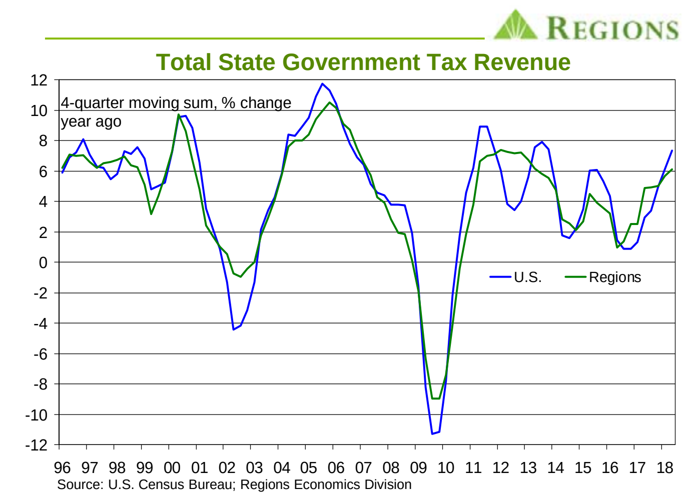
ECONOMIC UPDATE

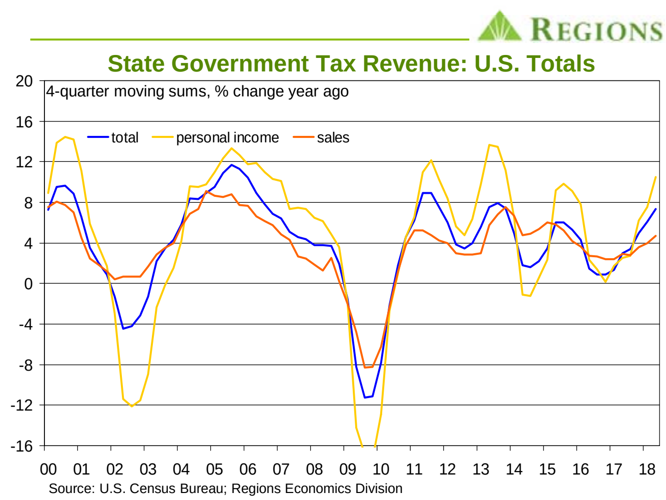
REGIONS

September 2018

Q2 2018 State Government Finances: Regions Footprint

Data on state government tax revenue through Q2 2018 show further acceleration in growth in state tax collections, and while rates of growth vary, growth has nonetheless accelerated across the various categories over the past few quarters. This comes after growth in state tax revenue had been notably uneven and weak over much of the current economic expansion which, as a reminder, began in Q3 2009. To be sure, this recent acceleration in revenue growth has been encouraging, but the extent to which revenue growth can, or will, accelerate over coming quarters is likely limited. Moreover, states are still facing pressing longer-term challenges on the spending front, in the form of unfunded pension obligations in many states and what in all states will remain a steadily increasing share of total expenditures diverted to transfer payments to individuals acting to crowd out state government spending on goods and services. That the current economic expansion is closer to its end than its beginning only compounds these concerns.





As we have noted in prior editions of this update, there are clear and pronounced seasonal patterns in tax collections that can make it challenging to properly assess short-term changes in revenue, and this is true in most of the major tax categories. One way to work around this issue is to base the analysis on longer-term patterns, which we do by looking at the four-quarter moving sums of revenue by source. While this does not totally rid the data of all seasonal patterns, it does allow for a more meaningful discussion of the underlying patterns in the data. As seen in the first chart above, revenue growth for the U.S. as a whole and the Regions footprint has clearly picked up over the past few quarters. As of Q2 2018, the four-quarter moving sum of total state tax revenue for the U.S. as a whole stood 7.4 percent higher on a year-over-year basis, while for the Regions footprint as a whole the year-over-year increase was 6.1 percent. As seen in the second chart above, for the U.S. as a whole growth in each of the three main components of total tax revenue has accelerated; on a year-on-year basis, revenue from personal income taxes was up 10.5 percent year-on-year, revenue from sales taxes was up 4.7 percent, and total state tax revenue was up 7.4 percent (again, these are the changes in the four-quarter moving sums). Though not shown in the second chart above, state-level revenue from corporate income taxes was up 10.0 percent year-on-year as of Q2 2018.

The recent acceleration in growth of state tax revenue is mainly a function of two factors. One is simply the duration of the current expansion having significantly pared down slack in the economy, particularly the labor market. For instance, growth in revenue from personal income taxes reflects ongoing improvement in growth in aggregate labor earnings – despite the focus on growth in average hourly earnings, it is aggregate wage and salary earnings that drive growth in total personal income and, in turn, growth in consumer spending. As such, improving labor market conditions have also contributed to faster growth in sales tax revenue. The other factor that has impacted growth in tax revenue over the past three quarters is the 2017 tax bill. In many states that impose personal income taxes, taxpayers accelerated tax payments into late-2017 to take advantage of the federal deduction for state and local income taxes before

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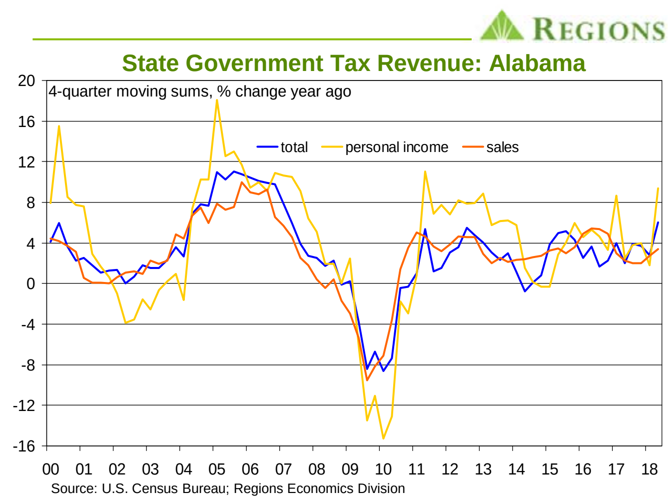
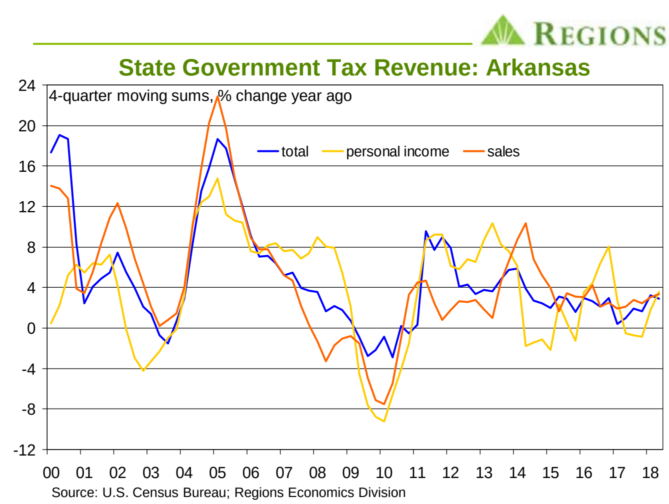
that deduction went away in 2018, which acted to boost state personal income tax collections in Q4 2017. While this will impact year-on-year comparisons in 2018, this base effect will wash from the data in 2019, which is one reason we see limited room for further acceleration in overall state tax revenue beyond this year. The impacts of the 2017 tax bill on state level corporate income tax collections will become more apparent over coming years. The corporate tax base is subject to change, but the specifics will vary across states and state-level tax rates may or may not change. At this point, the net effects on state level corporate income tax revenue are unclear.

There is, however, one component of state tax revenue with room for further growth over coming quarters. The recent U.S. Supreme Court decision requiring merchants to collect and remit local and state sales tax revenue should boost, perhaps significantly, state sales tax revenue. With implementation (which will vary across individual states) in either late-2018 or early-2019, this should begin to turn up in the revenue data in 2019 which will boost measured growth in sales tax revenue in 2019. Additionally, though this effect has gone widely overlooked, another drag on sales tax revenue over recent years has been the persistent decline in prices for core goods, or, consumer goods excluding food and energy. Lower core goods prices have effectively stunted the growth in the tax base for sales tax revenue, which has been a meaningful, even if underappreciated, drag on growth in sales tax revenue. Core goods prices have shown signs of firming over recent months, and if this continues this will be a further support for growth in sales tax revenue going forward.

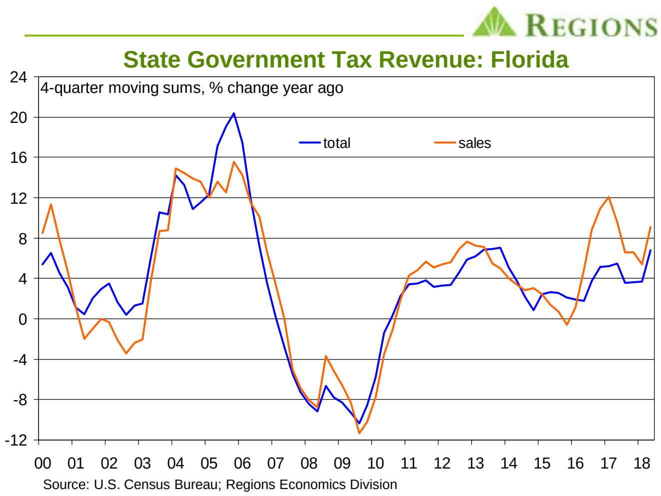
Alabama: On a four-quarter moving sum basis, total tax revenue in Alabama was up 6.0 percent year-on-year as of Q2 2018, the largest such increase since Q1 2007. Receipts from personal income tax collections posted double-digit year-on-year increases in each of the first two quarters of 2018, something last seen in Alabama in 2005. To a large extent, this reflects a faster pace of job growth in 2018 which, along with faster growth in hourly earnings, has sparked more meaningful growth in aggregate wage and salary earnings, the largest single component of personal income. Alabama saw a (seasonal) spike in corporate income tax revenue in Q2 2018, though the longer-term trend in this component remains fairly unimpressive. Growth in sales tax revenue in the state has also perked up, and with Alabama implementing new rules on out of state merchants collecting and remitting state sales tax revenue as of October 2018, there should be further acceleration in the growth of sales tax revenue over coming quarters. Compared to the same period of 2017, Alabama's total tax revenue was up 7.7 percent over the first half of 2018.

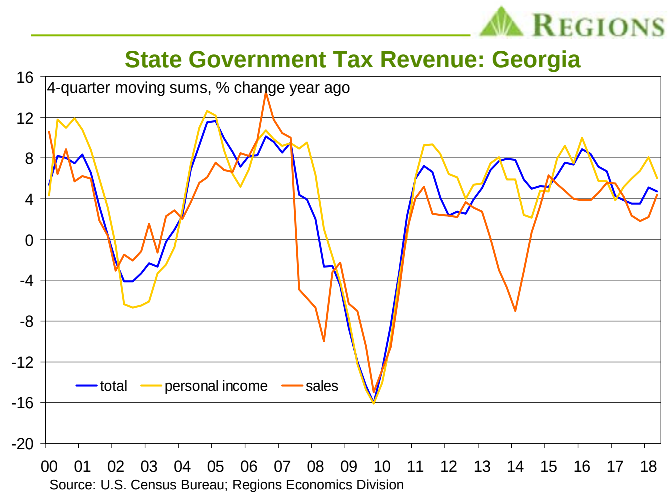


Arkansas: On a four-quarter moving sum basis, total tax revenue in Arkansas was up just 2.9 percent year-on-year as of Q2 2018. On a year-to-date basis through Q2 2018, total tax revenue in Arkansas was up 3.4 percent. The underlying trend rates of growth in revenue from the various sources remain tepid in Arkansas, in contrast to much of the rest of the Regions footprint. The four-quarter moving sum of tax revenue from personal income taxes was up 3.5 percent as of Q2 but, again, the broader trend in revenue from this source remains weak – revenue from individual income tax declined for 2017 as a whole in Arkansas. Both job growth and hourly earnings growth in the state remain weak, thus weighing down revenue from individual income taxes. Though rising sharply in Q2, in keeping with typical seasonal patterns, corporate tax collections in the state were still down 6.0 percent on a four-quarter moving sum basis as of Q2 2018. Growth in sales tax revenue has steadily picked up over recent quarters, but on a four-quarter moving sum basis, year-on-year growth stood at just 3.3 percent as of Q2 2018.



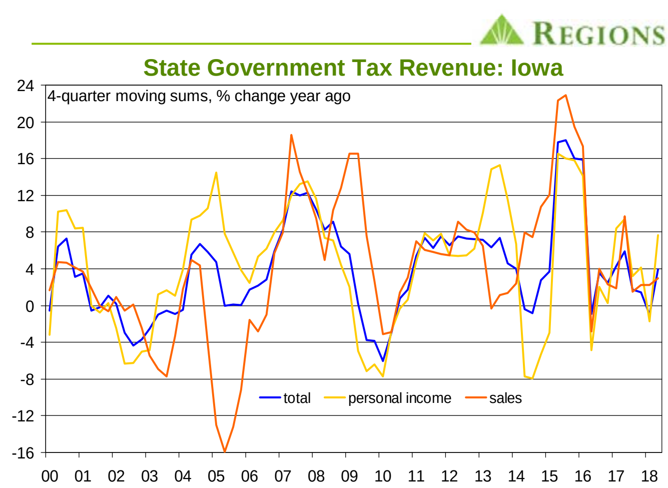
Florida: On a four-quarter moving sum basis, total tax revenue in Florida was up 6.8 percent year-on-year as of Q2 2018, and on a year-to-date basis through Q2, total tax revenue had increased by 9.9 percent. Keep in mind that Florida has no personal income tax. As such, at 62 percent of total tax revenue over the past four quarters, sales taxes are a more important source of overall tax revenue than is the case in most other states. Also keep in mind that growth in sales tax revenue in Florida reflects not only growth in spending by state residents but also spending on goods by tourists. With a stronger domestic economy supporting solid growth in travel and tourism, Florida has been a prime beneficiary. On a four-quarter moving sum basis, sales tax revenue in Florida was up 9.1 percent year-on-year as of Q2. The second quarter of 2018 brought a seasonal spike in corporate income tax collections, though this year's Q2 jump in Florida was much larger than normal. Note that with the significance of sales taxes to the state's total tax revenue, Florida is one of the states in the Regions footprint that could benefit the most from the requirement that out of state merchants collect and remit sales taxes.





<u>Georgia:</u> On a four-quarter moving sum basis, total tax revenue in Georgia was up 4.7 percent year-on-year as of Q2 2017, slightly slower growth than was the case as of Q1 2018. The raw quarterly data suggest that Georgia residents acted to pull income forward into Q4 2017 to take advantage of the final opportunity to deduct state income taxes on their federal returns. This has altered growth rates of individual income tax collections over the past few quarters, but the trend rate of growth remains healthy, reflecting Georgia's persistently strong job growth and what has been above-average growth in hourly earnings. Growth in sales tax revenue picked up considerably over the first half of 2018, which is not fully reflected in the 4.4 percent year-on-year increase in sales tax revenue on a four-quarter moving sum basis. Georgia has also seen moderate but steady growth in corporate income tax revenues. Above-average growth in a highly diversified economy along with the state's favorable demographic trends have resulted in healthy state finances, and Georgia has built up a sizeable "rainy day" fund as a buffer against an economic downturn.

<u>Iowa:</u> On a four-quarter moving sum basis, total tax revenue in Iowa was up 3.9 percent year-on-year as of Q2 2018, led by a 7.7 percent year-on-year increase in personal income tax collections. The broader trends in state revenue collections, however, remain weak. Nonfarm employment accounts for a smaller share of overall employment in Iowa than in most other states, with a greater reliance on the farm sector than is typical. Below-average growth in nonfarm employment coupled with what until recently has been notably slow growth in hourly earnings has acted as a drag on growth in revenue from personal income taxes, while what is shaping up as a fifth consecutive year of declining earnings in the agricultural sector will act as an additional drag on growth in personal income tax collections in the state. What has been persistently weak growth in personal income in Iowa has in turn acted as a drag on growth in consumer spending, which is reflected in the weak trend rate of growth in sales tax revenue. On a four-quarter moving sum basis, sales tax revenue in Iowa was up 3.0 percent year-on-year.



<u>Illinois:</u> On a four-quarter moving sum basis, total tax revenue in Illinois was up 8.8 percent year-on-year as of Q2 2018. This figure is, however, deceptively strong, and the longer-run trends in state tax revenue collections remain weak. The raw quarterly data show signs of state residents having availed themselves of the last opportunity to deduct state income taxes on their federal returns as personal

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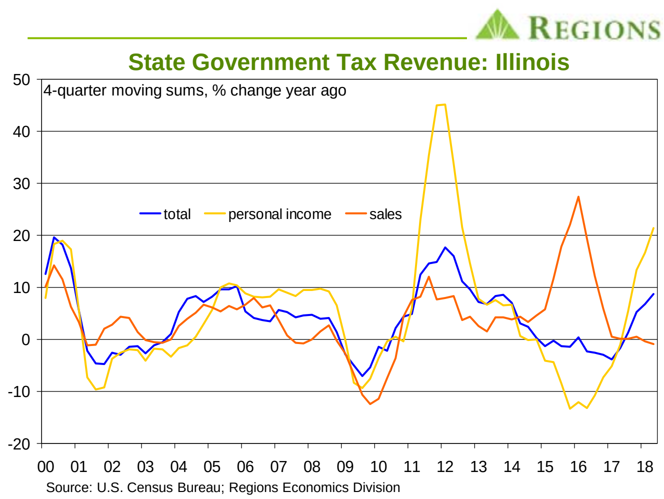
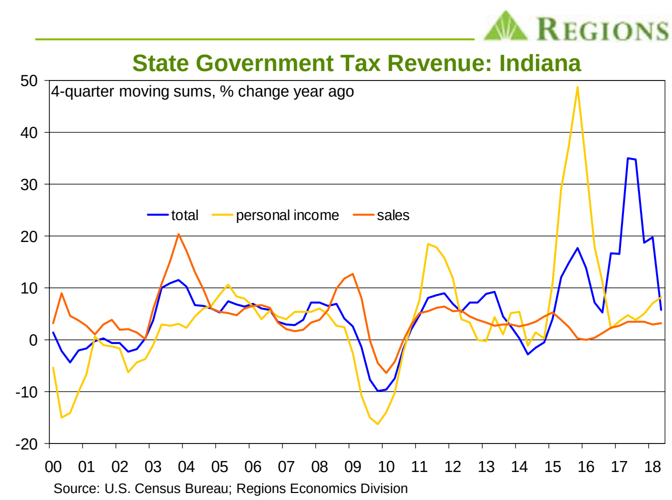
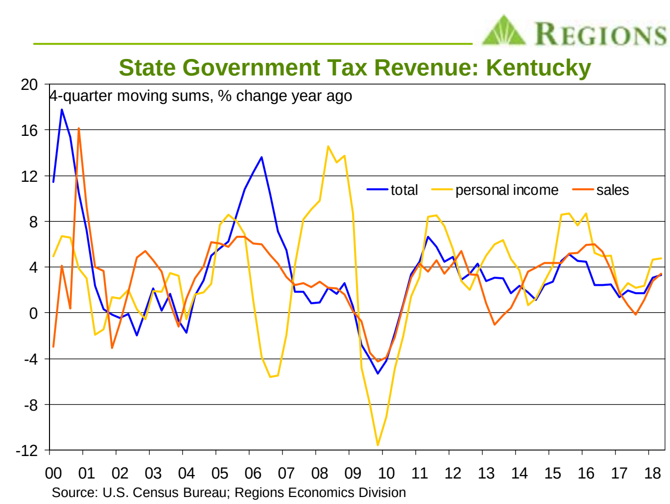
income tax collections were atypically strong in Q4 2017 while the increase in Q1 2018 was much smaller than is normal for the first quarter of any given year, but the jump in Q4 2017 continues to influence growth comparisons, with an upward bias on the four-quarter moving sum basis. Though the raw quarterly data show the normal seasonal spike in corporate income tax collections in Q2, collections from this source have been down on a year-over-year basis in each of the past two quarters. Sales tax collections have also been down year-on-year in each of the past two quarters, and are also down year-on-year on a four-quarter moving sum basis. Persistent population declines and persistently below-growth in total employment leave Illinois in an unenviable position in terms of the state's fiscal health, particularly in conjunction with ongoing budget woes and significantly unfunded pension obligations. In short, the state's financial situation is unlikely to improve materially any time soon.



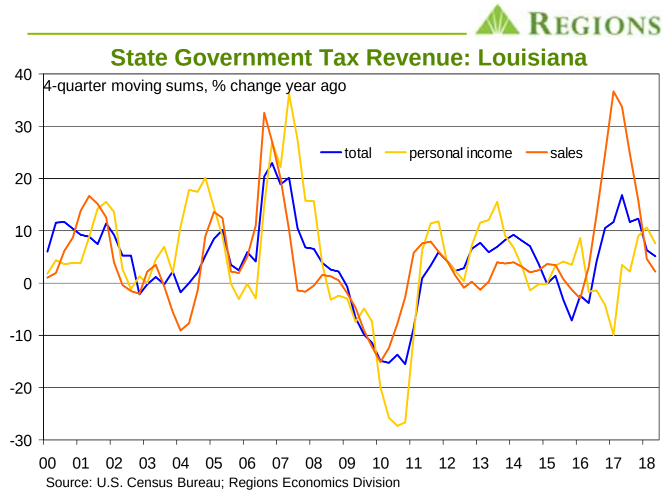


Indiana: On a four-quarter moving sum basis, total tax revenue in Indiana was up 5.8 percent year-on-year as of Q2 2018 but as seen in the chart above this follows several quarters of notably strong growth. Steadily falling corporate income tax rates have meant revenue from corporate income tax has been an increasingly less important source of total tax revenue. A modest reduction in the personal income tax rate in 2015 contributed to a spike in growth in revenue from this source as state residents deferred realizing income, but as that effect faded it had the opposite effect on the growth rate, which is reflected in the above chart. All in all, the broader trends in state tax revenue in Indiana remain mixed. While the state continues to see steady growth in employment in the goods producing industries, which tend to pay above-average wages and in which work weeks are typically longer, growth amongst service providers in the state remains notably below-average, which adds up to a fairly run of the mill long-term growth rate in personal income tax revenue. On a four-quarter moving sum basis, sales tax revenue was up 3.2 percent as of Q2 2018, in line with the longer-term trend rate of growth.

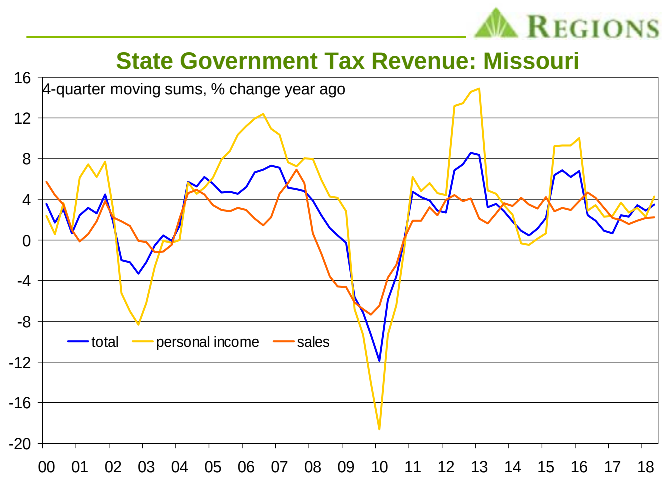
Kentucky: On a four-quarter moving sum basis, total tax revenue in Kentucky was up 3.3 percent year-on-year as of Q2 2018, well below the average for the footprint but still the largest such increase in the state since Q1 2016. On a four-quarter moving sum basis, personal income tax revenue was up 4.8 percent year-on-year, with sales tax revenue up 3.4 percent. The more favorable comparison for personal income tax revenue, however, has more to do with how weak revenue growth was last year as opposed to meaningfully stronger labor market conditions. Kentucky remains mired in a pattern of middling growth in both employment and hourly earnings, the effects of which are even more pronounced this year, as employment amongst the state's goods producing industry groups has declined in 2018. Weak growth in aggregate labor earnings has acted as a drag on growth in total personal income in the state. Kentucky has yet to fill the void left by the downturn in the coal industry, which has left revenues from severance taxes (i.e., taxes on the extraction of minerals/natural resources) far below the peak seen in 2012. Severance tax revenue has stabilized at a low level, but is unlikely to return to and hold at former levels even should the coal industry see a near-term reversal of fortunes.



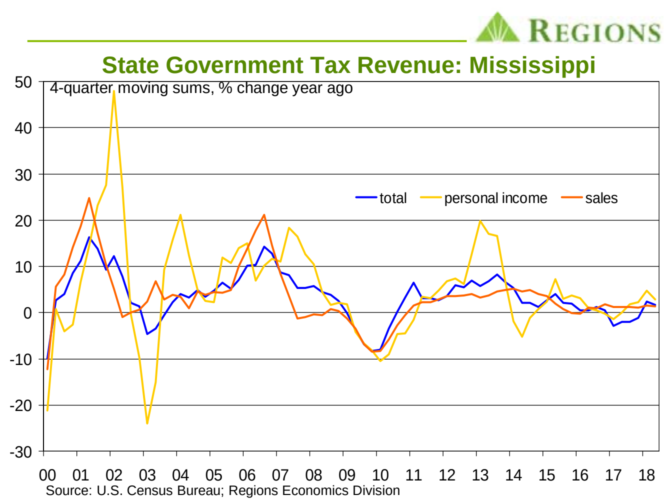
Louisiana: On a four-quarter moving sum basis, total tax revenue in Louisiana was up 5.1 percent year-on-year as of Q2 2018. The state's tax revenue collections have swung sharply over recent years, which to a large degree reflects the fortunes of the energy sector and hikes in sales tax rates that fueled rapid growth in sales tax revenue in 2016 and 2017. Year-on-year comparisons of sales tax revenue will get more challenging as 2018 progresses. On a four-quarter moving sum basis, personal income tax revenue was up 7.6 percent year-on-year as of Q2 2018, but as in other states collections from this source were atypically high in Q4 2017. That said, after nonfarm employment fell in both 2015 and 2016, Louisiana saw a modest increase in 2017 and 2018 is on course to be the state's best year for job growth since 2014, helping fuel growth in personal income tax revenue. Severance tax revenue remains over 50 percent below levels seen prior to the late-2014 decline in oil prices. Though oil prices have since recovered, growth in the industry has been heavily concentrated in shale as opposed to the types of offshore drilling that Louisiana has a greater exposure to, hence keeping severance tax revenue below its former levels.



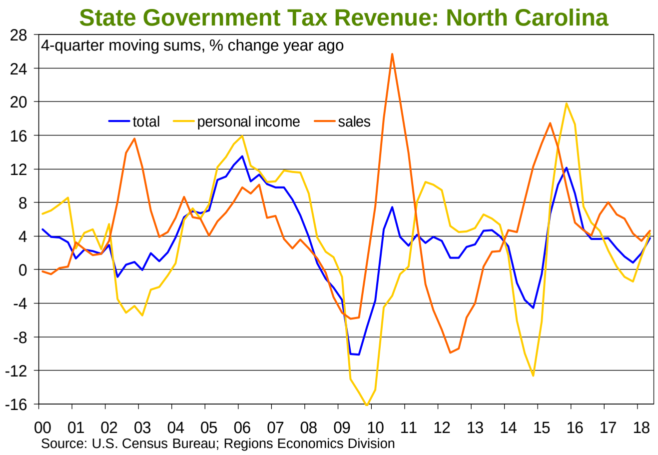
Missouri: On a four-quarter moving sum basis, total tax revenue in Missouri was up 3.4 percent year-on-year as of Q2 2018. Growth in sales tax revenue remains notably slow – the four-quarter moving sum was up just 2.3 percent year-on-year as of Q2 2018 – and as Missouri has long had special rules regarding the payment of state sales taxes on online purchases, the state may not see much additional growth as a result of the recent U.S. Supreme Court ruling as will be the case in other states. Individual income tax revenue on a four-quarter moving sum basis was up 4.2 percent year-on-year. While the raw quarterly data show no out of the ordinary activity in Q4 2017, a faster pace of job growth in 2018 has helped lift growth in revenue from individual income taxes. Missouri did see the typical seasonal spike in corporate income tax revenue in Q2, but longer term growth has been uneven.

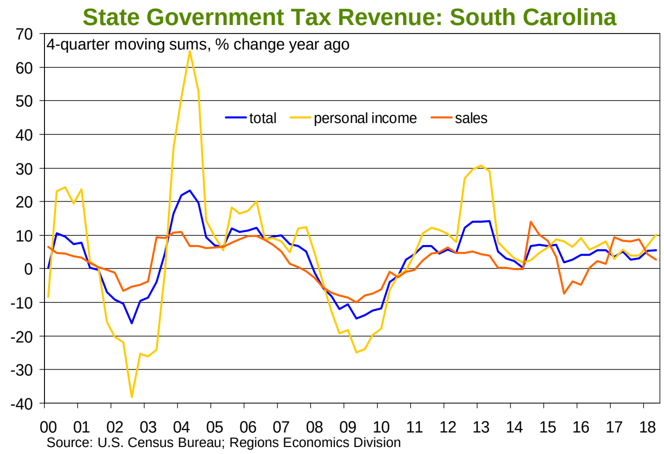


Mississippi: On a four-quarter moving sum basis, total tax revenue in Mississippi was up 1.6 percent year-on-year as of Q2 2018, continuing the pattern of notably weak revenue growth. This is the case with the various components of total tax revenue. Though having improved in 2018, the state's pace of job growth remains well below-average and there has been little growth in hourly earnings over the past few years. This combination has acted as a drag on growth in personal income and hence on growth in revenue from personal income taxes. On a four-quarter moving sum basis, personal income tax revenue was up just 2.9 percent year-on-year as of Q2 2018, the smallest such increase of any state in the Regions footprint. The 1.4 percent year-on-year increase in the four-quarter moving sum of sales tax revenue is also the smallest such increase of any state in the Regions footprint.



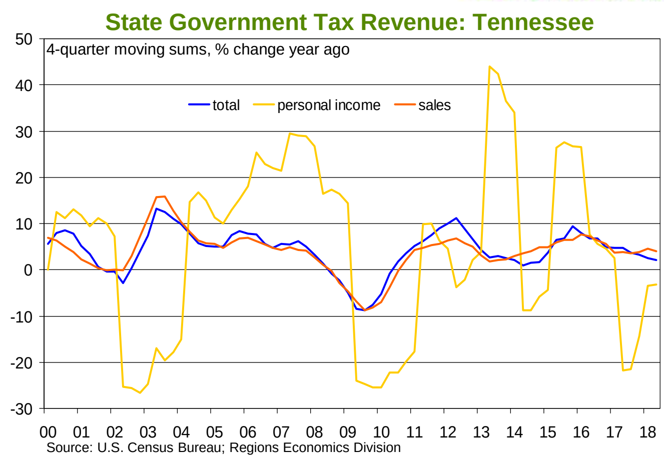
North Carolina: On a four-quarter moving sum basis, total tax revenue in North Carolina was up 3.7 percent year-on-year as of Q2 2018, though the running four-quarter totals are still being impacted by lower personal and corporate income tax rates. That said, growth in personal income tax revenue accelerated over the first half of 2018. North Carolina continues to post above-average job growth, the pace of which has accelerated in 2018, as has growth in hourly earnings. On a four-quarter moving sum basis, sales tax revenue was up 4.6 percent year-on-year as of Q2 2018. Though a strong and diverse state economy acts as a support for growth in tax revenue, coming quarters will clearly be impacted by the effects of Hurricane Florence. Specifically, the extent to which insurance and government funding can restore the infrastructure damaged by the storm and the extent to which economic activity returns to what were normal levels prior to Florence.

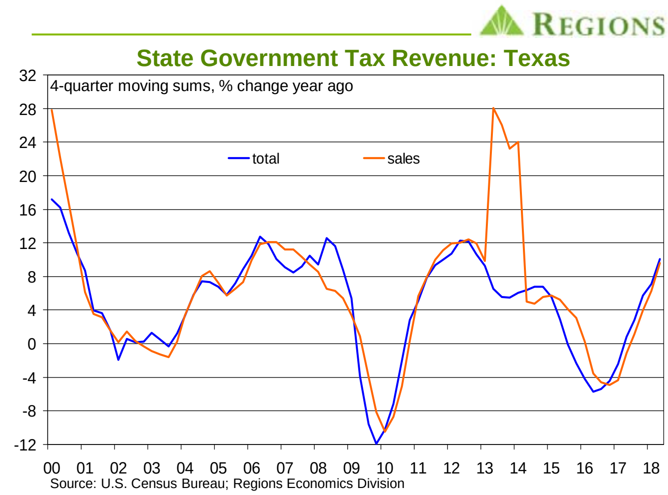




South Carolina: On a four-quarter moving sum basis, total tax revenue in South Carolina were up by 5.5 percent year-on-year as of Q2 2018 which, as seen in the chart above, is in line with the pace of growth that has prevailed over the past few years. Beneath the total, however, the performance of the individual components has varied and over the past few quarters growth in personal income tax revenue has replaced growth in sales tax revenue as the primary driver of growth in South Carolina's total tax revenue. As of Q2 2018, the four-quarter moving sum of personal income tax revenue was up 10.1 percent year-on-year. This rapid growth, however, in part reflects stronger than normal collections in Q4 2017 thanks to the 2017 tax bill, and this spike continues to bias the four-quarter moving sum higher. Nonetheless, the state continues to post job growth ahead of the national average, and growth in hourly earnings has accelerated in 2018, so the fundamental drivers of growth in personal income and in personal income tax revenue remain strong beyond the effects of the 2017 tax bill. The four-quarter sum of sales tax revenue was up just 2.8 percent year-on-year as of Q2 2018, but growth in sales tax revenue in South Carolina was notably strong in 2017 and some payback was to be expected. More broadly, assessing the behavior of sales tax collections in South Carolina is far from being a straightforward exercise. Depending on the county specific add-on to the state rate, the sales tax in South Carolina can range from 6.0 to 9.0 percent, but there is a long list of items exempted from sales taxes. As such, swings in sales tax collections can easily reflect shifts in spending patterns as opposed to changes in the state's underlying fundamentals.

Tennessee: On a four-quarter moving sum basis, total tax revenue in Tennessee was up just 2.1 percent year-on-year as of Q2 2018, which marks the eighth consecutive quarter in which year-on-year growth had decelerated. As has been the case over recent quarters, changes in Tennessee's tax revenue have to be assessed in terms of changes in personal income tax collections. While in principal Tennessee assesses a personal income tax, the reality is that only dividend income, interest income, and other investment income are subject to the tax, known in the state as the "Hall Tax." That tax is being phased out gradually until 2021, when it will be completely eliminated, and 2017 collections reflected the initial cut in the tax rate. So, in essence, the decline in personal income tax collections for 2017 reflects a large change in a small number. That said, the raw quarterly data do show unusually high collections in Q4 2017, again tied to pending changes in the federal tax code but which have biased 2018 collections lower. More fundamentally, growth in sales tax revenue has been fairly stable over the past few quarters, reflecting both solid growth in personal income amongst state residents and healthy growth in tourism that has helped support growth in spending on consumer goods and in turn sales tax revenue.





Texas: On a four-quarter moving sum basis, total tax revenue in Texas was up 10.1 percent year-on-year as of Q2 2018, the largest such increase of any state in the Regions footprint. After Texas saw total tax revenue fall in both 2015 and 2016, largely reflecting the slumping energy industry, revenue bounced back in 2017 and has strengthened even further over the first half of 2018. Like Florida, Texas has no personal income tax and is hence more reliant on sales tax as a source of total tax revenue. On a four-quarter moving sum basis, sales tax revenue was up 9.6 percent year-on-year as of Q2 2018, topping the 9.1 percent growth in Florida as the fastest in the Regions footprint. Severance taxes are also an important source of tax revenue for Texas, and after having fallen sharply in 2015 and 2016 severance tax revenue has since rebounded smartly, these moves in conjunction with movements in oil prices. On a four-quarter moving sum basis, severance tax revenue was up 50.8 percent year-on-year as of Q2 2018. Over the past four quarters, sales taxes have accounted for 60.2 percent of total tax revenue in Texas with severance taxes accounting for 21.8 percent. Obviously the heavy reliance on these two sources makes the state's revenue base tightly bound to cyclical patterns in the U.S. and, at least to some extent, global economies. While not likely to be an issue over the next several quarters, this could pose some challenges as we move through 2020 and into 2021.

While the economic expansion figures to persist at least into 2020, there is not a precise mapping from a given state's pace of economic growth into that state's tax collections, as the above summaries hopefully help illustrate. It is also worth noting that while our summaries compare actual tax collections across years, for state governments a more critical distinction is between actual tax collections and forecasted tax collections. Spending decisions in any given state are made ahead of time, and in large part on the basis of revenue forecasts, and forecasting tax collections is inherently difficult. But, for those states with balanced budget requirements, material misses on revenue forecasts can result in sometimes sharp and sudden changes in spending plans, which in turn can have an adverse impact on the broader state economy. In addition to an economic downturn – a matter of when, not if – coming years will see many states squeezed by pension funding obligations at the same time when personal transfer payments will account for a steadily increasing share of total state government spending. That revenue growth has generally improved over recent quarters from what had been fairly tepid growth over most of the current expansion clearly helps alleviate these budget challenges, but these challenges will nonetheless endure beyond the current cycle.

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