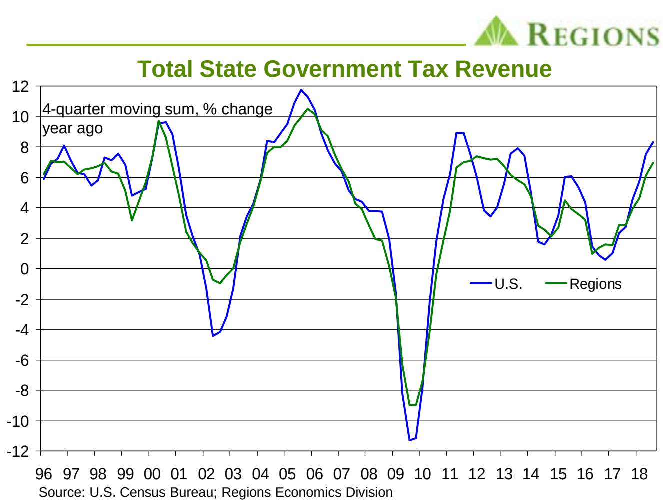
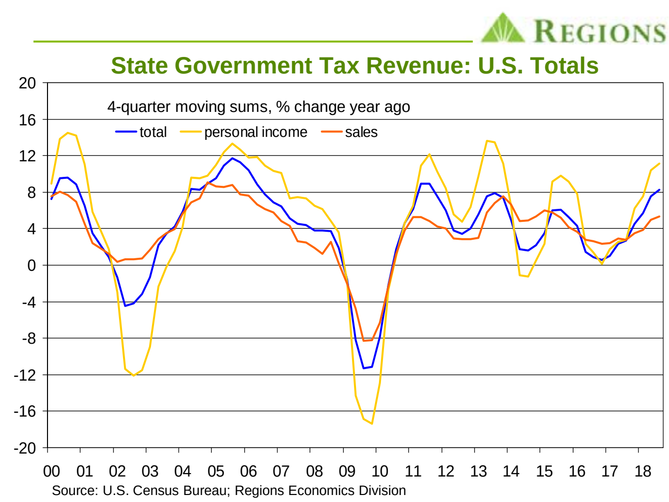
ECONOMIC UPDATE
REGIONS
January 2019

Q3 2018 State Government Finances: Regions Footprint

State governments realized another quarter of strong growth in tax revenue collections in Q3 2018, with growth in overall revenue spread broadly across the major components. For the U.S. as a whole, total state government tax revenue collections increased by 7.0 percent year-on-year in Q3 2018, which matches growth for the 15-state Regions footprint as a whole. The steady acceleration in growth of state government tax revenue over the past four quarters is in marked contrast to the notably slow and uneven growth seen over much of the current expansion. While Q4 2018 will likely prove to have been another quarter of solid growth in state government tax revenue, the combination of a maturing expansion and what we expect will be a deceleration in overall economic growth in 2019 and beyond raises the question of whether 2018 will be as good as it gets for state government tax revenue collections in this cycle. Moreover, states continue to face 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. As such, while providing much needed relief to government finances in most states, the run of strong growth in tax revenue collections over the past few quarters is not likely to change the longer-term prognosis for state government finances, particularly with the current economic expansion closer to its end than its beginning.





To some extent, the recent acceleration in growth of state tax revenue simply reflects 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, which accounts for the number of people working, the number of hours they work, and how much they earn for each hour worked. Despite the focus on growth in average hourly earnings as a sign of the health of the labor market, it is growth in aggregate wage and salary earnings that drives growth in total personal income and, in turn, growth in consumer spending. As such, improving labor market conditions have also contributed not only to faster growth in personal income tax collections but also to faster growth in sales tax revenue. The latter is relevant to those states – Florida, Tennessee, and Texas within the Regions footprint – which do not impose personal income taxes but still, through faster growth in consumer spending, are able to benefit from stronger labor market conditions. It should also be noted that the 2017 tax bill will help boost 2018 growth in state tax revenue in those states, such as Louisiana, which allow residents to deduct federal income taxes paid from their state level returns. With lower personal income tax rates lowering the amount of federal income taxes paid, deductions on state level returns for federal income tax paid will be lower in 2018 than in prior years, hence boosting growth in state income tax collections. This is a one-off boost, however, as federal income tax rates in 2019 will be unchanged from rates in 2018, and the same one-off boost to state level revenue will be seen in those states who allow residents to claim itemized deductions taken on the federal level on their state level tax returns, as fewer people itemizing on federal returns in 2018 will mean a smaller dollar volume of deductions on state level returns.

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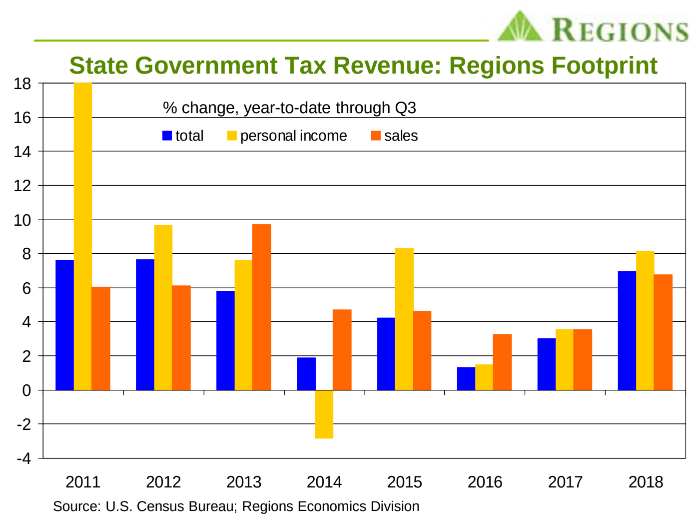
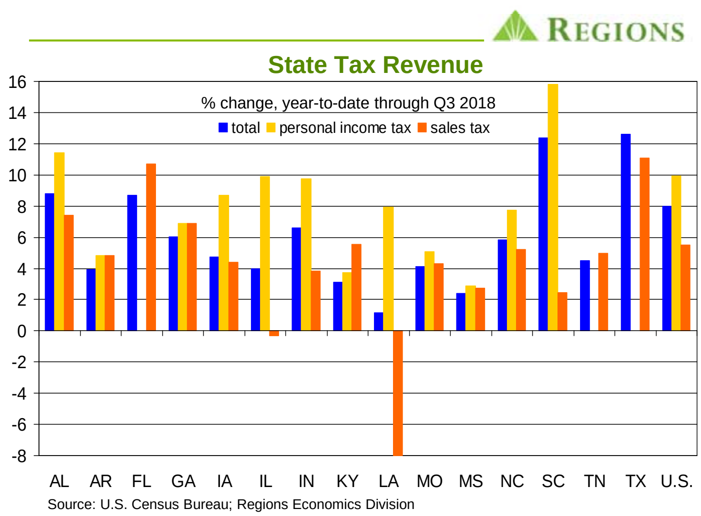
Though to a lesser degree than ongoing improvement in labor market conditions, price effects have also contributed to faster growth in tax revenue. As we have noted in prior updates of state government tax collections, persistent goods price deflation has for some time acted as a drag on growth in sales tax revenue, with falling prices for many categories of consumer goods weighing on growth in the tax base, which in this case is nominal (or, not adjusted for price changes) retail sales. With core goods prices having firmed, even if only modestly, the drain on the sales tax base has not been as pronounced, which has contributed to growth in sales tax revenue. While higher retail gasoline prices were a positive for growth in sales tax collections during the middle two quarters of 2018, we'll see the flip side of that in the data on sales tax revenue in Q4 2018 and Q1 2018, as sharply lower retail gasoline prices will curtail revenue from motor fuel taxes. Along these lines, higher oil prices provided a significant boost to revenue from severance taxes in Louisiana and, to a much greater degree, Texas over the first three quarters of 2018, but with oil prices having retreated rapidly in Q4 2018, there will be payback in severance tax revenues in these states. Though we think it too soon to be reflected in the data, the 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. While the timing of implementation varies across states, the boost to sales tax revenue from collections of taxes on online sales should be apparent in the data by mid-2019.

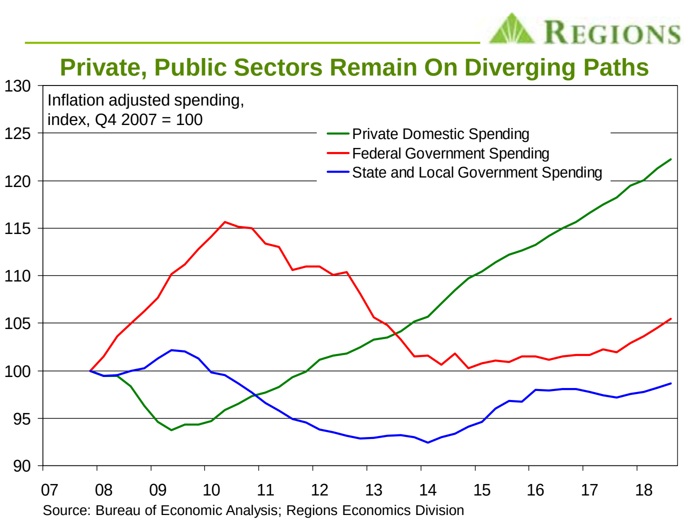


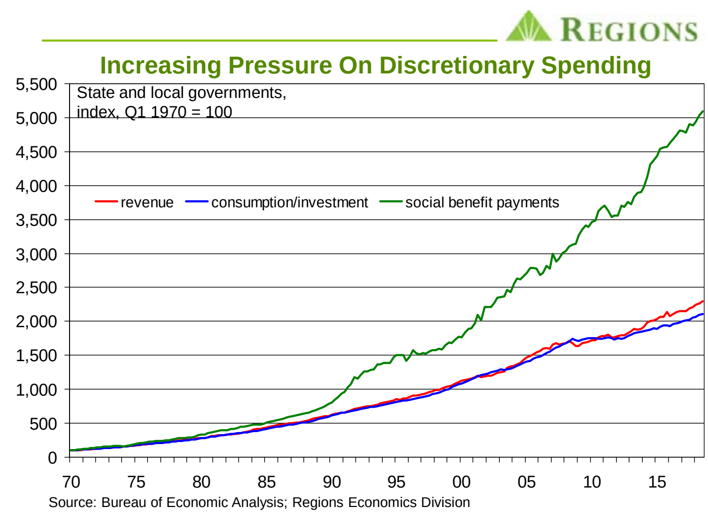


As seen in the first chart above, for the Regions footprint as a whole, growth in revenue from both personal income taxes and sales taxes on a year-to-date basis through Q3 was stronger in 2018 than in any year since 2013. As a side note, while we do collect and monitor the data on tax revenue from corporate income taxes, this is a small share of total tax revenue in most states and tends to behave rather erratically, to the point that what are often large and sudden changes in corporate income tax revenue can foul up the scaling of our charts, so we do not typically show it. In any event, the second chart above shows growth in tax revenue on a year-to-date basis through Q3 for each state in the footprint. On a year-to-date basis through Q3, total tax revenue in Texas was up by 12.6 percent relative to the first three quarters of 2017, with South Carolina a close second with 12.4 percent growth. On the other end of the spectrum, Louisiana saw only a 1.2 percent increase in total tax revenue on a year-to-date basis through Q3, with lower sales tax rates acting as a material drag on revenue from this source. More generally, it is possible that state level personal income tax collections through the first three quarters of 2018 were lifted by people realizing capital gains or seeing stronger growth in income from assets (interest and/or dividends). The disparity between personal income tax and sales tax revenue collections in Illinois stands out, but keep in mind that the state raised their individual income tax rate in July 2017, thus giving year-to-date collections over the first half of 2018 a boost when compared to the same period of 2017 – on a Q3/Q3 basis, 2018 collections were lower with the same tax rate in both Q3 2017 and Q3 2018.

The extent to which the 2017 tax bill acted as a one-off boost to state level personal income tax revenue in 2018 is unclear, but, to the extent these effects are skewing the 2018 data, any such effects will wash from the data in 2019. This is not to dismiss what are, at least in most states, notably improved labor market conditions, and growth in individual income tax collections had clearly begun to accelerate over the back half of 2017. Our point here is simply that no one should be, and we suspect few state treasurers are, counting on a repeat of the stellar growth in individual income tax revenue seen in 2018. The growth in state level sales tax revenue seems a more reliable indicator of underlying economic conditions, and we can point to a faster pace of growth in nominal consumer spending as effectively widening the tax base for sales tax revenue collections. What remains to be seen is whether, or to what extent, sharply lower equity prices in Q4 2018 will have impacted consumer spending in that quarter – the partial government shutdown, still in effect at the time of this writing, makes it harder to assess any such effects given the significant disruption in the flow of economic data, but we do not expect there to be a material hit to state level sales tax revenue. Of more significance is that healthy labor market conditions put a floor under consumer confidence and, in turn, consumer spending, which should mean state sales tax collections remained strong in Q4 2018. And, speaking of the partial government shutdown, to the extent those federal government employees/contractors not being paid during the shutdown are forced to curb their spending, that will be a drag on retail sales and, in turn, sales tax collections. But, any such effects will be fairly widely dispersed on a geographic basis, so may not be very visible in the data for any given state, and in many cases with back pay set to be distributed once the partial shutdown ends, there could easily be payback, though likely not full payback, in the form of higher spending in a subsequent quarter. As such, any effects stemming from the partial government shutdown are likely to be more in the form of disruptions in the timing of spending rather than the ultimate level of spending.

As noted above, however, while a welcome relief, the recent run of stronger growth in state government tax collections does not solve the longer-running stresses on state government finances in the form of increased mandatory spending and unfunded pension liabilities. While the run of stronger growth has afforded many states the opportunity to increase discretionary outlays, any such growth has been fairly weak and has been uneven across states. We think it is telling that, on an inflation adjusted basis, state government outlays on goods and services remains below the level seen as the 2007-09 recession began, in contrast to federal government outlays and private sector spending, as seen in the first chart below.





As seen in the second chart above, growth in state government tax revenue has not kept pace with growth in state government spending on mandatory programs such as Medicaid and other forms of transfer payments. This means that state government purchases of goods and services and investment outlays on things like equipment and infrastructure have been growing at only a slow pace on a nominal basis and, after accounting for inflation, have either declined or have grown at a very modest pace. Unfortunately, this trend is more likely to intensify rather than abate over the next several years. At the same time the federal government will likely be putting heavier spending burdens on state governments, many state (and local) governments will be contending with rapidly growing pension liabilities. As such, it is difficult to envision states being able to alleviate these stresses on their finances without cuts in other types of spending (i.e., discretionary spending) and/or potentially significant tax increases. Moreover, with the current expansion closer to its end than to its beginning, it is fair to ask how financially prepared state governments are for an economic downturn. This is not to suggest that state governments are staring a financial crisis in the face today, but, for those willing to look down the road, an ever-diminishing degree of financial flexibility coupled with what will eventually be a slower pace of revenue growth should be cause for concern.

State Tax Revenue, Regions Footprint

year-to-date through Q3, 2018

STATE	individual income tax % change year-ago	individual income tax % of total revenue	corporate income tax % change year-ago	corporate income tax % of total revenue	sales tax % change year-ago	sales tax % of total revenue
Alabama	11.42	37.72	8.24	4.66	7.40	26.10
Arkansas	4.81	30.34	-3.28	4.43	4.82	36.52
Florida	n/a	n/a	20.79	6.24	10.70	62.74
Georgia	6.90	50.01	6.43	4.82	6.90	26.29
Iowa	8.71	38.83	2.46	4.92	4.40	32.97
Illinois	9.91	39.81	-5.71	7.12	-0.31	26.80
Indiana	9.74	39.62	-14.36	3.80	3.83	35.34
Kentucky	3.72	37.71	-1.23	6.10	5.55	30.04
Louisiana	7.92	26.99	32.94	5.08	-8.15	33.50
Missouri	5.09	50.23	-4.83	2.53	4.30	28.34
Mississippi	2.87	23.37	3.56	6.32	2.75	44.40
North Carolina	7.75	45.89	11.72	3.58	5.20	28.31
South Carolina	15.81	40.18	24.64	5.13	2.43	32.66
Tennessee	n/a	n/a	-7.39	10.65	4.99	55.68
Texas	n/a	n/a	n/a	n/a	11.08	59.95
U.S.	9.92	38.32	13.53	5.15	5.50	30.65

Source: U.S. Census Bureau; Regions Economics Division

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