

State Personal Income Tax Revenues are Deteriorating Rapidly: A June 2002 Update

As 2001 began, there were signs that economic growth was beginning to moderate. By the end of the year, it was clear that the downturn in the national economy had caused state tax revenues, including receipts from the state individual income tax, which had been the real driving force for revenue growth during the late 1990's, to decline sharply.

The first few months of 2002 have seen this trend worsen. By the time states closed their books on April 2002, total individual income tax revenues for the first four months of the calendar year were running nearly 15 percent below 2001, according to a recent survey of state officials.¹ Even more dramatic was the fall-off in tax receipts normally associated with income not subject to tax withholding (e.g., capital gains, rents, interest and dividends) where receipts were running an average of 26 percent below 2001.² Based on these and other results from the survey discussed below, policy makers should not expect a quick turn around in revenues, and they should plan for continued fiscal stress in FY 2003 and 2004.

Recent Trends

From FY 1995 through FY 2001, individual income tax revenues increased at an average of 9 percent per year, peaking at 12.4 percent in FY 2000.³ While withholding grew strongly in this period, estimated or declared income tax payments – which reflect non-wage income, often from investments – grew at a very rapid pace. However, it was final payments with returns (i.e., payments made when returns were filed to reconcile tax liability for the prior year), due in April in most states that increased at an often-astonishing pace. For example in the April-June quarter of 1998, state individual income tax collections grew by 19.5 percent over the previous year. For most years in the late 1990s, final returns grew at a much faster pace than anyone was projecting. This became known at the “April Surprise.” These surprises usually left states with healthy surpluses at the end of their fiscal years.

In 2001, the April Surprise failed to appear. While final returns were up in most states, estimated and withholding revenues were beginning to show real weakness. Withholding grew by only 2.8 percent in April – June 2001 – after growth rates of up to 10 percent in previous quarters; the first two quarterly estimated tax payments -- April and June – showed no growth at all over the year before. Some states, especially in the Midwest and Southeast, were beginning to see a serious slump in their overall tax revenues.

This was consistent with the beginning of the recession in March of 2001. As 2001 progressed, the situation got worse. Total income tax collections in the last half of 2001 were about 3 percent below the same period a year earlier.

¹ The survey was conducted cooperatively by the Federation of Tax Administrators, National Association of State Budget Officers, National Conference of State Legislatures, and Nelson A. Rockefeller Institute of Government of the State University of New York. Survey responses were provided by state tax administrators and budget agencies, and other state fiscal officials.

² A similar phenomenon was occurring at the federal level where April 2002 income tax receipts from other than withholding tax were over 30 percent or \$55 billion below the April 2001 levels.

³ State fiscal year refers to the fiscal years of each state, July 1 to June 30 in 46 states, April 1 to March 31 in New York, October 1 to September 30 in Alabama and Michigan, and September 1 to August 31 in Texas.

Survey Results

While the overall economic situation seemed to improve in early 2002, this was not the case with state individual income tax revenues. Despite the gains in economic activity, states continued to report deterioration in their revenue positions.

To help gauge the breadth and the depth of the drop in state income tax revenues, state officials in the 41 states and the District of Columbia that have a broad-based individual income tax were surveyed. The survey looked at three types of income tax payments – payments with returns, withholding, and declarations of estimated taxes -- for April 2002 and January-April 2002, compared to the same periods one year earlier.⁴ The survey also asked for data on individual income tax refund payments and asked states to compare actual 2002 receipts to the estimates used in the state budget process. Finally, the survey asked open-ended questions on the perceived causes of the drop-off in receipts and the impact the 2002 performance would have on future budget periods.

The survey revealed that state individual income tax receipts, particularly those from non-wage income not subject to tax withholding, declined sharply from one year ago. As shown in the attached tables, nearly every state has experienced such a decline, and the drop-off often exceeds 25 percent. In addition, withholding tax receipts are slightly below last year (on average), and income tax refund payments are up moderately. As a result, individual income tax revenues through April are below projected amounts in nearly every state, and the trend in collections portends more difficult fiscal conditions ahead.

While the data and conclusions should be considered preliminary,⁵ they point to an ominous situation. Total income tax collections for January-April 2002 were 14.0 percent or about \$14.5 billion below the level of a year ago. In April alone, collections fell by 21.4 percent. The problem seems to be in both wages and salaries where the withholding tax collections for the first four months of the calendar year were down 3.0 percent relative to last year as well as the other components of personal income, i.e., rents, interests, dividends, and capital gains. Receipts from these non-wage and salary income components (as reflected in returns with payments and estimated payments) plummeted over 25 percent or \$10 billion in the first four months of the year. Estimated payments received in the first four months of 2002 were 27 percent behind the same period. This bodes ill for revenues the rest of the year.

When compared to the tax projections, which were the basis for state budgets for FY 2002, only two states reported that January-April collection were on or above budgeted or estimated amounts. Of the states that reported collections below budget, 12 indicated that January-April collections are below forecast by more than 10 percent. Most states in this position expect that the current FY 2003 revenue estimates will likely have to be revised downward because of the current pattern of income tax receipts in 2002. In other words, there will be no quick return to substantial positive growth in this tax source.

⁴ Six states have individual income tax return due dates later than the usual April 15. Hawaii returns are due on April 20. Delaware and Iowa are due on April 30. Virginia requires returns to be filed by May 1, while Arkansas and Louisiana have a May 15 due date.

⁵ The spring months are critical to year-long income tax receipts because they reflect the height of the income tax processing season when final payments are being received with the April 15 returns as well as the bulk of the income tax refund processing season. Substantial changes in processing flows can, however, significantly affect the comparison of receipts from one year to the next, particularly on a month-to-month basis. For that reason, the results should be viewed cautiously, focusing on the January-April figures, rather than on April alone. The final picture on income tax receipts will become clear only as May receipts are recorded.

Conclusion

The individual income tax was to a large degree the driving force that increased state revenues during the late 1990's. Recently, however, the decline in overall economic activity, rising unemployment and fall-off in investment returns has caused revenues to decline dramatically. Receipts in the first four months of 2002 are running well behind those of just one year ago in nearly every state. The prospects for a quick turn-around are not great. Policy makers should expect continued stress as they attempt to develop balanced spending plans for FY 2003 and 2004 even if the economy continues the upturn reported for the first quarter.

Attached is a summary of the survey results gained from the data gathered in the survey as well as a table displaying the collection figures from individual states.

SURVEY RESULTS

- Total individual income tax collections in January-April 2002 were 14.0 percent or about \$14.5 billion below the level of a year ago. In April alone, when many states receive the bulk of their balance due or final payments, collections fell by 21.4 percent, or \$8.5 billion. Income tax receipts from these sources in the first four months of April 2002 were greater than in 2001 in only seven states.
- Withholding tax collections, influenced by the recent drop in employment, were off by about 3.0 percent during the first four months of the year. They decreased by 0.2 percent in April, compared with April of last year.
- Final payments with individual income tax returns were down by 26.1 percent through April, and 28.7 percent in the month of April alone. Payments with returns in January – April 2002 exceeded 2001 in only seven states. In three cases, (Vermont, Pennsylvania and West Virginia) much of the excess was attributed to speedier processing of payments received in April 2002. Hawaii reported that much of the growth was due to extraordinary, non-recurring payments.
- Estimated payments received in the first four months of 2002, generally considered to be a harbinger of expected receipts in the year ahead, were running nearly 27.0 percent behind the same period in 2001. Receipts in April 2002 for the 2nd quarter installment decreased 24.5 percent from a year earlier. Only three states (Arizona, Vermont and West Virginia) showed any improvement from 2001 on this measure.
- Meanwhile, the dollar amount of individual income tax refunds processed by states increased by nearly 14 percent during the 2002 processing season. [It increased by 24.6 percent in April alone, but one-month figures in this area carry little meaning.] While the number of refund returns processed has increased only 3.3 percent in January-April 2002, the average refund amount has increased by 10.4 percent—to \$460.35. In total, states have paid out about \$3.5 billion more in refunds in 2002 than in 2001.
- Of the states that compared collections with budgeted amounts, only two states reported that January-April collections were on or above the budgeted or estimated amounts contained in the official state revenue forecast. Georgia reported collections about \$60 million or 2.2 percent above expectations. West Virginia reported collections were \$22.2 million or 5.8 percent above the estimate, but indicated that accelerated tax processing accounted for some significant portion of the performance.
- All of the other states reported collections below budgeted targets, with 12 states reporting January-April collections are below budgeted forecast by more than 10 percent.
- In discussing causes of the drop-off, nearly every state noted that it would not be able to pinpoint the precise causes until substantially later this year when all returns are processed and available for analysis. They noted, however, that the decline would likely be attributable to substantially lower amounts of income not subject to withholding, such as capital gains, interest and dividends. A number of states also noted the decline in stock options and employee bonus compensation as a contributor to the decline. Several noted that the increased refunds were most likely attributable to greater than anticipated short-term layoffs, reduced hours and other forms of wage and salary income. Finally, states noted that estimated declarations are likely to decline as taxpayers adjust their projected tax payments to a lower earnings forecast.

State Individual Income Taxes: Payments with Returns

State		April 2001 (\$ millions)	April 2002 (\$ millions)	Percent Change	Jan.-April 2001 (\$ millions)	Jan.-April 2002 (\$ millions)	Percent Change
Connecticut	1	655.7	410.3	-37.4%	716.2	468.9	-34.5%
Delaware	1	32.3	30.5	-5.6%	40.7	38.4	-5.7%
District of Columbia	1	79.0	49.0	-38.0%	88.0	58.0	-34.1%
Maine	1	154.2	114.1	-26.0%	170.1	131.2	-22.8%
Maryland	1	415.1	342.4	-17.5%	483.5	408.1	-15.6%
Massachusetts	1	584.0	365.0	-37.5%	640.8	428.7	-33.1%
New Jersey	1	1,068.7	793.0	-25.8%	1,141.5	879.0	-23.0%
New York	1	1,519.7	1,020.3	-32.9%	1,652.0	1,164.1	-29.5%
Pennsylvania	1	335.1	446.6	33.3%	407.3	517.5	27.1%
Rhode Island	1	125.2	89.9	-28.2%	134.9	100.1	-25.8%
Vermont	1	\$9.1	\$43.9	381.0%	\$14.3	\$48.6	239.0%
Northeast		\$4,978.1	\$3,705.1	-25.6%	\$5,489.3	\$4,242.6	-22.7%
Alabama	2	100.6	66.9	-33.5%	135.5	92.2	-32.0%
Arkansas	2	37.1	39.1	5.6%	62.2	62.7	0.7%
Georgia	2	73.8	69.7	-5.5%	121.3	127.5	5.1%
Kentucky	2	63.3	73.8	16.5%			
Louisiana	2	94.8	69.8	-26.4%	121.7	90.3	-25.8%
Mississippi	2	31.0	9.8	-68.3%	45.9	22.1	-51.9%
North Carolina	2	803.0	600.0	-25.3%	788.0	710.0	-9.9%
South Carolina	2	79.1	70.6	-10.8%	161.8	153.8	-5.0%
Virginia	2	188.2	160.2	-14.9%	222.2	178.6	-19.6%
West Virginia	2	42.3	46.5	9.9%	54.9	58.5	6.6%
Southeast		\$1,513.1	\$1,206.4	-20.3%	\$1,713.5	\$1,495.6	-12.7%
Illinois	3	509.6	418.9	-17.8%	590.1	492.6	-16.5%
Indiana	3	194.1	170.9	-12.0%	258.3	228.8	-11.4%
Iowa	3	100.0	71.5	-28.5%	141.0	101.8	-27.8%
Kansas	3	126.7	126.1	-0.5%	175.5	170.6	-2.8%

Michigan	3	496.9	361.7	-27.2%	560.6	419.9	-25.1%
Minnesota	3	232.0	173.0	-25.4%	306.6	241.0	-21.4%
Missouri	3	408.2	326.4	-20.0%	473.7	382/6	-19.2
Nebraska	3	130.9	104.0	-20.6%	170.0	137.4	-19.2%
North Dakota	3	30.9	23.8	-23.0%	40.3	32.5	-19.4%
Ohio	3	836.4	673.5	-19.5%	888.9	694.1	-21.9%
Oklahoma	3	142.0	141.2	-0.6%	178.1	177.2	-0.5%
Wisconsin	3	186.9	156.3	-16.4%	214.1	177.1	-17.3%
Midwest		\$ 3,312.3	\$ 2,659.4	-19.7%	\$ 3,892.4	\$ 3,149.8	-19.1%
Arizona	4	310.0	265.7	-14.3%	339.3	299.8	-11.6%
California	4	4,860.0	2,745.0	-43.5%	5,136.0	2,954.0	-42.5%
Colorado	4	110.3	114.1	3.4%	188.7	176.3	-6.6%
Hawaii	4	40.5	61.1	51.0%	51.6	77.7	50.7%
Idaho	4	193.3	124.1	-35.8%	219.7	144.0	-34.5%
Montana	4				86.6	64.4	-25.6%
New Mexico	4	108.0	86.0	-20.4%	124.0	103.0	-16.9%
Oregon	4	275.3	225.1	-18.2%	326.6	270.9	-17.1%
Utah	4	308.6	228.0	-26.1%	357.8	273.2	-23.6%
Far West		\$ 6,205.9	\$ 3,849.0	-38.0%	\$ 6,830.3	\$ 4,363.3	-36.1%
Total		\$ 16,009.4	\$ 11,419.9	-28.7%	\$ 17,925.5	\$ 13,251.3	-26.1%