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Rockefeller Institute: Weak Revenue Growth Amid Uncertainty About Federal Tax Changes

*State Tax Revenue Growth Slows Despite Improving
Economic Growth and a Strong Stock Market*

Summary

Albany, NY—Today, the Rockefeller Institute of Government released its latest *State Revenue Report* that found weak revenue growth for both state governments and local governments. State and local government revenue from major taxes increased 2.1 percent in the third quarter of 2016 from the same quarter a year ago. This is a substantial slowing from the 3.1 percent average growth for the four previous quarters. A one-percentage point slowdown, if sustained, can add meaningful stress to state and local budgets. For example, over the course of a year, 1 percent of taxes is equivalent to one-sixth of all state and local spending on highway capital needs.

State tax revenue, in particular, has been growing more slowly than the economy. Total state tax revenue grew by only 1.2 percent in the third quarter, and by 0.4 percent, preliminarily, in the fourth quarter, despite improving economic growth and a stock market that was up by double digits in the second half of the year. In the same two quarters, the economy grew by 2.9 percent, and 3.5 percent on a year-over-year basis, before adjusting for inflation.

State tax revenue has been held back primarily by year-over-year declines in estimated payments of personal income tax, slow growth in the sales tax, and by outright declines in corporate income taxes and in several excise taxes. Personal income tax and sales tax, the two largest sources of state revenues, grew by only 2.7 and 2.0 percent, respectively, well below growth in the economy. The declines in estimated payments of income tax may reflect taxpayer efforts to push income out of 2016, into 2017, to benefit from federal tax cuts anticipated for 2017. Corporate income tax revenue was down by 10.4 percent, marking the fourth consecutive quarterly decline. There was weakness in much of the country, but energy states were especially hard hit by continued weakness in oil prices.

If tax revenue growth does not accelerate, many states are likely to face shortfalls in the current fiscal year and will have to lower their forecasts for next year, leading to hard choices about whether to raise taxes, reduce spending, or search for alternative budget-balancing solutions.

Growing Uncertainty in Personal Income Tax Collections

The Rockefeller Institute collected and analyzed data from major components of personal income tax collections. The analysis indicates widespread and substantial declines in estimated and final payments of income tax in the last three quarters of calendar year 2016.

These declines are particularly difficult to interpret now. The stock market declined in the first half of 2016 but improved substantially in the second half of 2016. For the entire 2016, the stock market was up more than 9 percent, as measured by the S&P 500 index. All else equal, this would suggest relatively strong capital gains in 2016, which in turn could boost estimated payments of income tax. However, the picture is muddled by various factors, including changes in taxpayer behavior in anticipation of potential federal tax reform that could have a significant impact on personal income tax collections. On one hand, taxpayers could have been motivated to push taxable income out of 2016 into 2017 in the anticipation of lower income tax rates in 2017. On the other hand, some taxpayers had an incentive to accelerate payment of state and local government taxes into 2016 from 2017, because the federal tax deduction for these payments would become less valuable in 2017 if federal tax rates are reduced.

Sales Tax Revenue Loss Due to Online Sales

The weakness in sales tax collections is partially attributable to tax dollars owed but not collected for online sales. Therefore, a growing number of states seek tax revenues from online sales. In calendar year 2017 so far, 11 states have joined states that already collect taxes on sales by Amazon.com LLC or its subsidiaries, raising the number to 42 out of 45 states that impose such a general sales tax. Those 11 states are likely to see additional collections of sales tax beginning in the April-June quarter.

Energy States Hard Hit by Continued Weakness in Oil Prices

States collected \$926.7 billion in total tax revenues in fiscal year 2016, a gain of 1.5 percent from the \$913.2 billion collected in fiscal year 2015. The personal income tax and sales tax grew 2.8 percent and 2.0 percent, respectively, while the corporate income tax declined 8.0 percent. Thirty-eight states reported growth in fiscal 2016 compared to fiscal 2015 while 12 states reported declines. All oil- and mineral-dependent states—Alaska, Louisiana, Montana, New Mexico, North Dakota, Oklahoma, Texas, West Virginia, and Wyoming—had large tax declines in fiscal 2016 and their budgets suffered enormously due to the drastic fall of oil prices.

Continued Weak Growth in the Fourth Quarter of 2016 and Weak Forecasts for FY 2017

Preliminary data for the fourth quarter of 2016 indicate substantial softening of state tax revenues, with growth of only 0.4 percent.

States continue to forecast weak tax revenue growth for fiscal year 2017. The median forecasts of income tax and sales tax growth are 3.6 percent and 3.1 percent, respectively.

Revenue forecasts are also weak for fiscal 2018, which will be discussed in more detail in the forthcoming report on state revenue forecasts.

Promised but Uncertain Federal Tax Reform Creates State Challenges

Potential federal tax reform, health care reform and other fiscal policy changes would undoubtedly have a direct impact on state budgets, as well as impacts on state economies. The uncertainty tied to federal policy changes puts state forecasters in a tough position and quite understandably makes it harder to forecast state revenues with any precision

To read the *State Revenue Report*, go to

[http://www.rockinst.org/pdf/government finance/state revenue report/2017-03-09-srr_106.pdf](http://www.rockinst.org/pdf/government%20finance/state%20revenue%20report/2017-03-09-srr_106.pdf).

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