

Second, during the dot-com stock market boom of the 1990s capital gains surged, nearly reattaining their 1986 peak in 2000. (Note that many

**Figure 4. Capital Gains Increased Dramatically in 2012.
Gains in 2013 Are Estimated to Have Declined Substantially**



Source: (1) Capital gains for 1954-1998 are from US Treasury Table capgain1-2001.pdf and for 1995-2013 are from CBO at <http://www.cbo.gov/publication/45065>. (2) GDP from U.S. Bureau of Economic Analysis.

factors beside the stock market influence the pool of potential capital gains, including bond values, real estate values, and the economy in general. But gains from corporate stock appear to account for more than half of all capital gains and the stock market plays an extraordinarily important role.⁸⁾

Third, although 2000 was the first of three successive years of stock market declines, capital gains actually increased by 16.6 percent, perhaps because much of the selling during the initial decline was by investors selling stocks that still had gains (albeit vanishing rapidly) or because much of the selling and decline occurred late in the year and did not outweigh gains realized earlier in the year.

Fourth, capital gains declined for two successive years, falling 45.8 percent in 2001 and a further 23.1 percent in 2002 before increasing for five successive years to the 2007 peak, while the stock market climbed by 67 percent. Then market, financial system, and confidence collapses led to a capital gains decline of 46.1 percent in 2008 and a 47.1 decline in 2009. After sharp declines in 2008 and 2009, capital gains saw growth for three straight years. However, the growth was particularly strong in 2012, (although not as strong as in 2007), mostly due, we believe, to acceleration of income as taxpayers responded to incentives created by the federal fiscal cliff.

Many forecasters expected that capital gains in 2013 — which would influence tax payments in April and May of 2014 — would be down because of the behavioral incentives just described. The harder question was forecasting the magnitude of the decline. This was complicated by the strong stock market of 2013, which suggested that, all else equal, gains would have increased substantially. Capital gains forecasting models usually take into account factors such as stock market values, stock market volumes, real estate values, the general state of the economy, and current and expected tax rates.⁹ But the forecasts produced by these models can vary significantly depending on how these variables are specified.

Some models incorporate stock market values by using year-end measures of change, which is the way we often think of the market. For example, most people think of 2013 as a year in which the stock market increased dramatically, and by year-end measures this is true: the S&P index on December 31, 2013, was up 29.6 percent from its value on December 31, 2012. However, the average annual growth for the S&P 500 index was only 19 percent in calendar year 2013, which is still strong, but not as strong as the 29.6 percent growth reported for the year-end period.¹⁰ Because taxpayers realize gains throughout the year, the average value of the S&P 500 probably is more relevant. These two measures can diverge substantially in some years. For example, as shown in Table 2, although the year-end S&P 500 increase in 2009 was quite strong at 23.5 percent, the annual average change was -22.3 percent. In that year capital gains declined by 47.1 percent — more consistent with the annual average than with the year-end measure.

Even if states could forecast the stock market accurately, that would not be sufficient. States also have to estimate the impact of

Table 2. Despite the Strong Stock Market in 2013, Projections Indicate Steep Declines in Capital Gains and the S&P 500, 2006-2013

Year	Percent change in S&P 500 from prior period:		% change in capital gains
	Year-end	Calendar-year avg.	
2006	13.6	8.6	15.7
2007	3.5	12.7	15.8
2008	(38.5)	(17.4)	(46.1)
2009	23.5	(22.3)	(47.1)
2010	12.8	20.2	49.6
2011	(0.0)	11.2	2.6
2012	13.4	8.8	65.6 (est.)
2013	29.6	19.2	(37.8) (est.)

Sources: (1) S&P 500 index: Federal Reserve Bank of St. Louis,

<http://research.stlouisfed.org/fred2/series/SP500/downloaddata>;

(2) Capital gains: Congressional Budget Office: <http://www.cbo.gov/publication/45065>

other factors, such as the incentive to shift income. In some states, forecasters assumed that revenues were accelerated not only from 2013 but also from future years, while other states assumed that the acceleration was only from 2013. At the end of the day, even well-designed forecasting models are not reliable enough to predict the capital gains accurately.

Forecasts for capital gains in 2013 varied greatly. The Congressional Budget Office forecasted a decline of 37.8 percent. States that publish their capital gains forecasts expected capital gains to have declined in 2013.¹¹ For example, Arizona forecasted an 8.3 percent decline.¹² California initially forecasted a 44 percent decline in capital gains in 2013, based on the assumption that the federal tax rate changes led to a 20 percent shift in capital gains from 2013 to 2012. However, due to the strong stock market throughout 2013, forecasters in California revised their estimates and now estimate a 16 percent decline in capital gains in 2013.¹³ In Massachusetts forecasters projected that capital gains realizations would decrease by 31 percent in tax year 2013 compared to tax year 2012.¹⁴ New York forecasted a much smaller decline in capital gains in 2013 of 2.6 percent.¹⁵

The wide variation across states in projections for capital gains underscores the extreme difficulty of estimating their impact on the overall personal income tax. The federal tax rate increase on capital gains in January of 2013 created an incentive for taxpayers to accelerate capital gains into 2012, which ended up being a temporary but substantial benefit to state budgets for fiscal year 2013. However, it was almost guaranteed that the bubble in personal income tax would burst and that states would not have been wise to treat that revenue as continuing.

Which States Are Likely to be Most Affected by Volatile Capital Gains?

Table 3 shows, for each of the forty-one states with a broad-based income tax, (1) capital gains as a share of adjusted gross income in 2011 (the latest year available) based on federal Statistics of Income data; (2) the state's top tax rate on capital gains from corporate equities as reported by the American Council for Capital Formation for tax year 2012 (the latest available year);¹⁶ and (3) the state's reliance on the income tax as a share of total taxes for fiscal year 2013,

Table 3. Income-Tax States Ranked by a Measure of Capital Gains Dependence

State	Capital Gains as Share of AGI (2011)	Top Capital Gains Tax Rate on Corporate Equities (2012)	PIT as Share of Total Taxes (2013)	Rank (1=highest), considering capital gains share and top rate together
United States	4.09	5.30	36.59	
New York	7.20	8.82	54.61	1
California	5.05	10.30	50.16	2
Vermont	5.02	8.95	23.03	3
Connecticut	6.14	6.70	48.41	4
Oregon	3.84	9.90	68.34	5
Hawaii	3.05	11.00	28.49	6
Massachusetts	6.03	5.30	53.87	7
New Jersey	3.21	8.97	41.64	8
Idaho	3.64	7.80	36.11	9
Colorado	6.06	4.63	49.16	10
Iowa	2.96	8.98	41.04	11
Minnesota	3.35	7.85	42.56	12
Rhode Island	4.26	5.99	37.04	13
Maine	2.99	8.50	39.43	14
Nebraska	3.71	6.84	44.54	15
Kansas	3.84	6.45	38.80	16
Montana	4.78	4.90	39.53	17
North Carolina	2.85	7.75	46.57	18
Illinois	4.38	5.00	42.72	19
West Virginia	3.33	6.50	33.39	20
Oklahoma	4.10	5.25	32.80	21
Virginia	3.57	5.75	56.81	22
Missouri	3.20	6.00	48.30	23
Utah	3.84	5.00	45.06	24
Wisconsin	3.25	5.43	43.74	25
Georgia	2.83	6.00	49.30	26
Louisiana	2.82	6.00	29.71	27
Delaware	2.47	6.75	33.78	28
Maryland	2.86	5.50	42.46	29
Kentucky	2.58	6.00	34.42	30
North Dakota	5.50	2.79	12.11	31
Ohio	2.56	5.93	36.11	32
Arizona	3.33	4.54	25.22	33
Arkansas	2.99	4.90	30.86	34
Alabama	2.34	5.00	34.56	35
Pennsylvania	3.30	3.07	31.73	36
South Carolina	2.47	3.92	38.50	37
Mississippi	1.90	5.00	23.71	38
Indiana	2.48	3.40	29.39	39
Michigan	1.89	4.35	32.85	40
New Mexico	2.92	2.45	23.86	41

Sources: (1) Capital gains as share of AGI: calculated by Rockefeller Institute from IRS Statistics of Income File; (2) top capital gains tax rate: State and Federal Individual Capital Gains Tax Rates, American Council for Capital Formation, March 2012; (3) PIT as share of total taxes: calculated by Rockefeller Institute from Census Bureau state tax data; (4) rank calculated by Rockefeller Institute by first indexing each state's capital gains share and top rate, multiplying the two resulting indexes, and ranking them.

from the Census Bureau. The table also ranks states by an indicator of capital gains importance, which was constructed by indexing each state's capital gains share and its top capital gains tax rate to the nation, and then multiplying the two resulting indexes and ranking the result. States at the top of the list have relatively high reliance on capital gains, while those low on the list do not.* The measure should be taken as a broad indicator of capital gains reliance within the income tax, and small differences between states should not be considered meaningful. Table 3 also shows the income tax as a share of total taxes, but that is not reflected in the ranking measure in the table. A state with a high rank that also relies heavily on the PIT will find its budget particularly susceptible to capital gains volatility.

The Impact of April Income Tax Surprises

More than any other month, income tax shortfalls for April can lead states to experience massive budget problems.

The Impact on State Revenue Forecasts

In most months, the bulk of state income tax revenue comes from withholding taxes on wages. Because wages are the most significant part of the income tax, even small percentage shortfalls in withholding can accumulate over time and lead to large reductions in revenue forecasts. But it is unusual for a single month to swing these estimates dramatically – more likely, revenue estimates will be reduced significantly after an accumulation of evidence from employment data, wage data, and withholding collections warrants it. Huge month-to-month fluctuations in withholding tax collections are not typical, and when they occur often they are attributable to technical factors such as the number of payment days in a month, and do not necessarily indicate a huge recurring shortfall.

But income tax payments related to nonwage income are far more volatile and a single month – April – can be far more telling. During the course of the calendar year, taxpayers with significant nonwage income such as capital gains make payments generally in April, June, and September, and then in January of the new year. These payments are based partly on minimum requirements under the law, partly on tax liability in the prior year, and partly on habit and inertia. They tend to be “sticky” – often not changing by as much as the underlying income changes. Then, taxpayers settle up with the government in April when they file their tax returns.

This is all fine when the underlying income does not change very much. Final payments in April may be up or down more than the underlying nonwage income, but not enough to be of great consequence to the state budget.

However, not only are April final tax payment patterns volatile, but the underlying nonwage income itself is volatile. Throughout the last year we warned that the states would likely

* The rates for Kansas are based on 2012 tax rate. However, due to tax cuts the state's ranking would be much lower.

see significant declines in nonwage taxable income for 2013 and that this would affect tax payments made in 2013 and 2014. While most states anticipated that estimated and final payments would be lower, many were not able to predict the magnitudes of these declines with any accuracy, and reality turned out to be far worse than expected. State budget forecasters did not have reliable data to predict how much nonwage income was shifted from tax year 2013 to tax year 2012. Budget forecasters have external indicators such as stock market values and broad economic measures, which go into models they use to predict nonwage income subject to tax, but the models simply are not able to predict this income with the confidence that forecasters and policymakers would like. In fact, the strong stock market throughout 2013 likely helped to mitigate the decline in estimated and final payments to a certain degree.

The estimates of nonwage income subject to tax that state officials made over the past year were fraught with uncertainty, with forecasters revising nonwage income forecasts upward or downward. It was simply hard to know what to expect in April. It now appears that state income tax revenue in April and May has declined by far more than forecasters in a number of states had expected. Exactly how that will translate into new budget shortfalls is not clear and the full picture would not be clear until states close the FY 2014 budget books.

This Year's Forecast Errors

We collected data for those states that provide revenue forecasts on a monthly basis. Such information was available and easily retrievable for seventeen states and the data are presented in Table 4. In twelve of seventeen states, personal income tax collections were below the forecast, usually by double-digit percentages, while in four states they were above the forecast. Projections in Montana and California were pretty close to the actual collections.

In addition to April, in many states May also is an important month for collections related to income tax returns. Early figures from Indiana, Kansas, and Vermont show further underperformance in income tax collections in the month of May. Personal income tax collections were below the target levels by \$46 million, or 3.9 percent, in Indiana; \$282 million, or 43.3 percent, in Kansas; and \$27 million, or 14 percent, in Vermont in the months of April-May 2014 compared to April-May 2013.

We have also scanned state government websites and collected actual FY 2013 and projected FY 2014 and FY 2015 personal income tax revenue data based on the latest projections. It is important to note that revising forecasts is not a practice for every single state, but most states do revise forecasts on a regular or ad

Table 4. Actual and Projected Personal Income Tax Revenues, April 2014

State	April 2014 Actual	April 2014 Forecast	Percent difference
Arizona	394.4	450.3	(12.4)
Arkansas	466.6	496.7	(6.1)
California	10,953.9	10,871.0	0.8
Colorado	877.0	854.8	2.6
Idaho	295.2	317.6	(7.1)
Indiana	825.2	848.8	(2.8)
Kansas	226.0	315.6	(28.4)
Maine	224.5	215.8	4.0
Mississippi	212.4	248.9	(14.7)
Montana	180.7	180.5	0.1
Nebraska	354.9	385.9	(8.0)
North Dakota	162.4	121.7	33.4
Ohio	902.2	1,059.1	(14.8)
Pennsylvania	1,826.0	2,011.7	(9.2)
Rhode Island	152.6	180.8	(15.6)
Vermont	131.7	154.5	(14.8)
West Virginia	285.5	323.0	(11.6)

Source: Individual state data, compiled by Rockefeller Institute.

Table 5. Actual vs. Projected Personal Income Tax Revenues Latest Projections						
State	FY 2013 actual (\$ mlns)	FY 2014 forecast (\$ mlns)	FY 2015 forecast (\$ mlns)	Percent change, 2013-14	Percent change, 2014-15	Forecast month
Alabama	3,452.4	3,559.0	3,681.0	3.1	3.4	Feb-14
Arizona	3,397.5	3,610.8	3,868.1	6.3	7.1	Jan-14
Arkansas	3,144.4	3,076.8	3,173.4	(2.1)	3.1	Dec-13
California	64,154.0	66,533.0	70,238.0	3.7	5.6	May-14
Colorado	5,596.3	5,633.2	6,112.8	0.7	8.5	Mar-14
Connecticut	8,720.7	8,632.8	9,267.5	(1.0)	7.4	Apr-14
Delaware	1,139.8	1,175.4	1,217.8	3.1	3.6	May-14
Georgia	8,772.2	9,004.7	9,536.7	2.7	5.9	Apr-14
Hawaii	1,735.5	1,802.0	1,876.0	3.8	4.1	Mar-14
Idaho	1,284.4	1,319.8	1,403.0	2.8	6.3	Apr-14
Illinois	18,323.0	18,229.0	16,942.0	(0.5)	(7.1)	May-14
Indiana	4,977.5	5,021.4	5,279.6	0.9	5.1	Dec-13
Iowa	4,083.9	4,042.8	4,291.4	(1.0)	6.1	Mar-14
Kansas	2,931.2	2,525.0	2,525.0	(13.9)	0.0	Apr-14
Kentucky	3,723.0	3,812.3	3,977.3	2.4	4.3	Dec-13
Louisiana	2,753.8	2,843.0	2,939.7	3.2	3.4	Jan-14
Maine	1,521.9	1,380.7	1,447.2	(9.3)	4.8	Feb-14
Maryland	7,691.4	7,943.1	8,470.3	3.3	6.6	Mar-14
Massachusetts	12,831.0	12,904.0	13,779.0	0.6	6.8	Dec-13
Michigan	8,269.5	8,169.2	8,496.6	(1.2)	4.0	May-14
Minnesota	9,013.0	9,518.0	10,041.0	5.6	5.5	Feb-14
Mississippi	1,650.1	1,668.4	1,726.8	1.1	3.5	Oct-14
Missouri	6,368.0	6,573.9	6,981.0	3.2	6.2	Jan-14
Montana	1,045.5	1,039.1	1,104.8	(0.6)	6.3	Jun-13
Nebraska	2,101.9	2,115.0	2,216.0	0.6	4.8	Mar-14
New Jersey	12,108.6	12,927.8	13,988.2	6.8	8.2	Feb-14
New Mexico	1,240.9	1,211.5	1,280.0	(2.4)	5.7	Dec-13
New York /1	40,227.0	42,961.0	43,735.0	6.8	1.8	May-14
North Carolina	10,953.1	10,996.7	11,254.5	0.4	2.3	Jan-14
North Dakota /2						
Ohio	9,507.8	9,504.5	9,959.3	(0.0)	4.8	Jun-13
Oklahoma	2,056.8	2,122.7	2,126.3	3.2	0.2	Dec-13
Oregon	6,258.7	6,633.7	7,183.0	6.0	8.3	May-14
Pennsylvania	11,371.2	11,442.0	12,027.0	0.6	5.1	May-14
Rhode Island	1,085.8	1,103.2	1,148.1	1.6	4.1	May-14
South Carolina	3,357.5	3,402.2	3,512.8	1.3	3.3	Feb-14
Utah	2,852.0	2,763.4	2,876.3	(3.1)	4.1	Nov-13
Vermont	660.6	693.2	738.5	4.9	6.5	Jan-14
Virginia	11,340.0	11,762.4	12,359.0	3.7	5.1	Dec-13
West Virginia	1,700.5	1,766.8	1,809.6	3.9	2.4	Jan-14
Wisconsin	7,496.9	7,410.0	7,800.0	(1.2)	5.3	Jan-14
United States	310,899.3	318,833.4	332,389.6	2.6	4.3	

Source: Individual state data, compiled by Rockefeller Institute.

Notes: 1/ New York's fiscal year runs from April 1st to March 31st. Therefore, data for FY 2014 reported in here are for actual and not projected collections, and excludes April 2014 shortfalls.

2/ North Dakota is a biennial state and provides forecasts for the entire biennium.

hoc basis. The data are presented in Table 5 (see page 15), which also provides the month and year of the latest projection we were able to obtain. Most of the forecasts in this table were prepared before April tax return data was known, and many states are likely to have shortfalls relative to these forecasts. Once we have complete actual personal income tax collections data for FY 2014, we will compare it to the forecasted data. As of now, twenty-eight states are projecting higher income tax collections in FY 2014 than in 2013 and eleven states are projecting lower income tax collections. The total projected growth for the nation is 2.6 percent for FY 2014.*

The Impact of "Bad" April Surprises on State Budget Processes

An April income tax shortfall comes at the worst time of the year for three reasons.

First, by the time it is recognized in late April or mid-May, it is just six-ten weeks before the end of the fiscal year for forty-six states. For states without large cash balances, this can create a cash flow crunch or even a cash flow crisis. There is not enough time to enact and implement new legislation cutting spending, or laying off workers, or raising taxes, or otherwise obtaining resources sufficient to offset the lost revenue before the June 30th end of the fiscal year. As a result, a state without sufficient cash on hand to pay bills must resort to stopgap measures to "roll" the problem into the future. For example, Kansas and Missouri have delayed refund payments. These actions do not save any money — the state still has to pay refunds — but they do temporarily avert a cash flow crisis. In so doing, they make the size of the budget problem larger for the fiscal year about to start (by pushing payment requirements into that year), and greater action is needed to close that gap.

Second, it can have a "double whammy" effect on state revenue in the budget-negotiation period: if the shortfall was caused by income that is lower than previously expected, then that income may be lower in future years and the state may have to lower its forecasts for future years as well. For example, in the current situation, many states overestimated nonwage income for 2013 and they may have built their forecasts for 2014 and beyond upon that too-high estimate. So, when they learned that 2013

* The FY 2014 data reported for New York in Table 5 are for the state fiscal year that ended on March 31st. Collections for April 2014 will be reflected in FY 2015 data. In fact, personal income tax collections showed a significant drop of \$1.3 billion, or 19.4 percent, in the month of April 2014 versus the year earlier and were more than \$900 million short of the original estimate for that month.¹⁷ The large declines are attributable to declines in estimated payments that fell by \$1.8 billion, or 31 percent, in the month of April 2014. Most of this decline would be related to requests for extensions on the 2013 tax year, rather than for the 2014 tax year (see Estimated Payments). After obtaining information on April collections, the state lowered its FY 2015 income tax forecast by \$396 million, noting, "the decline in estimated tax payments in April 2014 was greater than expected in the Executive Budget Financial Plan. At the same time, refund payments were lower than expected, which is a positive development. DOB expects that the unanticipated portion of the decline in collections observed in April will reverse itself later in FY 2015." Because the April shortfall was more than \$900 million, but the state lowered its full-year forecast by only \$396 million, it will need a substantial improvement in revenue collections to hit its estimate for the year.¹⁸

income was lower than expected, they may have to lower their forecasts for 2014 and beyond — reducing not just their revenue in 2013-14, but in 2014-15 (and later years as well). The shortfall hits them twice in this crucial budget negotiation period.

Third, the increased budget problems caused by an April income tax shortfall come late in the fiscal year and late in the budget process — often as states are supposed to wrap up their budget negotiations. It takes time for revenue analysts to evaluate the shortfalls, and for budget forecasters to revise their forecasts, and for elected officials to come to grips with the magnitude of the new problem they face. The new bad news for elected officials can unsettle carefully balanced gap-closing plans already tentatively negotiated. Since the budget actions included in these tentative plans presumably were the most attractive options available to them, almost by definition actions to close new budget gaps will be much more difficult. New options also may be less enduring, including nonrecurring resources and other techniques that do not solve the gaps in an ongoing way. All of this makes it hard for budget negotiators to reach agreements that will fully close the new budget gaps and they may find themselves trying to close gaps again in the next fiscal year.

Correction: In this version of the Rockefeller Institute's State Revenue Special Report, we deleted certain statements regarding tax refund processes in Kansas, Missouri, and Wisconsin. The initial version of the report referred to stories in several newspapers, but the Institute has not confirmed those claims independently.

Endnotes

- 1 See Lucy Dadayan and Donald J. Boyd, "States Are Not Out of the Woods Despite Strong Revenue Gains in the Fourth Quarter" *State Revenue Special Report*, No. 91, The Nelson A. Rockefeller Institute of Government, April 2013, http://www.rockinst.org/newsroom/revenue_reports/2013/2013-04-24-SRR_91.pdf.
- 2 Data are missing for the following three states: Hawaii, Minnesota, and New Mexico.
- 3 Individual income tax returns are usually due on April 15th in thirty-five out of forty-one states that have broad-based personal income tax. The remaining six states have individual income tax return due dates later than the usual April 15th. Those states are: Arkansas (May 15th), Delaware (April 30th), Hawaii (April 20th), Iowa (April 30th), Louisiana (May 15th), and Virginia (May 1st).
- 4 See Michael Leachman and Chris Mai, "Lessons for Other States from Kansas Massive Tax Cuts," Center on Budget and Policy Priorities, March 27, 2014, <http://www.cbpp.org/cms/index.cfm?fa=view&id=4110>.
- 5 This is a simplified description of the process, and there are other possibilities as well. For example, taxpayers can adjust withholding upward or downward as a partial alternative to making estimated payments, and they may credit overpayments forward to the next tax year rather than claim a refund.
- 6 The estimates are from the Congressional Budget Office. Please see <http://www.cbo.gov/publication/45065>.
- 7 For detailed information on the Tax Reform Act of 1986, see <http://www.jct.gov/jcs-10-87.pdf>
- 8 See G. Thomas Woodward, "Capital Gains Taxes and Federal Revenues," *Revenue and Tax Policy Brief No. 1*, Congressional Budget Office, October 2002.
- 9 See, for example, Preston Miller and Larry Ozanne, "Forecasting Capital Gains Realizations," *Technical Paper 2000-5*, Congressional Budget Office, August 2000, <http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/31xx/doc3108/20005.pdf>; G. Thomas Woodward, "Revenue Projections and the Stock Market," *Revenue and Tax Policy Brief No. 3*, Congressional Budget Office, December 2002, <http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/40xx/doc4009/12-20-taxbrief3.pdf>; and Congressional Budget Office, "Estimating and Forecasting Capital Gains with Quarterly Models," *Technical Paper 2004-14*, September 2004, <http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/58xx/doc5833/2004-14.pdf>.
- 10 Source: Federal Reserve Bank of St. Louis. See <http://research.stlouisfed.org/fred2/series/SP500/downloaddata>.
- 11 Or in fiscal year 2014, for those that forecast only on a fiscal year basis. Capital gains, however, are a tax-year concept and so most forecasters forecast on that basis.
- 12 See JLBC Staff Report, "Estimating Capital Gains Tax Collections," n.d., <http://www.azleg.gov/jlbc/estimatingcapitalgainstaxcollections.pdf>.
- 13 See Office of the Governor, California, "Revenue Estimates," n.d., <http://www.ebudget.ca.gov/2014-15/pdf/BudgetSummary/RevenueEstimates.pdf>.
- 14 See Massachusetts Department of Revenue, "Briefing Book FY2015 Consensus Revenue Estimate Hearing," December 11, 2013, <http://www.mass.gov/dor/docs/dor/stats/briefing-book/fy2015/fy15-briefing-book.pdf>
- 15 See New York State Division of the Budget, "FY 2015 Economic and Revenue Outlook," n.d., <https://www.budget.ny.gov/pubs/executive/eBudget1415/economicRevenueOutlook/economicRevenueOutlook.pdf>.
- 16 See American Council For Capital Formation, "State and Federal Individual Capital Gains Tax Rates: How High Could They Go?," March 2012, http://accf.org/wp-content/uploads/2012/04/1204-15-ACCF-Special-Report-on-Capital-Gains_FINAL.pdf
It would be preferable to use capital gains tax rates for 2013 but we do not have them from a well-researched source.

- 17 See E.J. McMahon, "A big income tax dive in April," Empire Center, May 16, 2014, http://www.empirecenter.org/ec_ny-torch-post/a-big-income-tax-dive-in-april/.
- 18 See New York State Division of the Budget, "FY 2015 Enacted Budget Financial Plan," May 2014, <http://publications.budget.ny.gov/budgetFP/FY2015EnactedBudget.pdf>.

About The Nelson A. Rockefeller Institute of Government's Fiscal Studies Program

The Nelson A. Rockefeller Institute of Government, the public policy research arm of the State University of New York, was established in 1982 to bring the resources of the 64-campus SUNY system to bear on public policy issues. The Institute is active nationally in research and special projects on the role of state governments in American federalism and the management and finances of both state and local governments in major areas of domestic public affairs.

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This report was researched and written by Lucy Dadayan, senior policy analyst, and Donald J. Boyd, senior fellow. Thomas Gais, director of the Institute provided valuable feedback on the report. Michael Cooper, the Rockefeller Institute's director of publications, did the layout and design of this report, with assistance from Michele Charbonneau.

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