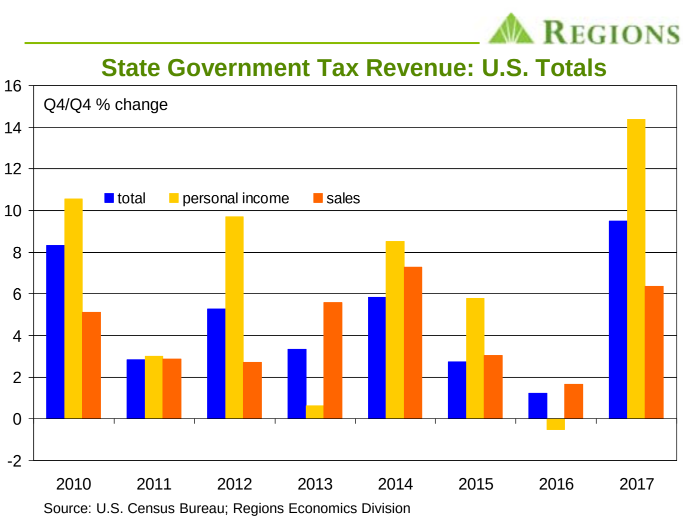
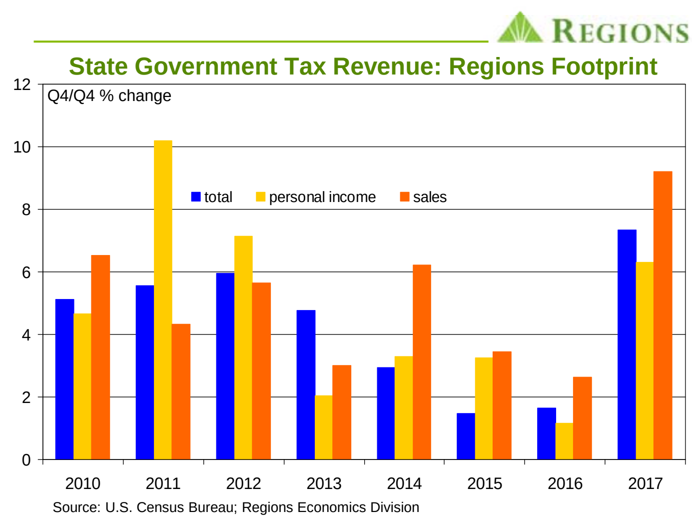
ECONOMIC UPDATE
REGIONS
March 2018

Q4 2017 State Government Finances: Regions Footprint

One point we have consistently made in these quarterly updates of state government finances is that for this late into an economic expansion (the current expansion is now in its ninth year) growth in state government tax revenue has been, at best, middling. This is concerning on many fronts, including the fact that in a revenue constrained environment, a steadily rising share of state government spending being diverted to transfer payments crowds out state government spending on goods and services, and what in many states are rapidly rising unfunded pension obligations. So, against this backdrop, you can imagine our relief when we saw the recently released data for Q4 2017, which show that for the U.S. as a whole, total state tax government revenue grew by 9.5 percent year-on-year, with 7.7 percent growth for the Regions footprint as a whole. These are easily the fastest growth rates seen since the early days of the current expansion after the brutal 2007-09 recession had decimated the tax bases of state and local governments across the U.S.

That sense of relief, however, lasted only for as long as it took us to sift through the details of the Q4 data. Which is to say not very long but, man, it sure was good while it lasted. As it turns out, the jump in state tax revenue in Q4 2017 reflects the combination of a few factors that led to a spike in individual income tax receipts and a notable jump in sales tax revenue collections. These factors will, for the most part, reverse in Q1 2018, and if we are correct on this point there will be a notable decline in Q1 2018 state government tax revenue. Underneath it all, then, the underlying trend of middling growth in state government tax revenue will remain undisturbed and the concerns we cited above will still be looming as dark clouds over the financial landscape for many state governments, including many in the Regions footprint. A glance at the annual data, presented in the table on Page 4, reinforces this point. One potential silver lining is that the growth in sales tax revenue seen in Q4 may have some staying power.





The above charts illustrate the extent to which state government tax revenue collections spiked in Q4 2017, notwithstanding the obvious caveat that the bar for over-the-year comparisons was not set all that high by a tepid Q4 2016 performance. That said, there is more than a weak base effect behind the 14.4 percent year-on-year increase in state level personal income tax collections for the U.S. as a whole. While ongoing improvement in labor market conditions over the course of 2017 contributed to this, far and away a bigger factor was the tax bill signed into law in December 2017, specifically the provision limiting the deduction of state and local taxes on federal tax returns beginning in 2018. To the extent possible, individuals pulled income forward into 2017 and/or pre-paid state income taxes by the end of 2017 in order to take advantage of the uncapped deduction while it was still available. Note that while the tax bill was not signed into law until December, this particular change had been tipped well in advance so that individuals, particularly those in high-tax states, had plenty of time to prepare to act. And, as to why this effect was far less pronounced in the Regions footprint than was the case for the U.S. as a whole, keep in mind that the two largest states in the footprint – Florida and Texas – have no state income tax, so residents of these two states had no incentive to either pull income forward or pre-pay taxes.

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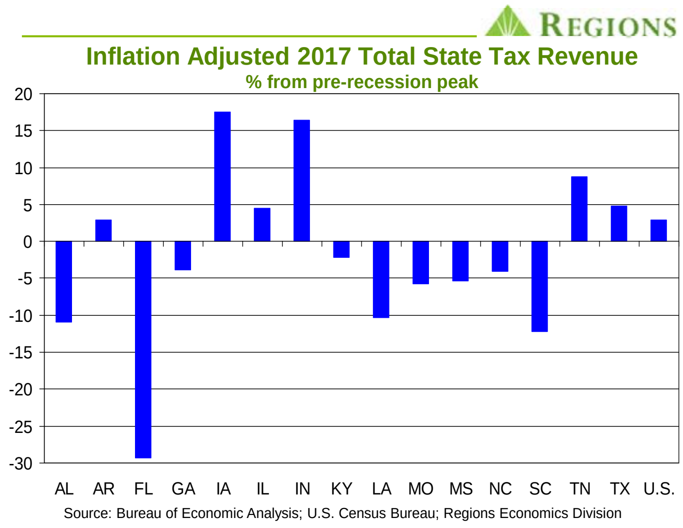
There were instances within the Regions footprint of unusually rapid Q4/Q4 growth in personal income tax collections, such as the 15.4 percent increase in Illinois and the 7.2 percent increase in Georgia. While Louisiana saw a 10.6 percent increase on a Q4/Q4 basis, that is more a reflection of base effects, as individual income tax collections were notably weak in Q4 2016, than any effects of the tax bill. Across the U.S., it is no surprise that Q4/Q4 growth in personal income tax collections was the strongest in the higher income, higher tax states, with California seeing 17.7 percent growth, Connecticut seeing 39.9 percent growth, Massachusetts seeing 19.3 percent growth, New Jersey seeing 17.7 percent growth, and New York seeing 26.4 percent growth. For the U.S. as a whole, personal income tax revenue accounted for 38.1 percent of total state tax revenue in Q4 2017. To put this in perspective, in any given year Q2 is the quarter in which personal income tax revenue peaks and contributes more to total tax revenue than in any other quarter; the 38.1 percent share in Q4 2017 is the highest on record for any Q1, Q3, or Q4 of any year, and even topped the Q2 share in several years. In other words, it is simply not realistic to expect personal income tax revenue to be as strong over coming quarters as it was in Q4 2017.

While year-on-year growth in personal income tax revenue in the Regions footprint was not as strong as was the case for the U.S. as a whole in Q4 2017, growth in sales tax revenue was considerably stronger (refer back to the charts on the prior page). For the footprint as a whole, sales tax revenue rose by 9.2 percent, year-on-year, in Q4, easily topping the 6.4 percent increase seen nationally. Growth in the footprint, however, is heavily skewed by Florida and Texas, which combined saw sales tax revenue increase by 17.6 percent, year-on-year, in Q4. This largely reflects the effects of Hurricanes Harvey (Texas) and Irma (Florida), as households impacted by the hurricanes engaged in what basically amounts to replacement spending on household items, clothing, and motor vehicles, among other types of goods. Together, Florida and Texas accounted for 46.4 percent of all state government sales tax revenue in the Regions footprint in Q4 2017, compared to a 43.1 percent share in Q4 2016. Excluding these two states, sales tax revenue for the rest of the Regions footprint grew by 2.9 percent, year-on-year, in Q4 2017. The jump in sales tax revenue in Florida and Texas was strong enough to impact the aggregated national data, as these two states accounted for 19.2 percent of total sales tax revenue for the U.S. as a whole in Q4 2017 (in Q4 2016 that figure was 17.3 percent).

This is not, however, the entire story behind growth in sales tax revenue in Q4 2017. Recall that Q4 saw robust growth in consumer spending – as reported in the GDP data, nominal spending on goods rose at an annualized rate of 9.4 percent in Q4, and the holiday sales season was the strongest since 2005. With such solid growth in what is effectively the base for sales taxes (personal services are not typically subject to sales tax) it is no surprise that growth in sales tax revenue was also strong in Q4. Again, though, there is simply no basis on which to expect the strength in sales tax revenue seen in Q4 to persist over coming quarters. Indeed, data available thus far show much slower growth in consumer spending in Q1 2018, which is as expected after the stellar growth seen in Q4. To the extent that the increase in disposable personal income stemming from the 2017 tax bill supports growth in consumer spending, then sales tax revenue growth will also get a lift. As we have noted elsewhere, however, given how low the personal saving rate had fallen by year-end 2017, it is uncertain how households will allocate the increase in disposable income stemming from the tax bill between saving and spending. In terms of this discussion, any increase in saving means less growth in consumer spending, and in turn sales tax revenue, than may be implied by simply looking at the growth in disposable personal income resulting from the tax bill.

If by now you're wondering what happened to that silver lining for growth in sales tax revenue we mentioned at the outset, don't worry, we haven't forgotten about it. As we've discussed in considerable detail both in these quarterly updates on state government finances and in other forums, persistent goods price deflation has been a material drag on growth in retail sales over the past few years, at least retail sales as reported on a nominal basis. As sales taxes are assessed on nominal retail sales, falling goods prices have in turn acted as a drag on growth in sales tax revenue for local and state governments. There are signs, however, that goods price deflation has run its course, as both the Consumer Price Index and the PCE Deflator show prices for "core" goods, i.e., consumer goods excluding food and energy, have stopped falling, even if the increases seen over the past few months are modest (even with these increases core goods prices are still down year-on-year). This isn't to say that core goods prices will go on a tear, and there is considerable debate as to whether the "Amazon effect" will act as a binding upper bound on core goods prices, but the main point here is that the long-running declines seen in core goods prices have, at least for now, come to an end. Firmer global economic growth and a weaker U.S. dollar have helped put at least some upward pressure on core goods prices. It is also worth noting that what have been higher retail gasoline prices have led to growth in revenue from gasoline taxes, which roll into the broader sales tax category.

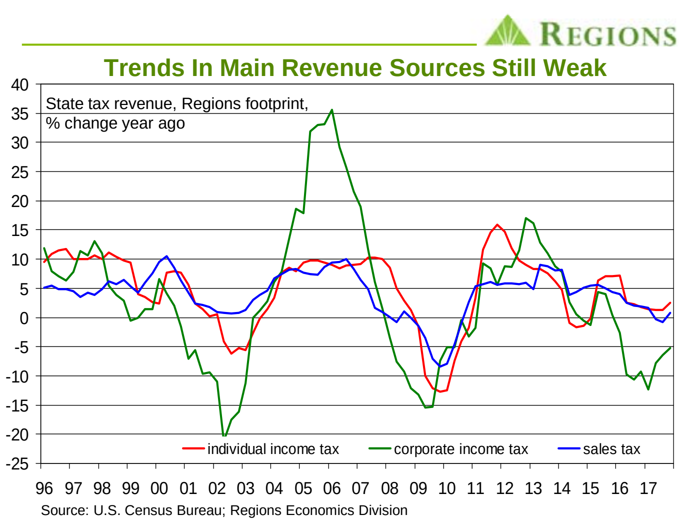
As it pertains to state government tax revenue, it is also worth thinking about inflation in another context. State governments are also purchasers of goods and services, though obviously the basket of goods and services purchased by state governments is not the same as that purchased by consumers. What has been listless growth in tax revenue in many states has failed to keep up with the pace at which prices are rising, in other words, even if nominal tax revenues are higher, the purchasing power of that revenue stream may have diminished. To be sure, changes in tax rates, higher or lower, have also impacted measured growth in state tax revenue, but that



distinction is not pertinent here, as the point is that, for whatever reason(s), revenue growth in many states simply has not kept pace with the costs of goods and services purchased by state governments. This is an often overlooked, but no less real, form of financial stress in many states.

The chart to the side shows the percentage difference between total 2017 state tax revenue and the pre-recession peak, both adjusted for inflation, for the U.S. as a whole and for each state in the Regions footprint. The price deflator used to deflate the nominal data on tax revenue, the GDP Price Deflator for state and local government consumption and investment expenditures, is tailored to the types of goods and services purchased by state and local governments and captures price changes for this basket. For a point of reference, the deflator for state and local government purchases has increased much more rapidly than deflators/price indexes that measure prices of consumer goods. There is, apparently, no "Amazon effect" when it comes to government purchases of goods and services.

As seen in the above chart, in nine of the 15 states in the Regions footprint, real (i.e., inflation adjusted) tax revenue has still not risen back to the pre-recession peak, with the almost 30 percent shortfall in Florida the largest of any of the states in the footprint. For the U.S. as a whole, as of 2017 inflation adjusted state tax revenue stood just 2.9 percent above the peak seen prior to the 2007-09 recession. So, in most states, real tax revenue is either still below or only marginally above the pre-recession peak, which is one reason state and local government consumption/investment expenditures have been a persistent drag on the current expansion. On average, since 2010 state and local government spending has subtracted from real GDP growth each quarter rather than adding to it as in every prior decade. Weak revenue growth and rising prices have teamed up to constrain growth in state and local government spending on goods and services, as has the rapidly increasing share of total state and local government spending devoted to personal transfer payments. Outlays on personal transfer payments are expected to continue growing at a rapid rate over coming years, meaning an increasing share of state and local government revenue will be diverted to such spending and away from spending on goods and services.



The most obvious remedy would be a faster rate of economic growth which, by enabling the revenue base to expand at a more rapid pace, would result in faster growth in tax revenue. While that seems likely over the course of 2018 and into 2019, it is highly unlikely that overall economic growth will be strong enough on a sustained basis to provide much relief to increasingly pressed state and local governments, particularly considering the extent of unfunded pension obligations in many states. That leaves us pretty much back where we started, and leaves state government finances pretty much back where they were prior to the bump in revenue seen in Q4 2017. As discussed above, most of that bump will be reversed in the Q1 2018 data, leaving the underlying trends in revenue growth largely unchanged. Coupled with the reality that the current expansion is closer to its end than its beginning, this set of circumstances will pose some exceptionally uncomfortable challenges to state and local government finances over coming years.

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State Government Tax Revenue

annual percentage change

STATE	personal income tax 2015	personal income tax 2016	personal income tax 2017	sales tax 2015	sales tax 2016	sales tax 2017	total tax revenue 2015	total tax revenue 2016	total tax revenue 2017
Alabama	5.97	3.35	3.95	3.57	4.89	-0.69	4.30	2.26	2.43
Arkansas	-1.25	8.03	-0.88	3.13	2.49	2.43	1.59	2.96	1.68
Florida	N/A	N/A	N/A	-0.62	6.00	-4.45	2.09	3.49	-8.37
Georgia	7.52	5.74	6.79	4.03	5.60	1.83	7.38	6.70	3.53
Iowa	15.81	0.42	-3.59	19.44	2.17	-6.56	16.01	2.51	-4.69
Illinois	-13.36	-8.23	2.79	22.09	5.85	-7.68	-1.36	-3.24	-1.43
Indiana	48.76	2.14	4.97	0.28	2.36	3.50	17.71	2.54	4.07
Kentucky	7.63	4.97	2.33	5.22	3.77	1.12	4.55	1.72	3.58
Louisiana	3.43	-4.17	6.50	-1.23	24.57	16.65	-7.18	10.48	11.12
Missouri	9.25	2.27	1.58	2.96	3.17	1.89	6.20	0.93	2.61
Mississippi	3.69	-0.22	2.23	-0.18	1.77	1.06	1.92	0.46	-1.20
North Carolina	19.77	4.64	-1.42	9.90	6.53	4.30	12.11	3.64	1.20
South Carolina	6.62	17.25	3.92	-3.76	-23.81	-0.95	2.78	0.75	0.25
Tennessee	26.75	4.55	-14.29	6.48	5.59	3.79	9.37	4.89	3.25
Texas	N/A	N/A	N/A	3.08	-4.92	3.95	-2.36	-4.46	5.72
U.S.	9.15	-0.01	5.82	4.19	1.75	2.42	5.30	0.32	3.78

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

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