Capital Gains: Its Recent, Varied, and Growing (?) Impact on State Revenues

by David L. Sjoquist and Sally Wallace

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Over the past decade, state government tax revenues have been strong, with the exception of two major downturns, one in the early 1990s and one beginning in 2001. During the 1990s, total state tax revenues grew an average of 6 percent per year in current dollars (4.2 percent per year in real terms). The good times of the 1990s have faded, and state governments are now facing some of their most difficult budget years in a decade.

For each quarter from fourth quarter 2000 through fourth quarter 2001, state governments posted year-over-year tax revenue growth that was less than 40 percent of the previous years' growth. In the third quarter of 2001, states faced both a nominal and real decrease in quarterly tax collections. It now appears that some of these losses are easing, with a number of states posting nominal increases in some important revenue categories.

State governments rely heavily on two sources of revenue: (1) general sales and gross receipts taxes and (2) the individual income tax. Although the income tax has grown in importance throughout the last century, there was substantial growth in the individual income tax as a state revenue source in the 1990s. In 1980, the general sales and use tax accounted for 31.5 percent of tax revenue and the personal income tax accounted for only 27.1 percent of revenue. Over the past two decades, this mix has changed — in 2000, general sales and individual income taxes accounted for 32.2 percent and 36 percent of total tax revenues, respectively (Table 1, next page).

Individual income tax receipts have been hard hit since the downturn in the economy. Stateline.org (2002) reports that reduced personal income taxes represented some of the largest declines in state tax revenues across the nation. Income taxes tend to respond strongly to changes in economic activity — that is, income tax revenues are income-elastic. The up side to that is that as the economy grows, income tax revenues grow, but as the economy slows, income tax revenues slow as well.

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In most states, the base of the income tax includes wage and salary income, some retirement income (such as pension income), self-employment income, and capital income (from interest, dividends, rents, and realized capital gains). The 1990s were marked by fast growth in the stock market and in capital gains, while more recently capital gains realizations have declined. It is natural, therefore, to ask how important were income taxes on capital gains realizations to the downturn in state revenues.

In this report, we analyze the impact of capital gains on the recent fall-off in state individual income tax revenues. Given the growing importance of the individual income tax, we analyze the impact of capital gains on state tax revenues since 1989 to determine whether capital gains have had more or less of an impact on state revenues over time.

The report proceeds as follows. In the first section, we set the stage for why we should expect capital gains realization activity to affect state tax revenues and why this relationship is important. In the second section, we review the basic structure of state individual income taxes and analyze the components of state income tax revenues. The next section presents a discussion of the impact of capital gains realizations on state income tax revenues. A conclusion section completes the report.

Capital Gains Realizations and State Tax Revenues

The stability of state tax collections is dependent on the stability of what is taxed. State tax structures typically tax wages and salaries, capital income (interest, dividends, rent, and capital gains), and consumption. Wage and salary income and consumption are relatively stable sources of revenue — they increase or decrease as the economy expands or contracts, but the swings are generally small. Capital income sources (including capital gains) tend to fluctuate more with changes in the economy. In fact, over the recent 30-year period, capital income was five times more volatile than wages and salaries or consumption. We therefore expect that states with more capital income in their tax base will have less stable income tax revenue.

There are a number of state taxes that include capital in the base. Property tax bases may include intangibles (a measure of the value of stocks and other nonrealized gains); corporate income tax bases include capital gains realizations; inheritance and estate and gift taxes may include taxes on the value of stocks and other appreciated assets; and individual income taxes typically include taxes on interest, dividends, rent, and capital gains. Of these revenue sources, individual income taxes are the largest revenue source for most states. Inheritance, estate, and gift taxes account for very small amounts of revenues. The National Conference of State Legislatures (NCSL) reports that these taxes accounted for 1 percent of state tax collections in fiscal 1997, while they had accounted for 2 percent of state tax revenues in the 1940s-1950s (NCSL, 1999).[1] Property taxes are also a small portion of state tax revenues — accounting for approximately 2 percent of state tax collections (U.S. Department of Commerce, Bureau of Census, 2003). The state corporate income tax is also a relatively small revenue source — particularly compared with the individual income and sales taxes. In 2000, state corporate income taxes accounted for 6 percent of all state tax collections (U.S. Department of Commerce, Bureau of Census, 2003).

In contrast, state governments rely heavily on individual income and sales taxes for revenues.[2] Table 1 demonstrates the importance of these taxes and the remarkable growth in importance over time. As the individual income tax is the single most important own-source revenue for states and the base typically includes capital gains, we focus on the interaction between capital gains and state individual income tax collections for the remainder of this report.

Table 1
Distribution of State Tax Revenues
(% of total tax revenue)
1970-2000

Tax	1970	1980	1990	2000
Individual Income	19.1	27.1	32.0	36.0
General sales and gross receipts	29.6	31.5	33.2	32.2
All other	51.3	41.4	34.8	31.8
Total	100.0	100.0	100.0	100.0

Source: Tax Foundation (2002) and U.S. Department of Commerce, Bureau of Census, http://www.census.gov/govs/statetax/0000usstax.html

To gain some insight into the potential magnitude of the impact of capital gains realizations on state tax revenues, we analyzed reported capital gains data by state from the Internal Revenue Service, Statistics of Income (SOI). These data represent capital gains reported by individuals filing their federal tax returns, identified by primary state of residence. This level of reported capital gain may not be the exact amount reported for state purposes due to state exemptions. However, as noted in the next section, few states offer special exemptions for capital gains realizations.

The IRS data demonstrate the large and growing role capital gains realizations play at the federal and state level. Figure 1 (p. 502) shows the trend in capital gains as a share of federal adjusted gross income (FAGI). In 1991, net capital gains accounted for 2.9 percent of FAGI.[3] In 1995, that figure was 3.9 percent and in 2000 it was 9.34 percent. Wages fell from a high of 80 percent of FAGI in 1994 to 70 percent in 2000. Given that most states couple their income tax to the federal income tax structure in some way, we expect to find a similar pattern at the state level — that state tax bases have become more reliant on capital gains realizations. The relative importance of capital gains could vary, however, based on state tax treatment of capital gains and the distribution of income within a state. Because most capital gains are reported by high-income households, states with lower levels of per capita income are likely to be less affected by swings in capital gains than states with higher levels of per capita income.[4]

The National Governors' Association describes the reduction in capital gains as part of the "perfect storm" that has led to the current state fiscal crisis. A number of state analysts have empirical evidence that capital gains have had a significant impact on their state tax revenues in the past. In New Jersey, the stock market boom of the mid-1990s was estimated to increase income tax revenues by 15 percent or more from 1995-1997 (Office of Legislative Services, New Jersey Legislature, 1998). In 1999, Missouri's Committee on Legislative Research estimated that exemption of capital gains from Missouri's income tax structure would reduce income tax revenues by about 7 percent (Missouri Committee on Legislative Research, 1999). Jenny (2003) posits that the downturn in income tax revenues across the country in 2001-2002 is due in large part to the decrease in more volatile income sources, such as capital gains.

State Individual Income Taxes

In 2002, all but seven states imposed an individual income tax; the exceptions are: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. Two states imposed a tax on interest and dividends only: New Hampshire and Tennessee. This leaves 41 states plus the District of Columbia with broad-based individual income taxes. Connecticut is the last state to adopt a broad-based income tax, in 1991. Prior to that, Connecticut's individual income tax was based on capital gains and dividends only.

Most states use federal adjusted gross income or federal taxable income as the starting point for their tax calculation. In 2002-03, 26 states use FAGI as their starting point, 10 states couple to federal taxable income, and one state couples to

[1]NCSL reports a large variation among states, with the following states imposing the highest burden of death taxes in fiscal 1997: Connecticut, Pennsylvania, New York, Delaware, and New Jersey (NCSL, 1999).

[2]Capital gains can affect other components of state tax systems. For example, stock options may increase during boom periods and these would taxable in most cases as ordinary income. We do not consider these impacts on state tax revenues.

[3]All net capital gain amounts are before exclusion.

[4]In 1992, 67 percent of realized capital gains were reported by families with incomes over $50,000 (Burman, 1999).

federal tax liability. Five states use their own starting point for calculation of state income tax (New Jersey, Pennsylvania, Alabama, Arkansas, and Mississippi), but these five also tax capital gains realizations.

All else equal, state individual income tax collections will be more affected by changes in capital gains realizations the higher the tax rate on capital gains and the larger capital gains realizations are relative to total taxable income. First consider tax rates. Table 2 (next page) presents a summary of the top statutory marginal tax rates on capital gains by state for 2001.

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For most states, the top marginal tax rates for capital gains and ordinary income are the same. In six cases, long-term capital gains get a preferential tax rate ranging from a low of 2.7 percent in Wisconsin to 5.1 percent in Rhode Island. Seven states have top marginal tax rates on capital gains equal to or greater than 7.75 percent: California, Hawaii, Idaho, Iowa, Maine, Minnesota, and North Carolina. While higher rates alone do not necessarily equate to higher tax burdens, they do give us some indication of the marginal impact of an additional dollar of capital gains realization on state tax revenue.

Second, consider the size of capital gains. We look at the composition of state income tax bases by state, based on information reported for federal tax purposes. The SOI reports the distribution of reported income by source and by FAGI group for each state, but are available only through 2000. These data are based on the individual's, reported state of residence. These data give us information on the relative importance of wages, capital gains, and other forms of income in federal adjusted gross income. While FAGI does not exactly mirror each state's taxable income base, given the close coupling of most states to the federal income tax system, it serves as a reasonable proxy to evaluate the composition of taxable income by state.

Table 3 (p. 501) shows, by state, how capital gains as a percentage of FAGI grew over the 1990s. All states experienced an increase in capital gains as a percent of FAGI, although there are sizable differences in the magnitude of the change. For example, while Hawaii witnessed a very small increase (6 percent over the decade), and Alaska a modest increase (45 percent), all other states posted increases of well over 50 percent for the decade. Connecticut and Massachusetts posted growth of capital gains in FAGI of 364 and 398 percent respectively. Twenty-five percent of all states saw the importance of capital gains in FAGI increase by 200 percent or more.

Capital Gains and State Income Tax Revenue

Since capital gains have become a larger component of the state tax base, states will be more susceptible to the ups and downs of capital gains realizations. Unfortunately, we do not have state-level data for 2001 nor for 2002, as they have not yet been finalized by the Internal Revenue Service. However, by relating growth in capital gains at the national level to state growth in capital gains during the 1990s we can draw some indication of how much state income taxes would be impacted by the national decline in capital gains realizations in 2001/2002. Figure 1 (see p. 502) showed that capital gains have been a growing portion of the federal income tax base, and therefore, state income tax bases. Given this, at the very least, we expect that the exposure of state income taxes due to a reduction in capital gains realizations in the most recent recession to be higher than they were in the 1990-91 recession. In the earlier recession, capital gains were only about 3 percent of FAGI, and from 1990-1992, the distribution was relatively stable. While we do not have the actual 2001-2002 figures for capital gains, CBO (2003) estimates that realizations fell by 50 percent between 2000 and 2001. The obvious implication is that the capital gains component of state income tax bases fell for all states. The resulting decrease in income tax revenues depends, however, on the distribution across states in the decline of capital gains and of the income tax rates.

Why should states differ in their relative level of capital gains? A major factor is the level of income in the state. Because capital gains realizations accrue to relatively higher-income individuals, we might expect that an extra dollar of capital gains reported on a tax return would show up in the taxable income of a relatively rich person. If this is true and a state has a progressive income tax structure, an extra dollar of taxable income via capital gains may be taxed at a higher tax rate (and yield more revenue) than an extra dollar of wage income. In 2000, SOI reports that returns with FAGI over $200,000 report over 75 percent of all realized capital gains (Internal Revenue Service, 2002). In 1990, the FAGI group with income over $200,000, held approximately 60 percent of capital gains realizations. This top income group holds slightly over 16 percent of reported wage and salary income (up from 7.5 percent in 1990).

One might ask whether or not states with higher shares of capital gains in their tax base have higher tax revenues per capita. If we compare states with high per capita levels of capital gains with states with high per capita income taxes, we do find some similarities. Over the past decade, capital gains have grown in all states — both those with and without an income tax. It is not surprising that in states with high-income individuals and more retirees, who hold proportionately more capital income than wage earners, the growth was stronger. However, the pattern of growth across states is an interesting way to look at the potential for disparate impacts of capital gains on state tax revenues. If a state saw an increase in per capita capital gains larger than the average state, did that increase that state's susceptibility to the current economic downturn?

Table 4 (p. 503) shows the state ranking by per capita capital gains in 1990 and 1999 (we took 1999 as it is a "before crisis" year). One might believe that states that saw relatively large increases in capital gains might be more susceptible to the downturn in capital gains in the 2001-03 period.[5] From Table

(Text continued on p. 504.)

[5]We did this analysis using capital gains realization as a percent of federal adjusted gross income and also with both capital gains measures for 2000. The results in each case are similar, although there are some changes in the rankings.

Table 2
State Individual Income Tax Rates

State	Top Marginal Tax Rate	Capital Gains Tax Rate Short-Term Gains	Capital Gains Tax Rate Long-Term Gains	Special Provisions
Alabama	5	5	5	
Alaska	0	0	0	No state income tax
Arizona	5.04	5.04	5.04	
Arkansas	7	7	4.9	Capital gain rate is 70% of state income tax rate for long-term gains
California	9.3	9.3	9.3	
Colorado	4.63	4.63	4.63	Allows $1,200 ($2,400 married) credit for capital gains; no tax on capital gains for in-state businesses
Connecticut	4.5	4.5	4.5	
Delaware	5.95	5.95	5.95	
DC	9	9	9	
Florida	0	0	0	No state income tax
Georgia	6	6	6	
Hawaii	8.5	8.5	8.5	
Idaho	8.2	8.2	8.2	60% reduction in capital gains tax provided for cap gains produced in Idaho
Illinois	3	3	3	Flat rate
Indiana	3.4	3.4	3.4	Flat rate
Iowa	8.98	8.98	8.98	
Kansas	6.45	6.45	6.45	
Kentucky	6	6	6	
Louisiana	6	6	6	
Maine	8.5	8.5	8.5	
Maryland	4.8	4.8	4.8	
Massachusetts	5.6	5.6	5	Flat rate; long-term gain taxed at lower rates based on length of time security has been held
Michigan	4.2	4.2	4.2	Flat rate
Minnesota	7.85	7.85	7.85	
Mississippi	5	5	5	
Missouri	6	6	6	
Montana	11	11	11	
Nebraska	6.68	6.68	6.68	
Nevada	0	0	0	No state income tax
New Hampshire	0	0	0	State income tax on dividends and interest only
New Jersey	6.37	6.37	6.37	
New Mexico	8.2	8.2	8.2	
New York	6.85	6.85	6.85	
North Carolina	7.75	7.75	7.75	
North Dakota	5.54	5.54	5.54	
Ohio	6.98	6.98	6.98	
Oklahoma	6.75	6.75	6.75	
Oregon	9	9	9	
Pennsylvania	2.8	2.8	2.8	Flat rate

Table 2 (continued)

State	Top Marginal Tax Rate	Capital Gains Tax Rate Short-Term Gains	Capital Gains Tax Rate Long-Term Gains	Special Provisions
Rhode Island	10.1	5.1	5.1	25.5% federal tax liability for income and cap gains*
South Carolina	7	7	3.92	
South Dakota	0	0	0	No state income tax
Tennessee	0	0	0	State income tax on dividends and interest only
Texas	0	0	0	No state income tax
Utah	7	7	7	
Vermont	9.5	4.8	4.8	24% federal tax liability for income and cap gains*
Virginia	5.75	5.75	5.75	
Washington	0	0	0	No state income tax
West Virginia	6.5	6.5	6.5	
Wisconsin	6.75	6.75	2.7	
Wyoming	0	0	0	No state income tax

Source: http://demo.assetstream.com/calculator/help/state_tax_rates.htm
* State rate applies to federal tax liability

Table 3
Capital Gains as a Percent of Federal Adjusted Gross Income, by State

State	1990	1995	2000	Percent Change 1990-2000
Alabama	2.13%	3.54%	5.81%	173
Alaska	3.89%	2.63%	5.66%	45
Arizona	3.40%	4.04%	8.51%	150
Arkansas	2.50%	3.28%	5.89%	136
California	4.75%	4.22%	12.93%	172
Colorado	3.81%	5.01%	11.32%	197
Connecticut	2.66%	5.01%	12.36%	364
Delaware	2.32%	2.93%	7.08%	205
DC	4.92%	4.19%	13.32%	171
Florida	5.41%	6.39%	12.29%	127
Georgia	3.09%	3.53%	7.51%	143
Hawaii	6.87%	2.54%	7.28%	6
Idaho	4.24%	4.83%	9.39%	121
Illinois	3.38%	4.37%	9.63%	185
Indiana	2.08%	2.46%	5.22%	151
Iowa	2.69%	3.16%	5.79%	115
Kansas	2.44%	3.30%	6.30%	158
Kentucky	2.51%	3.09%	5.67%	126
Louisiana	1.98%	2.80%	5.76%	192
Maine	2.80%	3.34%	9.59%	243
Maryland	2.59%	3.13%	8.07%	211
Massachusetts	3.01%	5.29%	14.99%	398
Michigan	1.89%	2.77%	6.10%	223
Minnesota	2.67%	3.70%	7.83%	193
Mississippi	2.31%	3.33%	5.02%	117

Table 3 (continued)				
State	**1990**	**1995**	**2000**	**Percent Change 1990-2000**
Missouri	2.40%	3.06%	6.86%	186
Montana	4.30%	5.25%	9.33%	117
Nebraska	3.26%	3.57%	9.04%	177
Nevada	5.98%	6.54%	13.77%	130
New Hampshire	4.18%	4.77%	11.92%	186
New Jersey	2.52%	3.15%	8.82%	250
New Mexico	2.52%	3.27%	4.70%	86
New York	3.43%	4.57%	10.80%	215
North Carolina	2.61%	3.18%	6.56%	152
North Dakota	3.00%	3.00%	6.17%	106
Ohio	1.90%	2.57%	5.69%	199
Oklahoma	2.06%	2.63%	5.69%	176
Oregon	4.21%	4.72%	9.24%	120
Pennsylvania	2.31%	3.27%	7.62%	230
Rhode Island	2.66%	3.05%	9.12%	243
South Carolina	2.40%	3.24%	6.01%	150
South Dakota	4.68%	5.29%	8.84%	89
Tennessee	2.45%	3.49%	6.70%	174
Texas	3.20%	3.91%	8.46%	164
Utah	2.80%	4.05%	7.35%	162
Vermont	3.30%	4.04%	10.13%	207
Virginia	2.76%	3.01%	7.47%	170
Washington	4.92%	5.04%	10.84%	120
West Virginia	1.86%	2.08%	4.18%	124
Wisconsin	2.73%	3.48%	7.49%	174
Wyoming	4.90%	6.80%	17.75%	262
Source: Authors' calculations of IRS, Statistics of Income data.				

Figure 1: Share of Federal AGI

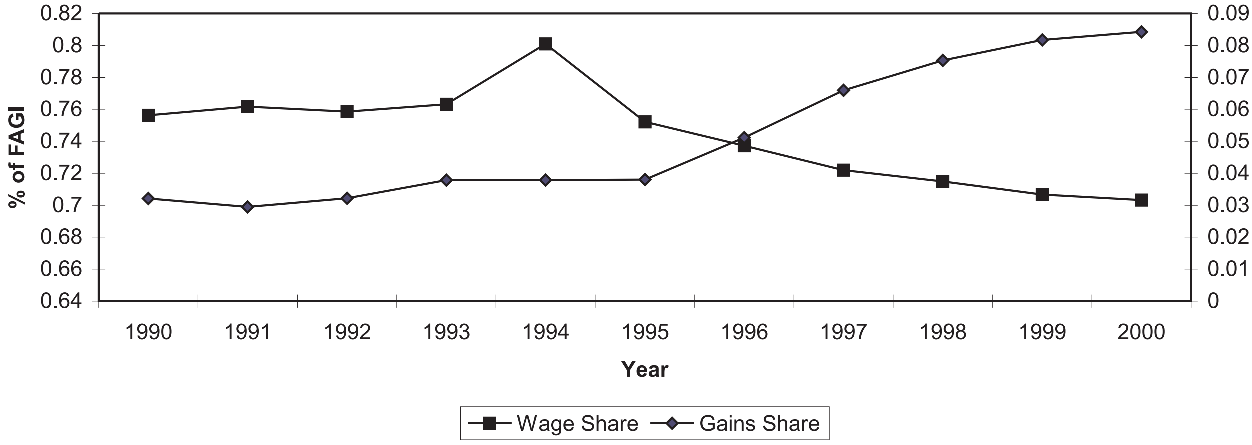

Table 4
State Rankings Based on Per Capita Capital Gains Realizations
1990 and 1999

State	1990 Capital Gains Per Capita ($000)	1990 Rank	1999 Capital Gains Per Capita ($000)	1999 Rank
Hawaii	1.077	1	1.349	30
Nevada	0.952	2	2.888	5
DC	0.830	3	3.130	4
Florida	0.732	4	2.570	11
California	0.718	5	2.578	10
Washington	0.715	6	2.811	6
New Hampshire	0.637	7	2.594	7
Alaska	0.633	8	1.064	40
Wyoming	0.604	9	3.130	3
New York	0.538	10	2.570	9
Oregon	0.528	11	1.667	18
Colorado	0.523	12	2.590	8
Connecticut	0.517	13	3.482	1
Illinois	0.502	14	2.136	13
Massachusetts	0.481	15	3.324	2
South Dakota	0.480	16	1.743	16
New Jersey	0.459	17	2.304	12
Idaho	0.446	18	1.369	29
Montana	0.432	19	1.331	32
Maryland	0.431	20	1.772	13
Vermont	0.420	21	1.771	14
Virginia	0.404	22	1.627	17
Arizona	0.399	23	1.625	18
Nebraska	0.389	24	1.579	20
Georgia	0.386	25	1.449	25
Texas	0.384	26	1.581	19
Minnesota	0.366	27	1.739	17
Rhode Island	0.365	28	1.463	26
Delaware	0.362	29	1.475	25
Wisconsin	0.351	30	1.357	28
Maine	0.327	31	1.515	23
North Carolina	0.312	32	1.180	38
Iowa	0.312	33	1.205	37
North Dakota	0.310	34	0.880	46
Pennsylvania	0.308	35	1.507	24
Kansas	0.306	36	1.290	34
Utah	0.296	37	1.300	33
Missouri	0.290	38	1.278	35
Tennessee	0.278	39	1.237	36
South Carolina	0.265	40	1.054	41
Kentucky	0.258	41	0.905	45
Indiana	0.258	42	1.043	42

Table 4 (continued)

State	1990 Capital Gains Per Capita ($000)	1990 Rank	1999 Capital Gains Per Capita ($000)	1999 Rank
New Mexico	0.256	43	1.036	43
Michigan	0.253	44	1.354	30
Ohio	0.243	45	1.103	39
Arkansas	0.233	46	0.843	48
Alabama	0.227	47	0.980	44
Oklahoma	0.216	48	0.866	47
Mississippi	0.197	49	0.742	50
Louisiana	0.194	50	0.817	49
West Virginia	0.177	51	0.540	51

(Text continued from p. 499.)

4, we can see that many states did not significantly change their relative position in terms of per capita capital gains. The states with relatively small gains per capita in 1990 are largely the same group with small per capita gains in 1999. Some changes were much more significant. For the top 15 spots, Hawaii and Alaska fell significantly from 1 to 30 and from 8 to 40, respectively. However, Connecticut and Massachusetts went from 13 and 15, respectively, to 1 and 2, respectively. In the next group of 15, New Jersey, Maryland, Vermont, Virginia, Minnesota, and Texas moved up significantly while Idaho and Montana fell in the rankings. From the bottom of the 1990 rankings, we see few dramatic swings. Pennsylvania increased from No. 35 to No. 24, Maine from 31 to 23, Michigan from 44 to 30. In the other direction, North Dakota fell from 34 to 46 and North Carolina from 32 to 38. Also of note is that in 1999, out of the top 11 states ranked in terms of capital gains per capita, five states had no state personal income tax.

Are the states with personal income taxes and high capital gains per capita more susceptible to the economic downturn?

Are the states with personal income taxes and high capital gains per capita more susceptible to the economic downturn? We might expect that they would be, but this question is difficult to analyze because susceptibility is a difficult concept to quantify. The Center on Budget and Policy Priorities (Johnson, 2002) categorized state tax collection changes between fiscal 2001 and fiscal 2002 into categories based on the magnitude of decline. We use these data as follows. States with the most significant declines (-30 to -10 percent of tax revenues) are coded a "1," states with decreases of -10 to -5 percent are coded a "2," states with decreases of -5 to 0 percent are coded a "3," and states with no decline or an increase are coded a "4." We correlated these collections deficiency indexes (1-4) with the 1999 state ranking of per capita capital gains. Our hypothesis is that for states with an income tax, the higher the capital gains ranking (lower number), the worse the budget situation (lower number).

The results of this simple correlation show that, not controlling for tax changes or other variables, states with more capital gains per capita are more likely to be facing larger declines in tax revenue for the fiscal 2001 to fiscal 2002 period. Our correlation coefficient between per capita capital gains rank (from 1 to 51, with a 1 for the state with the most capital gains per capita in 1999) and collections deficiency (from 1 to 4, with a 1 for states in the most trouble) is 0.583 and is significant at the 0.01 percent level.

How do the states stack up in terms of the taxes they collect on capital gains? For each state for 1999, we estimated the tax on capital gains by applying the top statutory tax rate on long-term capital gains for each state by the amount of capital gains realizations reported in the SOI, and divided this "capital gains tax" by total individual income tax collections. We realize that this is an overstatement of the relative importance of capital gains for at least two reasons. First, the top tax rate does not apply to all capital gains, and secondly, some states have some exemptions for capital income. For example, the state of Georgia (as well as other states) exempts a portion of all income of retirees (including wages and capital gains), Idaho and Colorado exempt in-state capital gains, and Colorado includes a credit for capital gains.[6] Thus, this calculation should be considered an upper bound of the impact of capital gains on state income tax revenues.

Table 5 contains the results of the analysis. The average state gets 13 percent of its state income tax revenue from capital gains. If capital gains income totally disappeared, the average state would see a reduction in state tax revenue of 13 percent — a significant loss of revenue. A number of states are well above average in terms of the importance of capital gains as a portion of their income tax revenue. These states include: Arizona, California, Idaho, Maine, Montana, Nebraska, and New Jersey. Of these states, Arizona, California, Nebraska, and New Jersey all saw substantial reductions in tax collections in fiscal 2001 to fiscal 2002. The high ratio for Montana is a function of the relatively high marginal tax rates. Repeating this same analysis for 1990, we find that on average, capital

[6]For a good summary of tax exclusions and exemptions for retirees, see: http://www.ncsl.org/programs/fiscal/pitaxretire.htm.

Table 5
Tax on Capital Gains as a Percent of State Personal Income Tax Collections (1999)

State	Tax on Capital Gains/Total State Personal Income Tax (%)	State	Tax on Capital Gains/Total State Personal Income Tax (%)
Alabama	11.39	Montana	27.21
Alaska	NA	Nebraska	16.77
Arizona	19.61	Nevada	NA
Arkansas	7.64	New Hampshire	NA
California	26.13	New Jersey	19.40
Colorado	15.11	New Mexico	18.98
Connecticut	14.70	New York	16.24
Delaware	8.82	North Carolina	11.04
Florida	NA	North Dakota	17.29
Georgia	12.28	Ohio	12.13
Hawaii	12.99	Oklahoma	9.71
Idaho	16.90	Oregon	13.72
Illinois	10.93	Pennsylvania	8.07
Indiana	5.79	Rhode Island	10.18
Iowa	18.41	South Carolina	7.15
Kansas	13.13	South Dakota	NA
Kentucky	8.62	Tennessee	NA
Louisiana	14.23	Texas	NA
Maine	15.99	Utah	13.73
Maryland	10.70	Vermont	13.41
Massachusetts	13.06	Virginia	10.76
Michigan	8.09	Washington	NA
Minnesota	12.54	West Virginia	6.87
Mississippi	10.68	Wisconsin	3.84
Missouri	11.76	Wyoming	NA

Source: Authors' tabulations based on SOI data and state tax rates on capital gains. DC is not included in the analysis.

gains only accounted for 7 percent of income tax revenues. This analysis suggests that capital gains have affected revenues and that this effect has increased in importance over time.

A final part of this story is to look at whether or not states with faster run-ups in capital gains during the 1990s took advantage of the run-up to reduce income tax rates (or other tax rates) more than other states. If they did, we might expect that they would have a harder time dealing with the downturn in capital gains.

Analyzing the relative size of the various tax changes from 1995 to 1999 is not an easy task. It is really not enough to determine whether states with larger increases in capital gains reduced income taxes because they may have used the relatively large revenue surge of capital gains to offset other taxes, like the sales tax. We used the National Conference of State Legislatures (NCSL) annual compilation of state tax changes, *State Tax Actions* (various years), to develop a measure of tax change. NCSL publishes the estimated percent increase or decrease in all taxes due to tax changes in any one given period. NCSL assigns both levels and percentage changes of revenue from the fiscal year two years earlier. We use the percentage change estimate as an indication of the relative amount of tax change for each state for 1997 through 2000. We find that states with higher capital gains per capita had larger reductions in state taxes over this period. For a $1,000 increase in capital gains per capita, we find that state taxes decreased by 0.3 percent — not necessarily large, but significant.

Conclusions

What we take away from this analysis of capital gains and state income taxes is that while the underlying relationship between gains and tax revenues does not appear to have changed, the mere increase in capital gains realizations gave a boost to state income tax revenues. The magnitude of the growth in gains in FAGI increased the susceptibility of state income taxes to downturns in the economy. In some cases, the revenue boost from capital gains may have been offset by income tax or other tax reductions. Now that capital gains have turned down, some states are facing a more difficult time because of the tax changes that were "induced" by the hearty gains earlier in the decade.

States certainly can't fully insulate themselves from downturns in the economy, but the lesson of capital gains speaks to the importance of tax base diversification and the need for awareness of transitory versus permanent increases in tax bases.

If the growth in capital gains in the coming years is more similar to historic gains, we would expect that real capital gains would increase about 3 percent per year. In some sense, states have already adjusted to the large and previously growing capital gains. From the analysis of this report, we believe that the growth in capital gains has added significantly to the fiscal stress of state governments, and added more than it did in the early 1990s. States certainly can't fully insulate themselves from downturns in the economy, but the lesson of capital gains speaks to the importance of tax base diversification and the need for awareness of transitory versus permanent increases in tax bases.

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