OBSERVATION

TD Economics

April 29, 2014

CRUNCHING U.S. STATE TAX NUMBERS

STATE FINANCES CONTINUE TO IMPROVE, BUT ACHIEVEMENTS ARE LESS IMPRESSIVE ONCE POPULATION GROWTH IS TAKEN INTO ACCOUNT

Highlights

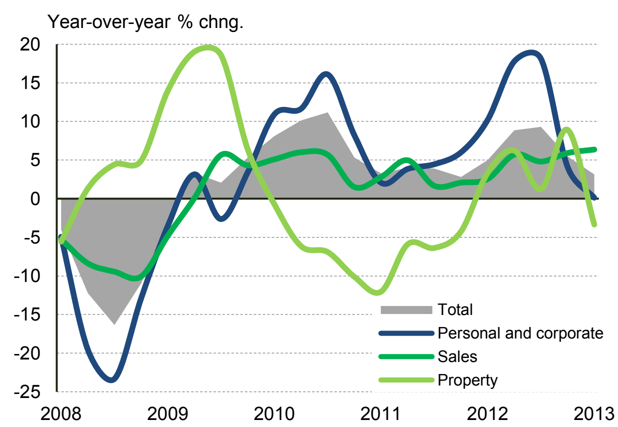
- The U.S. government shutdown delayed the release of the Quarterly Tax Survey of states last year, however both third and fourth quarter data recently became available, offering a complete view on state tax collections in calendar 2013.
- State tax revenues continued to expand through the second half of 2013, however the overall momentum decelerated relative to the first half of the year. Brisk revenue growth at the start of the year was artificially propped up by significant changes in federal and state tax policies.
- For 2013 as a whole, aggregate tax revenues rose by 6.8% from year-ago levels, bringing them 11% above their pre-recession peak.
- Despite this achievement, it is still too early to declare victory. Population growth did not stand still all this time – averaging 0.8% per year since 2009. As a result, tax revenues remain 3% below the level that would be consistent with population growth and inflation.
- Applying this measure, tax collections are behind the curve in all but 16 states. Among states in TD's footprint, the biggest gaps are in Georgia, Florida, South Carolina, New Jersey and North Carolina.

The U.S. government shutdown may seem like a distant memory at this point, but delays in data releases continue to trickle through. The Quarterly Tax Survey of states was one such postponed release. Both third and fourth quarter data recently became available, offering a complete view on state tax collections in calendar 2013.

Tax revenues continued to expand through the second half of the year, advancing by 5.8% in Q3 and 3.1% in Q4; however the overall momentum decelerated from near-9% earlier in the year. Slower growth in personal and corporate income taxes was responsible for the bulk of the slowdown. In particular, year-over-year growth in personal income taxes decelerated from 19% in the first half of 2013, to a mere 2% in the second half.

Although this slowdown seems dramatic, it is not a cause for concern. The initial brisk revenue growth was propped by significant changes in federal tax policy, such as the expiration of the payroll tax cut and the so-called "Bush tax cuts", as well as the introduction of the Medicare surtax. Although these changes were done at the federal level, state-level tax systems are linked

CHART 1: TAX REVENUE GROWTH BY COMPONENT



Source: US Census, TD Economics

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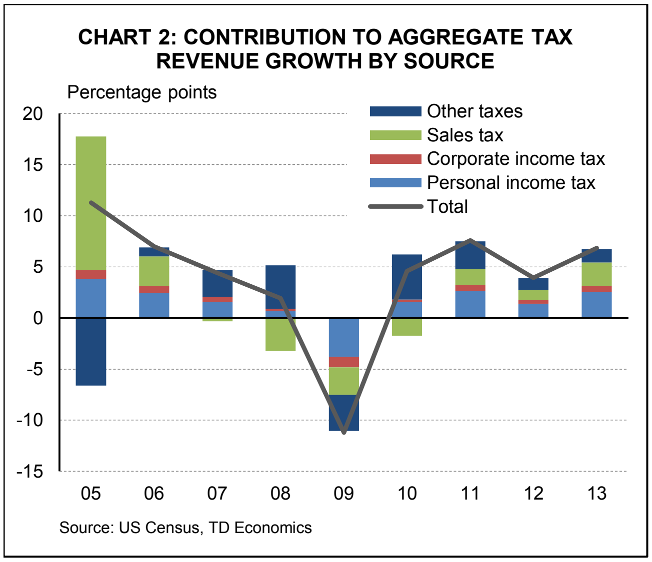

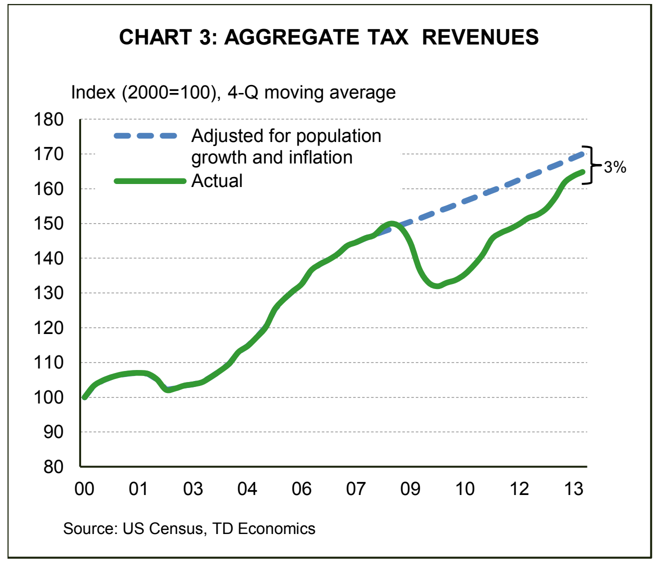

to the federal tax code and thus were also impacted. These changes have induced some taxpayers to use tax planning strategies to limit their exposure by shifting their income and capital gains into the fourth quarter of 2012 (which depressed year-over-year tax revenue growth in the fourth quarter of 2013). In addition, research by the Tax Foundation suggests that in certain cases, taxpayers could also benefit from shifting income forward, which appears to have taken place in the first two quarters of 2013.[1] Thus, the break-neck growth in income tax collections was temporary and recent data reflects this levelling-off.[2] The fact that the slowdown manifested itself on the personal income side, rather than sales taxes, supports this notion.

On top of influences stemming from federal tax policy, there were also notable tax developments in some states. California, which accounts for roughly one-fifth of aggregate personal income tax revenues, is one such example. Last year, voters approved an increase in the personal income tax (PIT) rate for high-income taxpayers, resulting in a 50% y/y surge in PIT collections in the first quarter of 2013.

Looking past the quarterly quirks in the data, on an annual basis, personal and corporate income taxes led the way in 2013, advancing by 11% and 7.7%, respectively. At 5.7%, sales tax receipts grew more moderately, but still delivered their best performance since 2006. Meanwhile, improvements in home prices boosted property tax collections (+2.6%), which increased after two years of declines. Tallying it up, aggregate tax revenues were up 6.8% from year-ago levels (+4.9% if California is excluded), with two-thirds of the gain coming from personal income and sales tax receipts (see Chart 2). Following this latest gain, tax revenues are now sitting 11% above their pre-recession high.

On a regional basis, all but five states posted gains in tax collections last year – a marginal increase from four in 2012. Among the laggards, Alaska experienced the biggest decline at 36% due to lower oil and gas severance taxes. Other under-performers included Connecticut (-2.6%), Wyoming (-1.5%), Kentucky (-0.7%), and New Hampshire (0%). California and Minnesota were on the other side of the coin, leading the way with tax revenues surging by 19% and 15% respectively. Tax increase from high-income earners, which bolstered personal tax collections in both states, were to credit for much of this strength. Other contenders for the top spots included New Jersey (+9.1%), Massachusetts (+8.9%)

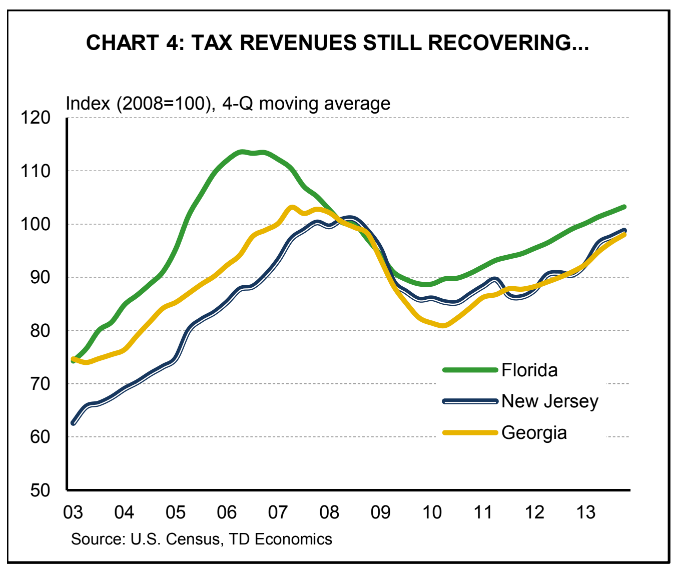

TABLE 1: GAP BETWEEN THE CURRENT LEVEL OF TAX REVENUES AND THE LEVEL CONSISTENT WITH POPULATION GROWTH			
10 LARGEST SHORTFALLS		10 LARGEST SURPLUSES	
STATE	SHORTAGE	STATE	EXCESS
Alaska	-21.6%	North Dakota	+137.5%
Arizona	-20.5%	Illinois	+21.5%
Louisiana	-19.7%	Oregon	+19.7%
Georgia	-19.3%	Minnesota	+14.2%
New Mexico	-17.6%	New York	+9.1%
Idaho	-17.3%	Iowa	+8.8%
Florida	-17.2%	Indiana	+5.6%
Utah	-16.4%	Vermont	+4.9%
South Carolina	-15.9%	Texas	+4.5%
Wyoming	-14.4%	Rhode Island	+3.0%

Source: US Census, TD Economics

and Illinois (+8.6%). Alongside Florida and Georgia, New Jersey rounds out the only three states in TD's Footprint where nominal tax revenues are yet to recover to their pre-recession level (see Chart 4 and Appendix). Therefore, the latest gain in tax collections is a welcome development for the Garden State, and marks the best performance since the onset of the recovery.

Despite this achievement, it is too early to declare victory. Even as personal and sales taxes have fully recovered, both corporate and property tax remain below their prior peaks. Moreover, population growth did not stand still all this time – averaging 0.8% per year since 2009. As a result, tax revenues remain 3% below the level they should have been at if they have kept up with population growth and inflation (see Chart 3).

While nominal revenues recovered to their pre-recession level in all but 11 states, once population growth is taken into account the picture becomes decisively less bright. On that basis, most state governments remain underfunded. Only in 16 states are current tax collections in line or above the level suggested by their population size. Among states in TD's Footprint, these include Massachusetts, Rhode Island, New York, Vermont, Maine and Connecticut, all of which exhibit relatively slow rates of population growth. On the other hand, in faster growing states – such as Florida, Georgia, and South and North Carolina – the gaps are considerable, ranging from 12% in North Carolina to 19% in Georgia (see Table 1). Because of subpar revenue recovery, New Jersey is facing a 14% gap, despite slow population growth.

This analysis helps to explain why, despite considerable improvement in their finances, many states have to continue to maintain a tight grip over spending, particularly when it comes to discretionary items.

On February 11, 2014 we produced a report which discussed state finances in great detail, ranking states according to their fiscal health in the near term and long term using the TD Fiscal Vulnerability Index. The near-term arm of the index takes into account the cyclical (or near-term) measures such as budgetary balances, the gap in unemployment rates from trend rates, growth in home prices, and, last but not least, tax revenue growth. In fact, tax revenues are assigned a 40% weight in the overall index. In light of the newly available data on state tax collection and state unemployment, we have updated the Near-Term State Vulnerability Index (see Appendix).

On a year-over-year basis the headline value of the Near-Term Index improved by 12.4 points (with lower value of index indicating lower fiscal vulnerability). This improvement reflects the cyclical upturn in the broad economy, featuring a declining unemployment rate (-0.8 percentage points y/y), rising property values (+13.2% y/y), strengthening household finances and growth in consumer spending (+2.3% y/y) – all of which are a net positive for state coffers.

The theme of improvement is also apparent across individual states. With the exception of Alaska, all states have seen a reduction in fiscal vulnerability over the past year, even those whose relative ranking remained unchanged or deteriorated. On that note, similar to their performance a year ago, Rhode Island, Nevada, Arizona, Connecticut, Georgia and New Jersey remain among the 10 states which face the most near-term fiscal challenges. The underperforming recovery in labor and housing markets is a common feature among those laggard states. Rhode Island's jobless rate remains 4.1 percentage points above its long-term trend and is the highest in the country. In addition to difficulties in labor and housing markets, some states are facing other challenges. Connecticut, for example, scored poorly in all index subcategories. Tax collections declined by -2.6% y/y, the unemployment rate remains significantly above its long-term trend, home price growth was a mere 1.5% last year, and the state budget balances are low.

Meanwhile, California, North Carolina, Michigan and Florida managed to escape the unenviable top 10 list of most vulnerable states. A 19% gain in tax collections, alongside stronger budget balances, helped California to leap-frog from 3rd to 15th position in our index. In Florida, which does not have an income tax, collections grew more moderately

(+4.1% y/y) and remain 17% below the level consistent with its population growth, however over the past year the Sunshine State did see a significant reduction in its jobless rate, which led to a moderate improvement in its ranking.

Seven out of ten best ranked states remained the same as last year. Oregon, South Carolina and Minnesota were new additions to get the best-in-class status.

Bottom Line

Decelerating momentum in tax revenue growth in the second half of 2013 reflects temporary factors, which buoyed collections at the start of the year. Therefore, some payback was expected to materialize and is not a cause for concern. Going forward, we expect to see continued improvement in state finances, as the economic recovery runs its course. However, in the absence of other major tax policy changes, aggregate tax collections will grow more moderately over the next two years, advancing by 4-5% annually and closely tracking growth in nominal GDP. That rate should prove sufficient for bringing aggregate tax revenues in line with the level consistent with population growth by the end of 2014.

Appendix

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TD Vulnerability Scorecards (as of April, 2014)

Tax Revenues

Rank	State	Y/Y change	From peak	Adjusted for population growth
		%	%	%
1	Alaska	-36.1	-55.0	-21.6
2	Connecticut	-2.6	5.3	1.7
3	Wyoming	-1.5	-20.0	-14.4
4	Kentucky	-0.7	5.8	-5.3
5	New Hampshire	0.0	0.3	-10.5
6	Oklahoma	1.5	-1.0	-10.5
7	Pennsylvania	1.9	7.6	-4.6
8	North Dakota	2.2	124.6	137.5
9	Tennessee	2.6	11.5	-4.3
10	Washington	2.8	2.7	-10.0
11	Missouri	2.8	4.1	-8.3
12	Kansas	2.9	10.7	-2.4
13	Alabama	3.0	1.8	-11.3
14	Delaware	3.0	12.1	-4.9
15	Maine	3.1	6.6	0.9
16	Virginia	3.5	4.7	-11.5
17	Hawaii	3.7	16.0	-2.3
18	Arizona	3.9	-5.4	-20.5
19	Iowa	4.0	17.3	8.8
20	North Carolina	4.0	5.0	-12.1
21	Florida	4.1	-9.0	-17.2
22	Wisconsin	4.2	12.3	1.9
23	Maryland	4.2	6.7	-0.7
24	West Virginia	4.2	13.4	-2.4
25	Michigan	4.3	-1.9	-6.9
26	New Mexico	4.5	-8.0	-17.6
27	Vermont	4.6	14.2	4.9
28	New York	4.7	17.6	9.1
29	Ohio	4.8	1.8	-5.2
30	Mississippi	5.3	9.4	-1.0
31	Idaho	5.4	-1.8	-17.3
32	Arkansas	5.7	14.7	2.2
33	Texas	5.9	18.2	4.5
34	Utah	6.1	3.5	-16.4
35	Nebraska	6.1	14.0	-2.1
36	Colorado	6.3	17.7	-2.4
37	South Carolina	6.3	0.0	-15.9
38	South Dakota	6.5	16.6	0.9
39	Indiana	6.6	10.5	5.6
40	Rhode Island	6.8	9.2	3.0
41	Montana	7.3	5.0	-6.3
42	Georgia	7.6	-4.6	-19.3
43	Nevada	8.1	12.3	-5.2
44	Oregon	8.2	13.0	19.7
45	Louisiana	8.5	-8.6	-19.7
46	Illinois	8.6	35.0	21.5
47	Massachusetts	8.9	12.9	1.6
48	New Jersey	9.1	-1.5	-13.7
49	Minnesota	14.9	29.9	14.2
50	California	18.6	15.1	-2.1
	US Aggregate	6.8	10.9	-3.0

Source: TD Economics

Near-Term Vulnerability Scorecard (From Worst to Best)

Rank 2013Q4	Rank 2012Q4	State	Index 2013Q4	Y/Y change
			Points	Points
1	2	Rhode Island	67.5	-7.7
2	1	Nevada	65.3	-18.0
3	6	Connecticut	59.1	-9.1
4	9	Arizona	56.1	-9.1
5	12	Illinois	55.9	-7.3
6	5	Georgia	54.9	-16.1
7	47	Alaska	54.8	10.2
8	14	Delaware	54.1	-8.1
9	4	New Jersey	52.9	-18.9
10	21	Kentucky	52.8	-6.6
11	7	Florida	50.9	-17.1
12	19	Tennessee	50.8	-9.3
13	3	California	49.4	-23.5
14	18	Maryland	49.0	-11.5
15	23	Massachusetts	48.9	-9.5
16	8	Michigan	48.2	-18.3
17	34	New Mexico	47.9	-5.2
18	26	Alabama	47.8	-9.0
19	15	Pennsylvania	47.7	-14.5
20	13	Maine	47.7	-14.7
21	24	Virginia	46.8	-11.3
22	28	New Hampshire	46.1	-10.4
23	25	Ohio	46.0	-11.1
24	37	Arkansas	45.9	-5.8
25	11	Indiana	45.9	-17.6
26	27	Wisconsin	45.5	-11.2
27	17	New York	44.4	-16.8
28	33	Missouri	44.1	-9.2
29	22	Mississippi	43.7	-15.6
30	29	Montana	43.6	-12.8
31	35	Colorado	43.4	-9.1
32	42	Hawaii	43.1	-5.0
33	10	North Carolina	42.8	-22.3
34	20	Idaho	42.6	-16.9
35	38	Oklahoma	42.2	-7.9
36	30	West Virginia	40.8	-15.3
37	16	Wyoming	39.3	-22.7
38	32	Washington	37.3	-16.2
39	44	Iowa	36.6	-10.9
40	36	Oregon	36.3	-16.2
41	43	Vermont	35.9	-11.9
42	31	South Carolina	35.5	-19.7
43	39	Minnesota	35.3	-14.7
44	41	South Dakota	35.1	-13.9
45	48	Texas	34.7	-9.2
46	46	Kansas	34.4	-11.5
47	45	Nebraska	34.3	-12.4
48	40	Louisiana	30.2	-18.8
49	49	Utah	29.8	-14.1
50	50	North Dakota	28.9	-0.6
		Average	45.0	-12.4

Source: TD Economics

References

1. Tax Foundation. "How Would Expiration of Bush-Era Tax Cuts Affect State and Local Budgets?" November 2010. http://taxfoundation.org/sites/taxfoundation.org/files/docs/sr187.pdf

2. The Nelson A. Rockefeller Institute of Government. "State Tax Revenues Slip Back to Slower Growth". March 11, 2014. http://www.rockinst.org/pdf/government_finance/state_revenue_report/2014-03-11_Data_Alertv3.pdf