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Fitch: Slow US State Tax Revenue Growth Pressuring Budgets.

Fitch Ratings-New York-14 June 2017: Tepid revenue growth is pressuring state budgets, leading to mid-year budget cuts and reserve draws, which is unusual eight years into a national economic expansion, Fitch Ratings says.

This may become a more significant issue for state governments if tax revenue growth continues to lag economic growth and continued divergence could pose long-term credit challenges for states. States have used the growing revenue typically accompanying economic expansions to restore structural budget balance, fund new priorities and build-up reserves. A permanent decoupling of this link could gradually pressure the typically robust revenue frameworks for states.

The median year-over-year (YoY) revenue growth for the 35 states reviewed by Fitch – those states that have reported monthly revenue data through April – was just 1.8%. April is typically a large month for income tax collections. This was below the 2.2% annual rate of inflation in April. Revenue growth also trailed growth in personal income at 3.7% and wages and salaries at 3.8%, which were both up solidly on an annual basis through March, the most recent month available.

Median sales tax collections grew at just 1.8%. The shift to online sales could be one cause as sales taxes are not always collected on those transactions. State and local governments may have missed out on as much as $26 billion in sales tax revenue from e-commerce and other remote sales in 2015 alone, according to the National Conference of State Legislatures and the International Council of Shopping Centers.

Personal income tax (PIT) revenues were somewhat better at a median growth rate of 2.7% YoY through April. PIT includes both paycheck-withholding revenues, which continue to generally track economic performance, and non-withholding revenues which tend to be linked to capital gains and are much more volatile.

In the limited states where non-withholding data is available, Fitch noted widespread sharp YoY declines as of April. The steepest declines were in Connecticut, which posted a nearly 14% decline and Massachusetts reporting a more than 6% drop off. Connecticut's shortfall contributed to the state's revision of its projection to a nearly $400 million operating deficit in the current year.

Pennsylvania's relatively smaller 4% decline in non-withholding revenues added to pressure from steep declines in business tax collections and softness in sales tax collections, leading the state to project an approximately $1 billion overall general fund shortfall for the current fiscal year.

States reported one possible driver of the declines in non-withholding personal income tax revenue could be taxpayers who shifted income to the 2017 tax year in anticipation of large federal tax cuts. If that is a key driver, states may see a rebound in revenues in the next fiscal year.

A closer look at historical data indicates a more fundamental shift may be underway. Based on a review of quarterly state and local tax receipt data from the US Bureau of Economic Analysis, Fitch notes a recently widening gap between growth rates for tax collections versus key economic indicators including personal income and wages and salaries.

Between third-quarter 2015 and first-quarter 2017, annual growth in quarterly state and local tax receipts averaged 1.9% while growth in quarterly personal income averaged 3.6% and growth in wages and salaries averaged 4.2%. Behavioral changes or ongoing consumer shifts to untaxed activity as described above may be factors. In the preceding decade, average growth rates in quarterly tax receipts, wages and salaries, and personal income were much closer.

Contact:

Eric Kim
Director, U.S. Public Finance
+1 212 908-0241
Fitch Ratings, Inc.
33 Whitehall Street, New York, NY

Laura Porter
Managing Director, U.S. Public Finance
+1 212 908-0575

Robert Rowan
Senior Analyst, Fitch Wire
+1 212 908-9159

Media Relations: Elizabeth Fogerty, New York, Tel: +1 (212) 908 0526, Email: elizabeth.fogerty@fitchratings.com.