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State Government Fiscal Conditions

**OpenSky Policy Institute
Legislative Symposium**

Lincoln, NE

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**With many thanks to my colleague,
Donald Boyd**

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Overview

- State fiscal challenges
- Slow economic recovery
- Demographic changes
- Slower tax revenue recovery
 - Growing reliance on non-traditional taxes
- Growing revenue volatility & fiscal challenges
- Fiscal reality & outlook
- Tax reform overview

State fiscal challenges

- 10+ years later still feeling the pain of the Great Recession
- Variables that drive revenue hit harder than broader economy, harder than before
- Revenue recovery is very slow
 - State inflation & population adjusted tax revenue is still below pre-recession levels in half of the states
- Longer-term spending pressures loom
- Employment and wage recovery is very slow
- Major cuts in state-local government employment
- Growing pension liabilities
- Growing Medicaid costs due to higher recession-related enrollment
- Growing uncertainty due to tax reform and other federal policies

Slow economic recovery

- Employment trends
 - Slow recovery for private sector employment
 - Deep cuts in state-local gov't jobs
- Personal income trends
 - Slower growth in wages & salaries than in prior recoveries
 - Changing nature of personal savings
- Retail sales
 - Weak and slow recovery
- Goods and services
 - Slow recovery in services and non-durable goods
 - High volatility in durable goods
 - Steep declines in energy goods and services

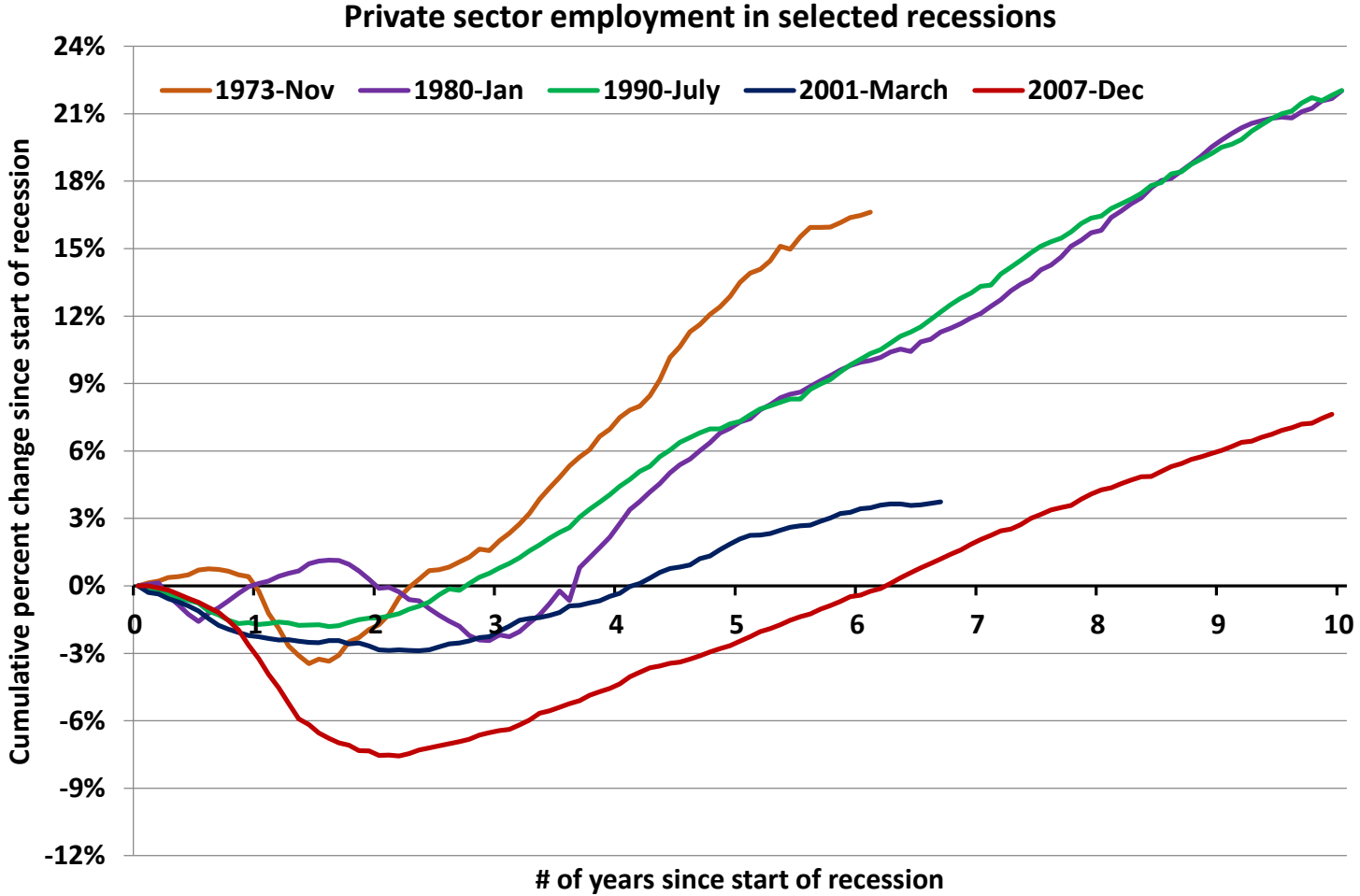
Private vs. state and local government employment trends

The impact of the Great Recession on employment: dire picture for government emp.

Employment Sector	Employment (in 1,000s)			Recession peak date	Percent change	
	Dec-07	Sep-17	Peak emp		Sep 2017 vs Dec 2007	Sep 2017 vs Peak
Total nonfarm	138,413	146,769	138,430	Jan-08	6.0	6.0
Total private	116,037	124,432	116,042	Jan-08	7.2	7.2
State and local government	19,620	19,529	19,801	Aug-08	(0.5)	(1.4)
State government	5,139	5,070	5,214	Aug-08	(1.3)	(2.8)
State gov education	2,327	2,410	2,383	Aug-08	3.6	1.1
State gov, non-education	2,812	2,660	2,830	Aug-08	(5.4)	(6.0)
Local government	14,481	14,459	14,610	Jul-08	(0.2)	(1.0)
Local gov education	8,055	7,990	8,119	Jul-08	(0.8)	(1.6)
Local gov, non-education	6,426	6,470	6,507	Dec-08	0.7	(0.6)

Source: U.S. Bureau of Labor Statistics, Current Employment Statistics (seasonally adjusted).

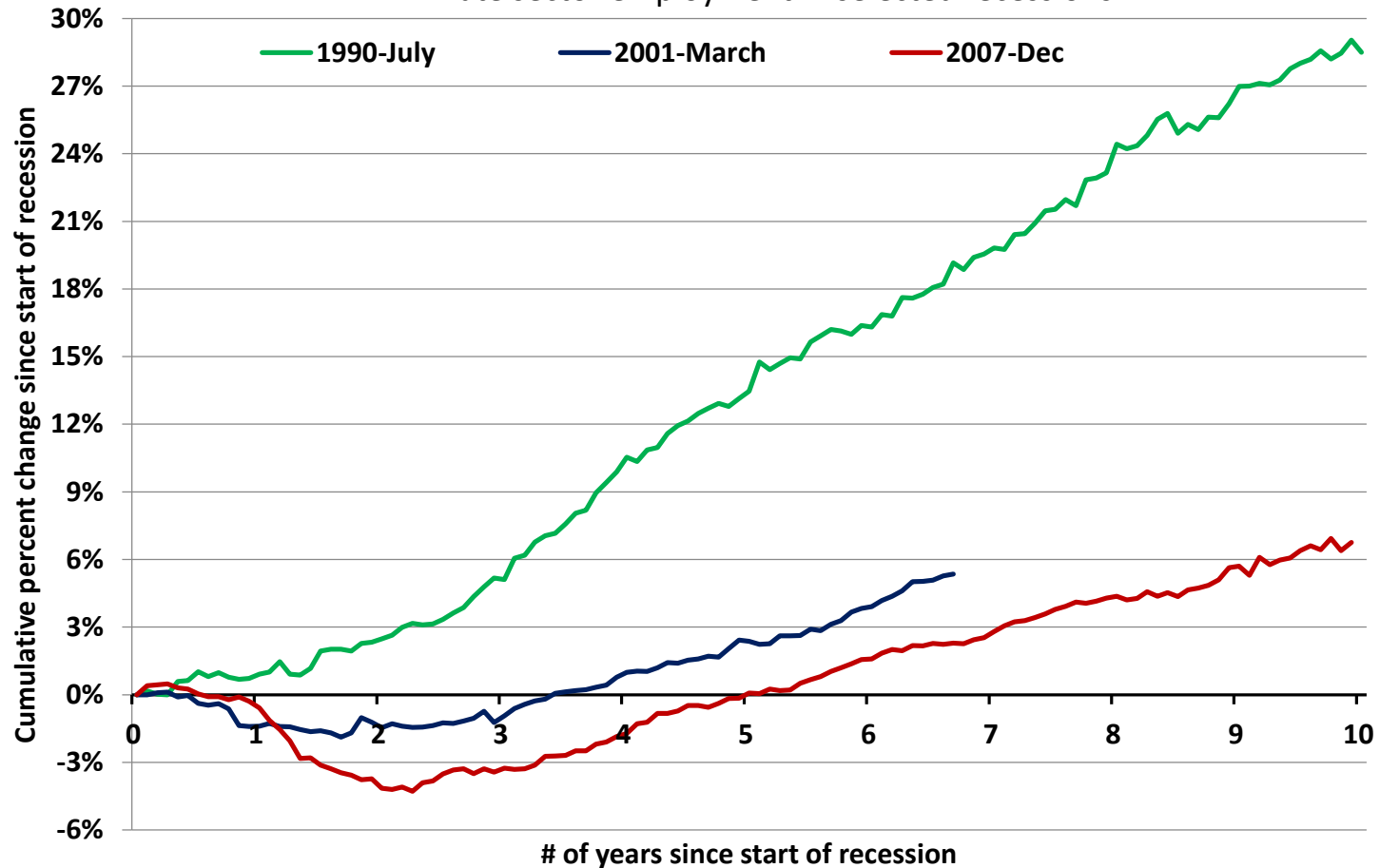
Private sector employment recovery much slower compared to past recoveries



Source: U.S. Bureau of Labor Statistics (CES, seasonally adjusted).
 Notes: Data are shown only until the start of the next recession; 1980 & 1981 recessions treated as single recession.

Private sector employment recovery is also slower in Nebraska

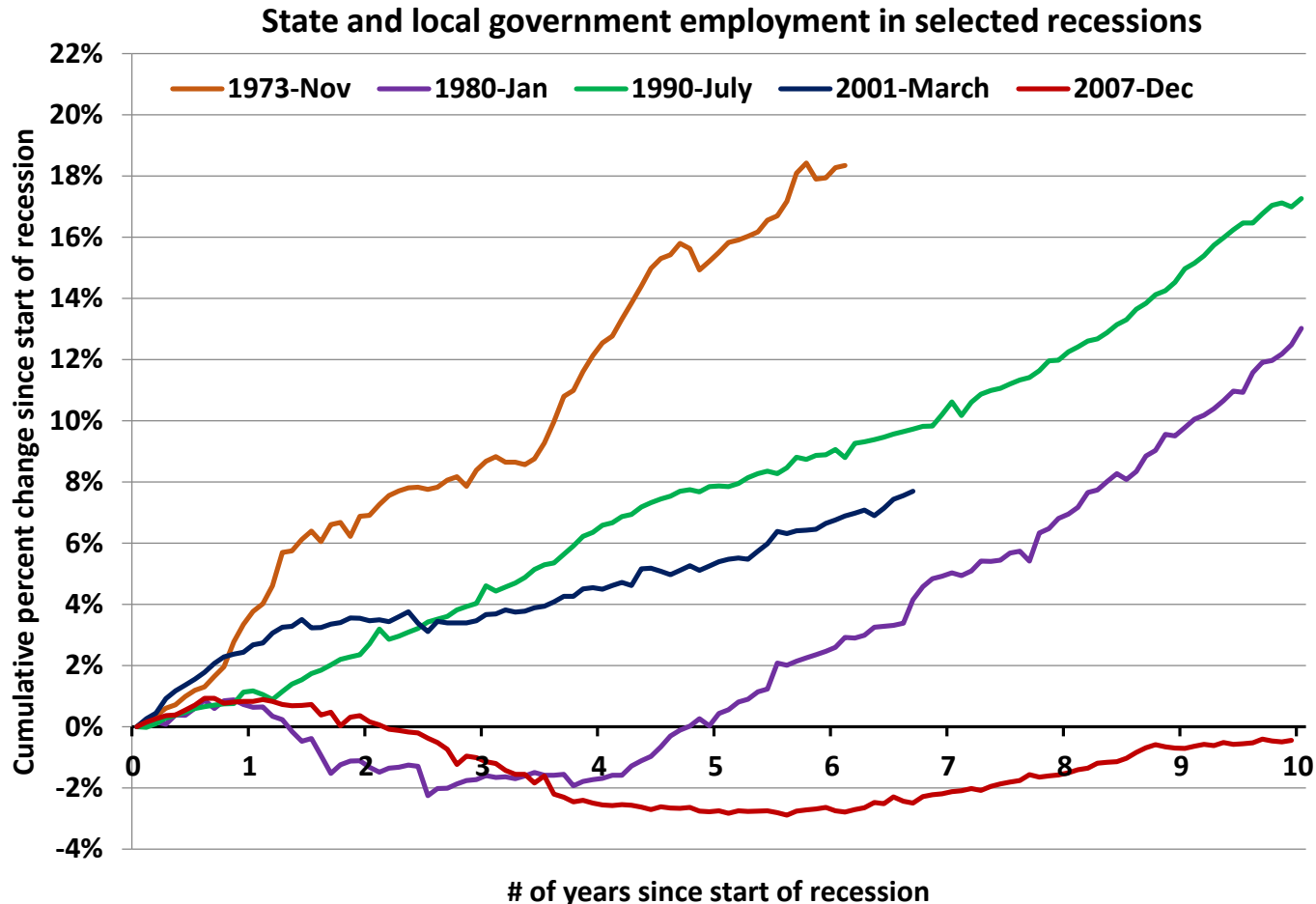
NE: Private sector employment in selected recessions



Source: U.S. Bureau of Labor Statistics (CES, seasonally adjusted).

Notes: Data are shown only until the start of the next recession; 1980 & 1981 recessions treated as single recession.

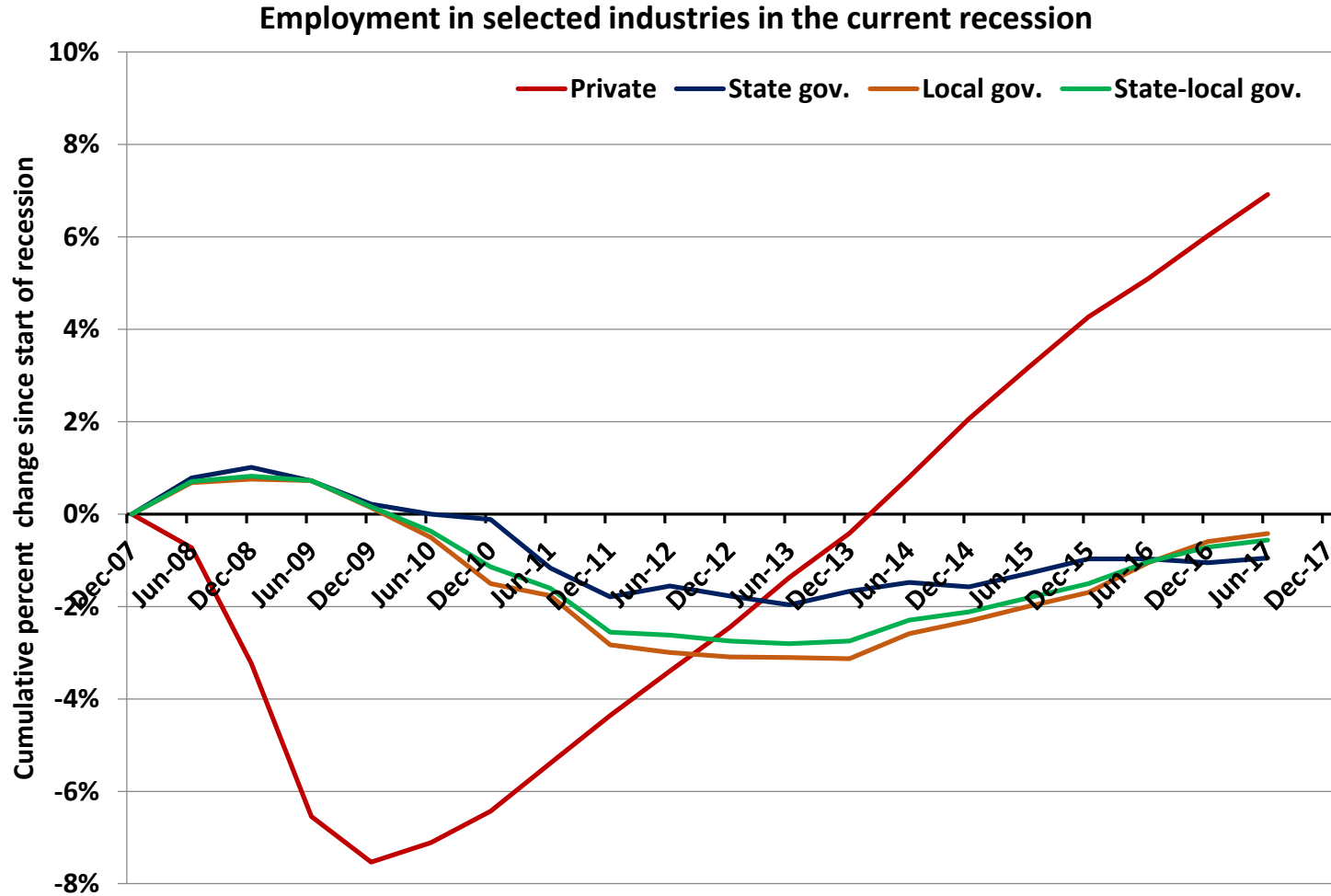
Deep cuts in state-local gov't jobs; deeper than any other recession in the last 50 years



Source: U.S. Bureau of Labor Statistics (CES, seasonally adjusted).

Notes: Data are shown for the next 10 years or until the start of the next recession, whichever came first; 1980 & 1981 recessions treated as single recession.

State-local gov't employment still declining, in contrast to the rebound in private employment

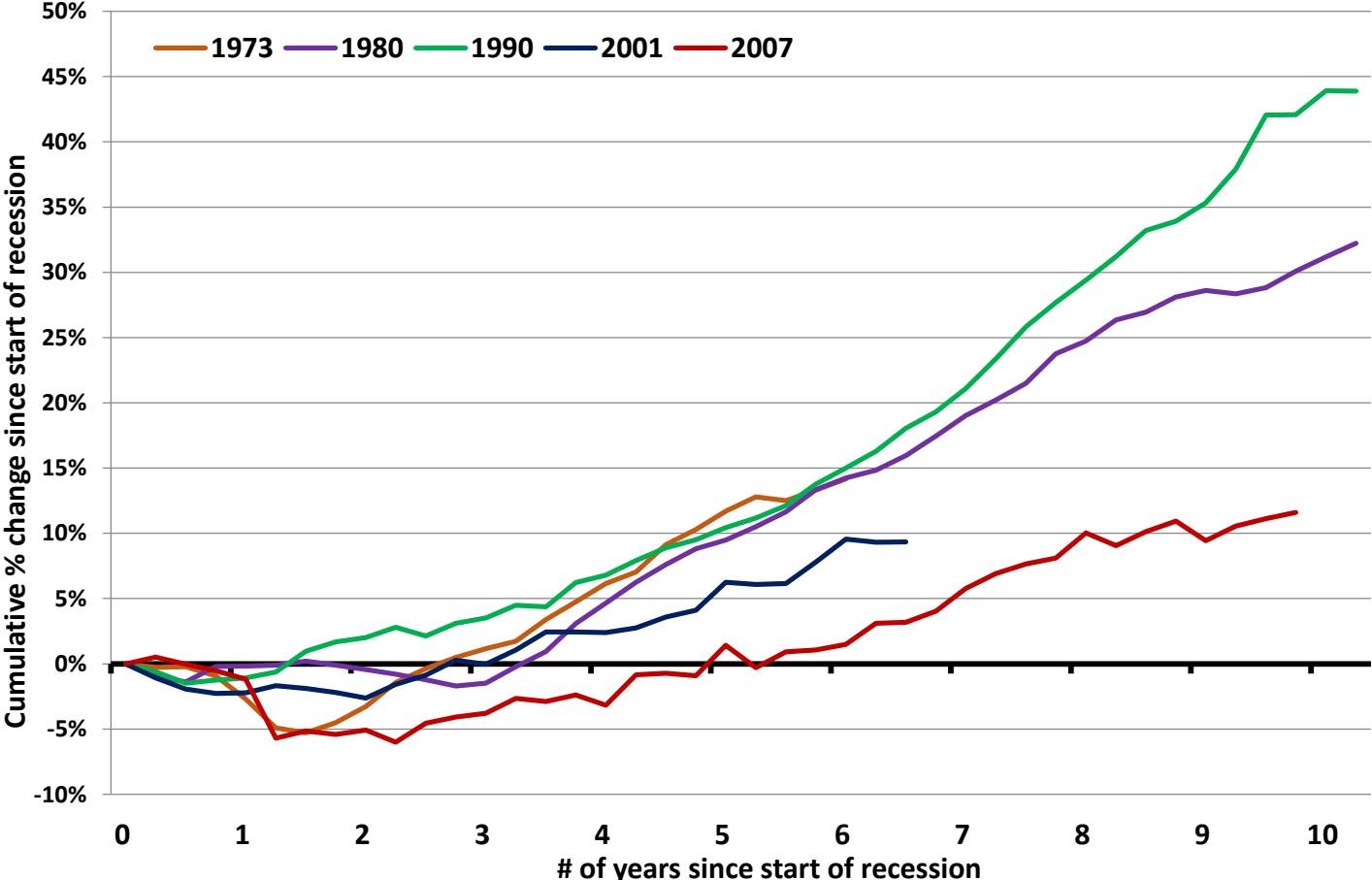


Source: U.S. Bureau of Labor Statistics (CES, seasonally adjusted).

Economic indicators:
Wages and salaries
Disposable income
Retail sales
Goods and services

Growth in salaries & wages slower compared to past recoveries

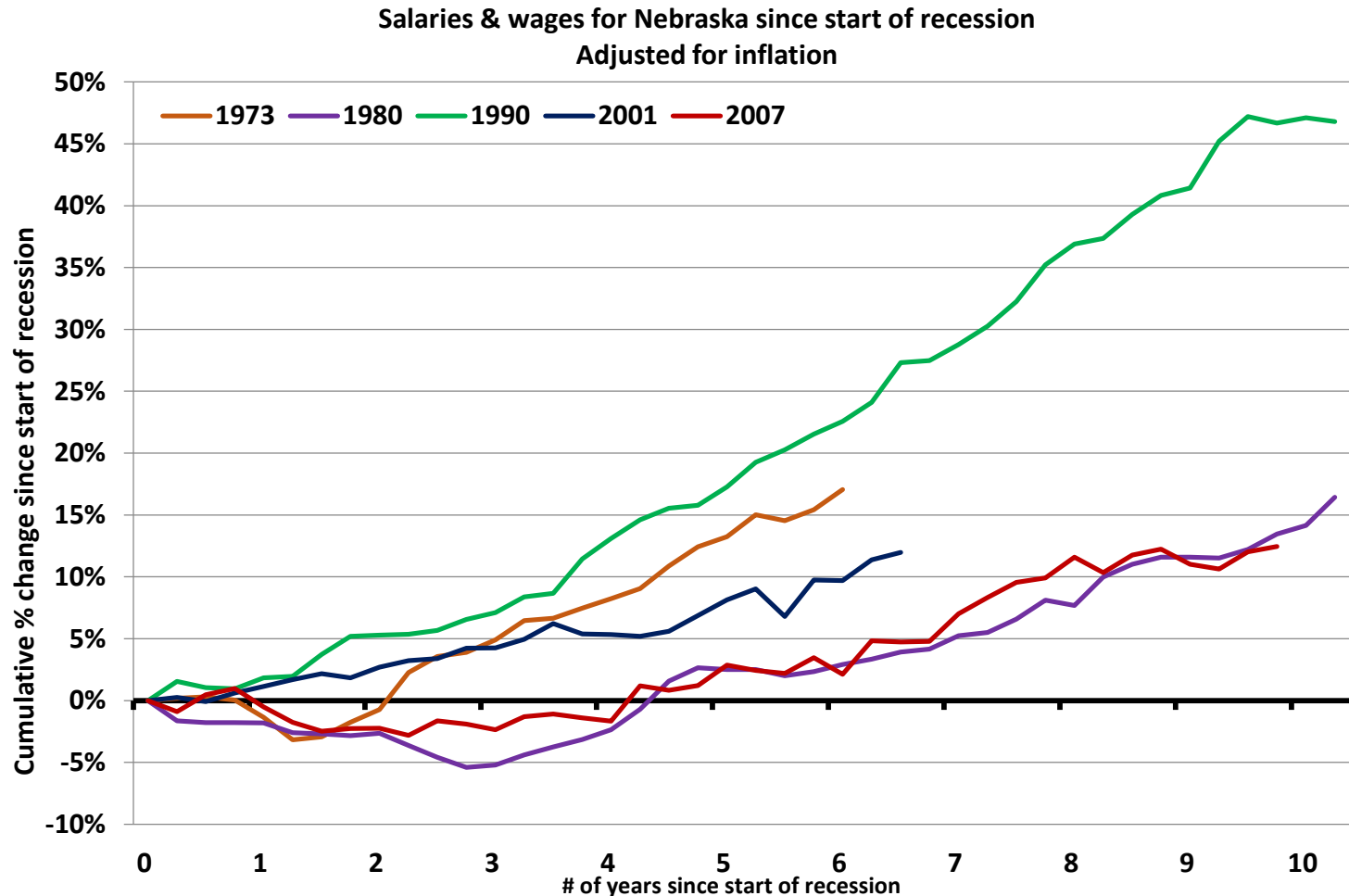
Salaries & wages for U.S. since start of recession
Adjusted for inflation



Source: Rockefeller Institute analysis of data from Bureau of Economic Analysis (Table 2.1).

Notes: Data are shown only until the start of the next recession; 1980 & 1981 recessions treated as single recession.

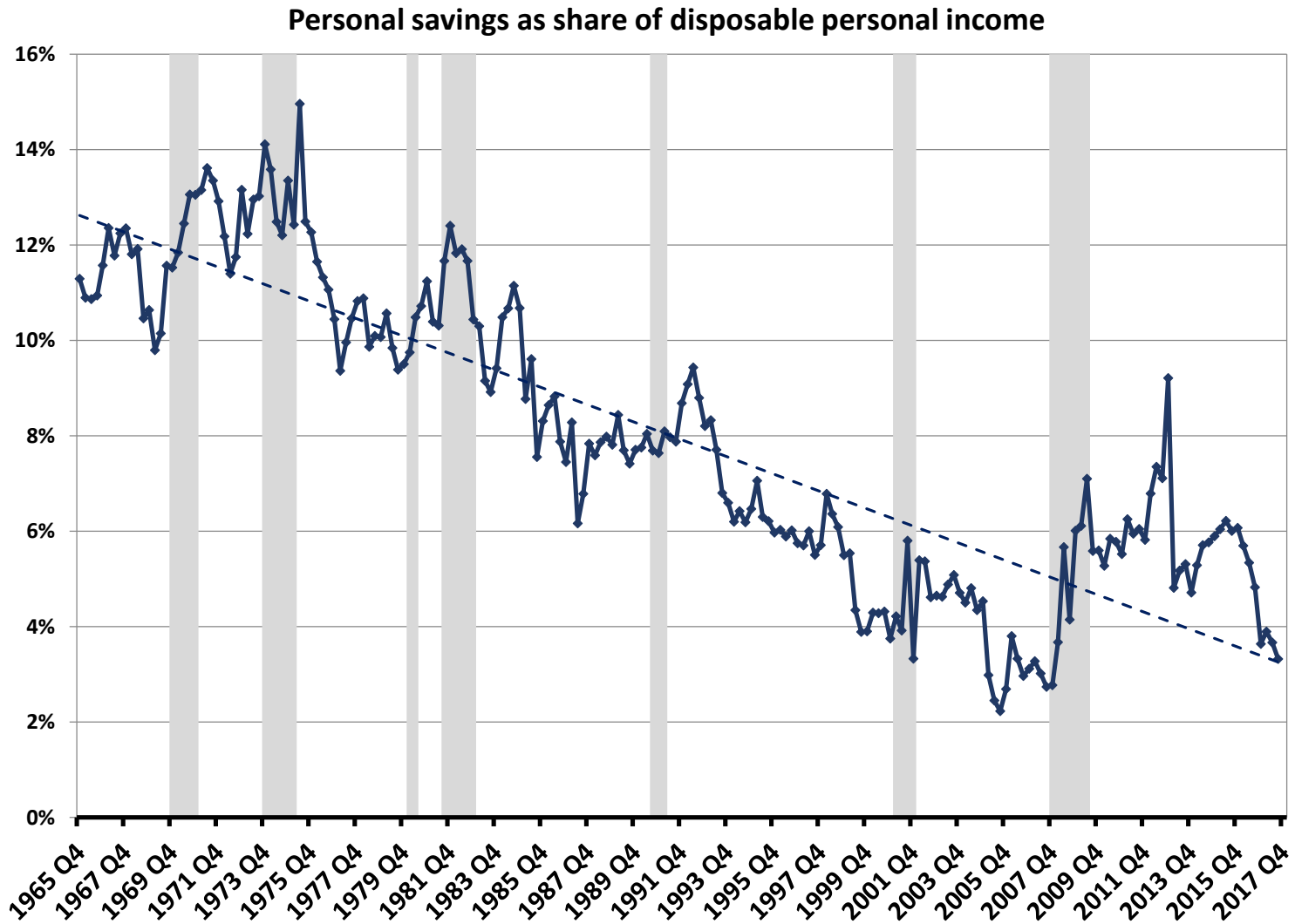
Nebraska: Growth in salaries & wages slower compared to most past recoveries



Source: Rockefeller Institute analysis of data from Bureau of Economic Analysis (Table 2.1).

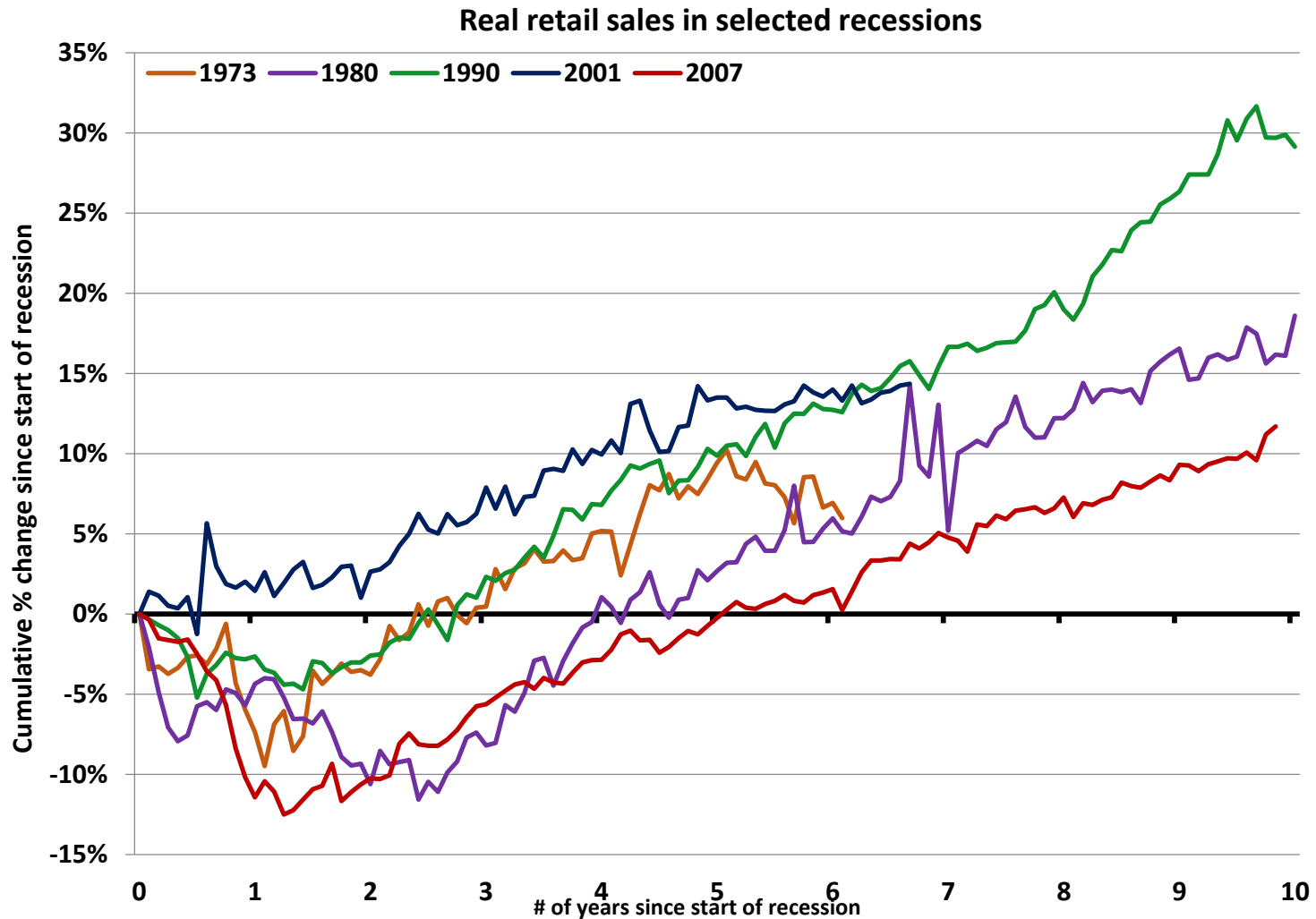
Notes: Data are shown only until the start of the next recession; 1980 & 1981 recessions treated as single recession.

Personal savings as share of disposable personal income



Sources: Rockefeller Institute analysis of data from Bureau of Economic Analysis (Table 2.1).

Real retail sales are weak compared to historical levels

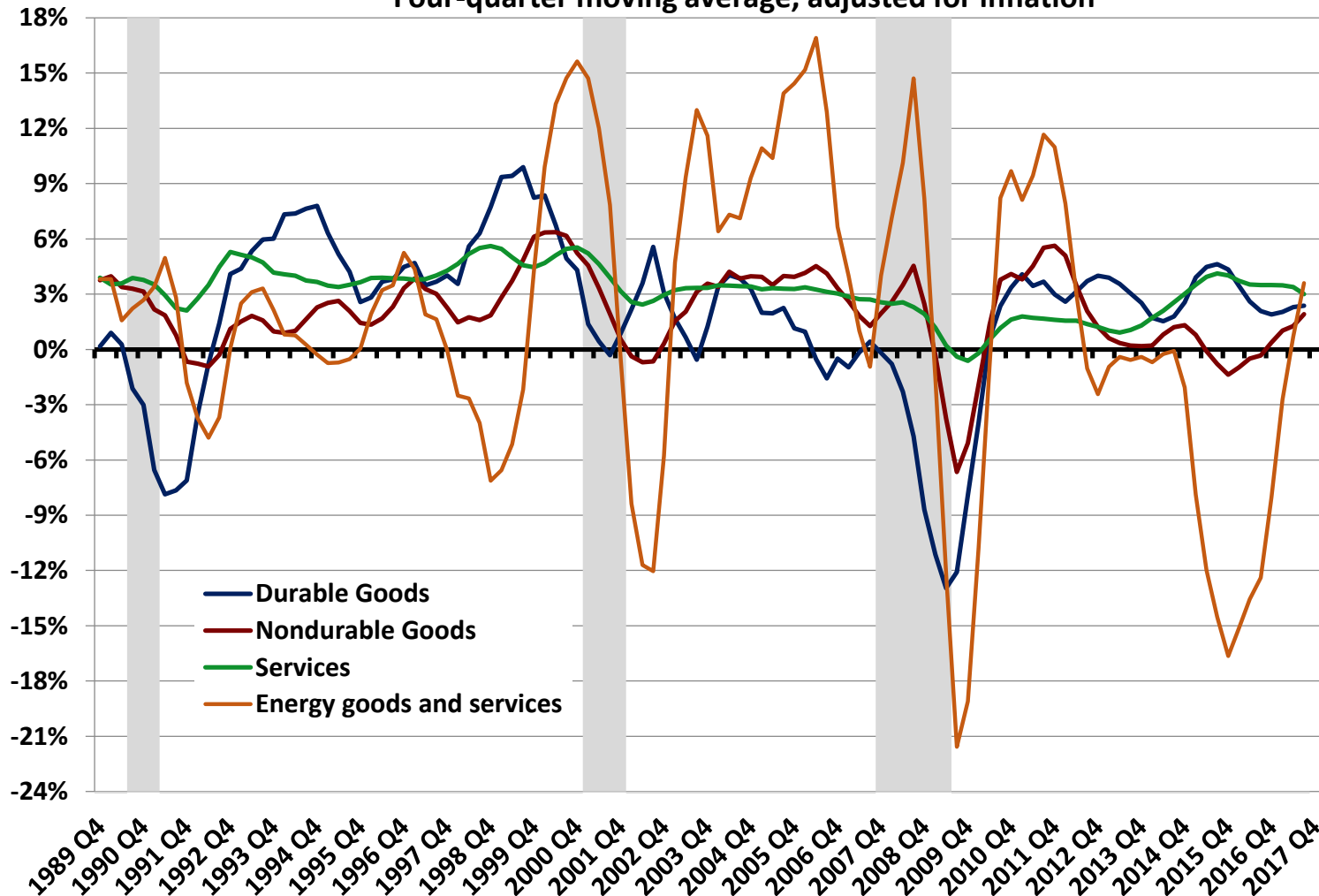


Sources: Cleveland Federal Reserve Bank (pre-1990 retail sales), U.S. Census Bureau (1990+), and Bureau of Labor Statistics (CPI).

Notes: Data are shown only until the start of the next recession; 1980 and 1982 recessions are treated as single recession.

Consumption of durable & non-durable goods was hit hard

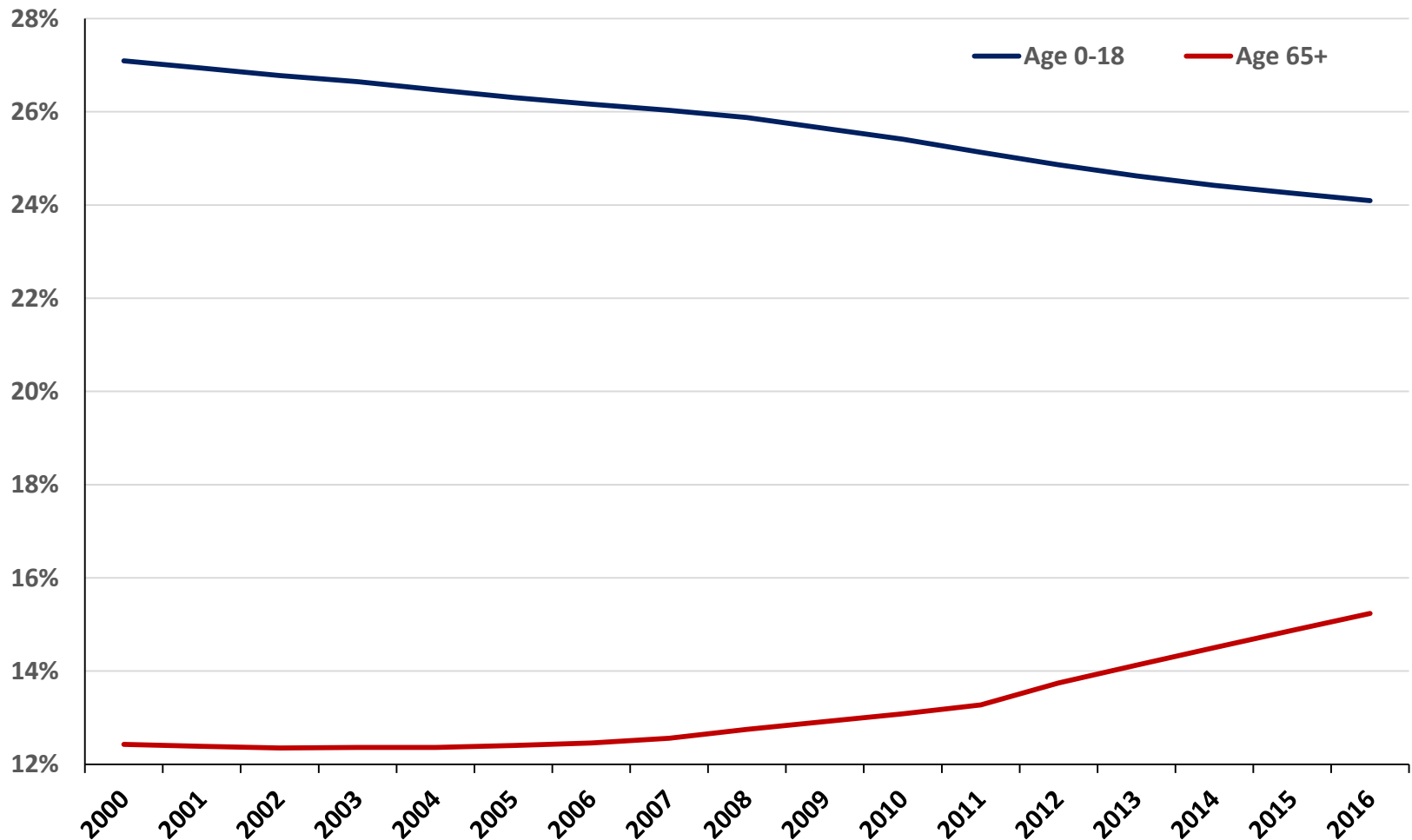
Year-over-year percent change in personal consumption
Four-quarter moving average, adjusted for inflation



Demographic changes and taxes

Aging problem: Growth in elderly population as share of total population

Age 0-18 and age 65+ as share of total population



Lower income and lower income tax for older individuals

- Total income falls for older individuals
 - Retirement income usually less than pre-retirement earnings
 - Aggregate retirement income is growing rapidly, but total income of retirees is lower than before retirement
- Tax breaks! For example:
 - Exclusion of Social Security income, public pensions, private pensions, IRA/401(k) withdrawals
 - Additional personal exemptions and credits for the elderly
 - 36 of 41 states with broad-based income tax provide exclusion for some retirement income (beyond Social Security), or elderly tax credit
 - NOT: CA, NE, ND, RI, VT

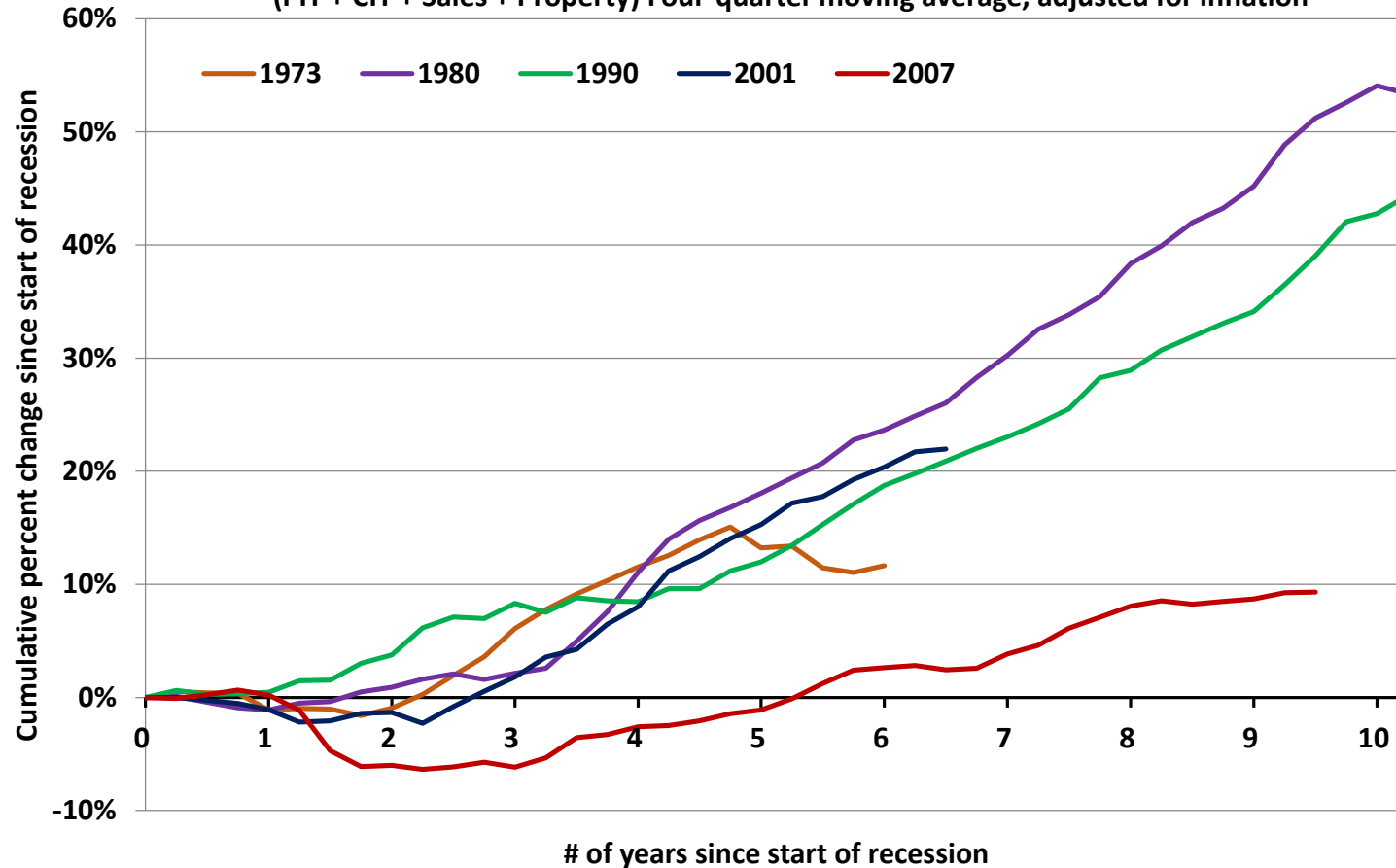


Slower tax revenue recovery

- Nearly 10 years after recession start, state-local taxes only 9+ % above prior peak
- State gov't tax recovery is weak & slow
- Sales taxes: above pre-recession level, but stagnant
- PIT: stronger recovery, but quite volatile
- CIT: **no** recovery
- Local property taxes: continued but soft growth

State & local government tax revenues: Only 9+⁰% above prior peak

Percent change in state & local government major tax revenue since start of recession
(PIT + CIT + Sales + Property) Four-quarter moving average, adjusted for inflation

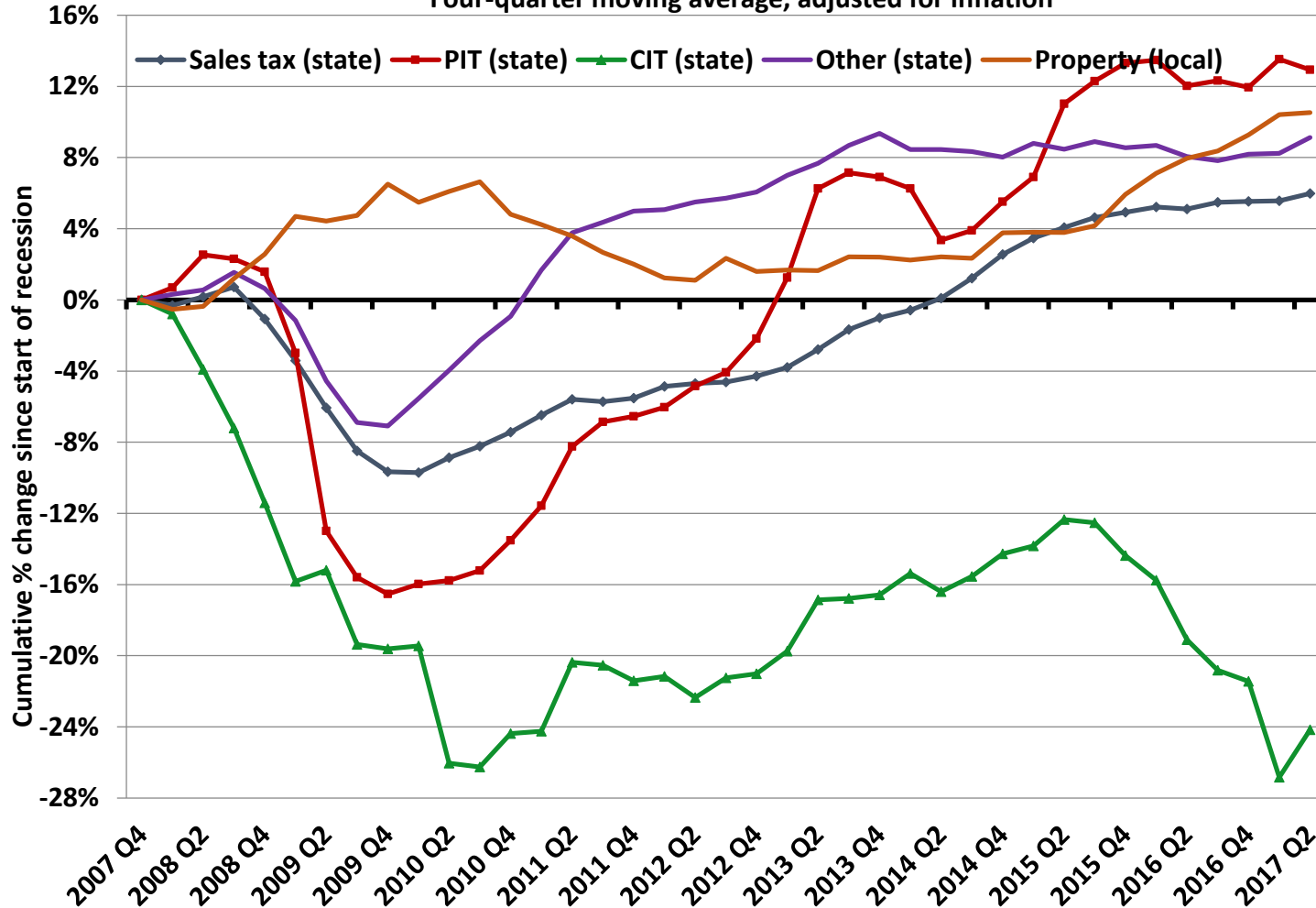


Source: Rockefeller Institute analysis of data from U.S. Census Bureau.

Notes: Data are shown only until the start of the next recession; 1980 & 1981 recessions are treated as single recession.

Volatile income tax; weak sales tax; stagnant "other" taxes; corporate 24% below prior peak

Major tax revenues since the start of the 2007 recession
Four-quarter moving average, adjusted for inflation

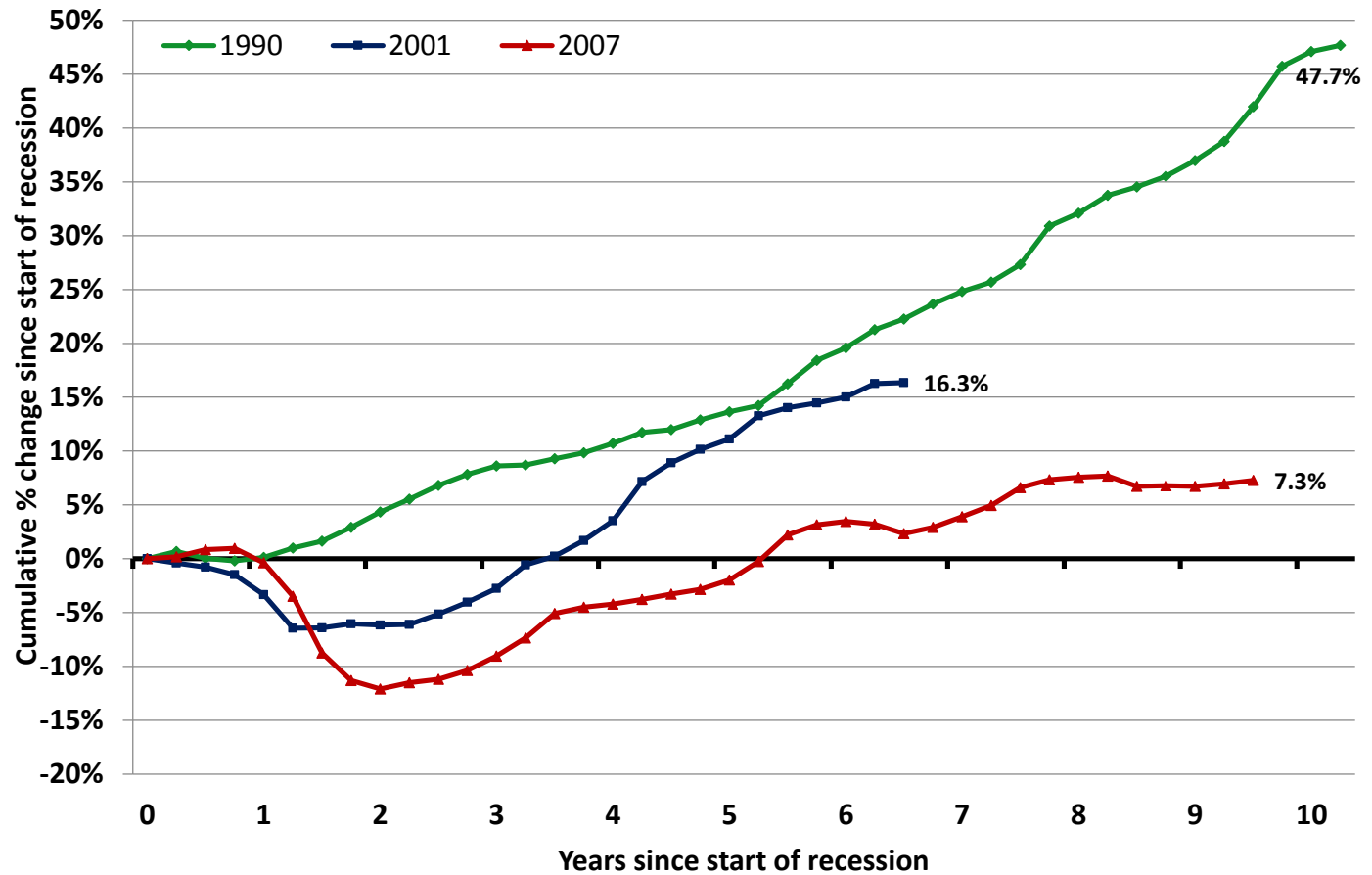


Sources: U.S. Census Bureau , Quarterly Summary of State & Local Government Tax Revenue and Bureau of Economic Analysis (GDP).

Notes: (1) 4-quarter moving average of inflation-adjusted tax revenue; (2) No adjustments for legislative changes.

State government tax revenues: Recovery is slow and weak

State tax revenue since the start of the recession
Four-quarter moving average, adjusted for inflation

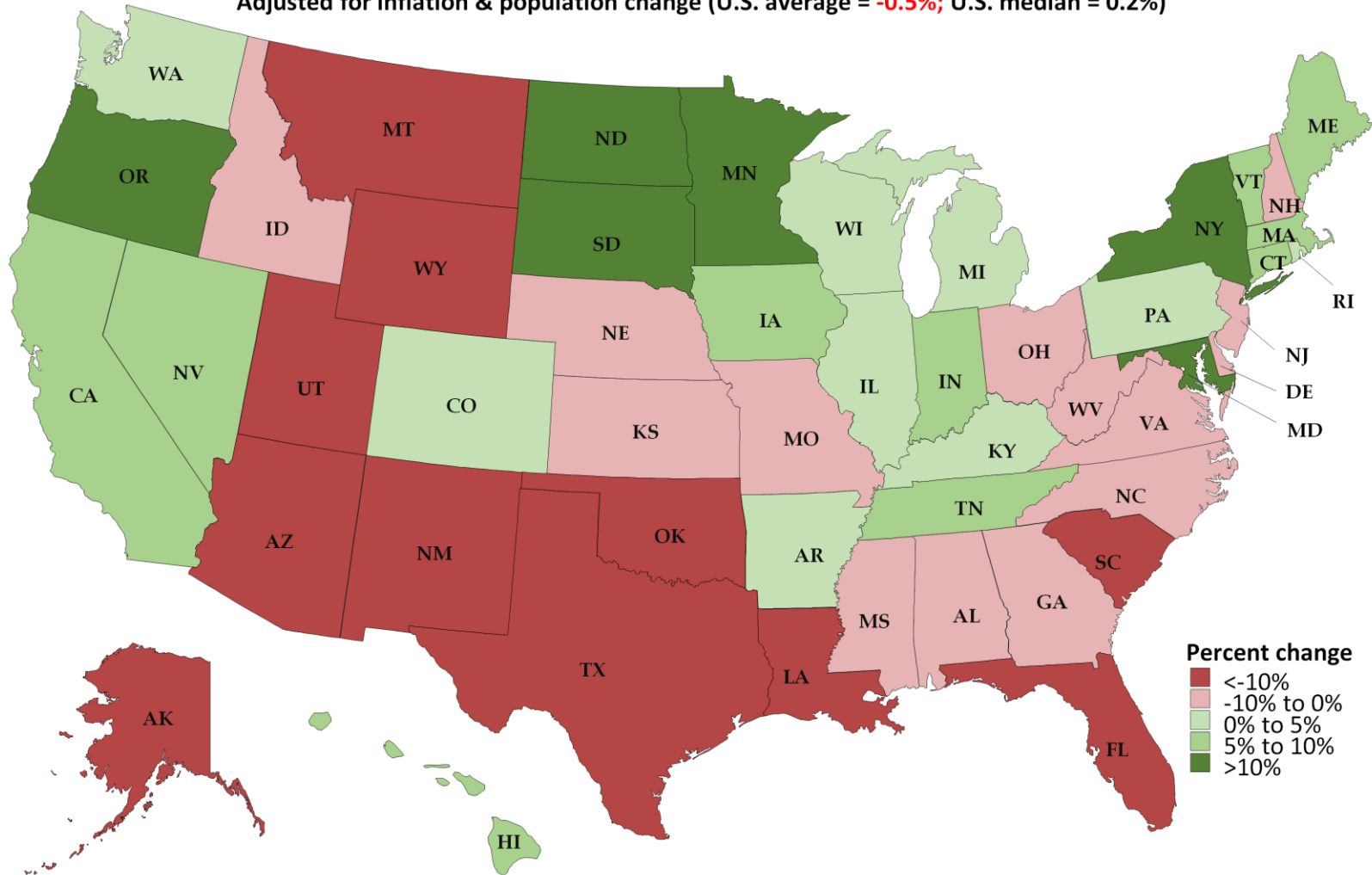


Sources: U.S. Census Bureau (taxes) and Bureau of Economic Analysis (GDP).

Notes: 4-quarter moving average of inflation-adjusted tax revenue. Data are shown only until the start of the next recession.

State taxes, adjusted for inflation & population growth, still below pre-recession in 25 states

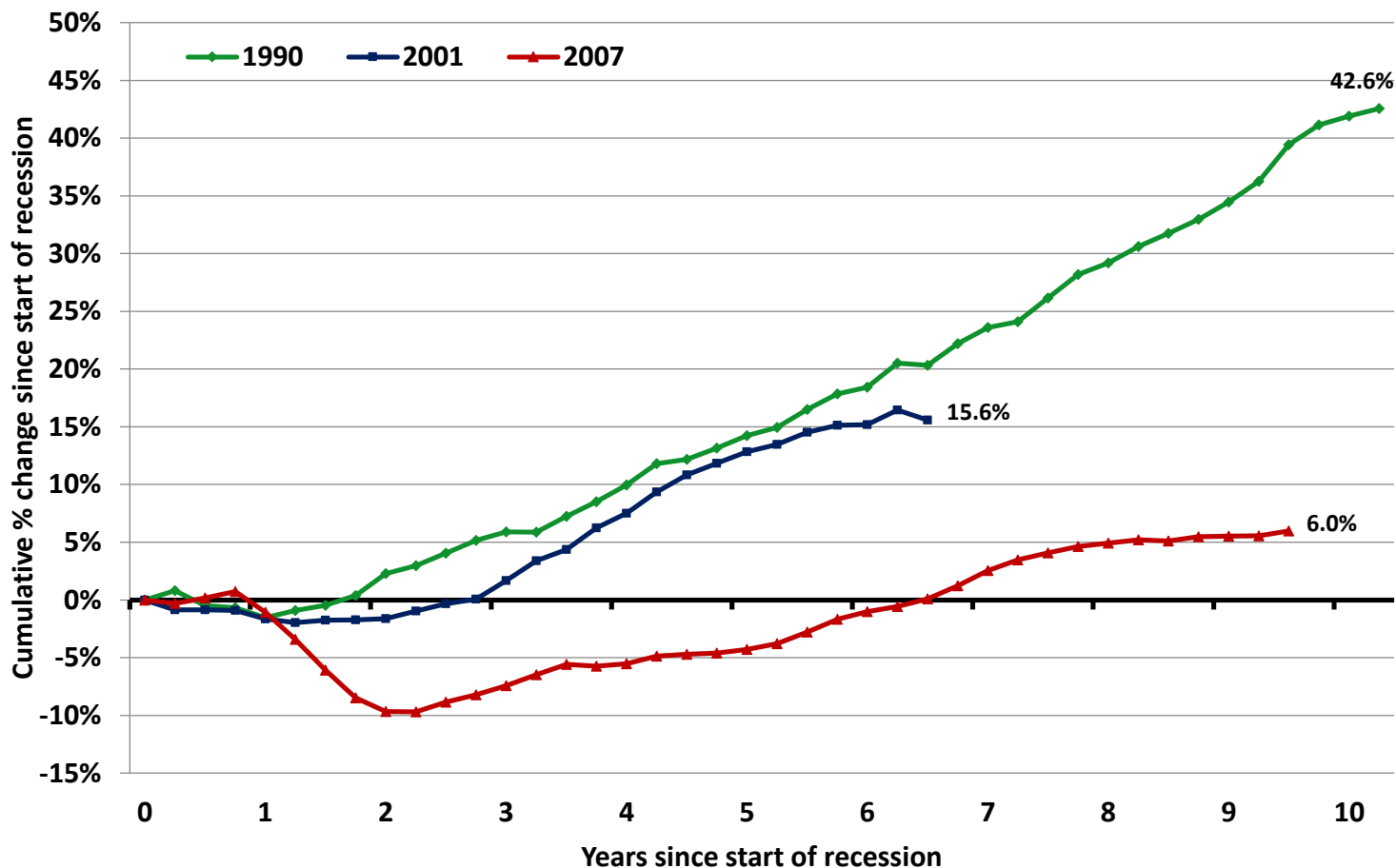
Percent change in 4-quarter moving average of state tax revenues, 2017q2 vs 2007q4
Adjusted for inflation & population change (U.S. average = **-0.5%**; U.S. median = 0.2%)



State government sales tax

State government sales taxes: Recovery is extremely weak

State sales tax revenue since the start of the recession
Four-quarter moving average, adjusted for inflation

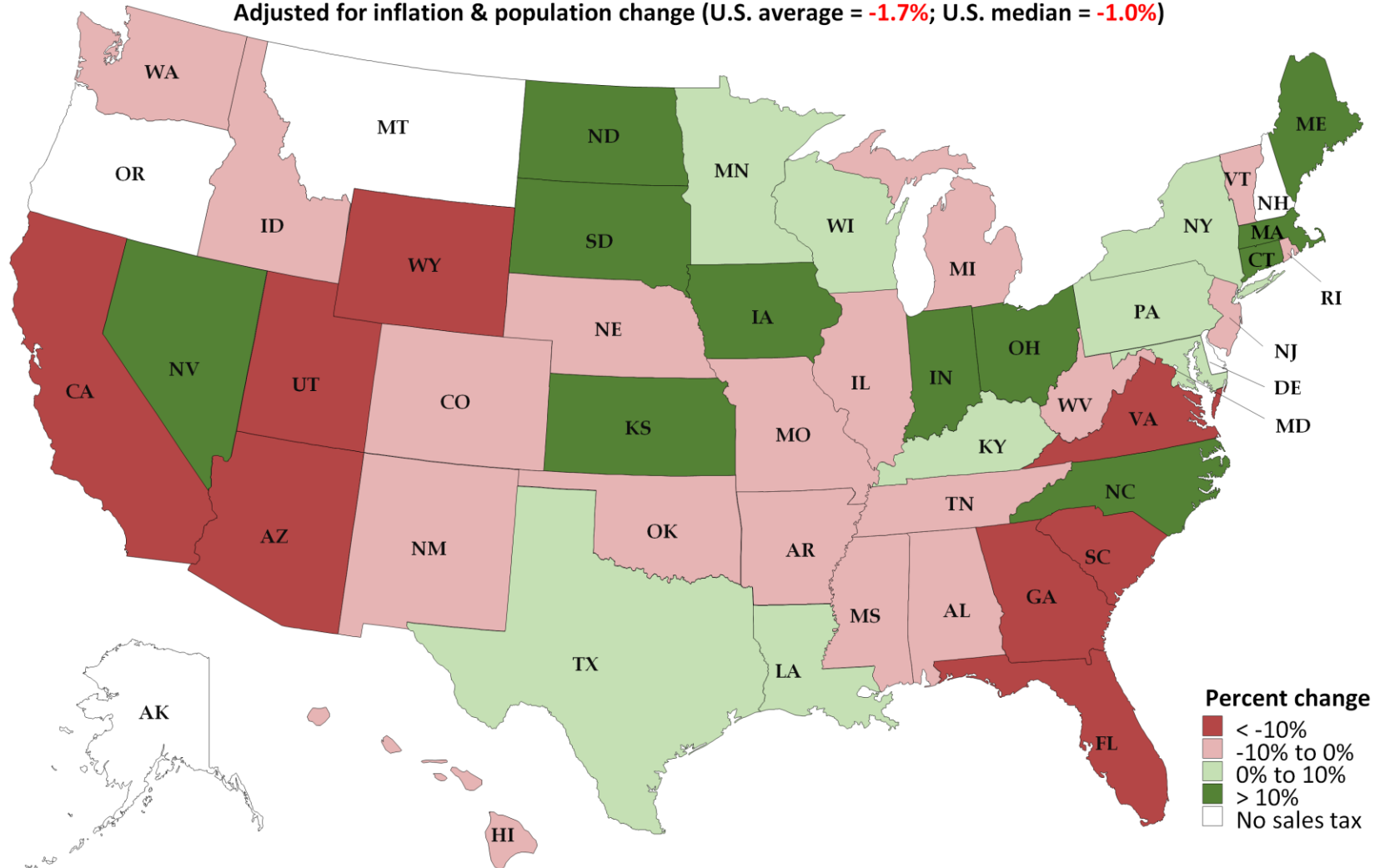


Sources: U.S. Census Bureau (taxes) and Bureau of Economic Analysis (GDP).

Notes: 4-quarter moving average of inflation-adjusted tax revenue. Data are shown only until the start of the next recession.

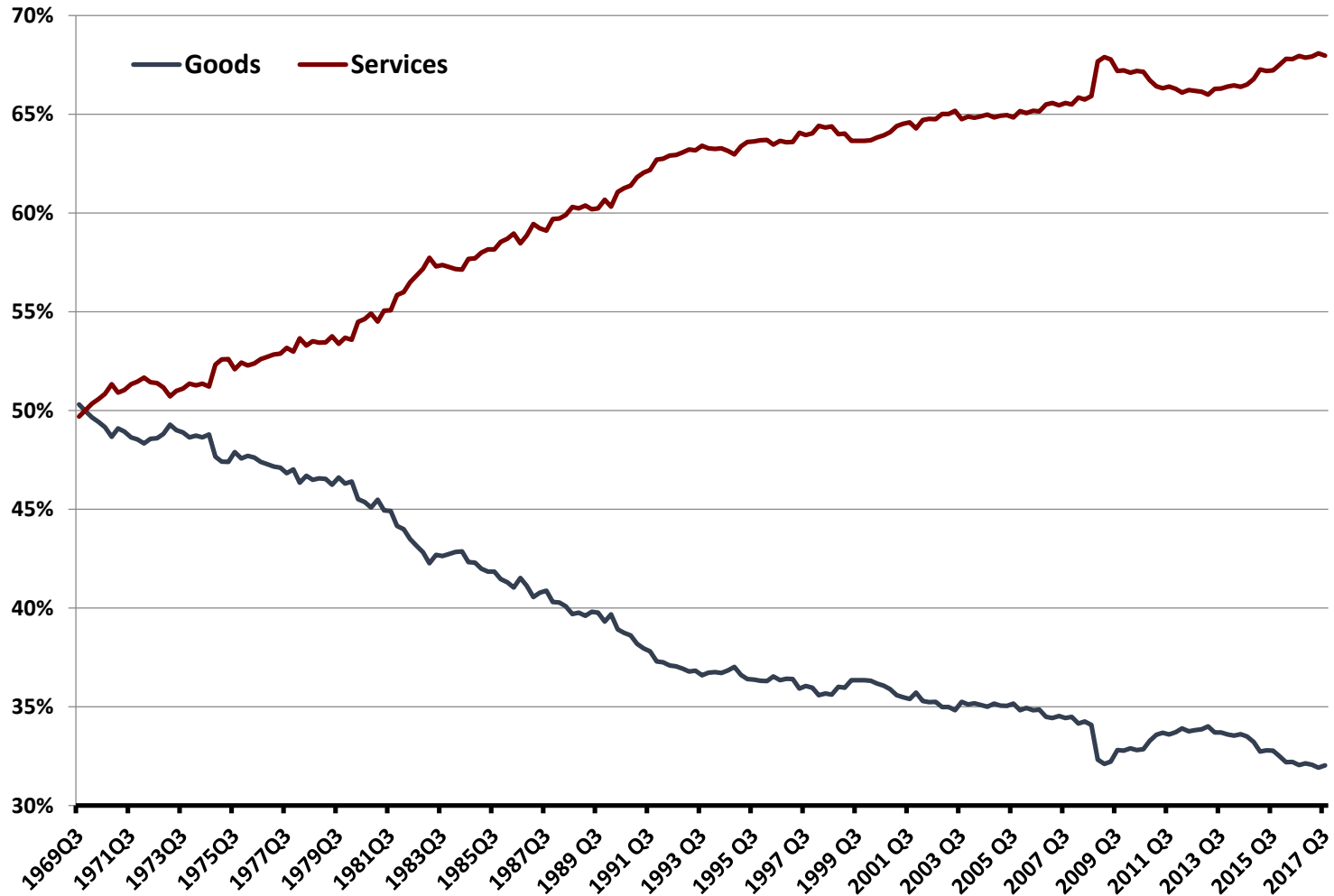
Sales tax, adjusted for inflation & population growth, still below pre-recession in **26** states

Percent change in 4-quarter moving average of sales tax revenues, 2017q2 vs 2007q4
Adjusted for inflation & population change (U.S. average = **-1.7%**; U.S. median = **-1.0%**)



Sales tax base and collections: Declining because of (1) shift to services, (2) e-commerce

Goods and services as percentage of personal consumption expenditures

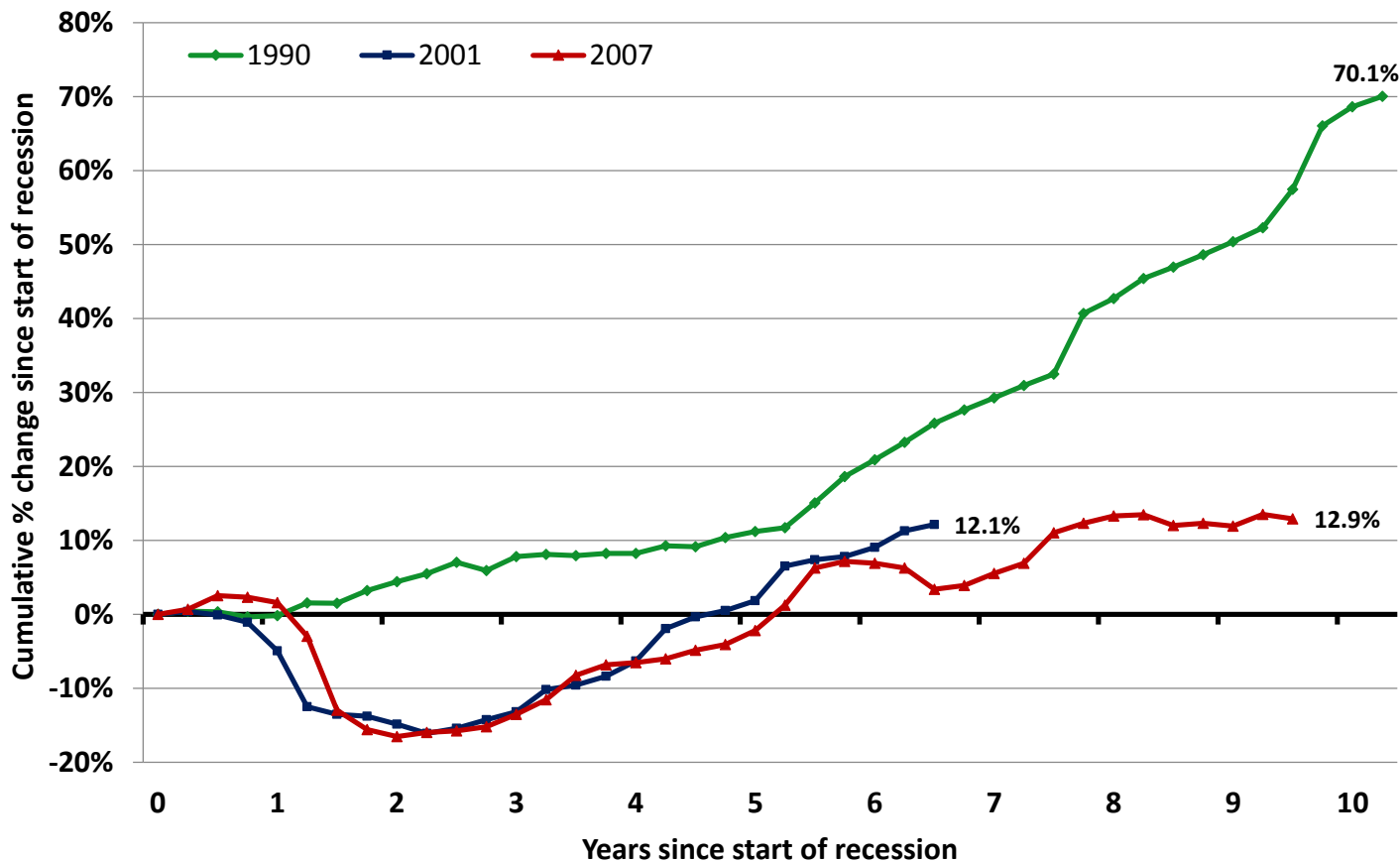


Source: U.S. Bureau of Economic Analysis, National Income and Product Accounts, Table 2.3.5.

State government personal income tax

State government personal income taxes: Stronger recovery, but volatile

State personal income tax revenue since the start of the recession
Four-quarter moving average, adjusted for inflation

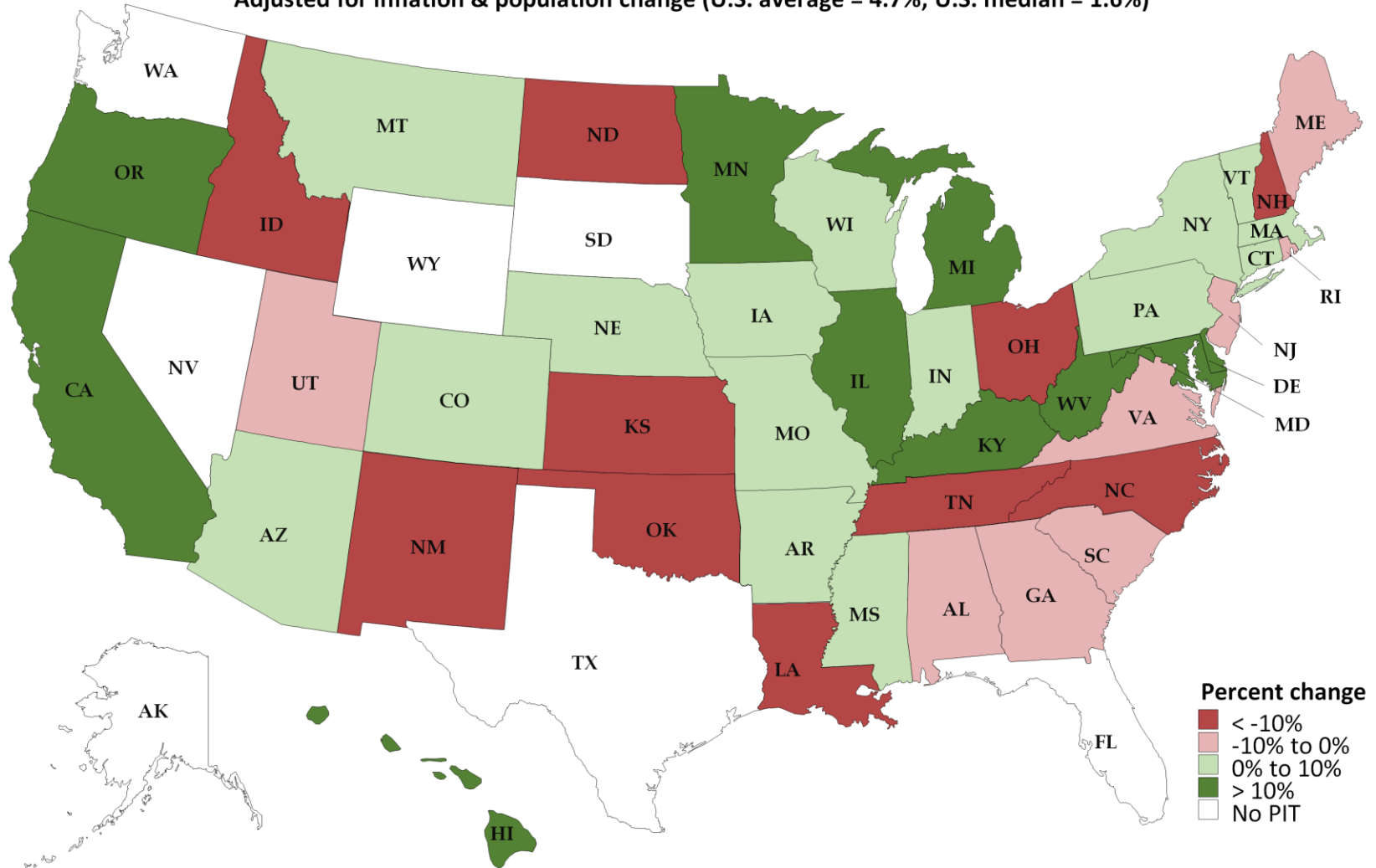


Sources: U.S. Census Bureau (taxes) and Bureau of Economic Analysis (GDP).

Notes: 4-quarter moving average of inflation-adjusted tax revenue. Data are shown only until the start of the next recession.

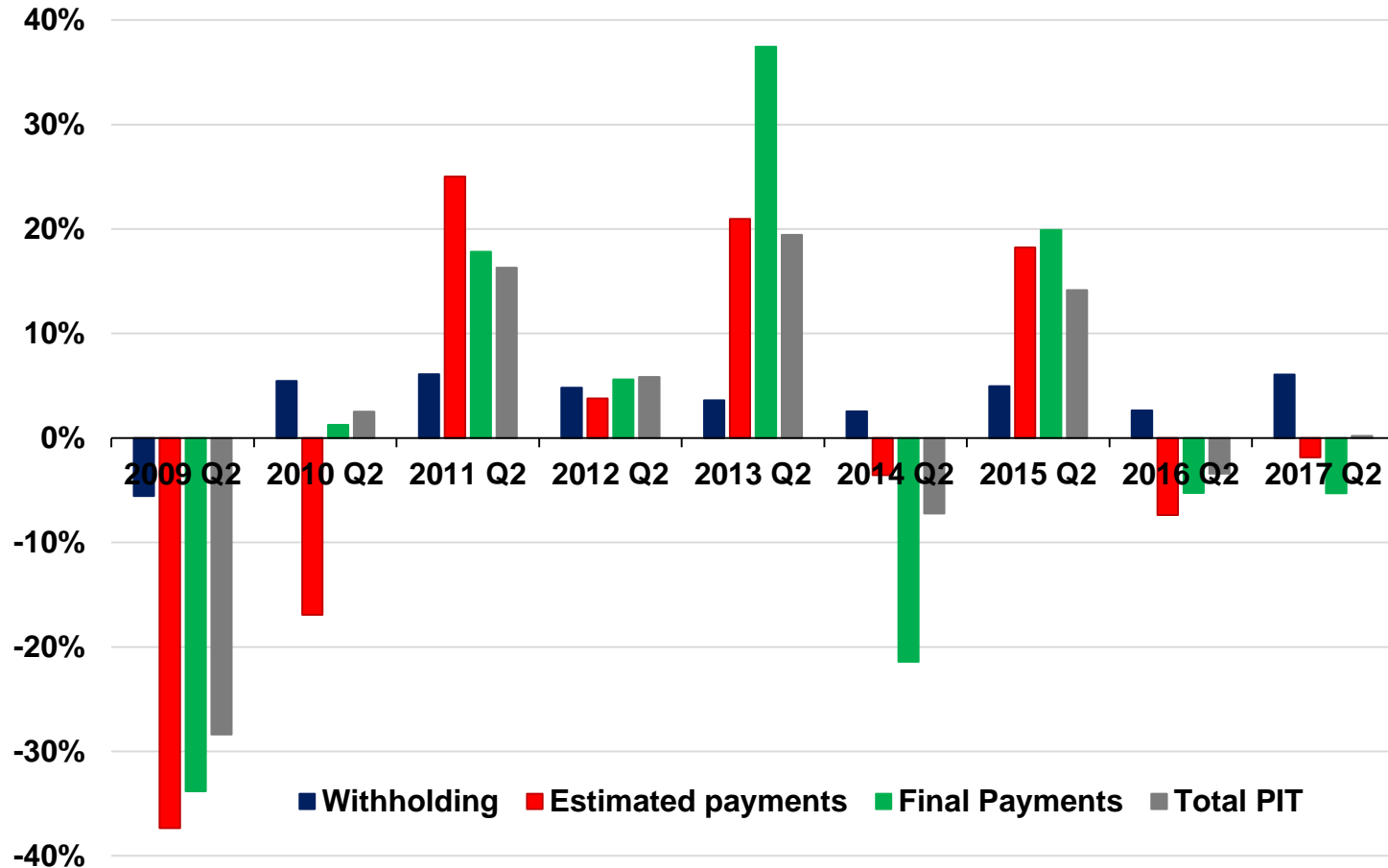
State PIT, adjusted for inflation & population growth, still below pre-recession in 18 states

Percent change in 4-quarter moving average of personal income tax revenues, 2017q2 vs 2007q4
Adjusted for inflation & population change (U.S. average = 4.7%; U.S. median = 1.6%)



April-June personal income tax collections are very volatile

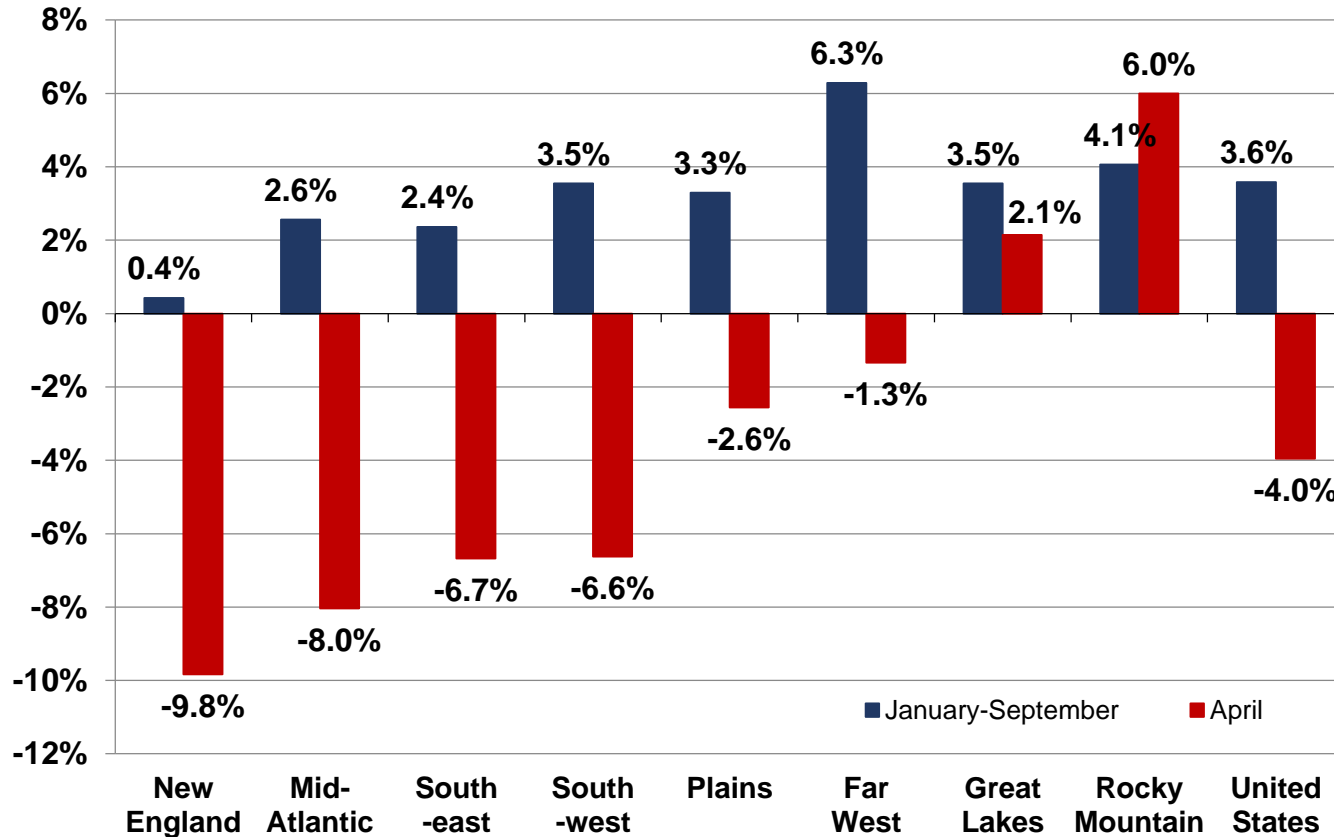
Year-Over-Year Nominal Percentage Change for April-June Quarters



Source: Individual state data, analysis by the Rockefeller Institute.

State personal income tax collections were down in April in most regions

Year-Over-Year Nominal Percent Change
January-September 2016 to 2017, and April 2016 to 2017



Source: Individual state data, analysis by the Rockefeller Institute.

April income tax shortfalls: Trump effect or weaker economy?

A little of both:

- Trump effect: Based on history, we believe some (10%??) capital gains were shifted out of 2016, to the future. Likely will happen again. Also, some evidence that wages were shifted out of 2016q4 into 2017q1.
- Weaker economy: Wage growth for 2016 revised downward 1%

Potential explanations and implications

• Trump effect

- Taxpayers in late 2016 saw promises of rate reductions, elimination of ACA net investment income tax (3.8%), elimination of SALT deduction
- Incentive to defer income out of 2016 (esp. cap gains and bonus wages), accelerate deductions into 2016, and even pay S&L taxes early
- Taxpayers might have realized deferred 2016 income in 2017, or might defer/accelerate again into 2018 due to the tax reform bill adopted so late. Implications for April 2018 returns, and for Dec/Jan estimated

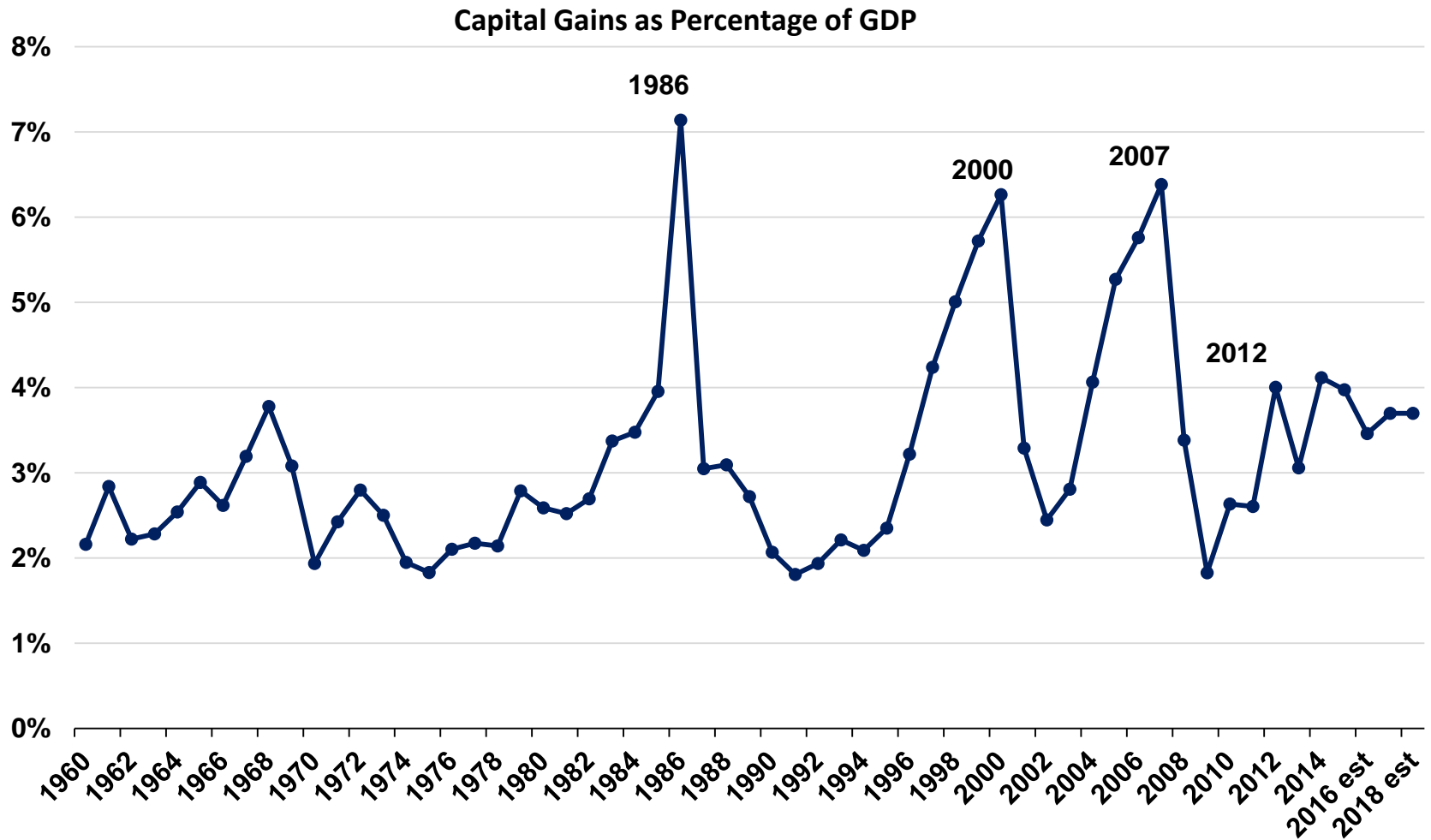
• Weaker economy

- Forecasters stand on shifting sands
- Preliminary economic data for 2016, at time forecasters had to put pencils down, were subject to significant uncertainty
- Eg, initial BEA 2014 wage estimate of 4.3% later revised to 5.1%; initial 2014 dividends estimate of 4.4% revised to 16.6%
- If 2016 economy was weaker than thought, could bring forecasts down, too

Income shifting and capital gains

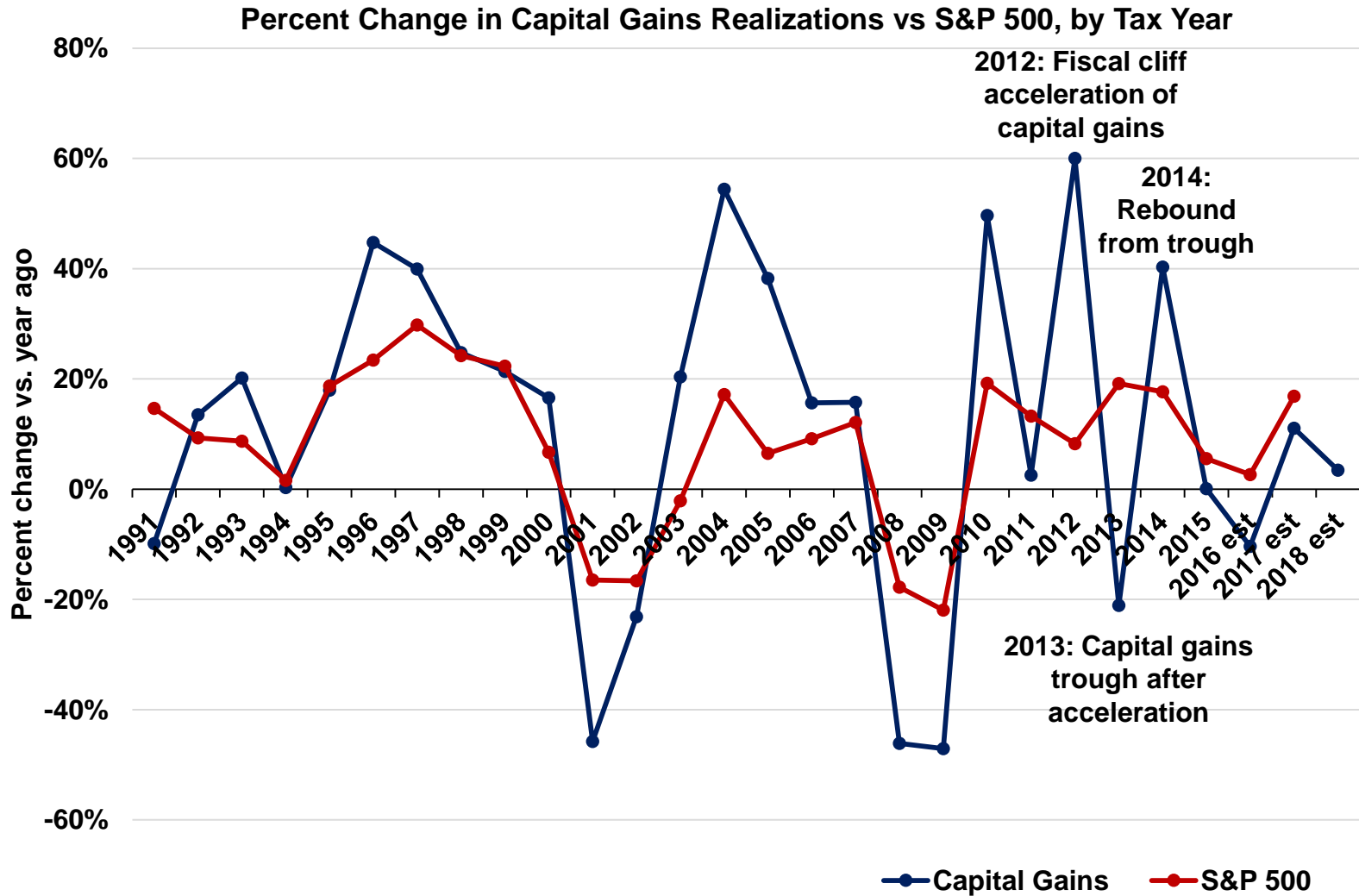
- In concept, taxpayers can shift many kinds of income, but....:
- “Regular” wages – not so easy – work less now, more later
- Bonus wages – easier – firm could shift out of q4 into q1
- IRA distributions – maybe not so hard
- Dividends – boards of closely held firms could delay payouts
- Capital gains – easiest – defer stock sales (rearrange assets); concentrated – 70% of cap gains claimed by just 0.7% of taxpayers

Capital gains: Big contributor to income tax volatility



Source: (1) Capital gains for 1960-1994 are from US Treasury and for 1995-2016 are from CBO at www.cbo.gov/about/products/budget-economic-data#7. (2) GDP from Bureau of Economic Analysis.

Capital gains are loosely related to the stock market



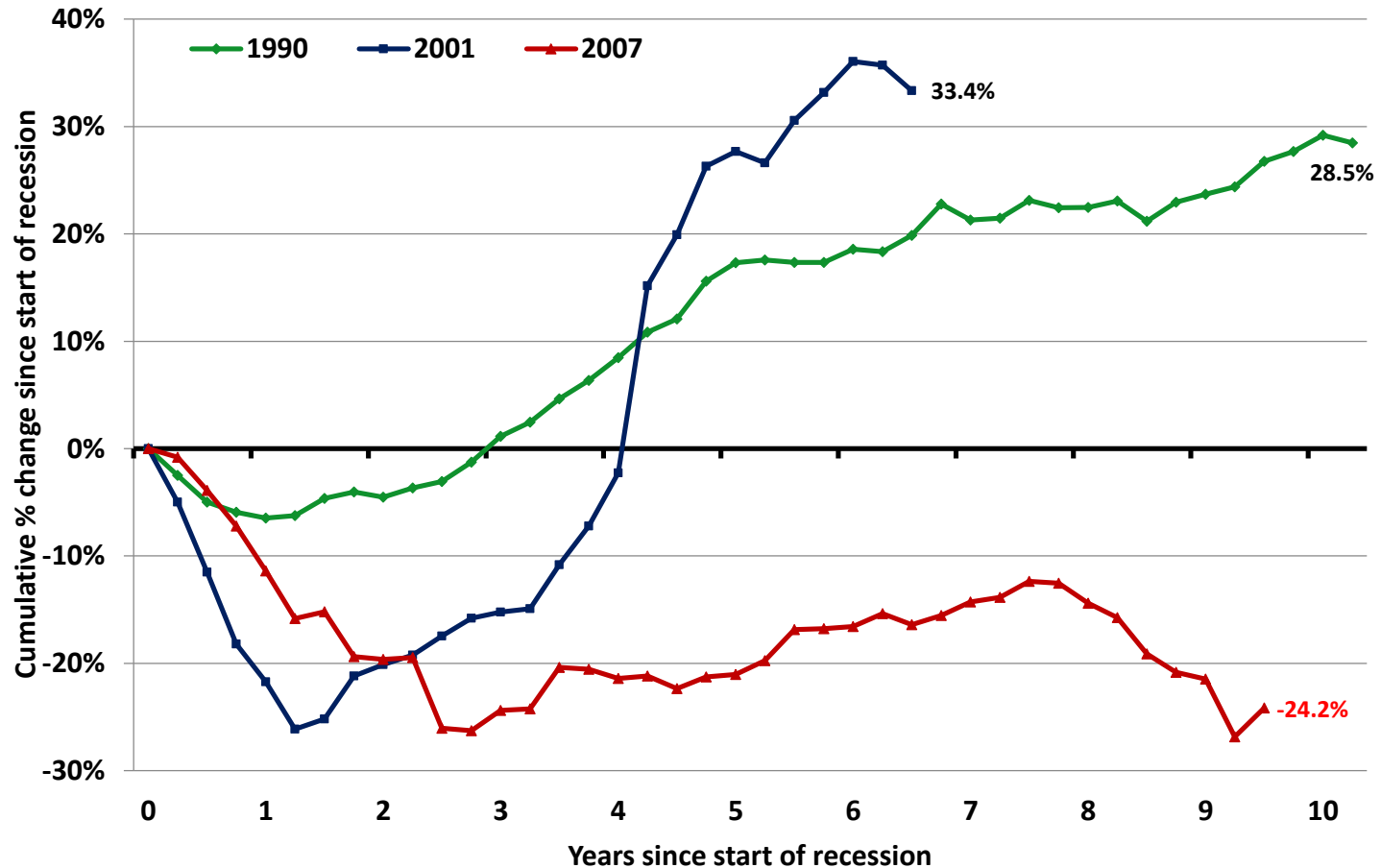
Actual vs. projected personal income tax revenues (\$ in millions)

State	April-May 2016 actual	April-May 2017 actual	April-May 2017 forecast	% change in actual, 2016 to 2017	% variance, April-May 2017 actual from forecast
North Dakota	110	95	114	(13.7)	(16.7)
New York	8,570	7,103	8,472	(17.1)	(16.2)
Vermont	189	174	201	(8.1)	(13.5)
Montana	280	254	294	(9.2)	(13.5)
Nebraska	527	494	571	(6.1)	(13.4)
Ohio	1,296	1,338	1,534	3.3	(12.7)
Rhode Island	264	234	262	(11.5)	(10.7)
Mississippi	411	415	458	0.8	(9.5)
Illinois	2,862	3,139	3,451	9.7	(9.0)
Pennsylvania	2,651	2,759	2,978	4.0	(7.4)
Arizona	913	839	896	(8.2)	(6.4)
West Virginia	412	392	419	(4.8)	(6.3)
Kansas	490	477	501	(2.6)	(4.8)
Colorado	1,479	1,528	1,604	3.3	(4.7)
California	17,638	17,397	18,073	(1.4)	(3.7)
Wisconsin	1,484	1,485	1,540	0.0	(3.6)
South Carolina	552	592	610	7.1	(3.1)
Indiana	1,284	1,303	1,337	1.5	(2.5)
Maine	337	323	331	(4.0)	(2.4)
Arkansas	722	731	730	1.3	0.2
Idaho	421	443	435	5.3	1.8
Median				(1.4)	(6.4)

State government corporate income tax

State government corporate income taxes: There is **NO** recovery

State corporate income tax revenue since the start of the recession
Four-quarter moving average, adjusted for inflation

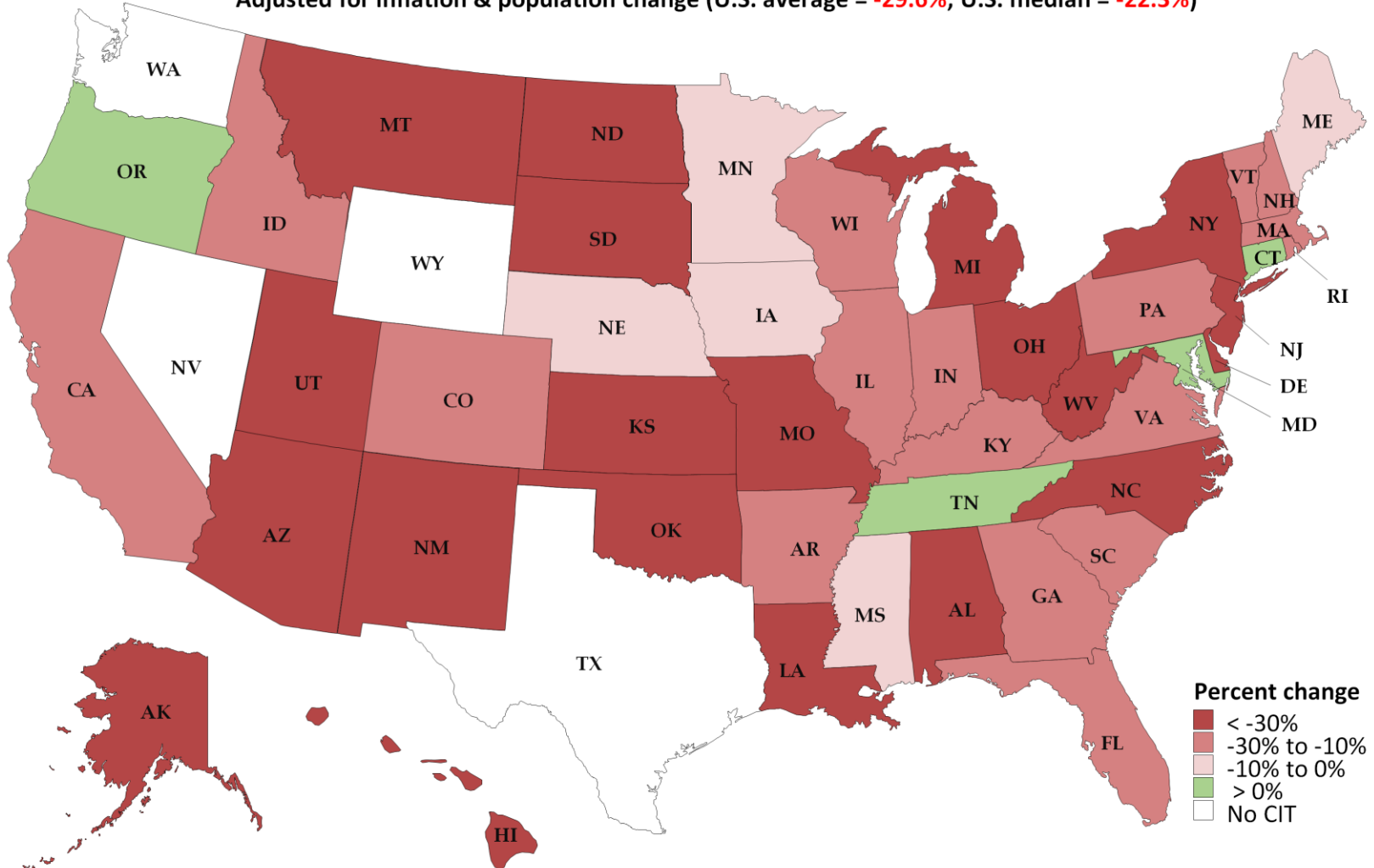


Sources: U.S. Census Bureau (taxes) and Bureau of Economic Analysis (GDP).

Notes: 4-quarter moving average of inflation-adjusted tax revenue. Data are shown only until the start of the next recession.

State CIT, adjusted for inflation & population growth, still below pre-recession in 42 states

Percent change in 4-quarter moving average of corporate income tax revenues, 2017q2 vs 2007q4
Adjusted for inflation & population change (U.S. average = -29.6%; U.S. median = -22.3%)



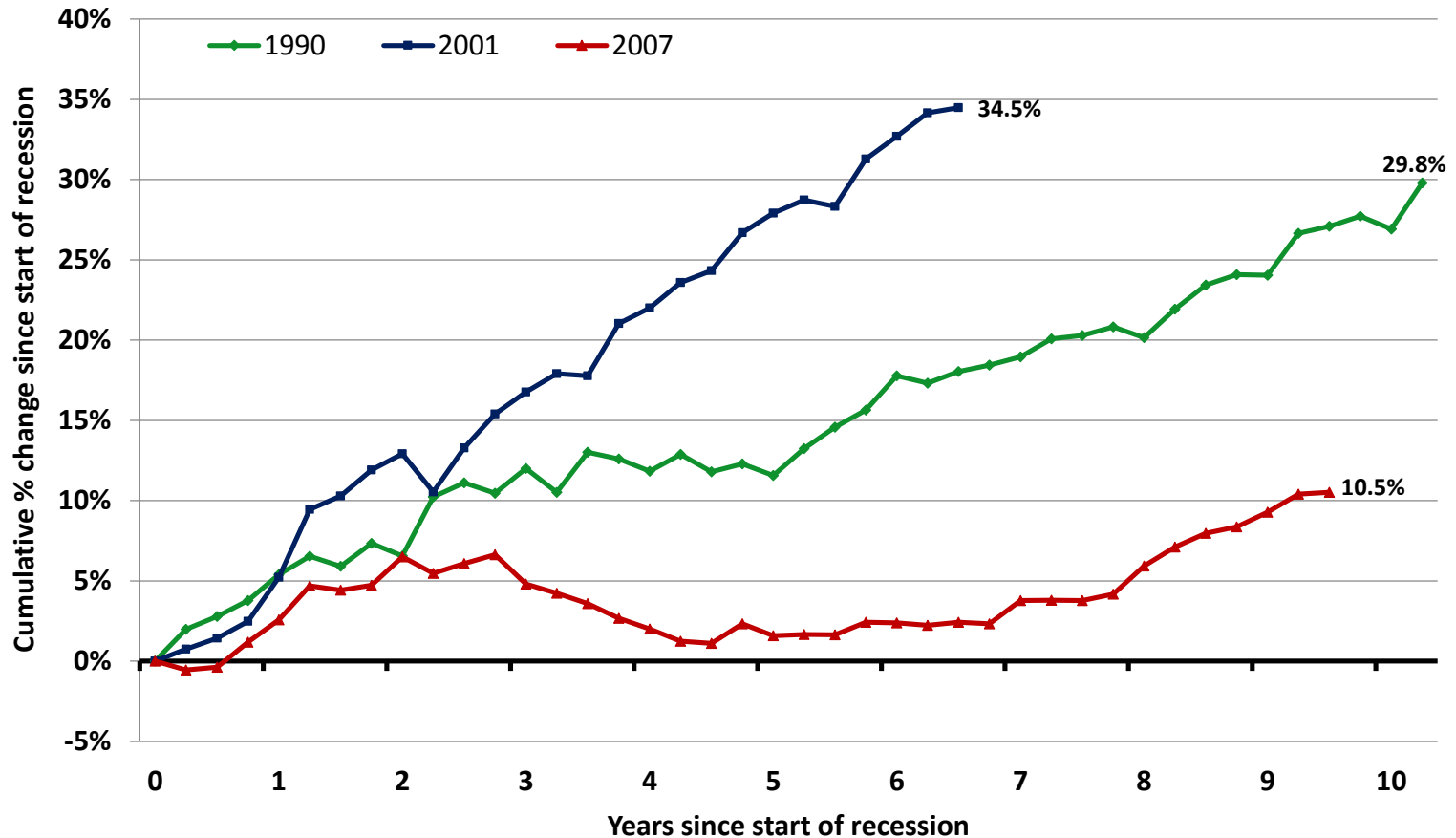
State tax revenue forecasts for FY 2018

State	Past forecasts, FY 2018 (\$ mlns)			Forecast date	Recent forecasts, FY 2018 (\$ mlns)			Forecast date	Recent vs past forecasts (\$ mlns)		
	PIT	CIT	Sales		PIT	CIT	Sales		PIT	CIT	Sales
Arizona	4,347	401	4,647	Apr-17	4,314	314	4,675	Sep-17	(32.8)	(87.1)	27.9
Arkansas	2,797	410	2,445	May-17	2,838	387	2,419	Dec-17	41.1	(23.3)	(26.0)
California	85,866	10,878	25,179	Jan-17	88,961	10,894	24,470	May-17	3,095.0	16.0	(709.0)
Colorado	7,263	566	3,346	Sep-17	7,277	532	3,363	Dec-17	13.6	(33.6)	16.9
Connecticut	9,097	872	3,842	Apr-17	9,093	933	4,151	Nov-17	(3.6)	61.2	309.4
Delaware	1,385	89	N/A	Sep-17	1,385	76	N/A	Dec-17	0.0	(13.0)	
Florida	N/A	2,340	24,091	Mar-17	N/A	2,405	23,948	Aug-17		65.2	(143.2)
Hawaii	2,197	83	3,460	May-17	2,285	91	3,366	Sep-17	88.4	8.0	(94.0)
Indiana	5,661	949	7,630	Apr-17	5,687	775	7,584	Dec-17	26.1	(174.4)	(46.1)
Iowa	4,656	593	2,918	Oct-17	4,656	593	2,918	Dec-17	0.0	0.0	0.0
Kansas	2,927	316	2,667	Jun-17	2,927	366	2,725	Nov-17	0.0	50.0	57.7
Kentucky	4,555	560	3,508	Aug-17	4,588	561	3,529	Oct-17	33.2	1.0	20.9
Louisiana	2,960	452	3,837	May-17	3,024	383	3,887	Dec-17	64.4	(68.5)	50.1
Maine	1,684	166	1,400	May-17	1,524	172	1,405	Dec-17	(160.8)	6.2	4.9
Maryland	9,381	827	4,655	Sep-17	9,289	844	4,622	Dec-17	(91.9)	17.2	(33.0)
Massachusetts	15,628	2,676	6,480	Dec-16	15,294	2,562	6,512	Dec-17	(334.0)	(114.0)	32.0
Michigan	10,044	980	7,957	Jan-17	9,965	960	8,196	May-17	(78.8)	(20.0)	238.9
Minnesota	11,839	1,280	5,592	Feb-17	11,524	1,226	5,469	Nov-17	(315.0)	(54.0)	(123.0)
Mississippi	1,896	587	2,388	Nov-16	1,835	551	2,303	Nov-17	(60.8)	(35.8)	(84.5)
Montana	1,291	134	N/A	Nov-16	1,321	169	N/A	Apr-17	29.6	34.4	
Nebraska	2,425	265	1,625	Apr-17	2,310	295	1,620	Oct-17	(115.0)	30.0	(5.0)
Nevada	N/A	N/A	1,201	Dec-16	N/A	N/A	1,200	May-17			(1.5)
New York	49,383	7,969	16,857	Jul-17	48,632	7,879	16,753	Nov-17	(751.0)	(90.0)	(104.0)
Oklahoma	1,880	102	2,142	Feb-17	1,927	103	2,358	Dec-17	47.8	1.0	216.3
Oregon	8,263	529	N/A	Sep-17	8,182	541	N/A	Dec-17	(81.5)	11.7	
Pennsylvania	13,322	2,855	10,236	Jun-17	13,223	3,018	10,230	Nov-17	(99.0)	163.0	(6.0)
Rhode Island	1,297	178	1,035	May-17	1,299	173	1,053	Nov-17	2.0	(5.2)	18.0
South Carolina	4,296	329	3,041	Feb-17	4,295	344	3,041	Nov-17	(1.0)	15.0	0.0
South Dakota	N/A	11	1,000	Feb-17	N/A	12	979	Nov-17		0.8	(20.2)
Texas	N/A	N/A	30,383	Jan-17	N/A	N/A	30,490	Oct-17			107.5
Utah	3,733	340	1,932	Nov-16	3,850	335	1,961	Nov-17	116.6	(5.4)	29.2
Vermont	795	87	397	Jan-17	784	81	391	Jul-17	(11.2)	(6.3)	(5.7)
Virginia	13,380	825	3,446	Dec-16	13,492	874	3,458	Dec-17	111.7	49.1	12.7
Washington	N/A	N/A	10,697	Sep-17	N/A	N/A	10,787	Nov-17			89.6
Wyoming	N/A	N/A	420	Jan-17	N/A	N/A	429	Oct-17			9.4
United States	284,248	38,651	200,452		285,781	38,450	200,292		1,533.2	(200.9)	(159.9)

Local government property taxes

Local government property taxes: Continued growth

Local government property tax revenue since the start of the recession
Four-quarter moving average, adjusted for inflation

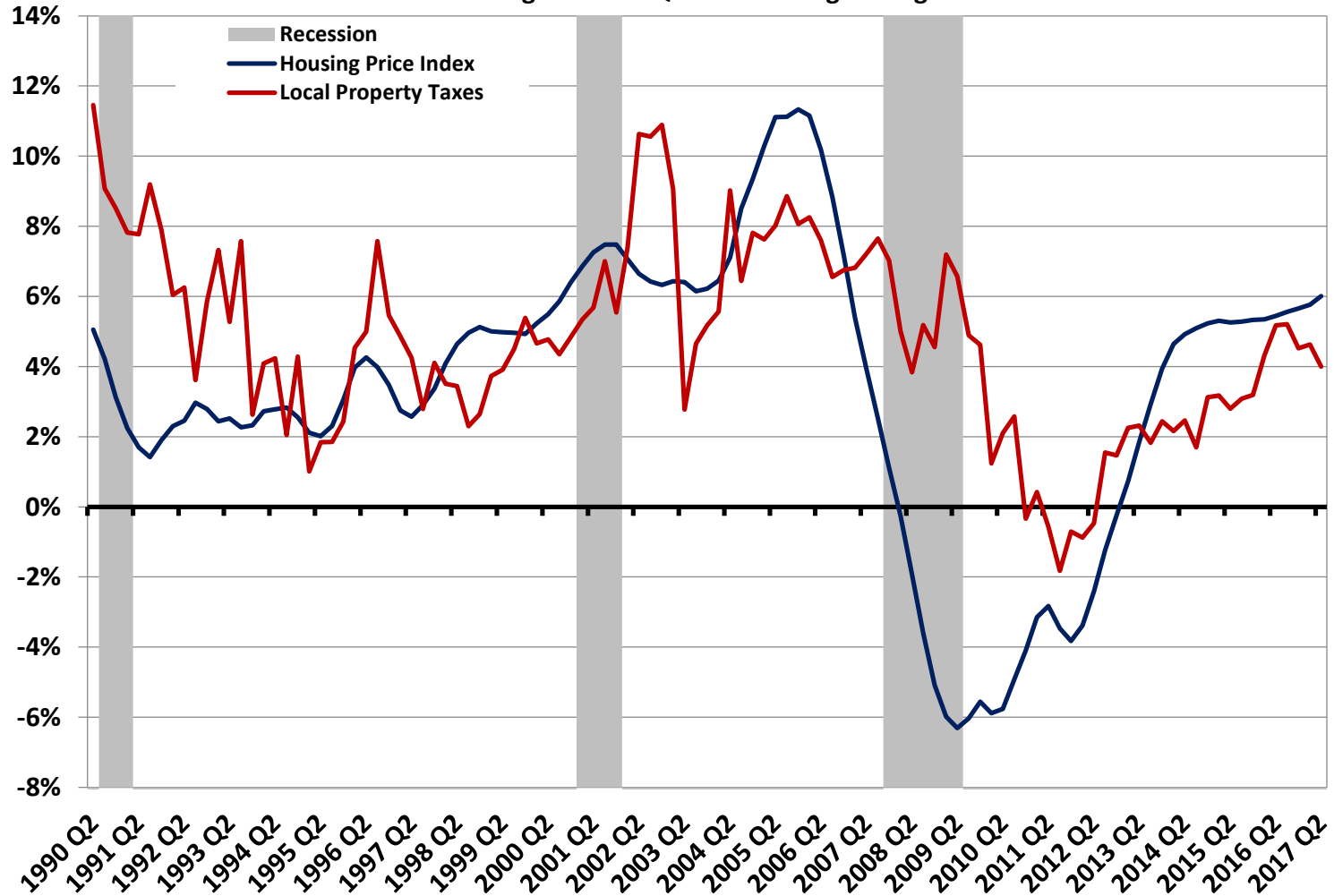


Sources: U.S. Census Bureau (taxes) and Bureau of Economic Analysis (GDP).

Notes: 4-quarter moving average of inflation-adjusted tax revenue. Data are shown only until the start of the next recession.

Continued Growth in Housing Prices; Downward Trends in Local Property Taxes

Year-Over-Year Change in Housing Prices vs. Local Property Taxes
Percent Change of Four-Quarter Moving Averages

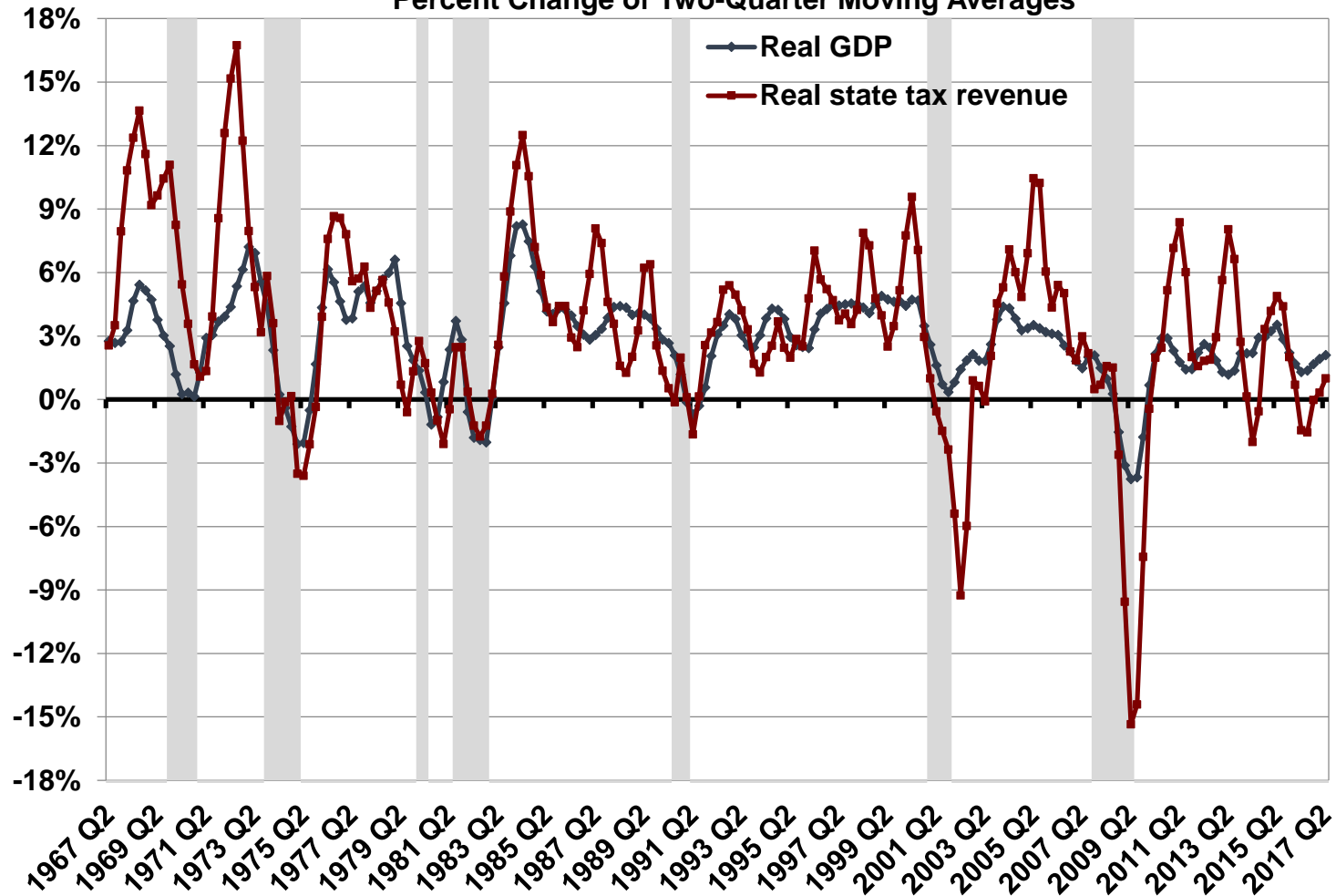


Sources: U.S. Census Bureau (tax revenue) and Federal Housing Finance Agency, House Price Indexes data (all transactions).

Tax revenues: Summary and conclusions

State taxes & the economy: States taxes far more volatile; Recent declines

Year-Over-Year Change in Inflation-Adjusted State Gov. Taxes and Real GDP
Percent Change of Two-Quarter Moving Averages



Sources: U.S. Census Bureau (tax revenue) and Bureau of Economic Analysis (GDP).

Notes: (1) Percentage change of two-quarter moving averages; (2) No legislative adjustments; (3) Recession periods are shaded.

Growing revenue volatility & fiscal challenges

- Tax revenue increasingly more volatile
- More reliant on economically sensitive taxes
- Income taxes rely more heavily on volatile income – capital gains, bonuses
- Sales tax bases are eroding
- Many services hard to tax: politically, legally, administratively
- Taxation of goods and services sold over the Internet
- Demographic changes and taxes
- Single-year cash balance is the goal:
 - Gimmicks, one-time solutions
 - Higher reliance on more regressive taxes
- No serious multi-year financial planning

State taxes:

Some thoughts about the future

- Income tax
 - Slower growth in wages
 - Stronger stock market growth in 2017
 - Strong incentive to defer income again, to 2018
 - Large uncertainties for PIT
- Sales tax
 - Some signs of improvement in some states mostly due to Amazon agreements
 - Taxable consumption had been boosted by energy and autos, but that boost has gone away
 - Continued trends toward internet-based purchases
 - Declines in retail sales
- Lots of uncertainties, lots of fiscal challenges ahead for state and local governments

Fiscal reality & outlook

- State & local gov't finances hit hard by recession & financial crisis, much harder than economy
- The revenue recovery is weak & prolonged
- Differing fiscal, tax & economic structures play important roles
- Many states face fiscal stresses
 - Growing revenue volatility
 - Uncertainty about the impact of the federal reform
- Long-term spending pressures; federal aid cuts
- Without significant state policy changes, long-term fiscal sustainability is under threat

Tax reform bill

Brief summary

- Won't apply to 2017 income tax
- Most provisions begin on January 1, 2018
 - Tax brackets, tax rates, etc.
- Few provisions start later on
 - Changes to alimony payment
 - Elimination of Obamacare mandate
- Tax cuts for individuals & small businesses expire on 2025
- Corporate tax cuts are permanent
- Elimination of unlimited deductions for property taxes
 - \$10K cap per year
 - Big deal for high-tax, high-income states (CA, NY, NJ, IL, etc.)
- Lower cap on the mortgage interest deduction for new buyers

New & old income tax brackets and rates

Old Vs. New Tax Brackets For Single Filers

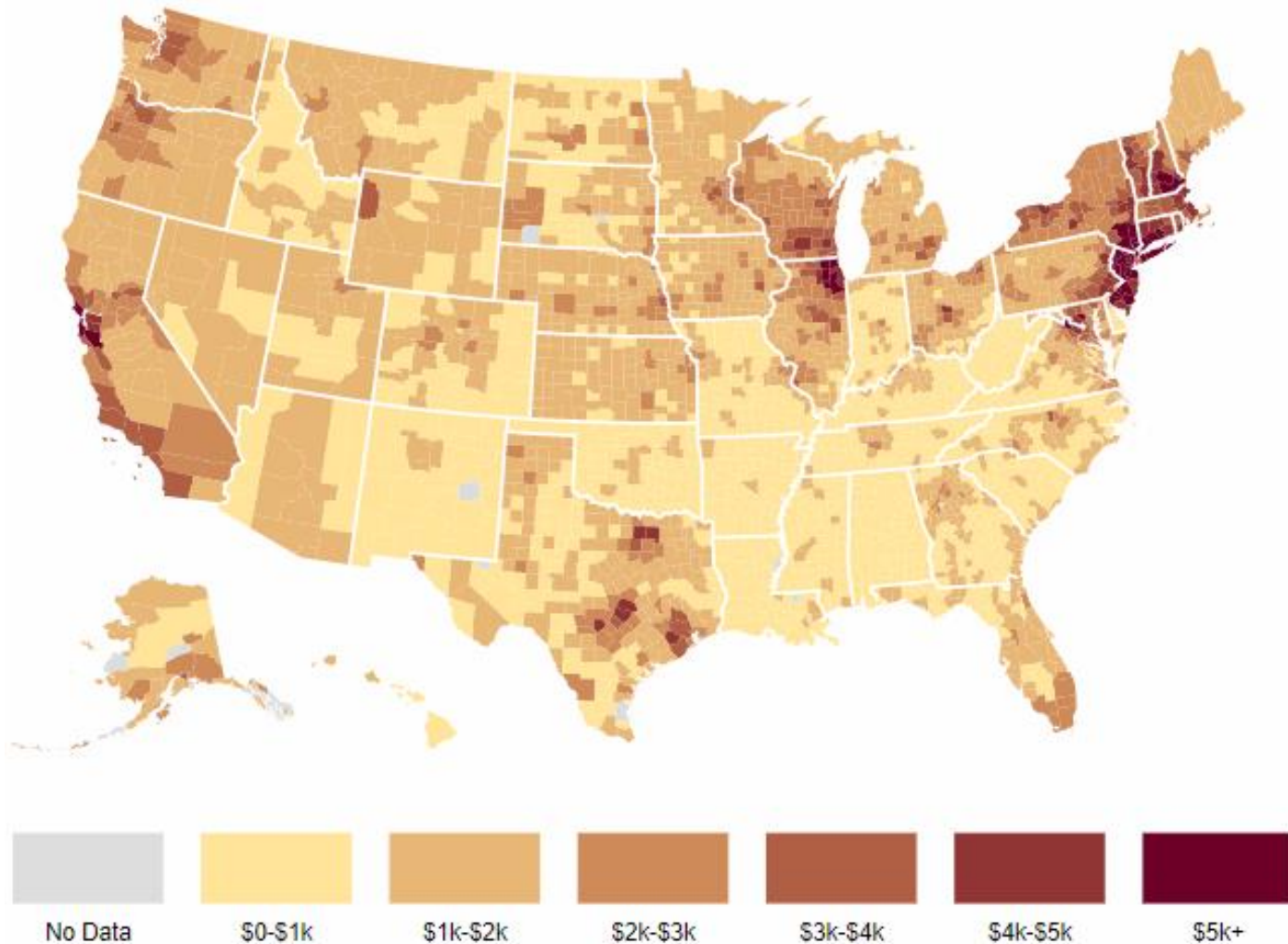
Old brackets		New brackets	
Taxable income	Tax rate	Taxable income	Tax rate
\$0-\$9,525	10%	\$0-\$9,525	10%
\$9,526-\$38,700	15%	\$9,526-\$38,700	12%
\$38,701-\$93,700	25%	\$38,701-\$82,500	22%
\$93,701-\$195,450	28%	\$82,501-\$157,500	24%
\$195,451-\$424,950	33%	\$157,501-\$200,000	32%
\$424,951-\$426,700	35%	\$200,001-\$500,000	35%
\$426,701+	39.6%	\$500,001+	37%

Sources: docs.house.gov, taxfoundation.org

2018 property tax pre-payment rush and chaos

- The new law is vague about state and local property tax pre-payments
- Governors in NY and NJ issued orders encouraging people to pre-pay and deduct their 2018 taxes this year
- Homeowners in some high-property tax states rushed into paying 2018 property taxes
- Taxpayers hoped they can deduct pre-payments from 2017 taxes
- Examples: Montgomery County, Maryland
 - Hold a special session and passed a [bill](#) allowing residents to pre-pay 2018 property tax bills
- On December 27th (after many taxpayers rushed to prepay), the IRS released an [advisory](#):
 - Prepaid real property taxes may be deductible in 2017 if assessed and paid in 2017

Median property taxes: Large variations among and within states

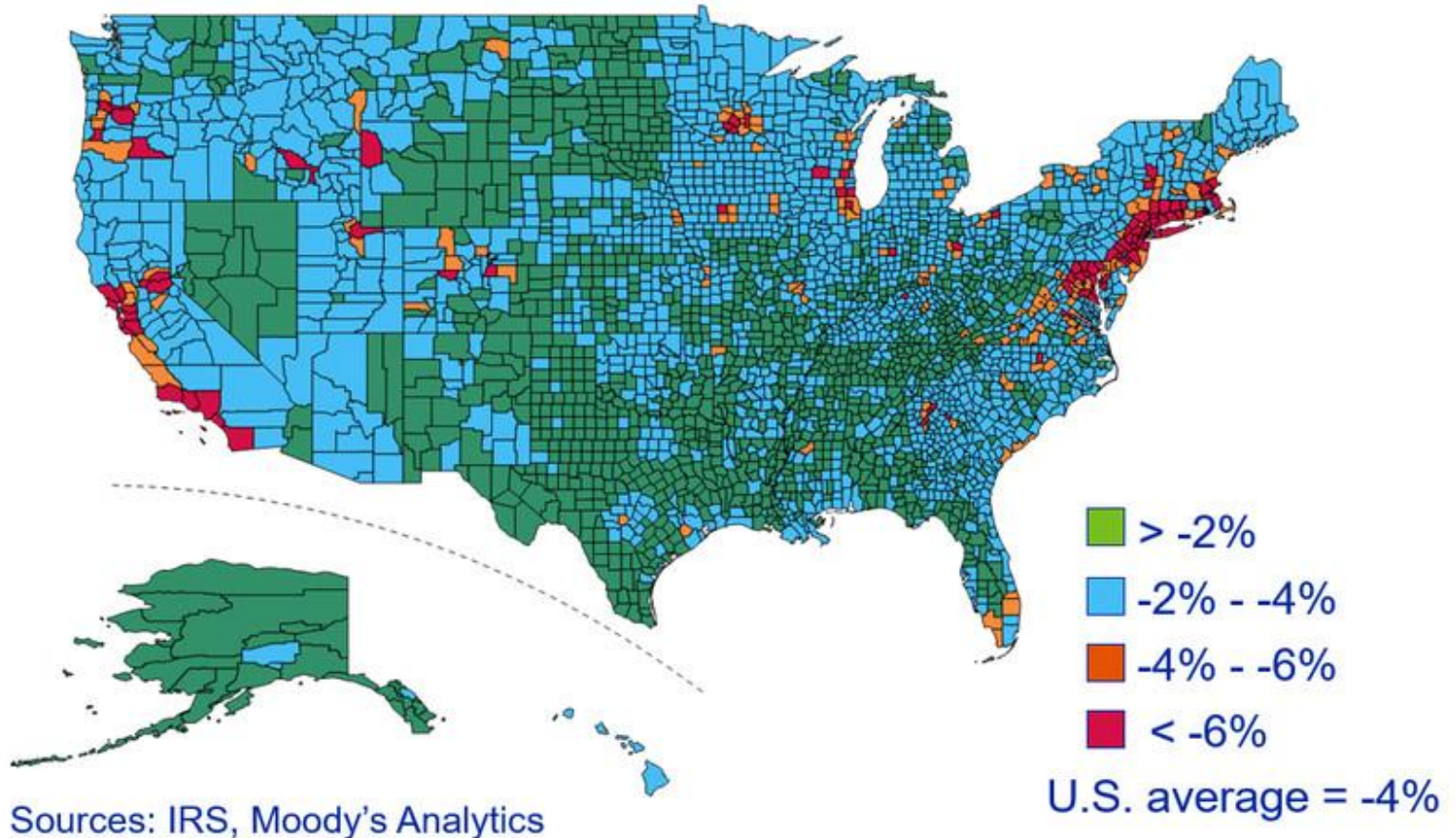


Source: Tax Foundation

Implications for the housing market

House Prices Are Hit Under Tax Plan

% change in FHFA HPI due to tax plan



Short-run disruptions; Long-term uncertainties

- Tax bill eliminated or reduced many popular tax deductions, allowing more income to be taxed
- Federal level: lowered tax rates and higher standard deduction
- State level: lots of fiscal uncertainty
 - Likely higher tax revenue collections in the short-run in some states
 - Taxpayer behavior in April 2018 and beyond
 - Other unintended consequences
- Officials in some states are looking into mitigating the impact of the federal tax reform on state taxpayers
- Bottom line: states are facing long-term fiscal challenges and need not to forget about the deteriorating revenues despite any temporary windfalls

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Thank you!

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**With many thanks to my colleague,
Donald Boyd**

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