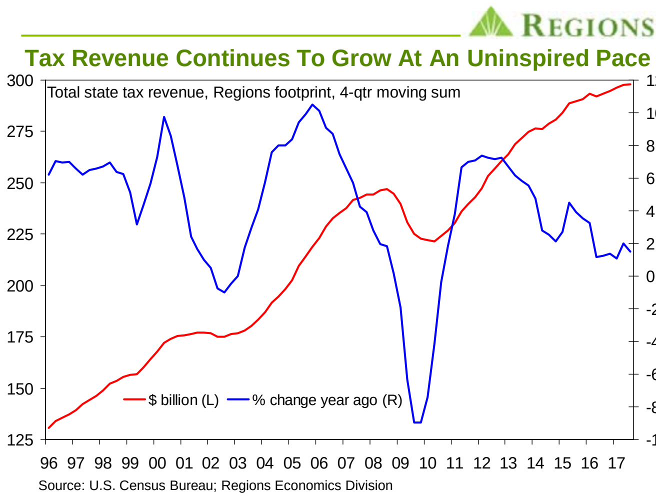
ECONOMIC UPDATE

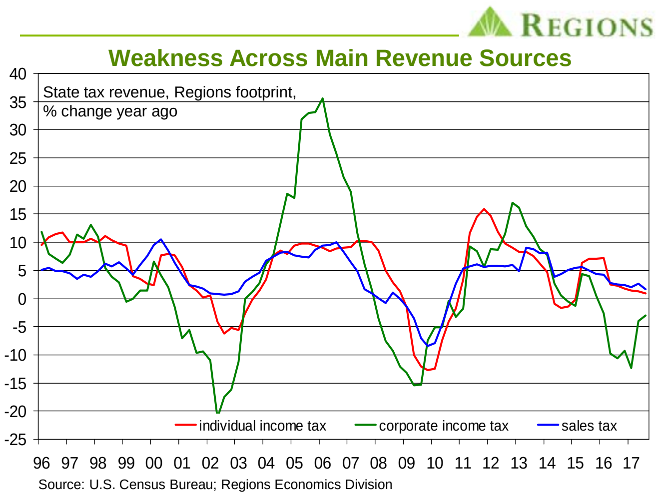
REGIONS

January 2018

Q3 2017 State Government Finances: Regions Footprint

Q3 data on state government tax revenue show continued moderate growth in state tax collections, with markedly divergent paths for different revenue sources. Total state tax revenue for the U.S. as a whole was up 2.4 percent year-on-year in Q3, slightly below the 2.6 percent growth in Q2. For the Regions footprint as a whole, total state tax revenue grew at a year-on-year rate of just 0.14 percent in Q3, the weakest performance since Q2 2016. For an economic expansion now in its ninth year, middling growth in state tax revenue is an increasing concern on multiple fronts. A steadily rising share of state government spending being diverted to transfer payments to individuals crowds out state government spending on goods and services in a revenue constrained environment, and what in many states are growing unfunded pension obligations make it critical that states find expanded revenue streams at some point in the near future. That the current economic expansion is closer to its end than its beginning only compounds these concerns.





Given the strong seasonal patterns in the data on state tax collections, we find it more useful to look at the data either on a four-quarter moving sum basis, as over any such period the conflicting seasonal patterns for the most part offset each other, or on a year-to-date basis. The first chart above shows growth in the four-quarter moving sum of aggregated state tax collections for the Regions footprint as a whole. As of Q3, the four-quarter moving sum of total tax revenue stood 1.51 percent above the year-ago level, in line with growth over the past several quarters. As seen in the second chart above, growth in each of the three main components of total tax revenue remains weak, with corporate income tax revenues down year-on-year in each of the past seven quarters. In Q3, the four-quarter moving sum of personal income tax collections for the Regions footprint as a whole was 0.96 percent above its year-ago level, while the four-quarter moving sum of sales tax collections was up 1.7 percent year-on-year.

In one sense, persistently tepid growth in state government tax collections is not surprising given that the current economic expansion, while soon to become the second longest on record, is also the slowest on record. One way to think about this is that the tax base has grown at a frustratingly slow pace over the course of the current expansion, hence the same would be expected of tax revenue. That, however, is not a totally satisfying explanation, as tax collections in some of the strongest segments of the economy are not significantly outperforming tax collections in other, slower growing, segments of the economy. For instance, though corporate profits have turned in a stellar performance over the current expansion, the same is clearly not the case for corporate tax revenue, at least on the state level. Just as there are differences in the performance of various segments of the economy to which tax revenues are tied, there are clearly differences, in some cases material differences, in the performance of the economies of the individual states that comprise the Regions footprint. In what follows, we will provide a brief state-by-state summary of trends in state government tax collections, focusing on changes in revenue collections on a year-to-date basis through Q3.

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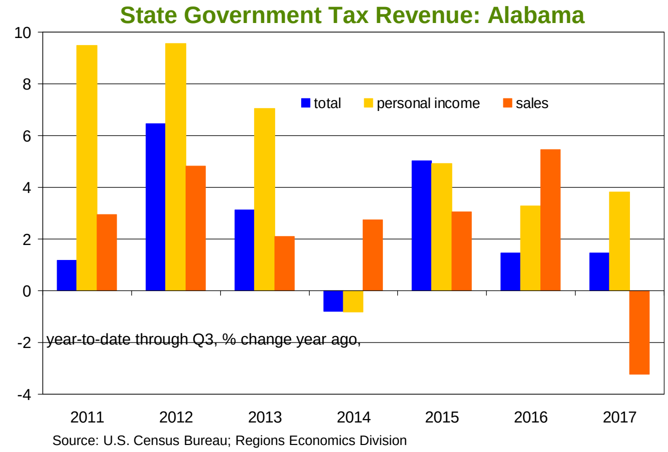
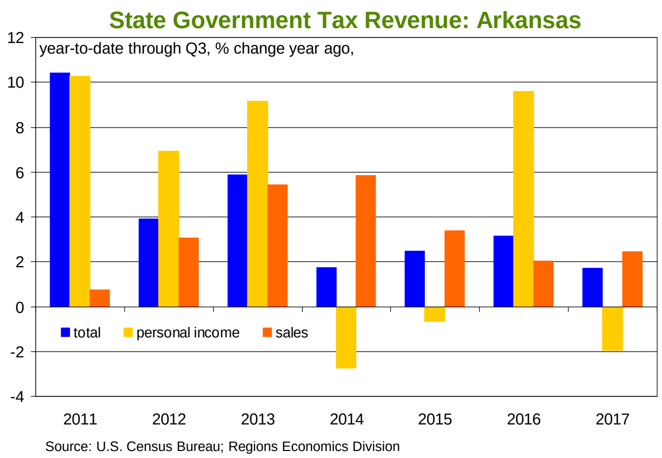
Alabama: On a year-to-date basis through Q3, total tax revenue in Alabama was up 1.46 percent compared to the first three quarters of 2016, compared to 1.39 percent for the Regions footprint as a whole and 2.67 percent for the U.S. as a whole. Using a 4-quarter moving sum as our basis of comparison, as of Q3 total tax revenue in Alabama was up 2.26 percent year-on-year. Growth in individual tax revenue has picked up in 2017, up 3.83 percent year-to-date through Q3. This reflects better job growth in the state in 2017 – preliminary data show 2017 to be the best year for job growth in the state since the end of the 2007-09 recession. At the same time, hourly earnings growth in 2017 has also been materially better than in recent years. Corporate income tax revenue is up 23.94 percent on a year-to-date basis through Q3, but the dollar amount is so small and accounts for such a minor share of total state tax revenue that the increase seen to date in 2017 has had little impact on overall state tax revenue. Sales tax revenue collections in Alabama are down 3.22 percent year-to-date through Q3. Even given the challenging environment for sales tax collections in every state – continued goods price deflation and a higher incidence of online shopping that may not be fully accounted for in state sales tax revenue collections – the weakness in Alabama's sales tax revenue in 2017 is notable, though it does follow steady growth over the prior three years.



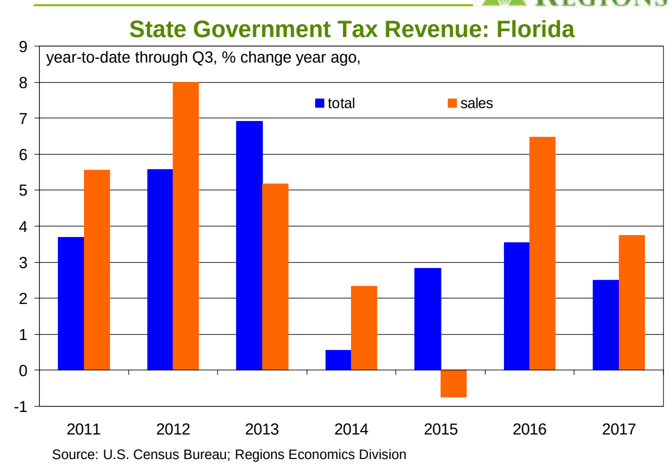
Source: U.S. Census Bureau; Regions Economics Division

Arkansas: On a year-to-date basis through Q3 2017, total tax collections were up by 1.70 percent relative to the first three quarters of 2016. While personal income tax collections were down by 1.94 percent on a year-to-date basis, sales tax collections were up by 2.45 percent and growth in total tax revenue was also aided by higher gasoline tax and severance tax collections. It is worth noting, however, that the dip in personal income tax revenue in Arkansas to date in 2016 comes on the heels of nearly double-digit growth in 2016 when the state cut personal income tax rates as well as capital gains taxes. As job growth in 2017 ran just above 2016's pace while growth in hourly wages has slowed modestly, the downturn in personal income tax collections in 2017 is a natural pullback from the strength seen in 2016 as opposed to an indication of a tailing off of the pace of economic activity. Growth in sales tax revenue in Arkansas was right in line with the U.S. average on a year-to-date basis through the first three quarters of 2017.



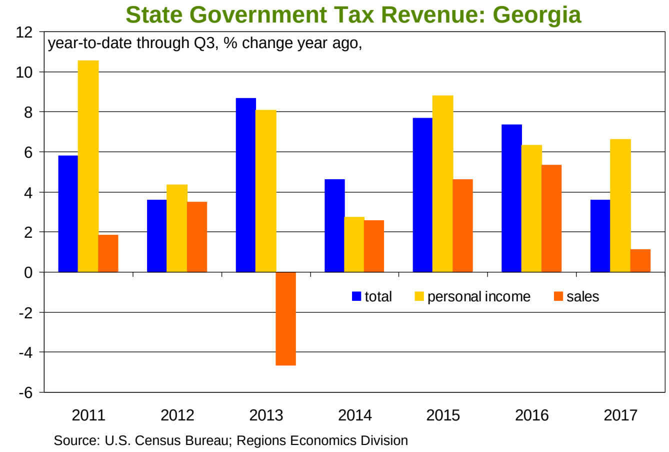
Source: U.S. Census Bureau; Regions Economics Division

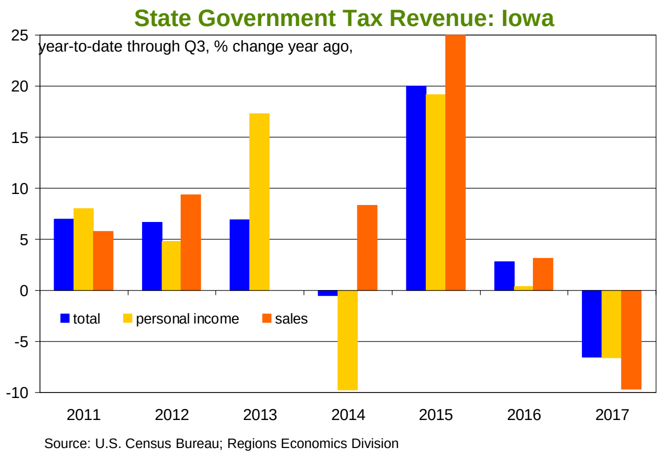
Florida: Total tax collections in Florida over the first three quarters of 2017 were up by 2.51 percent over the same period of 2016. Keep in mind that Florida has no personal income tax. As such, at just over 58 percent of total tax revenue through the first three quarters of 2017, sales taxes are a more important source of overall tax revenue than is the case in most other states. On a year-to-date basis through Q3, sales tax collections in Florida were up by 3.75 percent over the same period of 2016, and note from the chart how strong sales tax collections were in 2016. The Sunshine State has also seen steady growth in corporate tax revenue collections over recent years, even if this is a relatively small share of total tax revenue. Florida is one state in the Regions footprint that could potentially benefit from recent changes in the federal tax code, as the provision to cap the deduction for state and local taxes could lure even more people and small businesses to the state. To the extent this does happen over coming quarters/years, it will act to make an already solid tax base even more so.



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

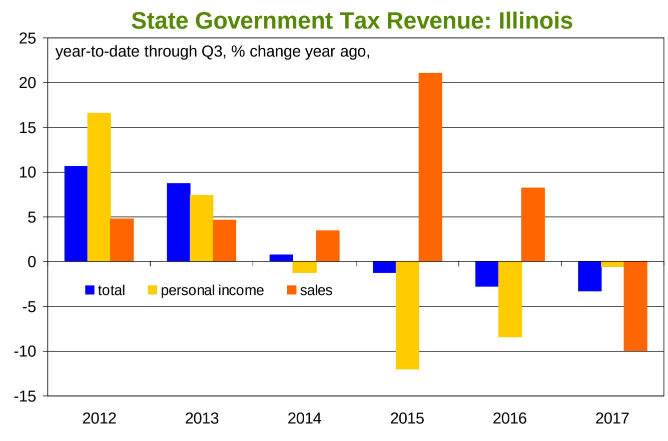
Georgia: On a year-to-date basis through Q3 2017, Georgia had seen total tax revenue collections rise by 3.58 percent relative to the same period of 2016, coming on the heels of two consecutive years of rapid growth in tax revenue collections. Strong job growth and even stronger growth in hourly earnings have sustained robust growth in personal income tax collections, which were up 6.62 percent year-to-date through Q3 2017. Sales tax collections are running just 1.13 percent ahead of 2016's pace, but 2016 was the strongest post-recession year for sales tax collections in Georgia so any growth in 2017 comes off of that base. Georgia has also seen moderate but steady growth in corporate income tax revenues. Above-average growth in a highly diversified economy along with the state's healthy demographic trends have resulted in healthy state finances, and Georgia is building up a sizeable "rainy day" fund as a buffer against an economic downturn.



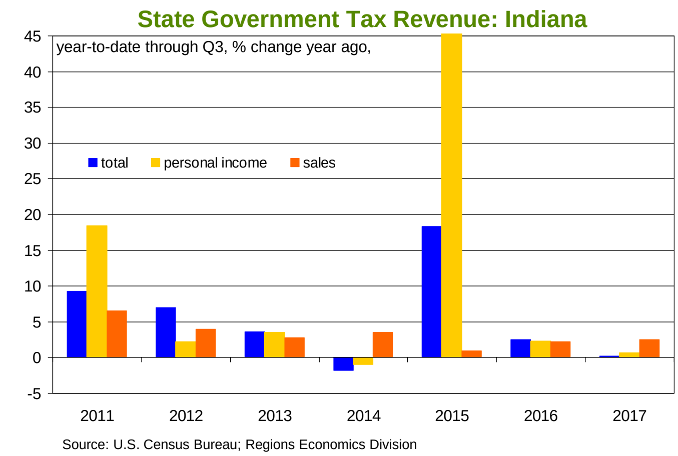


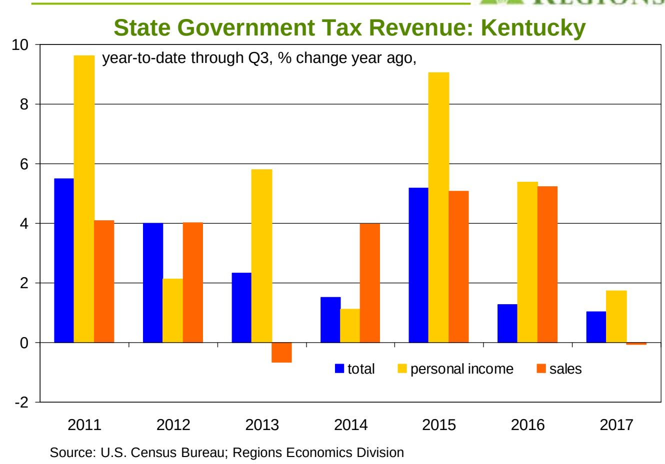
Iowa: 2017 is shaping up to be a notably weak year in terms of state government tax revenue, with total revenue down 6.53 percent on a year-to-date basis through Q3 2017. Personal income tax collections are running 6.62 percent below 2016's pace through Q3, with sales tax revenues down a whopping 10 percent. Miniscule growth in payrolls and basically flat hourly earnings have helped dampen personal income tax collections, and ongoing weakness in agriculture income has been felt across that state's tax structure. There is considerable discussion in Iowa of the extent to which the degree of consumer spending by state residents is being conducted online and escaping sales tax, which could be a contributing factor behind lagging state sales tax collections. It is not clear, however, why this issue would have suddenly become more pressing in 2017 than in prior years, but nonetheless the State Legislature is expected to address this issue in 2018. Ongoing weakness in income from the agricultural sector is likely to remain a more pressing concern, as it will remain a drag on overall tax revenue collections.

Illinois: State tax revenue collections have been persistently weak in Illinois over the past several years and 2017 will be no exception. On a year-to-date basis through Q3, total tax collections were down 3.28 percent relative to the first three quarters of 2016. Though less severe than the declines posted over the past few years, personal income tax collections were still on pace to decline for 2017 as a whole. After several years of steady growth, Illinois was on course to log a decline in sales tax collections in 2017. Corporate tax revenue collections were on course to post a fourth consecutive annual decline. Illinois faced another year of only middling growth in nonfarm employment and hourly earnings in 2017, thus holding down growth in the base for personal income tax collections. The January 2015 expiration of temporarily higher personal income tax rates has also contributed to weaker personal income tax collections over the past three years. Ongoing population declines also factor into the mix in that they bring less spending on goods and hence put downward pressure on sales tax collections. Persistent budget woes and mounting unfunded pension obligations put Illinois in the unenviable position of having to look for additional revenue sources from an economy growing at a feeble rate to which is added a shrinking population base. These problems will only be exacerbated by the new caps on the deductibility of state and local taxes on federal returns. In short, the state's financial situation is unlikely to improve materially any time soon.



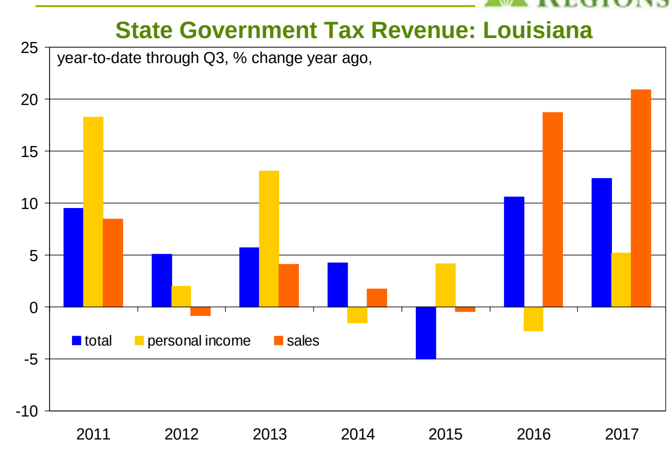
Indiana: Through Q3 total state tax collections in Indiana were only treading water, up just 0.26 percent over the first three quarters of 2016. Personal income tax collections were up just 0.68 percent year-to-date through Q3, with sales tax collections rising by 2.50 percent. Obviously the spike in personal income tax collections in 2015, mainly reflecting a spike in that year's second quarter, skewed the comparisons with the 2016 data; the deceleration in personal income tax collections in 2017 in part reflects a marked slowdown in job growth. It is worth noting that Indiana has a significantly above-average concentration of jobs in the manufacturing sector, but 2017 saw very little change in the level of employment in this sector while hourly earnings growth significantly lagged that in other sectors. This has acted as somewhat of a drag on growth in personal income tax collections in the state.



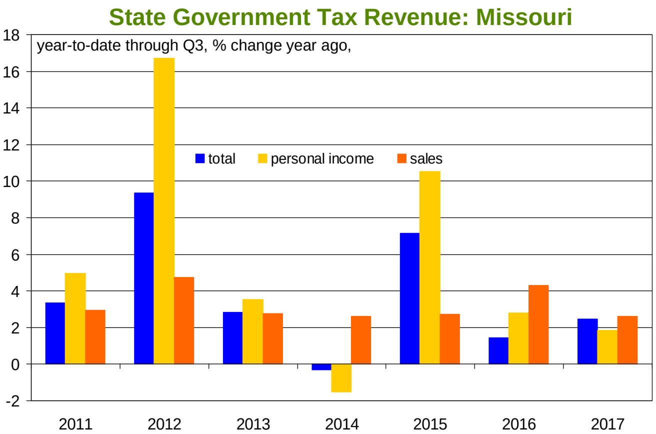


Kentucky: On a year-to-date basis through Q3 total tax collections in Kentucky were running only slightly ahead of 2016's pace, with an increase of 1.04 percent. Personal income tax collections were up by 1.73 percent while sales tax collections were down by 0.1 percent relative to the first three quarters of 2016. The state not only saw a slower pace of job growth in 2017 than in 2016 but the mix of jobs added in 2017 was highly skewed toward the services providing industries and away from the goods producing industries, and average earnings tend to be much higher in the latter group than the former group. This would have acted as a drag on growth in personal income tax revenue. While sales tax revenue basically flattened out in 2017, that came after two years of fairly strong growth, so there are some base effects at work here. After several years of sizeable declines, revenues from severance taxes (i.e., taxes on the extraction of minerals/natural resources) rose in 2017 but the dollar volume of severance taxes collected by the state is nowhere near where it had been before the declines took hold.

Louisiana: Louisiana was on course to see another solid increase in total tax revenue collections in 2017, with total revenue up 12.40 percent on a year-to-date basis through Q3. As in 2016, much of 2017's growth was fueled by growth in sales tax revenue, which was up by 20.91 percent on a year-to-date basis through Q3 relative to the first three quarters of 2016. Growth in sales tax revenue over the past two years was largely fueled by a higher tax rate applied to a broader base of goods, so it will be interesting to see how sales tax revenues fare in 2018, particularly as some of the higher sales taxes are slated to expire on July 1. Unlike 2016, however, growth in Louisiana's total tax collections in 2017 was aided by growth in personal income tax collections, which were up 5.16 percent on a year-to-date basis through Q3. Though only modestly, nonfarm payrolls in the state rose in 2017 after having fallen in both 2015 and 2016 as the state's energy sector struggled to gain traction, and the troubles in the energy sector were wide reaching across the state's economy. One area in which this is evident is in severance tax revenues, which were flat through the first three quarters of 2017 after posting significant declines in both 2015 and 2016. Despite sizeable gains in revenue collections in both 2016 and 2017, Louisiana is still facing a budget shortfall in the coming fiscal year.



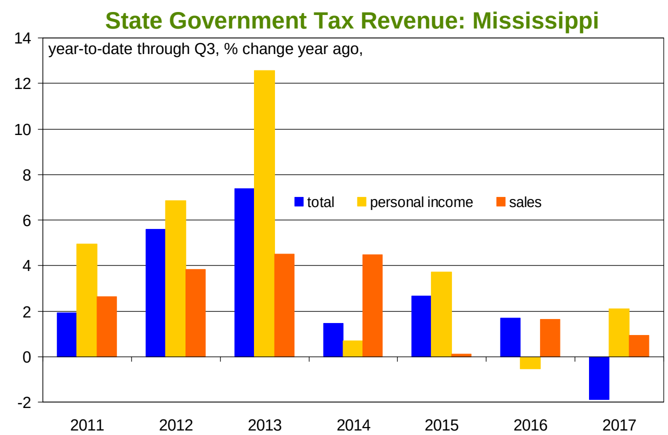
Missouri: Total state tax collections in Missouri were up 2.48 percent on a year-to-date basis through Q3 2017 over the same period of 2016. Personal income tax collections were up by 1.84 percent and sales tax collections were up by 2.60 percent. The state also saw corporate income tax collections bounce back after having declined in 2016. While growth in average hourly earnings accelerated sharply



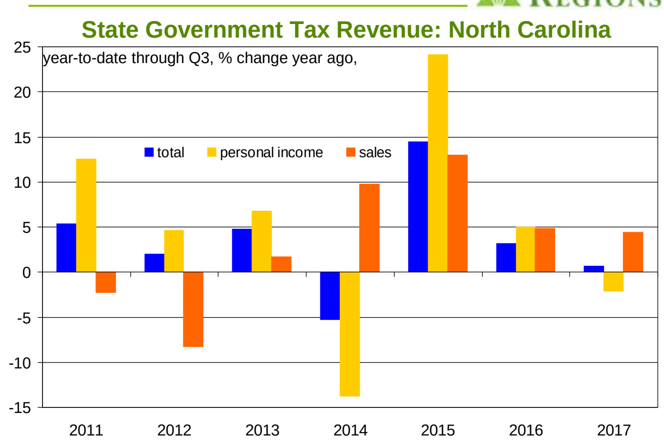
Source: U.S. Census Bureau; Regions Economics Division

in Missouri in 2017, the pace of job growth decelerated sharply, with the net effect of holding down growth in personal income tax collections. Missouri was on course to be one of just four states in the Regions footprint in which sales tax collections increased in each year between 2011 and 2017, even if annual growth has been fairly modest in most of these years. It is worth noting that Missouri is one of only a few states with special rules regarding collection of sales taxes from online sales even if the retailer has no physical presence in the state. This does not apply to all online retailers but it does help provide more stability in sales tax collections than seen in many other states. That growth in Missouri's sales tax revenue has nonetheless been fairly slow reflects persistent goods price deflation.

Mississippi: Total tax revenue collections in Mississippi were down 1.89 on a year-to-date basis through Q3 2017. Personal income tax collections were up 2.11 percent and sales tax collections were up 0.94 percent on a year-to-date basis, while corporate income, gasoline, and gaming tax collections were lower. Mississippi is one of the four states in the Regions footprint to see sales tax revenue rise in each year of the post-recession period, and a move to collect sales taxes from at least some online merchants should lead to improved growth in revenue on that front in 2018. Personal income tax collections in 2017 were aided by better job growth after nonfarm employment was basically flat in 2016, along with improved growth in hourly earnings. Still, without faster job and wage growth over coming quarters growth in personal income tax collections will remain modest, meaning that so too will growth in total tax collections.



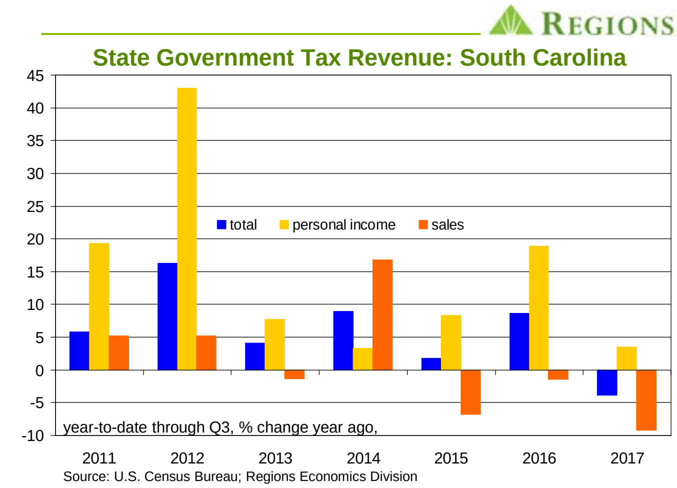
Source: U.S. Census Bureau; Regions Economics Division



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

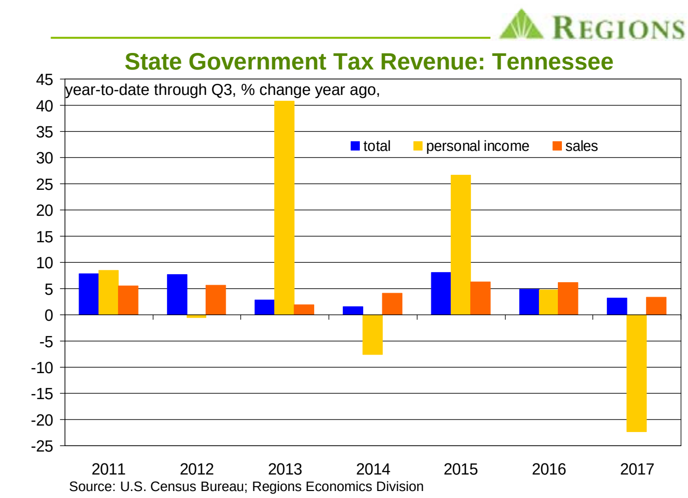
North Carolina: Total state tax collections in North Carolina eked out a small increase on a year-to-date basis through Q3 2017, rising by 0.64 percent. Declines in corporate income and personal income tax collections were offset by higher sales tax and franchise tax collections. Lower rates help account for lower income tax, both personal and corporate, revenue. Job growth in North Carolina was slower in 2017 than in 2016 and 2015, and in 2017 payrolls in the goods producing industries, in which hourly earnings tend to be higher, declined. This helps account for the slower pace of growth in average hourly earnings. Slower growth in both employment and earnings weighed on growth in the tax base for personal income tax collections. Sales tax collections were up 4.41 percent on a year-to-date basis through Q3, continuing a run of solid growth in this category in North Carolina over the past several years. With the exception of Louisiana, where sales tax collections were aided by higher tax rates, North Carolina posted the fastest year-to-date growth in sales tax collections in the Regions footprint in 2017.

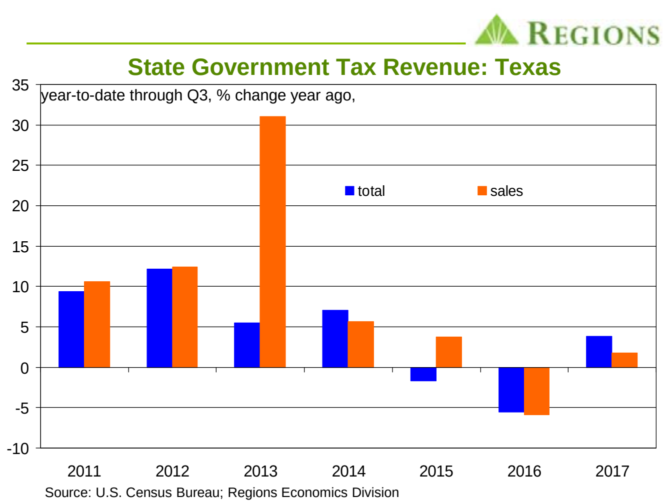
South Carolina: South Carolina saw total tax collections decline by 3.85 percent on a year-to-date basis through Q3. While personal income tax collections were up by 3.54 percent – coming off of a sizeable gain in 2016 – sales tax collections were down by 9.14 percent year-to-date after also logging declines in 2015 and 2016. Assessing the behavior of sales tax collections in South Carolina is far from being a straightforward exercise. Depending on the county specific add-on to the state rate, the sales tax in South Carolina can range from 6.0 to 9.0 percent, but there is a long list of items exempted from sales taxes. As such, swings in sales tax collections can easily



reflect shifts in spending patterns as opposed to changes in the state's underlying fundamentals, and these factors come on top of the two main drags on sales tax revenue faced by all states – persistent core goods price deflation and an increased incidence of online shopping. As such, while consistently been above-average growth in nonfarm employment and steady growth in hourly earnings have supported growth in personal income tax collections, sales taxes have been a persistent drag on growth in total tax collections in South Carolina, and this does not figure to change any time soon.

Tennessee: Tennessee saw total tax collections up 3.26 percent on a year-to-date basis through Q3 2017. The sizeable decline in personal income tax collections – down 22.33 percent year-to-date – is far less drastic than it appears. While in principal Tennessee assesses a personal income tax, the reality is that only dividend income, interest income, and other investment income are subject to the tax, known in the state as the "Hall Tax." That tax is being phased out gradually until 2021, when it will be completely eliminated, and 2017 collections reflect the initial cut in the tax rate. So, in essence, the decline in personal income tax collections for 2017 reflects a large change in a small number. With sales tax collections up 3.38 percent year-to-date through Q4, Tennessee remained on course to be one of only four states in the Regions footprint to see sales tax collections rise each year since the end of the 2007-09 recession.





Texas: Total state tax collections in Texas were up 3.83 percent on a year-to-date basis through Q3, which comes on the heels of lower collections in both 2015 and 2016. Like Florida, Texas has no personal income tax and is hence more reliant on sales tax as a source of total tax revenue. Sales tax collections in Texas were up 1.80 on a year-to-date basis through Q3 after having declined in 2016. Severance taxes are also an important source of tax revenue for Texas, and the picture on that front was brighter in 2017 than in the prior two years. Severance tax collections were up 60.20 percent year-to-date through Q3, which reflects higher energy prices in 2017 but also reflects the magnitude of the declines in severance tax collections in 2015 and 2016 (down roughly 40 percent in each year). With the energy sector on firmer footing, Texas should see further growth in severance tax revenue in 2018 which will support growth in overall tax collections.

While the economic expansion figures to persist at least into 2019, there is not a precise mapping from a given state's pace of economic growth into that state's tax collections, as the above discussion hopefully makes clear. It is also worth noting that while our summaries compare actual tax collections across years, for state governments a more critical distinction is between actual tax collections and forecasted tax collections. Spending decisions in any given state are made ahead of time on the basis of forecasts, and forecasting tax collections is inherently difficult. But, for those states with balanced budget requirements, material misses on revenue forecasts can result in sometimes sharp and sudden changes in spending plans, which in turn can have an adverse impact on the broader state economy. In addition to an economic downturn – a matter of when, not if – coming years will see many states squeezed by pension funding obligations. That revenue growth has been fairly tepid in the midst of a prolonged, even if less than robust, expansion means these challenges will be even harder for many states to overcome.