STATE FISCAL CRISIS FAR WORSE THAN ECONOMY WOULD SUGGEST

Huge Drop in Capital Gains, Other Investment Income Likely Cause

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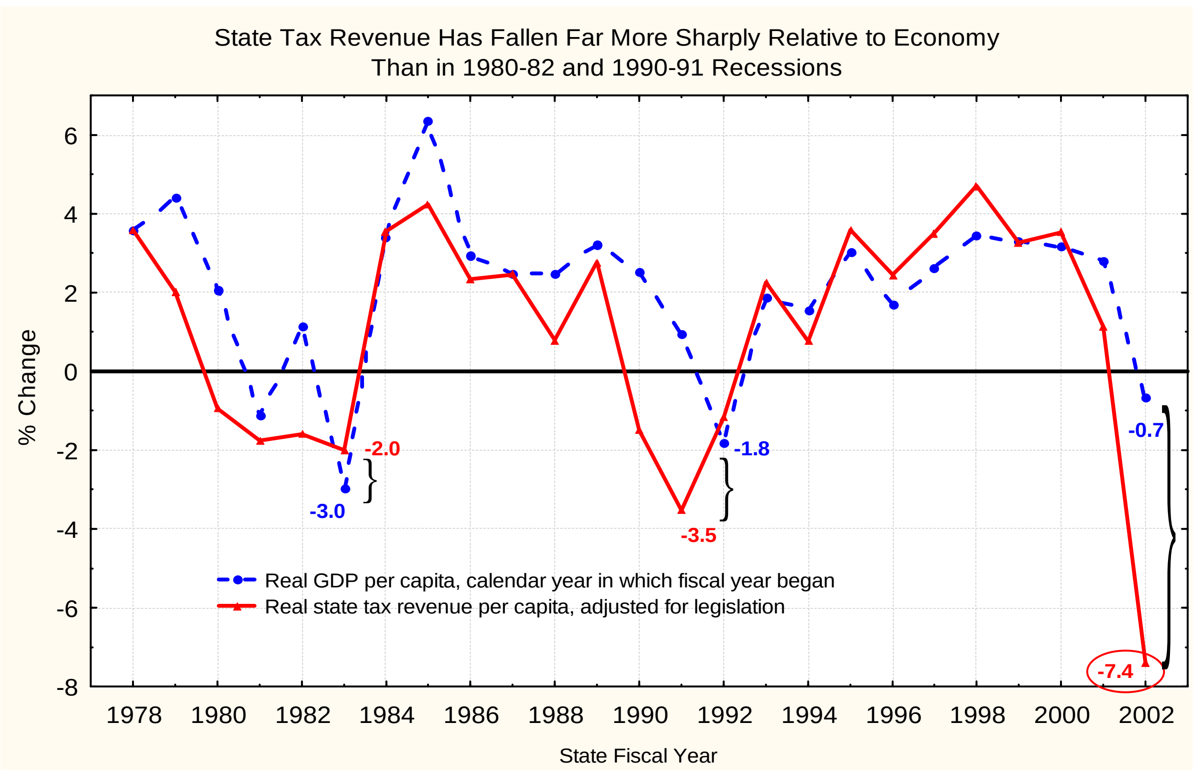
The United States economy entered its tenth recession since World War II in the spring of 2001. The recession has so far been relatively mild by historical standards, although employment has been weaker than in the last recession and there are now worrisome signs of renewed deterioration. But despite the relatively mild downturn to date, state tax revenue has been hit far harder than in the "double-dip" recessions of 1980-82 or the 1990-91 recession.

Figure 1, which compares growth in state tax revenue to growth in the economy, shows this clearly. Fiscal year 2002's astonishing 7.4 percent decline in real per-capita tax revenue (the solid line) was more than twice as steep as declines in the fiscal crises that accompanied the 1990-91 and 1980-82 recessions, even though real per-capita gross domestic product (the dashed line) fell far less this time than in either of the last two crises.

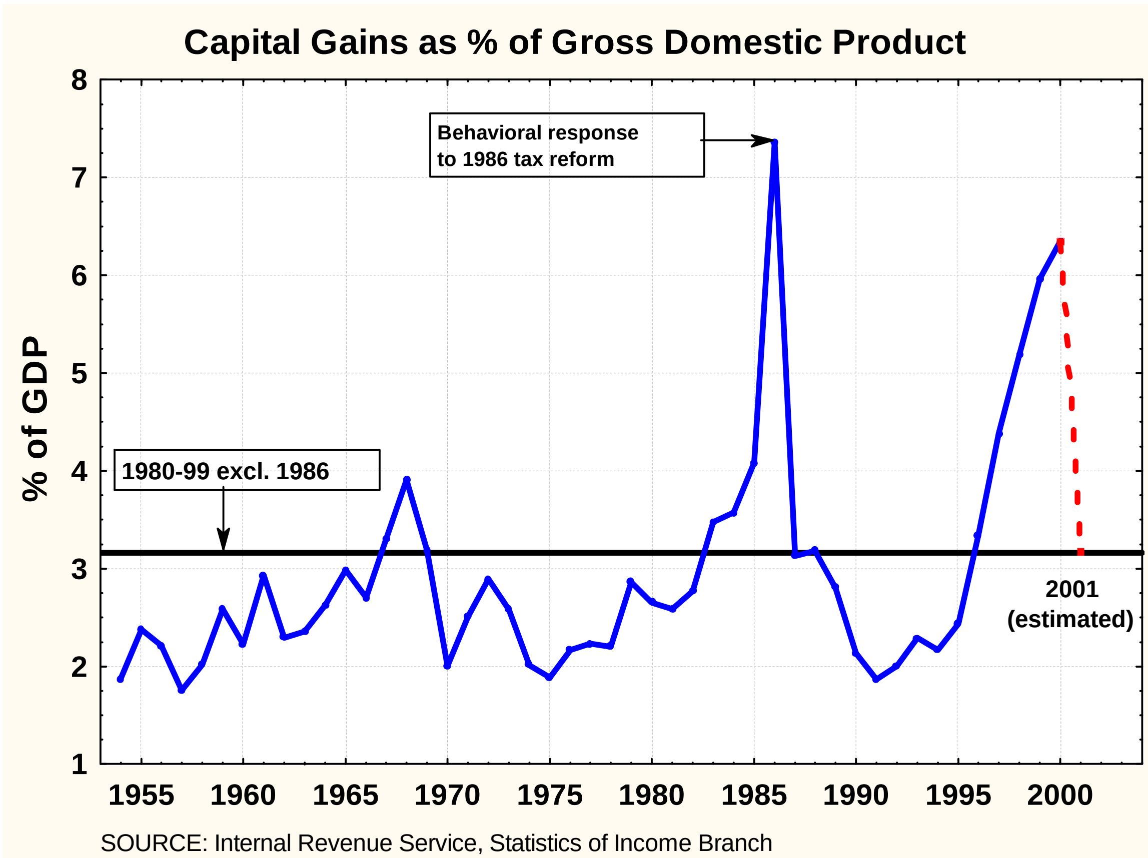
Figure 1



Sources: U.S. Bureau of Economic Analysis, U.S. Bureau of the Census, *Significant Features of Fiscal Federalism* - 1984 (ACIR), *Fiscal Survey of the States* (NGA), Rockefeller Institute of Government

The main reason tax revenue fell so sharply relative to the economy is that revenue had been propped up in the late 1990s by unsustainable forces, particularly forces related to the runup in the stock market, which more than tripled between the end of 1994 and its March 2000 peak. The strong stock market led to a surge in capital gains, which are included in most states' income taxes. The market also boosted wages of executives and others who exercised "nonqualified" stock options (the gain from which is taxed as compensation), and benefited state finances in other, difficult-to-measure ways.

Figure 2



These forces have unraveled rapidly. Figure 2 shows the extraordinary rise in capital gains in the late 1990s in the context of nearly 50 years of history. After stock markets fell for two consecutive years, this surge was followed by a sharp drop in 2001, now estimated by many analysts at approximately 50 percent. The late 1990s increase was unlike any other sustained increase in the prior 50 years (the one-year spike in 1986 was atypical, reflecting taxpayer response to President Reagan's tax reform act). The huge drop in 2001 contributed to massive tax revenue shortfalls in the states, which were especially pronounced when 2001 tax returns were filed in April of 2002 – the final quarter of the fiscal year for most states.

Capital gains are not included in traditional measures of the economy, helping to explain why the falloff in revenue was sharper than economic data might suggest.

The effect of these factors was not the same in all of the states. Table 1 shows the percentage change in the major state taxes and total tax revenue from fiscal year 2001 to fiscal year 2002 for all states, adjusting for inflation, population increase, and the effects of legislated tax changes.

Table 1
Real Per Capita Percent Change in State General Fund Tax Revenue, Adjusted for Legislation
FY 2001 to FY 2002

	Personal Income Tax	Corporate Income Tax	Sales Tax	Total Taxes
New England	**(18.1)**	**(39.4)**	**(2.3)**	**(12.7)**
Connecticut	(15.9)	(46.3)	(1.3)	(10.6)
Maine	(10.9)	(23.0)	(1.0)	(6.0)
Massachusetts	(20.3)	(39.3)	(3.7)	(15.6)
New Hampshire	NA	(23.4)	NA	(4.8)
Rhode Island	(13.5)	(77.5)	(0.2)	(9.6)
Vermont	(18.6)	(38.2)	(1.7)	(11.9)
Mid Atlantic	**(13.7)**	**(25.7)**	**(1.9)**	**(9.6)**
Delaware	NA	(3.7)	108.6	1.0
Maryland	(7.5)	(29.4)	(2.8)	(6.5)
New Jersey	(16.1)	(53.5)	(0.0)	(11.6)
New York	(16.1)	(22.6)	(4.1)	(12.5)
Pennsylvania	(6.5)	(11.3)	(0.7)	(3.6)
Great Lakes	**(8.1)**	**(12.5)**	**(1.2)**	**(4.9)**
Illinois	(8.3)	(20.5)	(3.7)	(6.9)
Indiana	(8.4)	(18.3)	(0.6)	(6.1)
Michigan	(9.4)	(2.1)	(1.0)	(2.7)
Ohio	(7.5)	(22.4)	(0.3)	(5.4)
Wisconsin	(6.5)	(8.1)	0.6	(3.6)
Plains	**(7.4)**	**(20.2)**	**(2.4)**	**(5.8)**
Iowa	(4.1)	(23.9)	(1.9)	(4.3)
Kansas	(9.6)	(56.6)	0.4	(8.8)
Minnesota	(10.2)	(28.4)	(4.4)	(7.3)
Missouri	(5.0)	19.8	(1.7)	(3.3)
Nebraska	(8.2)	(22.7)	(0.8)	(5.9)
North Dakota	(4.2)	(15.4)	(3.0)	(5.6)
South Dakota	NA	NA	(0.8)	(0.5)

Southeast	**(7.6)**	**(14.3)**	**(2.9)**	**(5.0)**
Alabama	(3.6)	60.6	(0.2)	(0.2)
Arkansas	(3.1)	(4.8)	(7.4)	(5.5)
Florida	NA	(12.8)	(2.2)	(2.8)
Georgia	(9.6)	(21.7)	(5.2)	(8.0)
Kentucky	(5.0)	(30.2)	(0.5)	(3.6)
Louisiana	0.5	(3.7)	(3.2)	(1.0)
Mississippi	(6.1)	(8.3)	(0.4)	(2.8)
North Carolina	(9.1)	(6.7)	(7.1)	(8.2)
South Carolina	(8.6)	(34.8)	(2.7)	(6.2)
Tennessee	NA	(27.2)	(2.8)	(5.0)
Virginia	(10.0)	(23.2)	(2.8)	(8.2)
West Virginia	0.0	(24.1)	1.7	2.0
Southwest	**(6.5)**	**(27.7)**	**(2.8)**	**(6.0)**
Arizona	(12.7)	(32.4)	(3.9)	(9.5)
New Mexico	(0.9)	(37.5)	(1.3)	(7.3)
Oklahoma	(1.8)	1.9	(2.8)	(7.1)
Texas	NA	NA	(2.7)	(4.9)
Rocky Mountain	**(12.2)**	**(35.4)**	**(2.4)**	**(8.7)**
Colorado	(14.7)	(38.9)	(3.4)	(12.1)
Idaho	(11.3)	(30.0)	(1.7)	(8.1)
Montana	(8.2)	(33.4)	NA	(0.1)
Utah	(8.6)	(34.3)	(2.7)	(6.7)
Wyoming	NA	NA	2.8	(4.9)
Far West	**(26.1)**	**(25.6)**	**(4.8)**	**(17.4)**
Alaska	NA	(16.8)	NA	(30.5)
California	(28.0)	(24.7)	(5.3)	(20.2)
Hawaii	(0.9)	12.9	(3.1)	(3.0)
Nevada	NA	NA	(4.0)	(4.1)
Oregon	(13.3)	(49.3)	NA	(15.2)
Washington	NA	NA	(3.7)	(3.3)

Source: The Nelson A. Rockefeller Instate of Government; United States Census Bureau; Bureau of Labor Statistics.

Numbers in parenthesis are negative.

Alaska had the largest drop in total tax revenue at 30.2 percent, but revenue in that state is tied to oil prices and notoriously volatile. The other states with double-digit declines – California, Colorado, Connecticut, Massachusetts, New Jersey, New York, Oregon, and Vermont – are generally states with progressive income taxes and many taxpayers who were paying taxes on capital gains.

This brief is drawn from data that can be found on *The Gateway to State and Local Government (http://StateAndLocalGateway.rockinst.org/)*, 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.

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