SPECIAL REPORT

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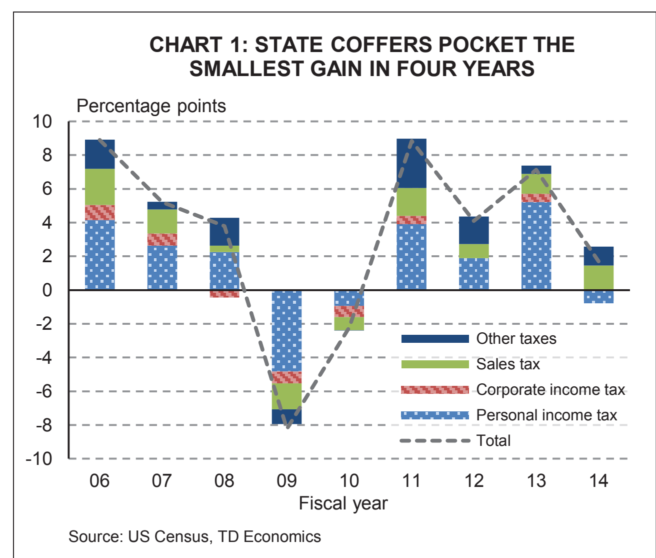
U.S. STATE FISCAL HEALTH UPDATE

TAX COLLECTIONS DISAPPOINT IN FISCAL 2014, BUT POISED TO REBOUND NEXT YEAR

Highlights

- State fiscal challenges have been a headwind to U.S. economic growth. Fortunately, the worst is over. After four years of gains, state tax collections are now 10% above their pre-recession peak. However, taking into account inflation and population growth, real per capita tax collections are still below pre-recession levels in 39 states.
- Tax receipts hit a soft patch in fiscal year 2014, growing by just 1.7% – the smallest increase since the onset of recovery.
- Looking across the country, there are important differences in the relative fiscal health of states. These are reflected in TD's Near-Term Fiscal Vulnerability Index. The index shows that fiscal pressures still persist in states where the recession left the deepest scars and where the economic recovery has been lagging.
- Looking through the temporary factors which impacted collections this year, the outlook is brighter for FY 2015. Revenues will likely re-gain momentum alongside the strengthening private-sector economy.

State fiscal challenges have been a major headwind to the American economic recovery. The need for states to close budget shortfalls led to steep spending cuts in the aftermath of the recession. Between 2008 and 2012, over 700 thousand jobs were shed from state and local government payrolls. Fortunately, the worst is over. State and local governments have been reinvesting and rehiring, adding back over 100k jobs since the beginning of 2013. Still, the ride has not been smooth. State tax collections hit a soft patch in fiscal year (FY) 2014 due to uneven economic growth and changes in federal tax policy.



The outlook is brighter for FY 2015, with revenues likely to re-gain momentum alongside a strengthening private-sector economy. However, amongst this generally upbeat story there are important regional divergences, which are reflected TD's Near-Term Fiscal Vulnerability Index. The index shows that fiscal pressures still persist in states where the recession left the deepest scars and where the economic recovery has been the slowest. Revenue underperformance is also more pronounced in states which lack diversity in their tax streams. Additionally,

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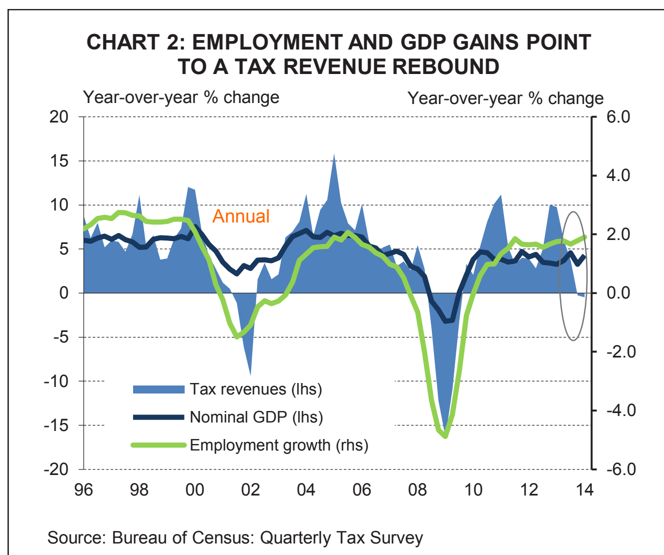
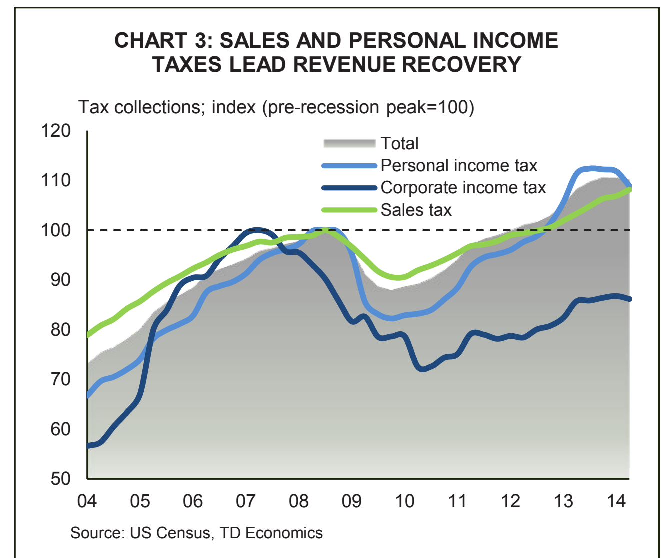
the upcoming year may prove to be more challenging for some commodity-producing states, as well as states that have made deep tax cuts.

Revenue growth disappointed in 2014

Fiscal year 2014 was a disappointing one for states, with revenues growing by just 1.7% – the smallest increase since the onset of recovery (see Chart 1). Many state governments expected collections to level-off as last year's revenue windfall, resulting from the American Relief Act of 2012, dissipated. Still, the magnitude of revenue declines in the second half of the fiscal year were a shock to many. On an annual basis, tax receipts declined in seventeen states, with the biggest drops in Alaska (-34%) and Kansas (-5%). Among states in the TD footprint, collections were lower in New Hampshire (-3.5%), New York (-2.2%), North Carolina (-1.6%), Virginia (-1.1%), Maine (-1.0%), and Connecticut (-0.3%).

Economic indicators rarely move in straight line, but state tax collections are especially volatile. Income taxes, in particular, exhibit high sensitivity to changes in tax policy and business cycles and thus are prone to surprises – something that happened this year. More than half of the states saw their personal income tax revenues edge lower this year. Those that posted the largest gains in the previous year – such as California, North Dakota, New Hampshire, South Carolina, Mississippi, Iowa and Minnesota – experienced the biggest declines. Some of the blame for this unpleasant surprise rests with the unanticipated pullback in economic activity in the first quarter of calendar 2014. But, it also





highlights the ongoing challenges that many state officials face in forecasting corporate and personal income taxes, which now account for a larger share of total receipts than they did historically, and also rely on an ever-volatile investment income to a greater extent.

While the latest revenue shortfall created short-term budgetary challenges for state fiscal planners, it should not be viewed as a sign of renewed economic troubles. Employment and GDP growth – two metrics which presage prolonged revenue declines – remain solid (see Chart 2). After a brief setback at the start of the year, the U.S. economic engine has kicked into higher gear with real GDP growth averaging 4.2% in the second and third quarters. National payrolls are also adding jobs at a healthy clip. Since the beginning of the year, the economy has created over 2.5 million new jobs – the highest tally since 1999. Finally, the revenue slowdown was limited to the categories most exposed to federal tax changes[i] – personal and corporate income taxes. General sales tax revenues improved, posting their best result since FY2011 at 4.7%.

All told, the latest weakness in the tax numbers is largely a result of an unusually strong base year effect from a one-off policy change and an economic contraction at the start of the year. Looking through these temporary factors, incoming data suggests that the economic backdrop remains solid and tax revenues should turn higher.

Revenues have generally recovered in nominal terms

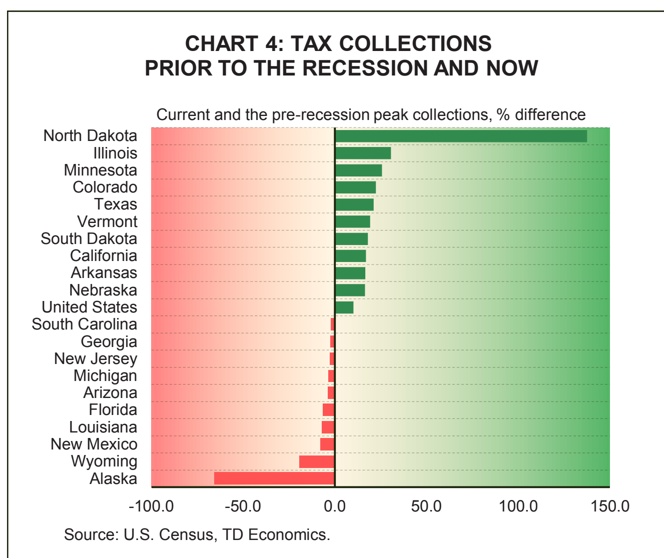
From a longer term perspective, FY 2014 marked the fourth consecutive year of gains in state tax receipts. In ag-

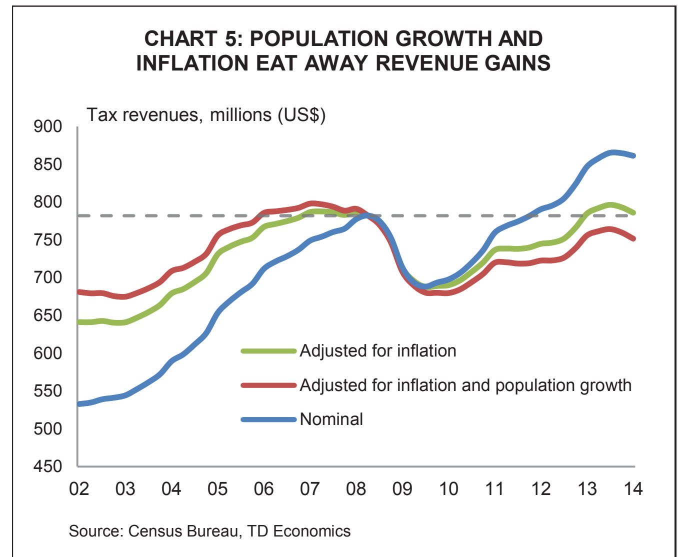
gregate, tax receipts are now 10% above their pre-recession peak in nominal terms and 0.5% higher in inflation-adjusted, or real, terms. The revenue recovery to-date has been led by sales and personal income tax categories. Progress has been slower on the corporate income tax side, which remains 14% below its pre-recession high (see Chart 3).

Regionally, fiscal performances are a mixed bag (see Chart 4 and Table B in Appendix). While in most states, tax collections have recovered to their pre-recession peaks, in fifteen states nominal tax collections are still catching up. Six of these – Florida, Georgia, South Carolina, New Jersey, New Hampshire, and Virginia – are in the TD footprint.

Three features tend to characterize states with lagging tax revenues: underperforming labor markets, a lack of diversity in tax streams, and the absence of tax rate increases. With the exception of Utah, Alaska and Louisiana, employment remains below its pre-recession level in the remaining twelve states either because they experienced worse-than-average recessions (Florida, Georgia, South Carolina, Arizona) or because their job creation has failed to keep up with the national rate (New Jersey, Virginia, New Hampshire, New Mexico).

Revenue weakness is exacerbated in states that do not levy certain types of taxes. For example, Florida and Wyoming do not levy income taxes, while New Hampshire and Alaska do not impose either income taxes or sales taxes. Lastly, a majority of the above states have chosen not to enact significant tax measures to boost collections (Georgia, South Carolina, Virginia, Wyoming, Ohio, New Mexico, Arizona, Ohio, Michigan, Louisiana).



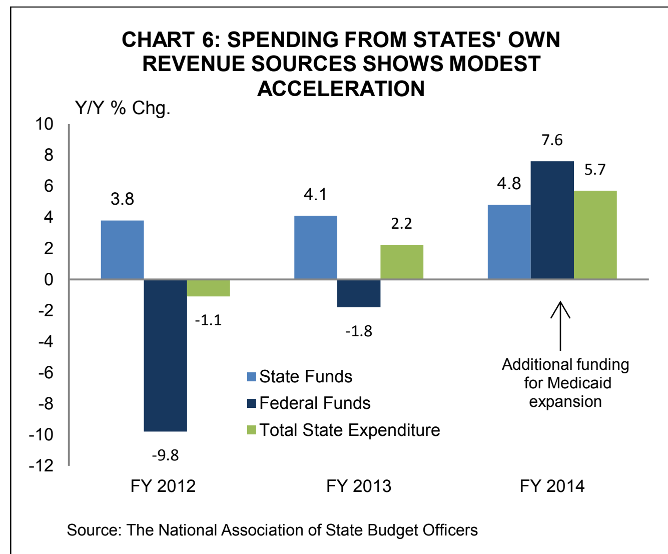


Adjusted for population growth, revenues are still not what they used to be

The calculus gets more somber after adjusting tax revenues for population growth. Aggregate real per-capita tax collections are still 4% below their 2008 peak (see Chart 5) and remain below their pre-recession levels in a whopping forty two states. In other words, most states still operate with less real per capita tax revenue than they did prior to recession (for details, see Table B in Appendix). The gaps are particularly wide in states with faster population growth, such as Florida, Georgia, South and North Carolina, and Virginia, ranging from 17% in North Carolina to 26% in Florida. This helps to explain why spending increases continue to be measured (see Chart 6), and are generally concentrated in priority areas such as education and transportation.

Nonetheless, even in priority areas such as education, recent increases have not been sufficient to offset cuts incurred in past years. According to a report by the Center on Budget and Policy Priorities, at least 30 states are providing less inflation-adjusted funding per school student for the 2014-15 school year than they did before the recession.[1] Most states are also spending less in real terms on higher education, which prompted widespread tuition increases.[2]

Only eleven states have seen revenues recover to the level consistent with population growth and inflation. New York and Vermont have made the cut, thanks to slow population growth, and, in the case of New York, a relatively fast recovery in employment. Ditto for Texas and North Dakota, where the booming oil industry has benefited both state coffers and the labor market. Still, even in relatively well-



off and quickly-growing Texas, real revenues are only 0.6% above their pre-recession peak in population adjusted terms. California and Colorado are also on firm ground. Both have enacted tax increases to boost collections and also benefited from stronger-than-average employment growth.

Update to states' near-term fiscal vulnerability index

To reflect recent fiscal developments, we updated the TD Near-Term Fiscal Vulnerability Index, which conveniently ranks states based on their near-term indicators of fiscal health. These indicators include recent tax revenue performances, budgetary balances, the deviation of unemployment from its long-term trend, and the growth rate of home prices.

The good news is that overall vulnerability continued to recede in the second half of fiscal 2014, reflecting ongoing improvements in the broad economy. However, due to decelerating home price growth and falling tax collections, the headline index remained relatively flat compared to the first half of the fiscal year.

There was also fairly little movement at the top and bottom of the index (for details see Table A in Appendix). Eight out of ten states facing the most near-term fiscal challenges and seven out of ten best-ranked states remained unchanged relative to our previous release. Alaska, Nevada, Rhode Island, Connecticut, Arizona, New Jersey, and New Mexico remained among the worst-ranked states. This seeming lack of changes captures the lingering impact of the recession in some states (Conn., N.J., R.I., Nev., Ariz.) and revenue exposure to the resource sector (N.M. and Alaska) in others. The relative ranking within the worse-performing group have changed slightly: Connecticut and New Jersey fared a tad worse as job growth has disappointed this year, while Arizona and New Mexico saw a slight improvement. Virginia and Ohio were new additions to this unenviable list.

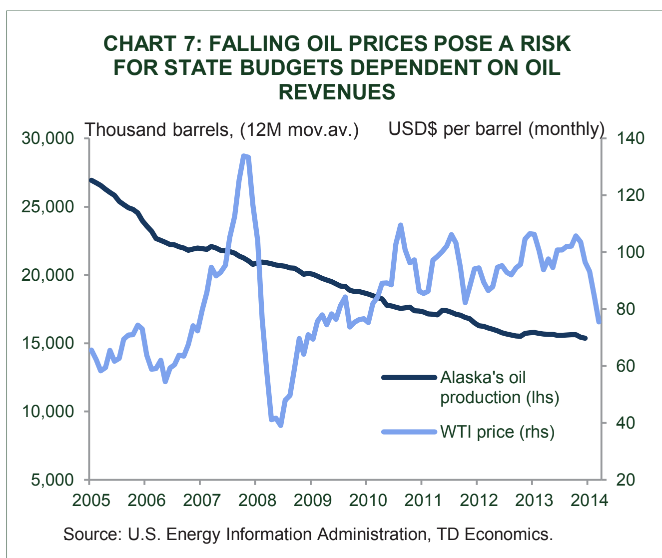
A drop in tax collections and underperforming labor market were behind the significant deterioration of Virginia's ranking. Virginia's unemployment rate has crept up during much of 2014, reversing some of the earlier improvements. Job creation has also struggled this year as the legacies of sequestration continued to weigh on a federal contract-dependent economy. Ditto for neighboring Maryland, whose ranking also tumbled. Meanwhile, income tax cuts hindered collections and rankings of Ohio, North Carolina and Kansas. On the brighter side, fiscal fortunes improved in Florida and Michigan and the duo has dropped out from the list of the worse-performing states. That being said, nominal revenues still remain below pre-recession level in both states, meaning that their vulnerability is still quite high.

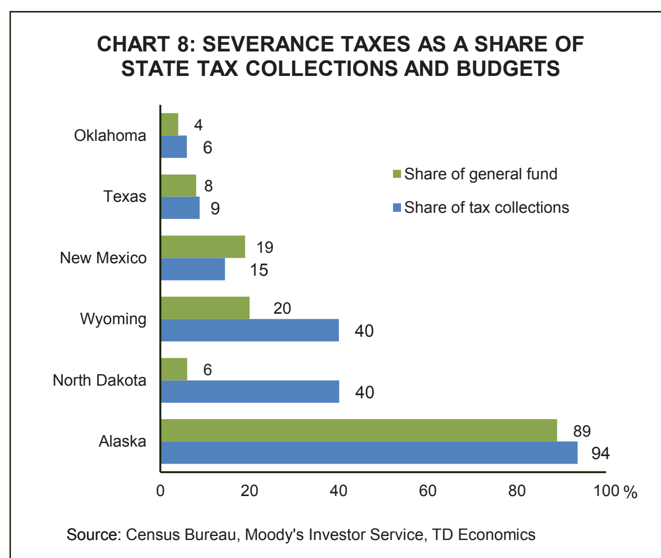
On the flip side, the resource-rich North Dakota, Texas, and Colorado continued lead the ranks of the best-rated states. New additions to this list most recently included Vermont, Massachusetts and Washington, which all had a relatively solid year in terms of tax collections and have also benefited from the full recovery in their revenue streams. Other states which saw upgrades were West Virginia, Delaware, Kentucky, and Oklahoma. While New York's tax collections have disappointed this year, the Empire State was able to retain its high rating thanks to steady job gains this year and fast recovery in its revenues. This year's upgrade of N.Y. general obligation debt by several credit-rating agencies also speaks to N.Y.'s much-improved fiscal position.

Low oil prices – another source of potential vulnerability for some states

Alaska and North Dakota are both resource-rich states; however their ranking in our fiscal vulnerability index could not be further from one another. While North Dakota continues to be the best-ranked state, Alaska once again got the last spot. So, what sets those two states apart? Unlike North Dakota, where oil production has surged as its shale supplies came online, Alaska's oil production peaked in 1987 and has been on a downward trend ever since. Elevated oil prices helped to limit the pressure on Alaska's finances, but the dramatic decline in oil prices has once again brought the state's vulnerability the forefront (see Chart 7).

With revenues from the resource sector accounting for





89% of Alaska's general fund budget, tax receipts have already declined for the past two years, and are down 66% from their peak in 2008, when oil prices hit a record-high. Fortunately, the state had also amassed the largest reserves – equivalent to roughly two years' worth of operating expenses – which should help shield its budget from near-term shortfalls. Still, with oil production and prices on a downward trend, there is little near-term upside to Alaska's finances. In January 2014, Alaska's government enacted new tax incentives for oil companies, meant to revive drilling activity and oil production; however, soft energy prices could derail those hopes.

While Alaska's budget clearly stands to lose the most from falling oil prices, this is also a relevant issue for other states whose budgets benefit from taxes on non-renewable resources (also known as severance taxes), such as Texas, North Dakota, Oklahoma, Wyoming, New Mexico, and a few others. Aside from Alaska, the budgets of Wyoming and New Mexico have the highest reliance on revenues from natural resources, which account for 20% and 19% of their respective general fund budgets (it is less than 10% in the rest of the above-mentioned states) (see Chart 8). North Dakota, Texas and Wyoming have accumulated sizeable rainy-day funds, which would help them weather the near-term weakness in oil prices. However, should the weakness persist for a considerable time, it could lead to a slowdown in production and investment in shale plays found in Texas and North Dakota, posing a headwind to their economic expansion. New Mexico and Oklahoma have fairly modest cushions, with reserves equal to 7.2% and 8.3% of their operating budgets. Should oil prices dip lower, this buffer may prove to be insufficient, particularly for New Mexico's budget, which is more reliant on oil revenues.

On the other hand, the budget of Pennsylvania – another state benefitting from the shale revolution which became the nation's third largest energy producer – should be mostly shielded from the slowdown in oil prices. For one, extraction activity in the Marcellus shale is largely related to drilling for natural gas. Since dry gas prices are not closely correlated with oil prices, being determined mostly by domestic rather than global demand, lower oil prices should not be detrimental to drilling activity. Secondly, the state does not levy a severance tax, further limiting any potential downside to state coffers from falling energy prices or production.

Tax cuts undermine collections in some states

Another factor that has impacted the fiscal health of states is the introduction of tax cuts. Kansas and North Carolina are two examples of this. Both states implemented tax cuts and have seen their revenues decline this year. Tax cuts in Kansas were particularly ambitious. The state reduced personal income tax rates and eliminated tax on small businesses, such as sole proprietorships. As a result, after rising by a modest 2.1% in the prior fiscal year, income tax collections tumbled by 15.5% this year – far larger than the 2.2% drop seen nationwide – leaving total receipts 5% lower than last year.

After raising taxes for six years, many state governments are now contemplating lowering tax rates. In fiscal 2014, states passed a total of $2.1 billion worth of tax cuts. In fiscal

2015, proposed tax reductions will lower revenues by $2.5 billion. The above two examples should serve as a cautionary tale. The reality is that in real population-adjusted terms tax collections are still below their pre-recession levels in most states. This means that most state coffers have less real per capita revenue than they did prior to the economic downturn. In this environment, any tax cuts should be carefully considered, as the decline in revenue may require additional cuts in program spending or ongoing efficiencies to be found.

Bottom Line

It has been years in the making, but governments will cease to be a drag on U.S. growth over the next several years. Inflation and population growth have eaten away some of the gains in revenues, which were particularly modest in fiscal year 2014, but tax collections will continue to improve alongside strengthening private-sector growth.

Underneath the surface there remains considerable variation. States that are have the least vulnerability are those that benefited from fast employment recovery or where revenue recovery has been helped along through additional revenue measures. It also includes states which benefited from the shale oil boom, however, the recent fall in commodity prices may present new challenges for states most-linked to extractive industries.

On the other hand, the most vulnerable states have been harder-hit during the recession, experienced weaker job growth during the recovery, or have less diversity in their tax streams.

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Appendix

Table A: Near-Term Vulnerability Scorecard (From Worst to Best)				
Rank in 2013Q4	Rank in 2014Q2	State	Index value in 2014Q2	Change in rating
1	1	Alaska	74.2	0
2	2	Nevada	56.5	0
3	3	Rhode Island	54.3	0
7	4	Connecticut	53.4	-3
4	5	Arizona	53.4	1
8	6	New Jersey	52.8	-2
5	7	New Mexico	52.4	2
10	8	Alabama	52.3	-2
20	9	Virginia	51.7	-11
15	10	Ohio	51.3	-5
6	11	Florida	51.0	5
16	12	Mississippi	50.8	-4
25	13	Maryland	50.8	-12
9	14	Michigan	50.8	5
29	15	Wisconsin	50.6	-14
11	16	New Hampshire	50.3	5
17	17	Georgia	50.0	0
18	18	Missouri	50.0	0
13	19	Pennsylvania	49.9	6
22	20	Illinois	49.8	-2
12	21	Delaware	49.3	9
19	22	Maine	48.8	3
14	23	Kentucky	48.6	9
30	24	North Carolina	48.6	-6
27	25	Kansas	48.4	-2
21	26	Tennessee	48.4	5
24	27	Idaho	48.2	3
32	28	Indiana	48.0	-4
43	29	Arkansas	48.0	-14
23	30	Wyoming	47.5	7
31	31	Montana	47.1	0
37	32	Oregon	46.9	-5
26	33	West Virginia	46.8	7
41	34	Iowa	46.7	-7
33	35	South Carolina	46.6	2
35	36	Hawaii	46.5	1
28	37	Oklahoma	46.0	9
38	38	New York	46.0	0
42	39	Nebraska	46.0	-3
34	40	Massachusetts	45.9	6
36	41	Vermont	45.6	5
45	42	California	45.5	-3
44	43	Louisiana	45.2	-1
47	44	Utah	44.6	-3
46	45	South Dakota	43.9	-1
39	46	Washington	43.8	7
40	47	Colorado	42.8	7
49	48	Minnesota	42.8	-1
48	49	Texas	39.1	1
50	50	North Dakota	35.3	0
		Average	48.7	

Source: TD Economics

Table B: Tax Revenues			
State	FY2014 growth rate, %	Gap (surplus) relative to pre-recession peak, %	Gap (surplus) relative to pre-recession peak, adjusted for population growth, %
Alabama	-0.8	-1.4	-12.4
Alaska	-34.0	-65.9	-71.1
Arizona	3.3	-3.8	-17.6
Arkansas	3.8	16.7	3.3
California	4.7	17.0	1.3
Colorado	5.4	22.5	2.5
Connecticut	-0.3	9.2	-3.3
Delaware	0.4	13.0	-3.1
Florida	4.8	-6.3	-25.7
Georgia	5.9	-2.5	-21.4
Hawaii	-0.2	16.0	-1.0
Idaho	5.5	1.5	-13.7
Illinois	1.2	30.7	17.9
Indiana	2.5	10.3	-1.9
Iowa	-1.2	14.3	1.6
Kansas	-5.0	2.3	-11.9
Kentucky	1.8	9.3	-2.8
Louisiana	8.3	-6.9	-18.7
Maine	-1.0	4.8	-4.2
Maryland	0.4	9.9	-4.4
Massachusetts	3.9	11.7	-2.2
Michigan	-0.5	-3.5	-11.6
Minnesota	0.9	25.7	10.4
Mississippi	2.2	9.6	-1.5
Missouri	0.9	2.9	-8.3
Montana	-0.1	3.0	-9.9
Nebraska	4.1	16.6	-2.2
Nevada	1.3	12.7	-9.7
New Hampshire	-3.5	-1.7	-10.8
New Jersey	2.5	-2.7	-13.3
New Mexico	2.5	-7.8	-25.4
New York	-2.2	15.4	3.4
North Carolina	-1.6	2.1	-16.7
North Dakota	10.6	137.5	93.5
Ohio	-1.6	-2.1	-12.4
Oklahoma	2.2	0.4	-12.7
Oregon	-0.3	11.3	-11.3
Pennsylvania	0.6	6.2	-5.7
Rhode Island	1.2	5.5	-6.5
South Carolina	0.3	-2.3	-19.9
South Dakota	5.0	18.1	1.7
Tennessee	1.0	11.2	-4.2
Texas	5.9	21.2	0.6
Utah	-2.2	-0.3	-21.7
Vermont	3.8	19.3	5.7
Virginia	-1.1	-1.2	-19.6
Washington	4.6	5.2	-13.2
West Virginia	1.1	9.2	-0.4
Wisconsin	-0.9	8.7	-2.8
Wyoming	3.5	-19.4	-30.3
United States	1.7	10.1	-3.9

Source: Census Bureau, TD Economics

Endnotes

i. Federal tax changes refer to an increase in personal income tax and capital gains tax for high income taxpayers, changes in estate tax rate, and the expiration of payroll tax cut which came into effect as a result of the passage of the American Taxpayer Relief Act on January 2, 2013. The Act was passed as a partial resolution to the United States "fiscal cliff". These tax changes induced some taxpayers to shift their income and capital gains into fiscal year 2013, resulting in a temporary surge in income tax collections.

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