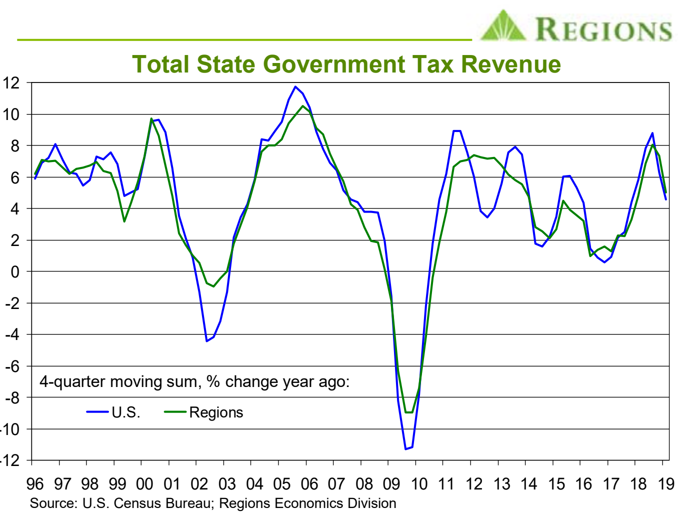
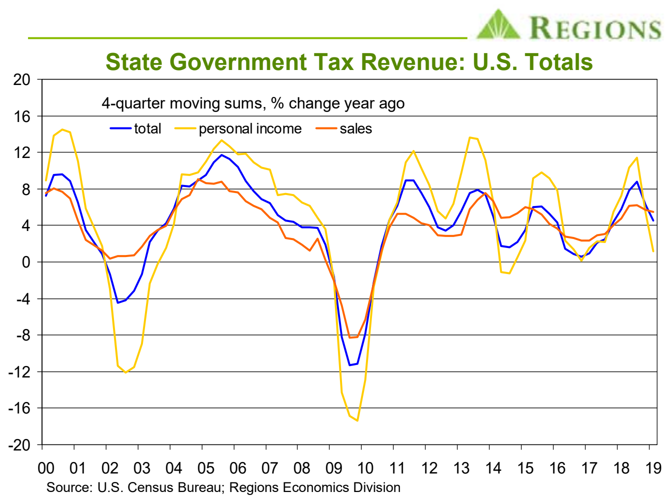
ECONOMIC UPDATE
REGIONS
June 2019

Q1 2019 and Annual 2018 State Government Finances: Regions Footprint

The U.S. Census Bureau has released data on Q1 2019 state government tax revenue along with revised data for the Q2 2017 through Q4 2018 period. The latest release offers us the chance to resume what had been regular quarterly updates on state government revenue collections. Those updates stopped after the partial government shutdown that began in December 2018 and ran through January 2019 – the Census Bureau was one of the government agencies that was shut down, which resulted in significant delays in the release of economic data series produced by Census, including the data on state government tax revenue. As such, our review of the Q4 2018 and full-year 2018 data fell by the wayside, so in what follows we'll hit on some of the highlights of the full-year 2018 data and the Q1 2019 data. We'd pledge to keep to a regular schedule from here out, but, with yet another showdown over government funding looming ahead of us, the best we can do is to pledge to cover the data if and when they are released.





For the U.S. as a whole, total state government tax revenue collections grew by 6.27 percent in 2018, the fastest annual growth since 2011 (when the revenue base was still depressed by the 2007-09 recession). For the 15-state Regions footprint total state government tax revenue grew by 7.35 percent in 2018, the fastest growth in the post-recession years. The strength of revenue collections in 2018, however, is setting a high bar for growth in 2019. On an over-the-year basis, total state government tax revenue collections for the U.S. as a whole rose by 1.98 percent but fell by 1.25 percent for the Regions footprint. As we routinely point out, however, there are strong seasonal patterns in tax collections, such that collections tend to vary sharply from one quarter to the next. This is why we prefer to look at the data on tax collections on a four-quarter moving sum basis, as shown in the two charts above, but even on this basis there is a clear deceleration in growth of state tax revenue. After a sharp acceleration that began in Q4 2017 and persisted through most of 2018, growth in state tax collections slowed in Q4 2018 and slowed further still in Q1 2019, and we expect this deceleration to persist over coming quarters.

It should be noted that aside from the normal quarter-to-quarter volatility, over the past several quarters the 2017 tax bill has added to the difficulty of assessing patterns in state tax collections. For instance, what historically had been an unlimited deduction of state and local income taxes (the "SALT" deduction) on federal income tax returns was capped at a maximum of $10,000 in the 2017 tax bill. This gave individuals in states with heavy individual income tax burdens the incentive to pre-pay 2018 taxes in order to claim the uncapped SALT deduction, which led to a spike in state individual income tax collections in Q4 2017 in many states. Conversely, individuals in states with lower individual income tax burdens had the incentive to push income realization back into 2018 in order to take advantage of lower federal income tax rates. The result was that in the aggregated national data, year-on-year growth in individual income tax receipts topped 14 percent in both Q4 2017 and Q1 2018, but these effects quickly faded from the data to the point that, on a year-on-year basis,

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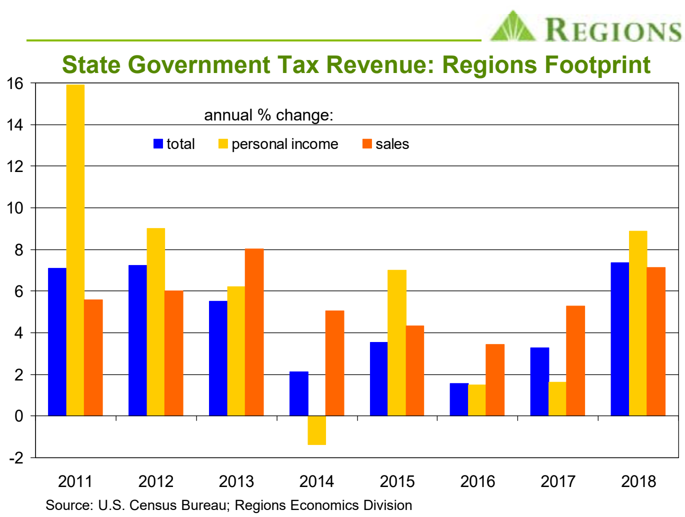
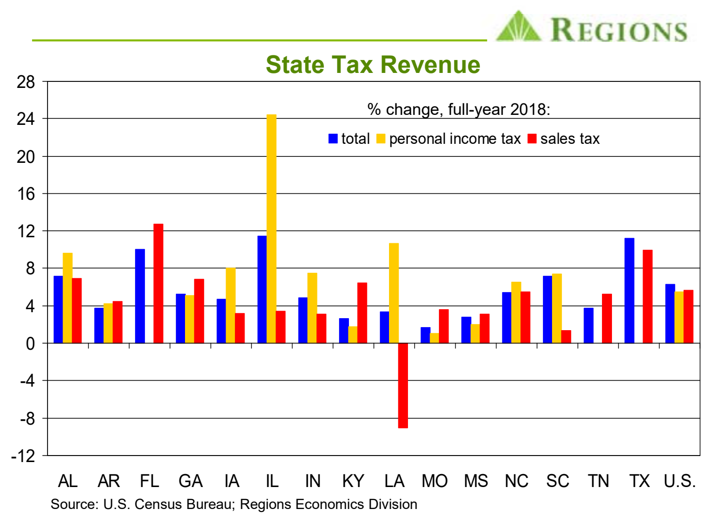
individual income tax collections were down 9.50 percent in Q4 2018 and 3.06 percent in Q1 2019, which reflects the high bases off of which these year-on-year changes were calculated. There were also pronounced swings in growth of corporate income tax collections, reflecting the sharp reduction in the statutory corporate income tax rate.

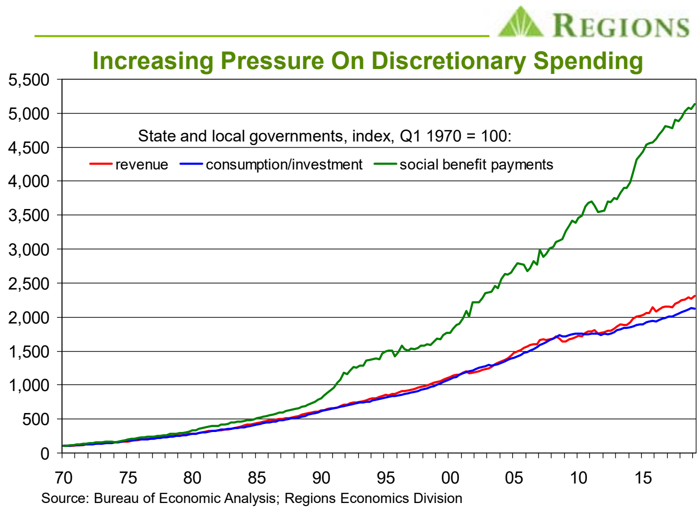
These effects will of course fade from the data as we move through 2019 and beyond, but make it harder today to interpret what state tax collections are telling us about underlying economic conditions in individual states. Not that this will stop us from trying. Alabama saw total tax revenue grow by 7.16 percent in 2018, easily the fastest growth in any of the post-recession years. To a large extent, this reflects Alabama catching up to much of the rest of the U.S. in terms of recovering from the 2007-09 recession. What had been a very slow and subdued recovery became broader and more intense in 2018, with faster job and wage growth propping up individual income tax receipts and supporting faster growth in sales tax revenue. Florida and Texas continued to benefit from well above-average rates of job and income growth, which supported growth in sales tax revenue (recall neither state has a personal income tax), and sales tax revenue was also supported by steady inflows of tourists, domestic and foreign. In contrast, less than robust growth in the broader economies weighed on growth of tax collections in Missouri and Mississippi. Tax rate changes also come into play – the individual income tax rate in Illinois rose from 3.75 percent in 2017 to 4.95 percent in 2018, which led to a spike in individual income tax receipts despite another year of middling job growth in the state (there will be a similar, though smaller, effect in the 2019 data with the move to a graduated income tax rate in Illinois). In contrast, lower tax rates weighed on sales tax collections in Louisiana in 2018, which in turn weighed on growth in total tax revenue despite a stronger year for job growth having supported individual income tax collections.





More broadly, it is highly unlikely that growth in state tax revenue collections will be as strong in 2019 as was the case in 2018. While timing effects related to the 2017 tax bill were, on net, a boost to 2018 revenue collections, there are more fundamental reasons to expect a slower pace of growth in total tax revenue collections in 2019. Given that the rate of overall economic growth will be slower this year than was the case in 2018 and that the rate of job growth is slowing, it would follow that growth in tax revenue collections would be slower as well. That said, there are reasons to think that the drop-off in the rate of revenue growth will be fairly moderate. For instance, while the rate of job growth is slowing, the pace of wage growth has been accelerating, and we expect this to remain the case through at least year-end 2019. Additionally, in addition to the number of people working and average hourly earnings, the number of hours worked is the third component of aggregate wage and salary earnings, and we see room for hours worked to rise as the pace of job growth slows. The bottom line, then, is that growth in aggregate wage and salary earnings should remain healthy this year, supporting individual income tax collections. Another support for tax revenue collections in 2019 will be expanded sales tax collections, as more and more states take measures to collect sales tax on online purchases by their residents.

Though slightly slower than in 2018, overall economic growth is nonetheless expected to be solid in 2019 (our baseline forecast calls for real GDP growth of around 2.5 percent). As such, it seems likely that 2020 will prove to be a more challenging year for state government tax revenue collections than this year will be. The rate of job growth will slow further, and the boost from the implementation of sales tax collections from online sales will be mostly realized in 2019, raising the bar for growth in sales tax revenue collections in 2020. If our outlook proves to be on or close to the mark, state governments will be confronted with slowing revenue growth coupled with growing 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 seen over the past few quarters does not materially alter the longer-term prognosis for state government finances, particularly with the current economic expansion closer to its end than its beginning.



The chart to the side illustrates this point. As seen in the chart, 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. Again, solid growth in revenue in 2018 has left most states in better position to withstand a recession, provided it is a relatively short and shallow recession, but cushions are thin in many states. 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

2018, Annual Data

	personal income tax		corporate income tax		sales tax	
STATE	% change	% of total revenue	% change	% of total revenue	% change	% of total revenue
Alabama	9.61	36.96	10.16	4.39	6.89	26.28
Arkansas	4.21	29.18	2.90	4.26	4.47	35.72
Florida	N/A	N/A	24.14	5.89	12.70	64.08
Georgia	5.13	50.52	11.29	4.74	6.88	26.12
Iowa	8.01	39.42	5.48	4.34	3.19	32.71
Illinois	24.42	38.65	18.53	6.74	3.47	28.47
Indiana	7.45	39.28	-5.88	3.72	3.09	36.02
Kentucky	1.79	36.42	-2.52	5.89	6.42	30.09
Louisiana	10.68	27.95	67.29	5.16	-9.04	33.13
Missouri	1.04	49.21	-10.08	2.54	3.59	28.89
Mississippi	2.02	23.62	9.57	5.78	3.09	44.61
North Carolina	6.52	45.40	8.37	2.74	5.47	29.03
South Carolina	7.42	41.39	7.59	3.84	1.40	32.07
Tennessee	-22.46	1.34	-10.98	9.65	5.24	57.59
Texas	N/A	N/A	N/A	N/A	9.99	59.83
U.S.	5.52	37.40	14.91	4.98	5.69	31.46

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

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Total State Tax Revenue, Regions Footprint

% change

STATE	2014	2015	2016	2017	2018	Q1 2019*
Alabama	0.80	4.30	2.26	3.69	7.16	5.06
Arkansas	2.41	1.59	2.96	1.68	3.78	1.33
Florida	0.88	2.09	5.16	7.06	10.04	-5.46
Georgia	5.25	7.38	6.70	3.74	5.25	-2.86
Iowa	2.75	16.01	2.48	1.55	4.72	-3.74
Illinois	0.25	-1.36	-2.92	-3.47	11.48	-0.10
Indiana	-0.55	17.71	2.54	4.07	4.82	-17.42
Kentucky	2.41	4.55	2.46	1.71	2.64	3.93
Louisiana	3.67	-7.18	10.48	12.57	3.36	-9.17
Missouri	1.11	6.20	0.93	3.39	1.65	-5.77
Mississippi	1.20	1.92	0.46	-1.12	2.76	4.04
North Carolina	-4.56	12.11	3.64	0.82	5.39	-3.16
South Carolina	7.13	2.78	5.62	3.97	7.18	2.40
Tennessee	1.63	9.37	4.89	3.25	3.75	6.83
Texas	6.75	-2.36	-4.46	5.72	11.23	5.89
U.S.	2.20	5.30	0.57	4.38	6.27	1.98

NOTE: 2014-2018 are annual changes, Q1 2019 is % change from Q1 2018

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