Forecasting Federal Actions: Unraveling the April Surprise

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State and Local Finance Initiative
Urban-Brookings Tax Policy Center
Revisiting 2012

• Economy still weak
  – Few states had recovered employment peak
  – 20 states had not recovered peak tax revenue

• Federal Spending
  – Government shutdown fall 2012
  – Austerity

• Looming Fiscal Cliff – 12/31/2012
## Fiscal Cliff:
### Federal Tax Uncertainty

<table>
<thead>
<tr>
<th></th>
<th>2012</th>
<th>2013</th>
<th>2013 w Affordable Care Act</th>
<th>Current Law</th>
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</thead>
<tbody>
<tr>
<td>Top rate on ordinary income</td>
<td>35</td>
<td>39.6</td>
<td>43.4</td>
<td>43.4*</td>
</tr>
<tr>
<td>Top rate on capital gains income</td>
<td>15</td>
<td>20</td>
<td>23.8</td>
<td>23.8</td>
</tr>
<tr>
<td>Top rate on dividends</td>
<td>15</td>
<td>39.6</td>
<td>43.4</td>
<td>23.8</td>
</tr>
</tbody>
</table>

* The 3.8 percent tax applies to the smaller of investment income and the excess of AGI over the thresholds—$250,000 for married couples filing joint tax returns and $200,000 for others. Limiting the investment subject to tax in that way prevents taxpayers from facing substantial tax increases over a short income range at the threshold. (TPC 2012)
Tax Year 2012 Ended With a Bang

- IRS Data from 2012:
  - Capital Gains Income increased 65% in 2012
  - Dividend income increased 34% and qualified dividend income grew by 44 percent

- BEA Quarterly Data:
  - 2012q4 private wages grew 7.9% (Bonuses?)
  - Personal Dividends grew by 37.5%

Source: BEA
Year-end Dividend Announcements Soar

Special dividend payouts in 2012: $22.9 billion
(source: Markit via Wall Street Journal 12/19/2012)

Source: S&P Dow Jones Indices
Capital gains strong in 2012

Source: CBO February 2014 Budget and Economic Outlook; Standard & Poors; Author’s calculation
Timing All Wrong for States

- Most states have to prepare revenue forecast in Fall and Winter for budget season
- Budget is negotiated (and often passed) before April returns are known
April 2013 Surprise

Forecasting State Personal Income Tax Growth, FY 2013

- Budget period for FY13: 4.8%
- FY 13 in progress: 3.1%
- Budget period for FY14: 4.7%
- Actual: 7.5%

Note: California and states without income taxes are excluded.
Source: NASBO Fiscal Survey Of States
What did they do with the $$

• Because of the timing, most of the money went straight to fund balance reserves

• May have offset planned reserve spending in FY 13

• One-time nature of increase downplayed

• Minimized initial effects of rate cuts
April 2014 “Surprise”

Forecasting State Personal Income Tax Growth, FY 2014

- Budget period for FY14: 4.2%
- FY 14 in progress: 0.9%
- Budget period for FY15: 1.8%
- Actual: 0.3%

Note: California and states without income taxes are excluded.
Source: NASBO Fiscal Survey Of States; Author calculation for actual.

Revised 10/20/14
What happened in 2014?

Source: CBO February 2014 Budget and Economic Outlook; Standard & Poors; Author’s Calculation
What to do?

• Forecasting
  – Multiple models
  – Frequent estimates
  – Data
  – Know your investment community

• Advising
  – Rainy day fund
  – Warn more explicitly of downside risks
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