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## HIGHLIGHTS

- Personal income tax collections grew by 11.5 percent, or \$13.2 billion in January-April of 2015, compared to the same period a year earlier for thirty-eight early reporting states (forty-one states have broad-based income taxes). Thirty-six states had growth, with twenty-five states reporting double-digit growth.
- Growth in personal income tax revenue is mostly attributable to the lingering impact of the federal fiscal cliff as well as to the relatively strong stock market. Collections for April, when income tax returns for the prior year generally are filed, represented the bulk of the growth, with states collecting \$8.7 billion, or 20.1 percent more than in April 2014.
- Both estimated payments and income tax returns showed strong growth in January-April of 2015, at 13.5 and 16.6 percent, respectively. Growth in withholding was much weaker, at 3.1 percent.
- The rapid income tax growth has created an associated windfall for some states. The pleasant surprise likely was driven mostly by volatile nonwage income and should not be treated as recurring. It is, nonetheless, good news for state budgets. However, states with windfalls in 2015 should be cautious not to overestimate revenues for 2016 and beyond. Despite this good news, many states face continued budget pressure — an issue we address in an upcoming Institute report.

# STATE REVENUE SPECIAL REPORT

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## Windfall “April Surprises”

### *Strong Growth in Overall Income Tax Revenues Despite Weak Withholding*

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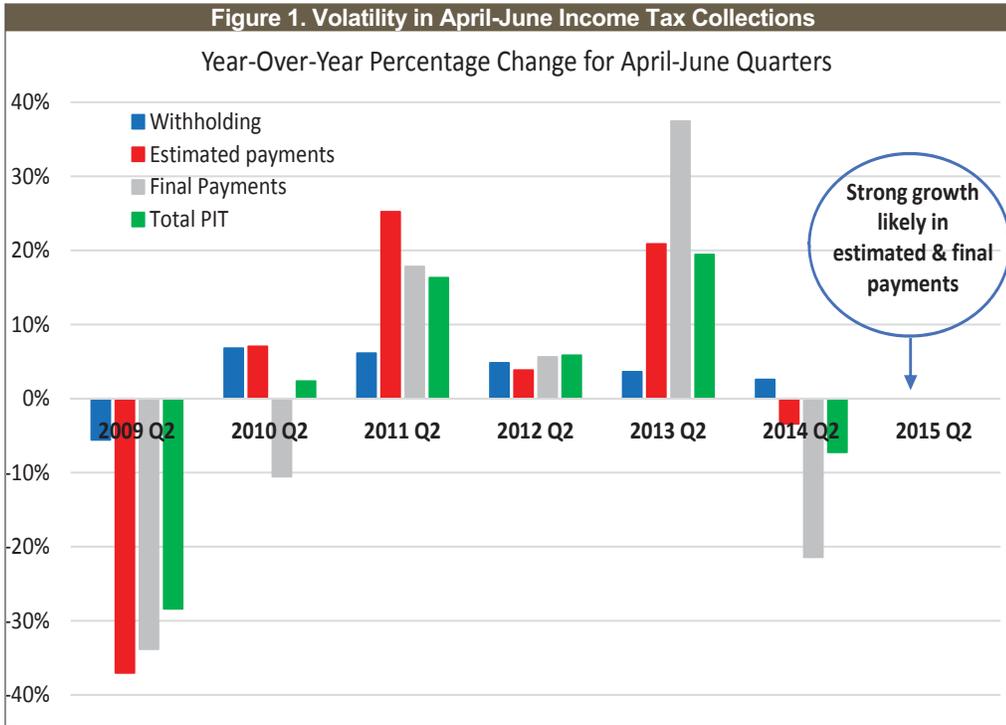
#### April Brings Good News to an Otherwise Dour Environment

The April 15th personal income tax return deadline brought some good news for nearly every state with a broad-based income tax. While most states had anticipated strong growth in personal tax collections, others had underestimated its magnitude. This April “windfall” in personal income tax collections was likely attributable to two factors, the first of which was a strong stock market throughout 2014. The second was the lingering impact of the early-2013 fiscal cliff. In anticipation of federal tax increases scheduled for the beginning of tax year 2013, many taxpayers had shifted income from 2013 to 2012. Consequently, April 2013 final payments for tax year 2012 were much higher than they otherwise would have been, and April 2014 final payments for tax year 2013 were much lower. Therefore, the rapid growth seen in April 2015 tax collections was actually based on an artificially depressed April 2014 base.

Growth in personal income tax collections with returns filed in April 2015 was large and widespread. Although we do not yet have tax-return data on the income sources responsible for this growth, capital gains is a key suspect for several reasons. First, we do have economic data on wages — the largest income source subject to state income taxes — and wages grew by only 4.6 percent in 2014.<sup>1</sup> This means that the surge in April tax collections was likely attributable to other sources of income. Second, the national economic accounts show that personal interest and dividend income — although not a perfect proxy for taxable interest and dividends — was up by only 2.2 percent. Capital gains are a main suspect for several reasons: they are an important remaining component of taxable income, they are highly volatile, and they are likely to have been driven upward by the strong stock market of 2014, which was up 17.5 percent.

To obtain early information on personal income tax revenues, Rockefeller Institute collected statistics from thirty-eight of forty-one states with a broad-based personal income tax.<sup>2</sup> The data cover different components of personal income tax including withholding, final returns, declarations of estimated taxes, and refunds.

Preliminary data for April 2015 show growth in overall personal income tax revenues. The April-June quarter is an important one for personal income tax revenue collections and can be very



volatile. While we do not have complete data for the April-June 2015 quarter, we can gain insight by analyzing prior years (see Figure 1).

Figure 1 shows the year-over-year percentage change in total personal income tax, withholding, estimated payments, and final payments for the April-June quarter for the last six years. Estimated and final payments have been particularly volatile. In the April-June 2009 quarter, overall income tax collections

declined steeply by 28.4 percent compared to a year earlier. This was mostly driven by large declines in estimated and final payments of 37 and 33.8 percent, respectively. Then, states began reporting strong year-over-year growth in overall income tax collections, reaching 19.4 percent in April-June 2013. The strong growth was mostly attributable to the fiscal cliff, which was mentioned earlier and is discussed in previous reports.<sup>3</sup> States reported a 7.2 percent decline in personal income tax collections for the April-June 2014 quarter. This appears to be due primarily to the mirror-image effect of the federal fiscal cliff. While we do not have data for the full April-June 2015 quarter, we anticipate strong growth in income tax collections driven by estimated and final payments that reflect the strong stock market of tax year 2014.

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.

April and May are critical months for personal income tax collections as individual income tax returns are due and most income tax refunds are processed in these two months.<sup>4</sup> In this report we focus on revenue collections for the month of April 2015, as well as for the period January through April. 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 for personal income tax collections will become clearer once we have complete data for May and June.

In the rest of this report, we will first discuss trends in overall personal income tax collections and in different components of income tax collections, including withholding, estimated payments, final payments, and refunds. After that, we will discuss the impact of capital gains and the stock market on the April income tax returns. Finally, we will discuss the impact of "April Surprises" on state revenue forecasts as well as on state budget processes.

### Personal Income Tax

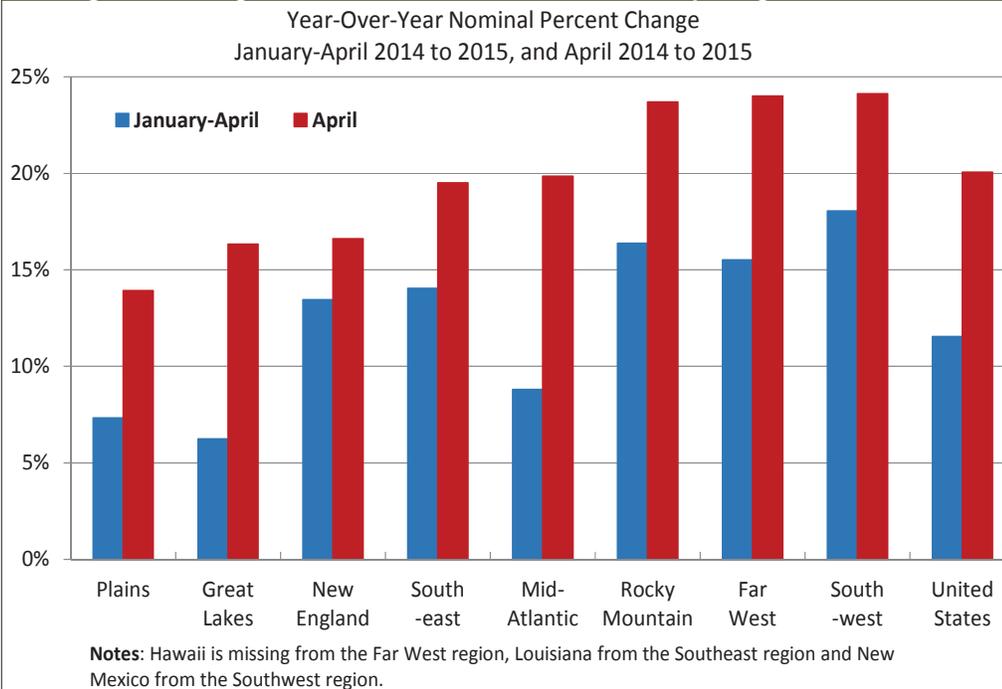
Total personal income tax collections in January-April 2015 were 11.5 percent, or about \$13.2 billion above the level of a year ago in the thirty-eight states for which we have data. In April 2015 alone (the month in which many states receive the bulk of their balance due, or final payments), personal income tax receipts grew by 20.1 percent, or \$8.7 billion.

Personal income tax receipts in the first four months of calendar year 2015 were lower than for the same period in 2014 for only two states — Illinois and Kansas. The decline for Illinois was mostly attributable to legislated tax increases that became effective in January 2011 and expired in January 2015. In Kansas, the decline was partially attributable to income tax reductions enacted in 2012 and 2013. The tax rates were cut from 3.5 percent to 3.0 percent for the bottom tax bracket, which includes people making less than \$15,000 per year. The top two tax brackets were consolidated into a single tax bracket, reducing rates from 6.45 percent and 6.25 percent, respectively, to a single rate of 4.9 percent for taxpayers earning over \$15,000 per year. Under current law the tax rates are scheduled to decrease further through 2018. In addition,

beginning in 2013 Kansas also fully exempted business profits that are "passed through" from the firm to individual owners.

As shown in Figure 2, personal income tax revenues showed solid growth across all regions, both for April and January-April collections (for state-by-state patterns see Table 1). The Southwest region reported the largest growth for the first four months of 2015 as well as for the month of April 2015 alone. (Revenue

**Figure 2. Strong Growth in Personal Income Taxes in Opening Months of 2015**

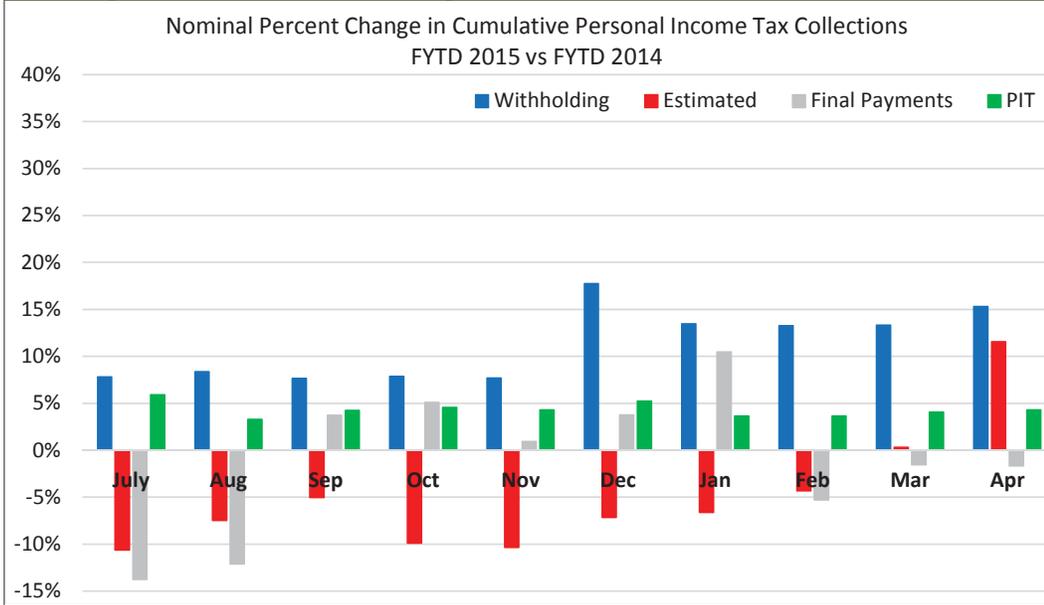


<b>Table 1. Nominal Percentage Change in State Personal Income Taxes</b>					
<b>State Tax Revenue by Major Component of Personal Income Tax</b>					
<b>January-April 2014 vs. January-April 2015, Percentage Change</b>					
	<b>Withholding</b>	<b>Estimated</b>	<b>Final Payments</b>	<b>Refunds</b>	<b>Total PIT</b>
<b>United States</b>	<b>3.1</b>	<b>13.5</b>	<b>16.6</b>	<b>(2.9)</b>	<b>11.5</b>
Alabama	5.4	5.2	18.5	(6.3)	9.3
Arizona	3.5	15.0	18.8	(6.5)	25.5
Arkansas	2.4	12.5	15.9	3.0	7.7
California	6.2	15.4	20.7	2.9	15.9
Colorado	7.9	25.5	24.0	5.3	16.8
Connecticut	5.3	4.7	15.2	(3.5)	10.6
Delaware	(2.1)	31.9	6.6	(1.1)	3.7
Georgia	4.5	17.5	18.9	2.6	11.8
Hawaii	ND	ND	ND	ND	ND
Idaho	7.5	ND	16.1	1.8	15.7
Illinois	(15.6)	1.2	21.9	(8.6)	(6.0)
Indiana	4.4	18.0	6.1	1.9	6.0
Iowa	5.6	(2.1)	(4.2)	(2.1)	6.3
Kansas	0.2	(12.7)	(37.7)	(21.2)	(4.2)
Kentucky	5.7	51.3	(23.2)	ND	19.4
Louisiana	ND	ND	ND	ND	ND
Maine	7.0	24.2	12.9	2.2	15.2
Maryland	5.2	0.3	(12.7)	(5.1)	4.4
Massachusetts	5.7	16.1	16.1	(6.2)	13.8
Michigan	3.6	8.8	19.4	(1.0)	13.5
Minnesota	8.5	13.5	2.5	12.4	7.2
Mississippi	1.6	47.2	ND	(1.8)	20.9
Missouri	7.0	7.4	20.7	ND	9.4
Montana	6.1	2.2	25.5	(4.2)	17.5
Nebraska	6.2	18.9	4.7	5.9	8.0
New Jersey	(0.0)	8.7	22.0	(10.8)	12.2
New Mexico	ND	ND	ND	ND	ND
New York	2.8	18.2	19.6	7.6	9.6
North Carolina	1.1	0.3	1.2	(52.2)	20.8
North Dakota	10.8	6.9	9.0	(27.7)	21.0
Ohio	3.6	(8.5)	33.8	(18.2)	20.9
Oklahoma	2.7	7.0	16.5	(9.6)	11.2
Oregon	7.8	21.2	ND	13.6	11.7
Pennsylvania	1.0	8.8	20.3	3.1	6.0
Rhode Island	3.5	12.0	25.2	(31.4)	35.6
South Carolina	2.7	10.8	31.7	4.5	12.2
Utah	7.8	ND	15.3	(7.8)	15.6
Vermont	(2.6)	12.3	28.3	(8.6)	10.8
Virginia	2.8	(0.3)	46.7	(1.9)	10.1
West Virginia	3.7	14.1	20.5	3.7	11.4
Wisconsin	(2.7)	10.1	26.3	(19.5)	18.5

**Source:** Individual state data, analysis by the Rockefeller Institute.

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

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



receipts are missing for New Mexico, and the picture for the Southwest region might change slightly once its numbers become available.) The Plains region saw the softest growth at 13.9 percent in the first four months of 2015.

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

estimated, and final payments at several points during fiscal year 2015 compared to the same points for the prior fiscal year. Cumulative growth rates for total personal income tax collections, as well as for withholding, were higher throughout fiscal year-to-date 2015 compared to the same period in 2014. Through February 2015, estimated payments were lower than for the same period in 2014. However, with the addition of March and April 2015, states reported higher cumulative estimated payments than in the same period of last year. Growth slipped for final payments in the last three months.

**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 3.1 percent growth during the first four months of tax year 2015. During April alone, withholding tax collections grew by 6.5 percent compared to April 2014. Only five of thirty-eight early reporting states showed declines in withholding for the January-April period. The five states reporting declines in withholding taxes for the first four months of 2015 are Delaware, Illinois, New Jersey, Vermont, and Wisconsin. Illinois reported the largest decline at 15.6 percent, which is attributable to the legislated changes discussed earlier. Withholding declined by less than 3.0 percent for the remaining four states.

Withholding tax collections increased more than 5.0 percent in seventeen of the thirty-three states reporting growth in the first four months of 2015. While most states reported growth in withholding in the first four months of 2015 compared to the same

period of 2014, the growth is not as strong as that observed in the first four months of the previous five years.

### ***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 often are 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, which is due in April, is a special case because in many states it includes two types of payment. The first is an initial payment on taxes for the current year. For example, the payment in April 2015 includes a taxpayer's initial payment on income for the 2015 tax year. But the April payment in some states also includes estimated taxes owed on income for the prior tax year by a taxpayer who has not yet filed a tax return for that year and has requested an extension. In April 2015, this would be a near-settling-up payment on taxes for the 2014 tax year, akin to a final payment, but based on an estimate. The two tax years involved 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 report these two types of payment separately, while others do not.

It is not wise to extrapolate trends from the first payment. As shown in Figure 3, through February 2015, estimated tax payments were 4.3 percent lower compared to the same period for the previous year. However, states reported slightly higher estimated tax payments through March 2015, at 0.3 percent. By April 2015, estimated tax collections showed strong growth at 11.5 percent compared to the same period last year.

In the thirty-six states for which we have complete data, estimated tax payments were up by \$3.7 billion, or 13.5 percent for the January-April months of 2015, and by \$2.4 billion, or 21.8 percent for the month of April 2015. Among individual states, thirty-two of thirty-six states reported growth in estimated payments in the months of January through April of 2015, with twenty states reporting double-digit growth. Four states — Iowa, Kansas, Ohio, and Virginia — reported declines in estimated payments for the January-April period. The largest decline was in Kansas, at 12.7 percent.

### ***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 previously discussed, and as illustrated in Figure 1, the second quarter is the most volatile quarter for final payments.

In the first four months of 2015, final payments accounted for \$27.4 billion, or 21.5 percent, of all personal income tax revenues. Final payments with personal income tax returns in the thirty-six early reporting states grew by \$3.9 billion, or 16.6 percent, in the months of January through April.

Final payments grew in thirty-two of thirty-six early reporting states in the January-April 2015 period, with twenty-six states reporting double-digit growth. Declines were recorded in four states: Iowa, Kansas, Kentucky, and Maryland.

### **Refunds**

Personal income tax refunds processed by states declined by 2.9 percent through April, and 1.9 percent in the month of April. In total, thirty-six reporting states have paid out about \$1.1 billion less in refunds in January-April of 2015 than in the same period in 2014. In April 2015 alone, states paid about \$0.3 billion less than in April of 2014. Fourteen of thirty-six reporting states paid out more personal income tax refunds to taxpayers in the January-April period of 2015 than in the same period of 2014. Twenty-two states paid out less 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 taxes 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.<sup>5</sup> Wages are fairly easy to determine and withholding can be a reasonably accurate estimate of taxes owed on wages. However, nonwage income can be difficult 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 strongly related to nonwage income, and quite variable.

Most years, the April-June quarter is the largest one for state government income tax revenue, and as a consequence it is also usually the largest for total tax revenue. Furthermore, revenue in this quarter is volatile, as already discussed. 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 rise and fall significantly, creating opportunity for taxpayers to take capital gains and losses. Interest income can also 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 completely to interest rate changes, but it certainly does happen.) The broader economy can also 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.

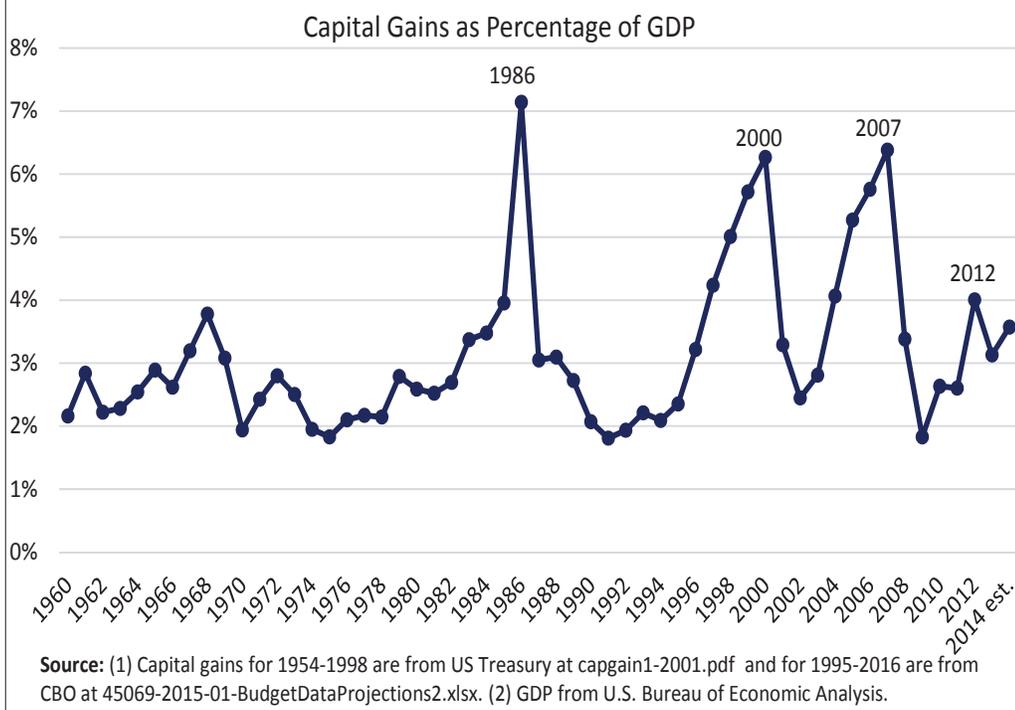
Because nonwage income is difficult to estimate during the year and because estimated payments may be only loosely related to taxes owed on that income, payments with April 15th tax returns are volatile. Making matters worse, the magnitude of this volatility is large relative to state budgets. Furthermore, 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 shortfalls in April 2014 and income tax surpluses in April 2015. 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.

### ***Forecasting Capital Gains***

As we have noted in previous reports and presentations, capital gains play an important role in personal income tax collections. Figure 4 shows capital gains as a share of gross domestic product (GDP) from 1955 through 2012 and provides Congressional Budget Office (CBO) estimates for 2013 and 2014.<sup>6</sup> 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 percent, creating a dramatic incentive for taxpayers to accelerate gains into 1986.<sup>7</sup> The

Figure 4. Capital Gains Likely Resumed Growth in 2014



near-doubling of gains in 1986 was followed by a 55 percent decline in 1987, illustrating 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 factors besides 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.<sup>8</sup>)

Third, although 2000 was the first of three consecutive 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, gains that were rapidly vanishing) 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 consecutive 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 grew for three straight years. However, the growth was particularly strong in 2012, mostly due to acceleration of income as taxpayers responded to incentives created by the federal fiscal cliff. Capital gains are estimated to have declined in 2013 due to the reverse impact of the fiscal cliff, and to have resumed growth in 2014.

Many forecasters expected that capital gains in 2013 – which would influence tax payments in April and May, 2014 – would be down because of the behavioral incentives just described. In addition, forecasters also expected growth in capital gains in 2014, which would be filed in the months of April and May 2015. The

harder question was forecasting the magnitude of the declines and growth. This was complicated by the strong stock market throughout 2013 and 2014, 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.<sup>9</sup> 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 500 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 19.2 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.<sup>10</sup> On the contrary, the year-end measure for the S&P 500 index showed 11.4 percent growth on December 31, 2014, compared to December 31, 2013, which is not as strong as the 17.5 percent average annual growth rate reported for calendar year 2014.

Because taxpayers realize gains throughout the year, the average value of the S&P 500 is probably 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 negative 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 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. As indicated on

Table 2. Stock Market and Capital Gains Showed Solid Growth in 2014

Year	% Change in S&P 500 From Prior Period		% Change in Capital Gains
	Year-end	Calendar Year Average	
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	60.0
2013	29.6	19.2	(18.8)
2014	11.4	17.5	18.5

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

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

(2) CBO (capital gains): 45069-2015-01-BudgetDataProjections2.xlsx.

Table 2, in 2014 the growth in capital gains was actually slightly higher than the average annual growth of stock market. At the end of the day, even well-designed forecasting models are not reliable enough to predict the capital gains accurately.

Forecasts for 2014 capital gains varied greatly. States that publish their capital gains forecasts expected capital gains to increase in 2014. For example, California initially forecasted a 32 percent growth in capital gains in 2014, 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 sustained strong performance of the stock market throughout 2014, forecasters in California revised their estimates and now estimate a 44 percent growth in capital gains for 2014.<sup>11</sup> In Massachusetts, forecasters initially projected that capital gains realizations would increase by 22 percent in tax year 2014 compared to tax year 2013.<sup>12</sup> However, the forecasters have revised their estimates and now estimate between 11.3 to 11.6 percent growth in capital gains for tax year 2014.<sup>13</sup> New York initially forecasted a 5.2 percent growth in capital gains in 2014,<sup>14</sup> but revised its estimate to 29.5 percent.<sup>15</sup>

The wide variation across states in projections for capital gains underscores the extreme difficulty of estimating their impact on overall personal income tax. The federal tax rate increase on capital gains in January 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. And as expected, most states did face significant shortfalls in personal income tax collections in fiscal year 2014, which was mostly due to large declines in capital gains associated with tax year 2013.

### ***The States Most Likely to be 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 2012 (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 Tax Foundation for 2015<sup>16</sup>; and (3) the state's reliance on the income tax as a share of total taxes for fiscal year 2014, 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

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

State	Capital Gains as Share of AGI (2012)	Top Capital Gains Tax Rate on Corporate Equities (2015)	PIT as Share of Total Taxes (2014)	Rank (1=highest), Considering Capital Gains Share & Top Rate Together
<b>United States</b>	<b>6.67</b>	<b>6.10</b>	<b>35.90</b>	
California	8.18	13.30	49.25	1
New York	10.66	8.80	55.81	2
Vermont	6.73	9.00	22.79	3
Connecticut	8.26	6.70	48.77	4
Minnesota	5.42	9.90	41.20	5
Montana	7.57	6.90	40.04	6
Oregon	5.23	9.90	68.67	7
Idaho	6.39	7.40	36.44	8
Nebraska	6.47	6.80	43.55	9
New Jersey	4.86	9.00	40.34	10
Iowa	4.84	9.00	38.66	11
Massachusetts	8.36	5.20	52.49	12
Colorado	8.24	4.60	48.13	13
Maine	4.57	8.00	36.76	14
Hawaii	4.78	7.30	28.93	15
Oklahoma	6.55	5.30	32.54	16
Utah	6.90	5.00	45.78	17
Arkansas	4.87	7.00	29.12	18
Wisconsin	4.41	7.70	41.39	19
South Carolina	4.28	7.00	38.32	20
Rhode Island	4.99	6.00	36.70	21
North Dakota	8.54	3.20	8.15	22
Louisiana	4.51	6.00	28.40	23
Virginia	4.65	5.80	57.40	24
Georgia	4.32	6.00	48.13	25
Kansas	5.27	4.80	34.24	26
North Carolina	4.33	5.80	44.41	27
Illinois	6.51	3.80	40.98	28
Missouri	3.95	6.00	47.70	29
Maryland	3.85	5.80	41.07	30
Kentucky	3.70	6.00	33.77	31
New Mexico	4.51	4.90	22.54	32
Delaware	3.34	6.60	32.75	33
Arizona	4.72	4.50	26.46	34
Ohio	3.73	5.30	31.18	35
Alabama	3.67	5.00	34.50	36
Mississippi	3.34	5.00	22.01	37
Pennsylvania	5.05	3.10	31.61	38
West Virginia	2.40	6.50	32.91	39
Michigan	3.40	4.30	31.75	40
Indiana	3.51	3.30	29.06	41

**Sources:** (1) Capital gains as share of adjusted gross income (AGI): IRS Statistics of Income File; (2) Top capital gains tax rate: "The High Burden of State and Federal Capital Gains Tax Rates in the United States," The Tax Foundation, March 2015; (3) PIT as share of total taxes: Census Bureau State Government Tax Collections data; (4) Rank calculated by the Rockefeller Institute by first indexing each state's capital gains share and top rate, multiplying the two resulting indexes, and ranking them.

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 or windfalls for April can lead states to experience budget challenges.

#### ***Impact on State Revenue Forecasts***

In most months, the bulk of state income tax revenue comes from withholding taxes on wages. Because taxes on wages are the most significant portion of total income tax, even small percentage shortfalls or windfalls in withholding can accumulate over time and lead to large fluctuations in revenue forecasts. But it is unusual for a single month to swing these estimates dramatically — more likely, revenue estimates will be revised after an accumulation of evidence from employment data, wage data, and withholding collections warrants it. Large month-to-month fluctuations in withholding tax collections are not typical, and when they do 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 or windfall.

But income tax payments related to nonwage income are far more volatile and a single month — if it is 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. The payments 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 rise or fall 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. Many states expected to see significant declines in nonwage taxable income for tax year 2013 and strong growth in tax year 2014. However, most states were unable to predict the magnitudes of these declines and increases with any accuracy. State budget forecasters have external indicators, such as stock market values and broad economic measures, which go into the models they use to predict nonwage income subject to tax. These models simply are not able to predict nonwage income with the confidence that forecasters and policymakers would like.

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 2015 has grown by far more than expected by forecasters in a number of states. This is good news, particularly at a time when many states are projecting budget shortfalls for fiscal year 2016. However, the magnitude of the income tax windfall will not be clear until states close the FY 2015 budget books.

### ***This Year's Forecast Errors: Selected States***

We collected data for those states that provide forecasts of monthly revenue. Such information was available and easily retrievable for seventeen states and the data are presented in Table 4 for the months of April 2014 and April 2015. Due to uncertainty caused by the fiscal cliff, many states overestimated income tax collections for April 2014. As shown in Table 4, in eleven out of seventeen states personal income tax collections were below the forecast, usually by double-digit percentages in April 2014. The reverse trend was observed in April 2015: state officials underestimated income tax collections in fourteen out of seventeen states.

### ***The Impact of April Surprises on State Budget Processes***

An April income tax shortfall or windfall comes at the worst time of year for three reasons. First, by the time it is recognized in late April or mid-May, it is just six to 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 to cut spending, lay off workers, raise taxes, or otherwise obtain resources sufficient to offset the lost revenue before the June 30th fiscal year end. As a result, a state without

**Table 4. Actual vs. Projected Personal Income Tax Revenues, April 2014 vs. April 2015**

State	April 2014	April 2014	Percentage Difference	April 2015	April 2015	Percentage Difference
	Actual	Forecast		Actual	Forecast	
Arizona	394.4	450.3	(12.4)	543.3	424.6	28.0
Arkansas	568.3	496.7	14.4	466.6	468.2	(0.3)
California	10,953.9	10,871.0	0.8	13,789.6	12,168.2	13.3
Colorado	877.0	854.8	2.6	1,127.4	984.0	14.6
Idaho	295.2	317.6	(7.1)	330.1	337.9	(2.3)
Indiana	825.2	848.8	(2.8)	929.6	783.9	18.6
Kansas	226.0	315.6	(28.4)	230.0	230.3	(0.1)
Maine	224.5	215.8	4.0	256.9	223.7	14.8
Mississippi	212.4	248.9	(14.7)	281.2	227.3	23.7
Montana	180.7	180.5	0.1	227.3	195.2	16.5
Nebraska	280.3	319.1	(12.2)	320.6	314.6	1.9
North Dakota	162.4	121.7	33.4	189.5	149.4	26.8
Ohio	902.2	1,059.1	(14.8)	1,222.3	994.4	22.9
Pennsylvania	1,826.0	2,011.7	(9.2)	2,054.3	2,033.2	1.0
Rhode Island	152.5	180.8	(15.7)	194.5	166.1	17.1
Vermont	131.7	154.5	(14.8)	160.8	150.0	7.2
West Virginia	285.5	323.0	(11.6)	338.2	312.6	8.2

Source: Individual state data, compiled by the Rockefeller Institute.

sufficient cash on hand to pay bills must resort to stopgap measures to "roll" the problem into the future. For example, states may delay income tax refund payments. Such actions do not save any money, but they do temporarily avert a cash flow crisis. In so doing, they increase the budget problem for the fiscal year about to start (by pushing payment requirements into that year), requiring greater action 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 will have to lower its forecasts for future years as well. For example, last year many states overestimated nonwage income for 2013 and they have built their forecasts for 2014 and beyond upon that too-high estimate. So, when they learned that 2013 income was lower than expected, they had 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 hit them twice in this crucial budget negotiation period. Consequently, this year many states underestimated nonwage income for 2014 and ended up with a windfall. This comes at a time when many states are actually facing budget shortfalls for fiscal year 2016. The windfalls are certainly good news for the states as long as they treat the unexpected revenue as a one-time event and do not overestimate revenues for future years or build budgets based on windfall revenues.

Third, the April income tax shortfalls or windfalls come late in the fiscal year and late in the budget process — often as states are due to wrap up their budget negotiations. It takes time for revenue analysts to evaluate the shortfalls or windfalls, 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 "April Surprises," whether good or bad, for elected officials can unsettle carefully balanced gap-closing plans already tentatively negotiated.

## Endnotes

- 1 U.S. Department of Commerce, Bureau of Economic Analysis, "National Data: National Income and Product Accounts Tables," n.d., <http://www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1#reqid=9&step=3&isuri=1&904=2009&903=58&906=a&905=2015&910=x&911=0>.
- 2 Data are missing for three states — Hawaii, Louisiana, and New Mexico.
- 3 See Lucy Dadayan and Donald J. Boyd, "States Are Not Out of the Woods Despite Strong Revenue Gains in the Fourth Quarter" (Albany: Nelson A. Rockefeller Institute of Government, April 2013), [http://www.rockinst.org/newsroom/revenue\\_reports/2013/2013-04-24-SRR\\_91.pdf](http://www.rockinst.org/newsroom/revenue_reports/2013/2013-04-24-SRR_91.pdf).
- 4 Individual income tax returns are usually due on April 15th in thirty-five 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 15), Delaware (April 30), Hawaii (April 20), Iowa (April 30), Louisiana (May 15), and Virginia (May 1).

- 5 This is a simplified description of the process, and there are other possibilities as well. For example, taxpayers can adjust withholding taxes upward or downward as a partial alternative to making estimated payments, and they may carry forward credit overpayments to the next tax year rather than claim a refund.
- 6 The estimates are from the Congressional Budget Office. Please see [www.cbo.gov/sites/default/files/cbofiles/attachments/45069-2015-01-BudgetDataProjections2.xlsx](http://www.cbo.gov/sites/default/files/cbofiles/attachments/45069-2015-01-BudgetDataProjections2.xlsx).
- 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*, (Washington, DC: Congressional Budget Office, October 9, 2002), <http://www.cbo.gov/sites/default/files/taxbrief2.pdf>.
- 9 See, for example, Preston Miller and Larry Ozanne, "Forecasting Capital Gains Realizations," *Technical Paper 2000-5* (Washington, DC: Congressional Budget Office, August 2000), <https://www.cbo.gov/sites/default/files/20005.pdf>; G. Thomas Woodward, "Revenue Projections and the Stock Market," *Revenue and Tax Policy Brief No. 3* (Washington, DC: Congressional Budget Office, December 2002), <https://www.cbo.gov/sites/default/files/12-20-taxbrief3.pdf>; and Jangryoul Kim, Preston Miller, and Larry Ozanne, "Estimating and Forecasting Capital Gains with Quarterly Models," *Technical Paper 2004-14* (Washington, DC: Congressional Budget Office, September 2004), <https://www.cbo.gov/sites/default/files/2004-14.pdf>.
- 10 Source: Federal Reserve Bank of St. Louis. See <http://research.stlouisfed.org/fred2/series/SP500/downloaddata>.
- 11 See *Governor's Budget Summary* for 2014-15 and 2015-16 (Sacramento: California Department of Finance), <http://www.ebudget.ca.gov/home.php?selectedYear=2015-16>.
- 12 See *Briefing Book: FY2015 Consensus Revenue Estimate Hearing* (Springfield: Massachusetts Department of Revenue, December 11, 2013), <http://www.mass.gov/dor/docs/dor/stats/briefing-book/fy2015/fy15-briefing-book.pdf>
- 13 See *Briefing Book: FY2016 Consensus Revenue Estimate Hearing* (Springfield: Massachusetts Department of Revenue, January 22, 2015), <http://www.mass.gov/dor/docs/dor/stats/briefing-book/fy2016/briefing-book.pdf>.
- 14 See *FY 2015 Economic and Revenue Outlook* (Albany: NYS Division of the Budget, n.d.), <https://www.budget.ny.gov/pubs/archive/fy1415archive/eBudget1415/economicRevenueOutlook/economicRevenueOutlook.pdf>
- 15 See *FY 2016 Economic & Revenue Outlook* (Albany: NYS Division of the Budget, n.d.), <https://www.budget.ny.gov/pubs/executive/eBudget1516/economicRevenueOutlook/economicRevenueOutlook.pdf>.
- 16 See Kyle Pomerleau, "The High Burden of State and Federal Capital Gains Tax Rates in the United States," *The Tax Foundation*, March 2015, <http://taxfoundation.org/article/high-burden-state-and-federal-capital-gains-tax-rates-united-states>.

## 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.

The Institute's Fiscal Studies Program, originally called the Center for the Study of the States, was established in May 1990 in response to the growing importance of state governments in the American federal system. Despite the ever-growing role of the states, there is a dearth of high-quality, practical, independent research about state and local programs and finances.

The mission of the Fiscal Studies Program is to help fill this important gap. The Program conducts research on trends affecting all fifty states and serves as a national resource for public officials, the media, public affairs experts, researchers, and others.

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.