Observation

TD Economics
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AN UPDATE ON STATE TAX REVENUES: Another step forward on a long road

HIGHLIGHTS

- **State tax revenues increased for the third quarter in a row, with a 4.8% year-on-year gain in Q3**
- **Income tax revenues rose by 4.9% y/y; sales revenues rose by 4.4%; corporate taxes were a hair in the red at -0.2%**
- **As long as the economy and the job base continue to expand, so too will the number of states reporting improved tax revenues**
- **However we must curb our enthusiasm with the reality that the patient has moved from the ICU ward to convalescent care – and the road to a full recovery is still long. Revenues remain 29% below pre-recession levels**
- **The updated TD State Vulnerability Index revealed that Connecticut and Maine were knocked out of the near-term top-10 list, replaced by Washington and Colorado**

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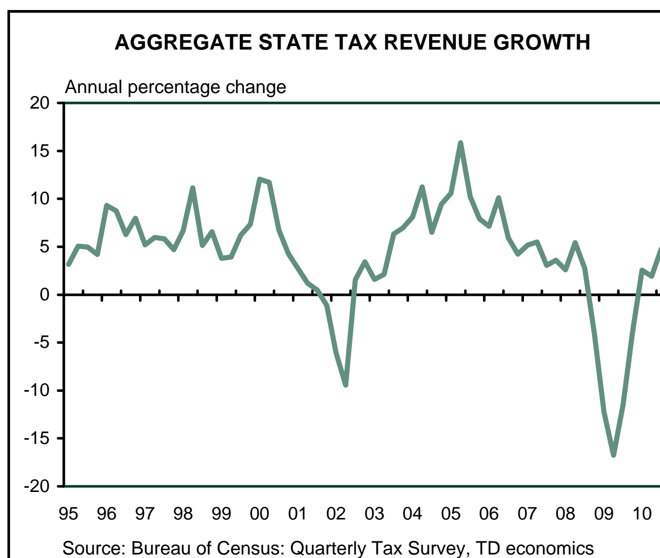
Over the holidays, third quarter U.S. state tax revenue data were released. A 4.8% gain from year-ago levels offered reassurance that state finances remain on the road to recovery. This marked the third consecutive quarter that revenues inched up, which is a trend we expect to remain in place going forward. As long as the economy and the job base continue to expand, so too will the number of states reporting improved tax revenues. In the third quarter, 42 states reported an annual gain in tax revenues, up from 33 states in the prior quarter. Among the laggards, Maryland and Louisiana are having the most difficulty gaining traction within their revenue base. They are the only two remaining states that have yet to see even a single quarter of expanding revenues since the recession caused the initial deterioration. On the flip side, New Hampshire and North Dakota are leading the pack with the strongest recovery in the tax base, with year-to-date tallies already above the peak in 2008. Within TD's Near-term State Vulnerability Index, Connecticut and Maine have dropped out of the unenviable top 10 positions, replaced by Washington and Colorado.

The trend is your friend

Personal income and sales taxes accounted for the bulk of the improvement in the tax base in the third quarter. Income tax revenues rose by 4.9%, nudging out a sales revenue gain of 4.4%. Although the recovery in the job market has been weak, any new job is a direct addition to the income base. As such, we are seeing a smart rebound in income taxes corresponding with the 740,000 jobs that were created in the first three quarters of 2010. This trend will only strengthen in 2011 with an expected 2.7 million jobs added to payrolls. Incorporated in the employment figure is the boost derived from the recent federal tax-cut compromise negotiated between President Obama and Congressional Republicans. We anticipate that the tax cut will increase employment growth by 0.4 percentage points in 2011. Applying a simple rule-of-thumb on elasticities, this additional employment could increase corporate income tax revenue growth by 1.2 percentage points, personal income tax revenue growth by 1 percentage point and sales income tax revenue growth by 0.7 percentage points



Source: Bureau of Census: Quarterly Tax Survey, TD economics

in 2011. However, the Federal-State dynamics are not all in one positive direction. Allowing the full expensing of business investment included in the recent tax-cut agreement is estimated to cost states more than $11 billion over 2 years in lost tax revenue due to the interaction of state and federal tax codes.[1]

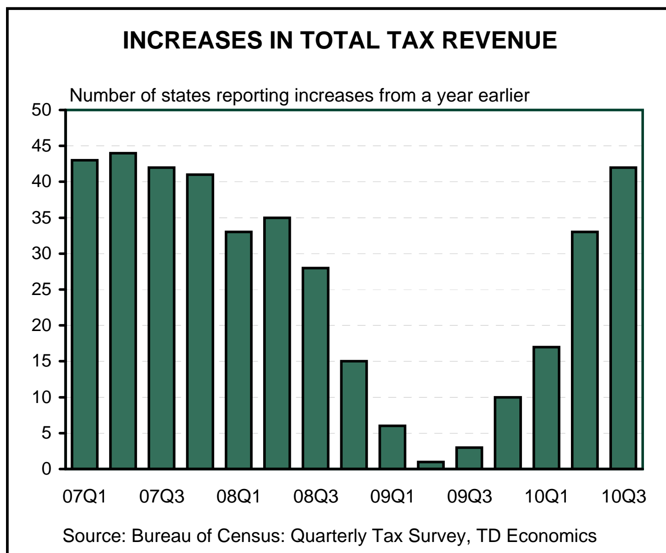
However, this potential loss in corporate revenues will not be sufficient to derail the ongoing improvement in the tax base. Although corporate revenues remained in the red by a hair (-0.2% y/y), the national trend is being largely influenced by tax policy in California. Corporate taxes in California account for one-quarter of the U.S. total for that component. Excluding California from the national tally, corporate taxes are up 7.2%, which is the first year-on-year gain in three years. Two-thirds of the reporting states experienced revenue gains.

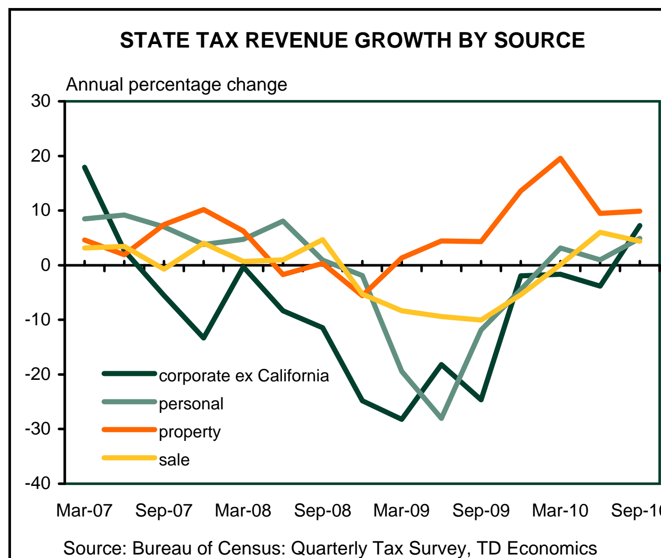
On paper, the strongest revenue gains were seen in property taxes (+9.9%), but that does little to help finance budget gaps for the vast majority of states, because property taxes generate only about 2% of all state revenues.

State finances far from in the clear

The ongoing recovery in state revenues is good news and should help alleviate some investor concern over state debt default risks. As long as the job market continues to expand, even at a slow pace, state revenues will also continue to recover. However we must curb our enthusiasm with the reality that the patient has moved from the ICU ward to convalescent care – and the road to a full recovery is still long.

Revenues remain 29% below pre-recession levels. Because state revenue growth lags real GDP growth – particularly when job growth is tepid – it could be another 2 to 3 years before revenues are restored to their former glory for the majority of states. Following the "jobless recovery" of the 2001 recession cycle, it took two-and-a-half years for aggregate state revenues to return to pre-recession levels and four years before budget gaps ceased to be a material problem. The Center on Budget and Policy Priorities (CBPP) estimates a budget shortfall of $140 billion in FY2012, and the potential for large gaps to persist in 2013 and beyond. The rate of recovery in state revenues takes on increased importance in 2012 as federal aid to help states close funding gaps dries up. About $6 billion will remain after $145-150 billion was shelled out in federal assistance over the FY2009-FY2011 period.





The bottom line is that even as government revenues continue to improve, spending restraint will remain the order of the day, and for the many American families that have experienced a loss of public services, little will likely change on that front.

TD's Vulnerability Index – how are the states stacking up?

On October 27th we produced a report entitled "Nifty Fifty No More" in which we evaluated and ranked the fiscal vulnerability of U.S. states. We have updated that index to reflect the Q3 tax revenue data, while also incorporating new figures on employment and mid-year budget gaps for FY2011. In doing so, 8 of the top 10 states in TD's Near-term State Vulnerability Index remained unchanged, though their relative rankings may have shifted slightly. However, Connecticut and Maine dropped out of the top 10 list, with Washington and Colorado taking their place.

Although Connecticut had to address an unexpected mid-year budget gap, it was relatively small (0.3% of its budget) and the negative impact on its index score was more than offset by a large gain in tax revenues. Connecticut recorded the seventh largest year-over-year increase in total tax revenues (11.9%) in the nation. In particular, personal income taxes rose by 13%, and since this tax base makes up just over half of the state's collection, it offered a welcomed boost. Going hand-in-hand with the tax increase was an improvement in employment.

Likewise, Maine recorded its fourth consecutive quarterly improvement in its tax base – a feat accomplished by only two other states. Moreover, it is one of the few states that saw a large improvement in the unemployment rate relative to the previous quarter, which improved its index value. However, this improvement may prove fleeting since the unemployment rate was greatly influenced by a drop in the labor force, rather than strong employment. If discouraged workers come back into the workforce in the coming months, upward pressure would resume on Maine's unemployment rate.

Among the new entrants to the unenviable top 10 list, Washington and Colorado both recorded small increases in their total tax revenues; however the gains were insufficient to offset deterioration in other areas. Washington had to address a $1.1 billion mid-year budget gap, equaling 7.1% of its budget. On top of that, the unemployment rate trended up, flagging increased slack in the local economy. Similarly, Colorado had to address a $257 million mid-year budget gap, amassing to 3.6% of its budget. This too occurred alongside an upward push in its unemployment rate.

As we detailed in the Nifty Fifty No More report, the near-term (or cyclical) factors impacting state finances should continue to improve alongside the economy. However, this index carries a smaller weight in the aggregate vulnerability index, which also incorporates long-term indicators like underfunded pension and health obligations. These are indicators of financial vulnerability for which there are no quick fixes and where economic hardships from the recession will mark the financial landscape far beyond the economic recovery. Since there were no updates to the variables on the long-term index, updating the overall vulnerability scorecard reveals little change in the top 10 states, with only minor shifts in rankings. For instance, Rhode Island and New Jersey traded places for the 2nd and 3rd worst positions – but the margin of difference between the two is razor thin. Likewise, California was bumped out of the top 10 list by Arizona, which had the worst mid-year budget gap to emerge relative to the size of its total budget. However, we all know that California is no starlet in this area either.

For details on the implication of these rankings and for how near-term funding shortfalls have impacted the long-term obligations of states, please see the "Nifty Fifty No More" report.

Appendix

Overall Vulnerability Scorecard (From Worst to Best)		
Rank	States	TD Index
1	Illinois	90.3
2	Rhode Island	82.5
3	New Jersey	82.2
4	Nevada	81.6
5	Connecticut	77.4
6	South Carolina	75.3
7	Kentucky	75.2
8	Massachusetts	71.8
9	Hawaii	70.7
10	Arizona	69.9
11	California	68.7
12	Colorado	68.4
13	Louisiana	64.8
14	Kansas	64.5
15	Maine	64.4
16	Oklahoma	63.7
17	New Hampshire	62.7
18	Michigan	61.4
19	Alaska	60.7
20	Mississippi	60.3
21	West Virginia	59.9
22	Oregon	59.0
23	Alabama	56.5
24	Vermont	55.4
25	Pennsylvania	54.8
26	Missouri	53.7
27	Indiana	52.8
28	Washington	52.7
29	Minnesota	52.5
30	New York	52.2
31	Maryland	51.8
32	New Mexico	51.0
33	Florida	50.6
34	Georgia	48.5
35	Utah	47.5
36	Texas	45.0
37	North Carolina	44.3
38	Ohio	43.6
39	Montana	43.6
40	Delaware	41.8
41	Wisconsin	41.7
42	Virginia	41.2
43	Iowa	40.2
44	Arkansas	39.2
45	Nebraska	38.7
46	Idaho	36.8
47	Wyoming	36.5
48	Tennessee	35.6
49	South Dakota	34.1
50	North Dakota	22.3
Source: TD Economics		

Near-Term Vulnerability Scorecard (From Worst to Best)		
Rank	States	TD Index
1	Arizona	100.0
2	Nevada	97.2
3	Illinois	75.9
4	California	75.0
5	New Jersey	72.3
6	Florida	61.7
7	Washington	59.0
8	Rhode Island	58.2
9	Colorado	57.4
10	Georgia	56.9
11	Connecticut	56.7
12	Maine	55.9
13	Louisiana	54.9
14	Oregon	53.7
15	North Carolina	53.5
16	Vermont	52.4
17	South Carolina	52.4
18	Oklahoma	51.5
19	New York	51.2
20	Mississippi	46.0
21	Missouri	45.9
22	Wisconsin	45.4
23	Minnesota	45.3
24	New Hampshire	44.7
25	Michigan	43.8
26	Delaware	43.3
27	Iowa	41.8
28	Kansas	41.4
29	Hawaii	41.2
30	Alaska	40.6
31	Maryland	40.5
32	Pennsylvania	40.4
33	Utah	40.0
34	Kentucky	38.9
35	Virginia	38.6
36	Idaho	36.6
37	Texas	35.7
38	Massachusetts	34.8
39	Ohio	34.6
40	New Mexico	33.8
41	Alabama	32.1
42	Indiana	31.3
43	Wyoming	29.9
44	Tennessee	29.9
45	South Dakota	27.2
46	Nebraska	25.7
47	Arkansas	25.4
48	West Virginia	21.5
49	Montana	14.9
50	North Dakota	2.5
Source: TD Economics		

Endnotes

1 "States Continue to feel Recession's Impact", Center on Budget and Policy Priorities, December 16, 2010.

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