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Fitch: US States' Economic Growth Diverges from Revenue Growth.

Fitch Ratings-New York-29 January 2018: The contrast of broad U.S. economic growth versus tepid state revenue growth and uncertain budget outlooks highlights a rising risk to some states' long-term credit profiles says Fitch Ratings. Weak revenue growth already took a toll on some states' fiscal results. We expect this trend to continue in the coming fiscal years.

The Bureau of Economic Analysis reported last week that quarterly real state GDP grew in every state in 3Q17 for the first time since it began reporting the data in 2005. State tax collections grew slower and less consistently through 3Q17, according to the US Census Bureau.

The budget issues are indicative of long-term credit challenges posed by revenue growth that lags economic growth. States have typically used growing revenue in 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 state revenue frameworks. A state's revenue framework is one of four key factors driving Fitch's credit analysis – the strongest frameworks show growth potential above national GDP and reflect revenue systems best positioned to capture economic growth. Despite widespread economic growth, the National Association of State Budget Officers (NASBO) reported that 22 states made mid-year budget cuts in fiscal 2017 and mid-year budget reports and executive budget proposals released to date indicate some will report deficits for the current and upcoming fiscal years.

Real GDP growth in 3Q17 (annualized) varied from a low of 0.5% for South Dakota to a high of 5.7% in Delaware, and the median across all states was 3.0%. Similarly, real national GDP growth also accelerated in recent years reaching 3.2% in 3Q17. Fitch estimates full-year US GDP growth to be 2.3% in 2017 and forecasts 2.5% in 2018 and 2.2% in 2019.

Real yoy growth in state tax collections was just 0.4% in 3Q17 and lagged real yoy national GDP growth since 2016. Previously, state tax collections and national real GDP growth were more correlated with state tax collections typically growing or shrinking more aggressively. Individuals and corporations that anticipated federal tax reductions may have played a role in the more recent decoupling. Policy adjustments by individual states may skew results from year to year.

State fiscal results and plans indicate the toll the trend has had on budgets. The 22 states NASBO reported on made mid-year cuts in fiscal 2017. This was the highest number since fiscal 2010 when nearly all states were managing the Great Recession's repercussions – the $3.5 billion of cumulative deficits in fiscal 2017 was much lower than the roughly $20 billion in fiscal 2010, indicating less severe but widespread fiscal challenges. Declines in states' fiscal 2017 year-end total balances reflect this revenue weakness as 31 states reported lower balances to NASBO than the prior year. Total balances were $72 billion at the end of fiscal 2017, or 9% of spending, down from $81 billion, or 10% of spending, in 2016. The 2017 levels were also below the pre-recession peak of 12% of spending.

Revenue uncertainty and budget tension will continue in the current and future budget years. Some states have reported modest current year deficits. Rhode Island’s $60 million shortfall, just 2% of the budget, is one. However, projected budget holes for upcoming years appear more significant. Kentucky’s roughly $2 billion gap for the upcoming biennium, to address a ramp up in pension funding, would be 10% of the budget. Federal tax changes and related shifts in taxpayer behavior will also cloud the revenue picture for states.