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BETTER-THAN-EXPECTED STATE TAX COLLECTIONS HIGHLIGHT IMPORTANCE OF INCOME TAXES

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State revenues—especially income tax collections—are beginning to recover from the worst recession since the 1930s, but they still have a long way to go.

At least 28 states have reported that tax collections for the just-ended fiscal year will exceed the amount expected when their budgets were adopted last spring. In 23 of those states, the improvement is driven by gains in income tax collections—a result of rapid increases in the incomes of wealthy individuals and corporations over the last year. (Aside from North Carolina, the exceptions don't have a personal or corporate income tax or both.)

The better-than-expected revenue picture is good news. For instance, it could allow these states to reduce the spending cuts they have planned for schools, health care, human services and other areas. Even with the additional revenue, states are still cutting spending for the upcoming fiscal year. States will maintain the very deep cuts they made when the recession hit over three years ago because their revenues remain far below pre-recession levels. They are addressing shortfalls for the 2012 fiscal year (that began on July 1 in most states) of more than $100 billion.[1] Despite the improvement, it will take years for states to overcome the damage the recession did to their ability to make fundamental public investments.

Because states still face these very large budget gaps, their best strategy will remain a balanced combination of modest spending cuts, new measures to strengthen the revenue recovery, and (in a few states) utilization of remaining reserves. Because it is unclear whether these positive revenue developments are temporary or long-lasting, states would be wise to avoid new tax cuts that have the potential to create or widen future budget gaps if the recovery is weak.

[1] See box, page 3, for discussion of continuing state fiscal problems.

Many States Are Collecting Revenues That Exceed Original Estimates

States pay close attention to spring revenue collection reports. More state taxes are collected in April, when income taxes are due, than in any other month. The end of the fiscal year[2] is generally the last chance states have to adjust their revenue projections before adopting the next year's budget.

This year, the media have reported that many states had positive "April surprises"—that is, revenue collections that were higher than expected. This is good news, especially since most of the "surprises" were in the wrong direction in the last two years.

Comprehensive figures comparing original revenue estimates to actual collections for all 50 states will not be available for many months, but a clear pattern is emerging. At least 28 states have reported recent tax collections that are higher than the estimates in their budgets adopted last spring. See Table 1. In contrast, few reports show revenues below projections.[3]

On average, in the 28 states with higher-than-expected growth, personal income taxes have grown 9 percent over last year. That jump is more than double the 4.4 percent growth rate that was anticipated when these states' budgets were enacted. Sales tax growth is only about 1.5 percentage points above the 2.9 percent originally projected. Some of the states where collections exceeded projections by a large margin in 2011 include California ($2.8 billion), Connecticut ($929 million), Delaware ($23.5 million), Idaho ($74.2

TABLE 1:

Revenue Source with Largest Percentage Improvement Compared to Original Estimate

State	Revenue Source
Arkansas	Personal Income Tax
California	Personal Income Tax
Colorado	Personal Income Tax
Connecticut	Personal Income Tax
Delaware	Corporate Income Tax
Florida	Sales Tax
Idaho	Corporate Income Tax
Indiana	Personal Income Tax
Iowa	Corporate Income Tax
Kentucky	Personal Income Tax
Maryland	Corporate Income Tax
Massachusetts	Personal Income Tax
Michigan	Personal Income Tax
Montana	Corporate Income Tax
Nebraska	Personal Income Tax
Nevada	Sales Tax*
New Jersey	Personal Income Tax
North Carolina	Sales Tax
Ohio	Corporate Income Tax
Oklahoma	Corporate Income Tax
Pennsylvania	Corporate Income Tax
Rhode Island	Corporate Income Tax
South Carolina	Corporate Income Tax
Tennessee	Sales Tax
Vermont	Corporate Income Tax
West Virginia	Corporate Income Tax
Wisconsin	Corporate Income Tax
Wyoming	Sales Tax*

Sources: Various State tax collection reports, NASBO Fiscal Survey of the states, Fall 2010. CBPP calculations.

Notes: The method of comparison to original estimates varies across states. In most states, growth in year-to-date collections were compared to the rate projected in the original budget as reported by the National Association of State Budget Officers. Some states – California, Colorado, Connecticut, Delaware, Michigan, Montana, Nevada, Ohio, and Wisconsin --revised their growth projections for the year. In these states, the new growth rate was compared to the original projection. **Nevada** and **Wyoming** do not have personal or corporate income taxes. **Florida** and **Tennessee** do not have broad-based personal income taxes.

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[2] The fiscal year starts on July 1 in all but 4 states (Alabama, New York, Michigan, and Texas).

[3] For example, Hawaii lowered its 2011 estimate by $200 million in March and New Hampshire's revenues are below estimates.

million), Kentucky ($319 million) New Jersey ($342 million), Pennsylvania ($274 million), and South Carolina ($107 million).

States That Rely on Income Taxes Benefit the Most

Increases in corporate profits and rising incomes for individuals and families—especially the wealthy—have fueled the boost in revenues. Personal and corporate income taxes are significantly higher than expected, while sales taxes generally are much closer to targets. These gains in personal or corporate income tax collections led to higher-than-expected revenues than had been forecast when the budgets in at least 23 states were adopted last year.

The Great Recession appears to be following the pattern of recent recessions where the incomes of the wealthy recover well before those of low- and middle-income individuals and families. For example, during the economic expansion that followed the 2001 recession, the average inflation-adjusted income of the bottom 90 percent of households grew just 4 percent while the incomes of the top 1 percent grew more than ten times faster (by 62 percent).[4] Many experts expect a similar pattern now.[5]

TABLE 2:
Trends In Personal Income, By Income Category

	Annual growth, first quarter 2010 to first quarter 2011
Wage and salary disbursements	3.7%
Proprietors' income	6.5%
Rental income	11.1%
Personal dividend income	5.3%
Dow Jones Industrial Average (change from May 31, 2010 to May 31, 2011)	24.0%
Source: Bureau of Economic Analysis, NIPA tables last revised May 26, 2011	

Income trends suggest that this is occurring again. Wages—the primary form of income for low- and middle-income households—have grown slowly over the last year, but other forms of income disproportionately collected by wealthy individuals have grown rapidly. Between early 2010 and early 2011, income from business ownership, rental property, and investment dividends increased more rapidly than income from wages (Table 2). Capital gains also have risen as stock prices have jumped—as reflected in the 24 percent increase in the Dow Jones Industrial Average compared to a year ago.[6]

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[4] Hannah Shaw and Chad Stone, "Tax Data Show Richest 1 Percent Took a Hit in 2008, But Income Remained Highly Concentrated at the Top," Center on Budget and Policy Priorities, October 21, 2010, http://www.cbpp.org/cms/index.cfm?fa=view&id=3309

[5] For example, Berkeley Professor Emmanuel Saez, who has been studying income distribution in the United States for many years, wrote that the data for the years after 2009 will likely show that, "…based on the U.S. historical record, falls in income concentration due to economic downturns are temporary unless drastic regulation and tax policy changes are implemented and prevent income concentration from bouncing back …Recent downturns, such as the 2001 recession, lead to only very temporary drops in income concentration."[5] This rebound can only occur if the incomes of the very wealthy once again grow much faster than those of low- and middle income individuals and families.

[6] The Bureau of Economic Analysis does not track realized capital gains, so this income source does not appear in Table 2.

Better-Than-Expected Revenues Are Good News But States Remain In Fiscal Trouble

States continue to face a significant fiscal challenge; the worst recession since the 1930s has caused the steepest decline in state tax receipts on record. The revenue that states expected to receive in fiscal year 2011 was some 9 percent less than the amount collected in fiscal year 2008, after adjusting for inflation, while the need for state-funded services has not declined. As a result, states were forced to close large shortfalls — on average, some 20 percent of their budgets — when they adopted their fiscal year 2011 budgets.

Now it appears that many states will collect somewhat more revenue in 2011 than they initially estimated. This is good news, but it will not resolve states' fiscal problems. The additional revenue will not come close to the amount needed to reverse all of the spending cuts and tax increases used to close the states' shortfalls. For example:

- South Carolina expects to receive just over $100 million in unanticipated revenues in fiscal year 2011; the state closed a 2011 budget gap of $1.3 billion.
- The$233 million in additional revenue that Wisconsin expects to receive is only a small fraction of the $1.8 billion shortfall that the state faced.
- Even Connecticut, whose 2011 revenues are expected to exceed estimates by close to $1 billion, closed budget gaps of more than $5 billion for fiscal year 2011 and $3.2 billion for 2012

It will still take years for state budgets to recover from the deep problems caused by the recession.

- State revenues still remain well below pre-recession levels. As of the middle of fiscal year 2011, state revenues remain roughly 9 percent below pre-recession levels.
- Even after accounting for the recent improvements, states have closed or expect to close shortfalls for the upcoming 2012 fiscal year that total $103 billion, and many have projected shortfalls for fiscal year 2013.[a]

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[a] Phil Oliff, Elizabeth McNichol, and Nicholas Johnson, "States Continue to Feel Recession's Impact," Center on Budget and Policy Priorities, June 17. 2011, http://www.cbpp.org/cms/index.cfm?fa=view&id=711.

The concentration of income gains among the wealthy is likely to cause personal income tax revenues to rise at a slightly faster rate than the growth in total state income. This is because most states' personal income taxes are at least slightly progressive—that is, higher incomes are taxed at a higher rate than lower incomes. The degree of progressivity varies widely.

In addition, corporate profits are rising rapidly. By the end of 2010, the output produced by private corporations had returned to its pre-recession fourth-quarter 2007 level. The profits of these businesses are 21.7 percent higher than before the recession.[7] This has boosted collections of corporate income taxes. Increased corporate profits also contribute to the jump in the incomes of the wealthy from increased corporate dividends, and higher share prices that cause higher capital gains. This combination produces more income subject to personal income tax.

By contrast, collections of sales taxes—states' other major source of revenue—are rebounding more slowly. Consumer spending has recovered more slowly than after other post-World War II recessions. Forecasters, including the Congressional Budget Office, are projecting continued modest growth in spending because housing prices are still depressed. Consequently, households have less wealth to spend.[8] In addition, many individuals and families are using their disposable income to pay down debt—not for spending.

As a result, personal and corporate income tax collections are far more likely to exceed estimates than are sales tax collections. States that rely on personal income taxes and robust corporate taxes are seeing positive results. In particular, progressive taxes can harness the economic gains flowing primarily to the wealthy.

The Volatility Issue

Along with the superior potential for revenue growth, income taxes have a potential downside—their volatility when incomes are rising or falling rapidly.[9] For example, income tax revenue fell dramatically in the aftermath of the recession, as incomes dropped and the stock market declined. In some states, this has led to calls to cut or radically restructure income taxes.

States can respond to concerns about volatility without giving up on the positive aspects of income taxes. They might, for example, rely on a mix of different types of taxes, including sales and excise taxes to reduce the likelihood that all fall simultaneously. States can also set a share of income tax receipts aside in a rainy day fund when collections are rising. Filling and maintaining an adequate rainy day fund will allow states to smooth the ups and downs of an income tax.[10] These measures serve to mute the effects of a normal economic downturn on state budgets.

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[7] Lawrence Mishel, "We're Not Broke Nor Will We Be," Economic Policy Institute, May 19, 2011, http://w3.epi-data.org/temp2011/BriefingPaper310.pdf.

[8] Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2011 to 2021," Congress of the United States, January 2011. http://www.cbo.gov/ftpdocs/120xx/doc12039/01-26_FY2011Outlook.pdf.

[9] For a discussion of these types of concerns, see, for example, Robert Frank, "The Price of Taxing the Rich," *Wall Street Journal,* March 26, 2011, http://tinyurl.com/4vn3ldt.

[10] For more on Rainy Day Fund design see Elizabeth McNichol and Kwame Brown, "Why and How States Should Strengthen Their Rainy Day Funds," Center on Budget and Policy Priorities, February 3, 2011, http://www.cbpp.org/cms/index.cfm?fa=view&id=3387.

Continue to Be Cautious

If the trend towards improved revenues continues, it is likely that states will again see better-than-expected revenue collections at some point in the 2012 fiscal year. It is, however, going to take years to reverse the damage inflicted by the recession on state budgets. Improving revenues will help only if states do not move too quickly to implement new permanent programs or to cut taxes. The first priority should be to avoid additional cuts or to undo measures used to balance budgets in recent years.

Improved revenue collections mean that deficit-closing measures can be less harsh than planned. For example, Oregon has used higher-than-expected revenues to restore cuts made in human services and public safety programs. In addition, improved collections—if sustained—can put states on a firmer footing by reducing dependence on temporary budget balancing measures. For example, Connecticut may be able to balance its 2012 budget with a little less borrowing than it had expected. New Jersey's governor has accelerated the phase-in to full pension fund payments.

Despite these positive developments, most states' revenues will continue to fall far short of what they need to maintain public services in fiscal year 2012 and beyond. States have addressed $103 billion in shortfalls for 2012 and many have projected gaps for 2013.

Until employment returns to pre-recession levels, state revenue growth will not be healthy enough to avert the need for more spending cuts and tax increases. A balanced approach that includes spending cuts, new revenue, and the use of available reserves is the best course. States should not permanently cut taxes or permanently increase spending until they determine whether these positive revenue developments are temporary or more long-lasting.