

What Happened to the State Personal Income Tax? Components of the Recent Decline

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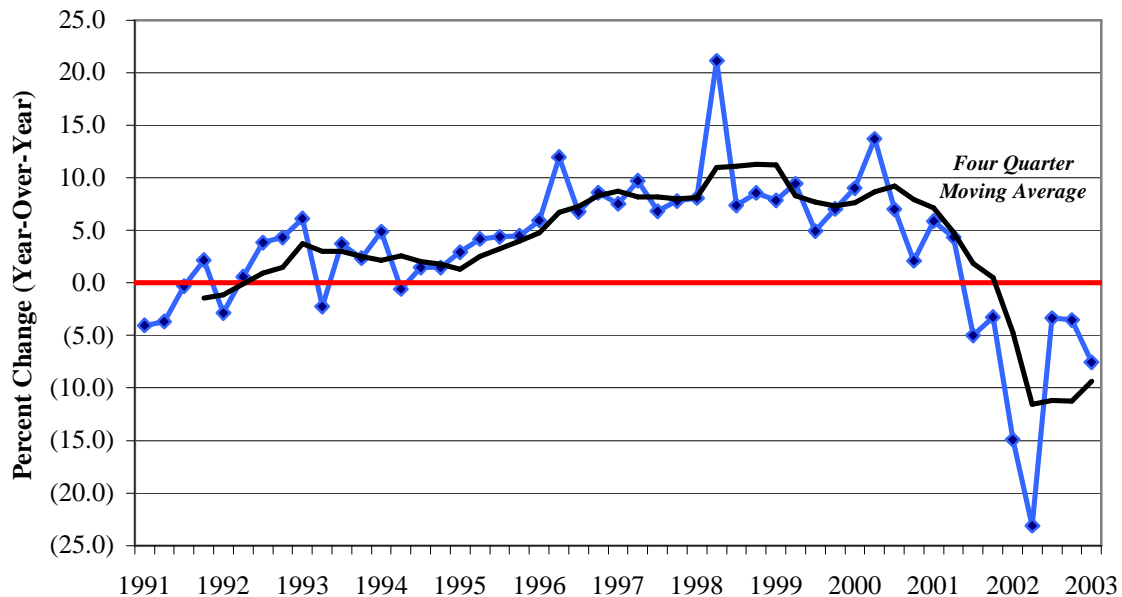
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Over the last few years, the personal income tax has gone from being the engine of state revenue growth to being the dead weight that is dragging state revenue down. Figure 1 shows the performance of the state personal income tax over the last 12 years, adjusted for the effects of enacted tax changes and inflation. After somewhat sluggish performance coming out of the recession of the early 1990s, state personal income tax revenue growth accelerated through the late 1990s. The big upward spikes in the quarterly year-over-year line seen in Figure 1 are the “April Surprises,” when big payments with final returns surged into state coffers.¹ Even if we smooth the line by taking a four-quarter moving average, personal income tax revenue was growing at over a 10 percent annual rate by 1998 and 1999.

This changed as the recession set in during 2001. There was a negative April Surprise in 2002, as the states felt the full effect of the economic downturn. However, the personal income tax decline has not ended, and the four-quarter moving average is still showing nearly a 10 percent drop though March of 2003, even though the recession officially ended 16 months before.²

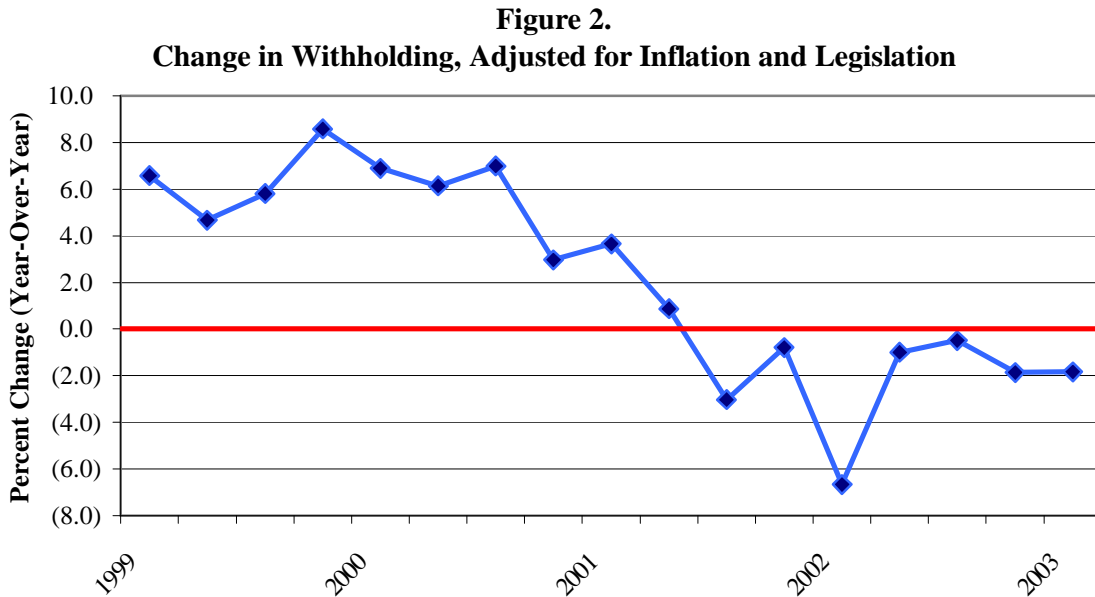
Figure 1.
Change in State Personal Income Tax,
Adjusted for Legislation and Inflation



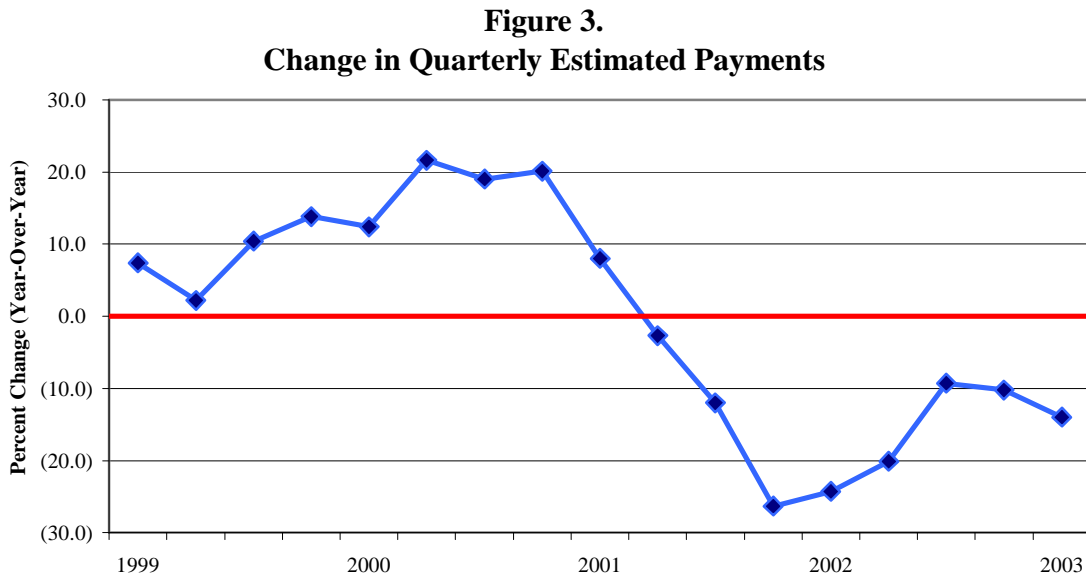
¹ All data is from the Rockefeller Institute of Government Revenue Report Database.

² The recession ended in November 2001 according to the National Bureau of Economic Research, see “NBER Declares Date of Economic Upturn,” <http://release.nber.org/july2003.html>.

Most personal income tax collections come from withholding. Figure 2 shows the performance of state withholding collections for the last four years. Withholding neither increased as quickly as total personal income tax collections in the good years nor declined as quickly in the bad years.



We need to look elsewhere to find the rest of the reason for the recent big swings in personal income tax collections. An important part of the picture are estimated tax payments, which are made on a quarterly basis by taxpayers who have income that is not subject to withholding; this includes income from capital gains and other investment-related income. Estimated taxpayers are heavily skewed towards the highest incomes. Figure 3 shows what has happened to estimated tax payments over the last four years.



Estimated tax payments only amount to about a fifth as much as withholding, but they obviously have had a big impact on the overall swings in personal income tax collections. In 2000, they were still increasing at a 20 percent year-over-year rate, and by 2002 they were declining by over 20 percent. This data is not adjusted for legislation or inflation because of the difficulty in apportioning the impact of these factors on any given payment.

The final major components of the personal income tax are payments with final returns, and refunds. Big surges in final payments were what generated the April Surprises, as they jumped in the late 1990s, and then plunged in 2002. We do not have full data on April 2003 yet, but a survey that includes most of the largest personal income tax states indicates that it will be another year-over-year decline, though much smaller than the decline seen in April 2002, which was abetted by large amounts of refunds.

This brief is drawn from data that can be found on the *Gateway to State and Local Government*, a new website that is a clearinghouse of information on state and local government finances and a tool for understanding what is happening in the states on spending, taxation and employment. Its web address is StateAndLocalGateway.rockinst.org.

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