

State-Local Tax Slowdown Continues

State and Local Revenue Alert October-December 2007

Don Boyd ♦ Boyd Research
don@boydresearch.com

March 2008

Highlights

- New data from the U.S. Bureau of the Census show that state and local government tax revenue grew by 4.9 percent in the October-December quarter compared with the same period a year earlier, continuing a slowdown in tax collections for state and local governments.
- State government tax revenue has been slowing far more sharply than local tax revenue. State tax revenue grew by 3.9 percent while local revenue grew by 6.2 percent.
- After adjusting for inflation, state tax revenue grew by only 0.9 percent, while local revenue grew by 3.5 percent.
- The slowdown in the sales tax has been especially significant, and the income tax has weakened as well. Property taxes – the mainstay of finance in the typical local government – have held up much better. But property taxes are under pressure, too, and local governments face additional difficulties as a result of the weakening economy.
- Deteriorating growth in wages, retail sales, and corporate profits all suggest that the January-March quarter is likely to slow further.
- State tax revenue growth has been strongest by far in the Rocky Mountain region, reflecting an economy that has performed better than the national average plus extraordinary growth in severance taxes.
- Motor fuel taxes have been weak throughout the nation, in large part reflecting the impact of higher gas prices on consumption.

To receive future reports on state and local government fiscal topics, please send email to don@boydresearch.com. Suggestions on how to improve this report are welcome. It may be possible to include details about more taxes and specific states in future reports.

Introduction

State and local government tax revenue grew by 4.9 percent in the October-December quarter over the same period last year, according to new data from the U.S. Census Bureau's quarterly tax survey. (See "Appendix: About the data") State tax revenue fared worse than local revenue, rising by 3.9 percent, while local revenue rose by 6.2 percent. After adjusting for inflation of approximately 2.6 percent, real state tax revenue grew a slim 0.9 percent and real local tax revenue grew by 3.5 percent, as Figure 1 shows.¹

Figure 1 Growth in state and local tax revenue

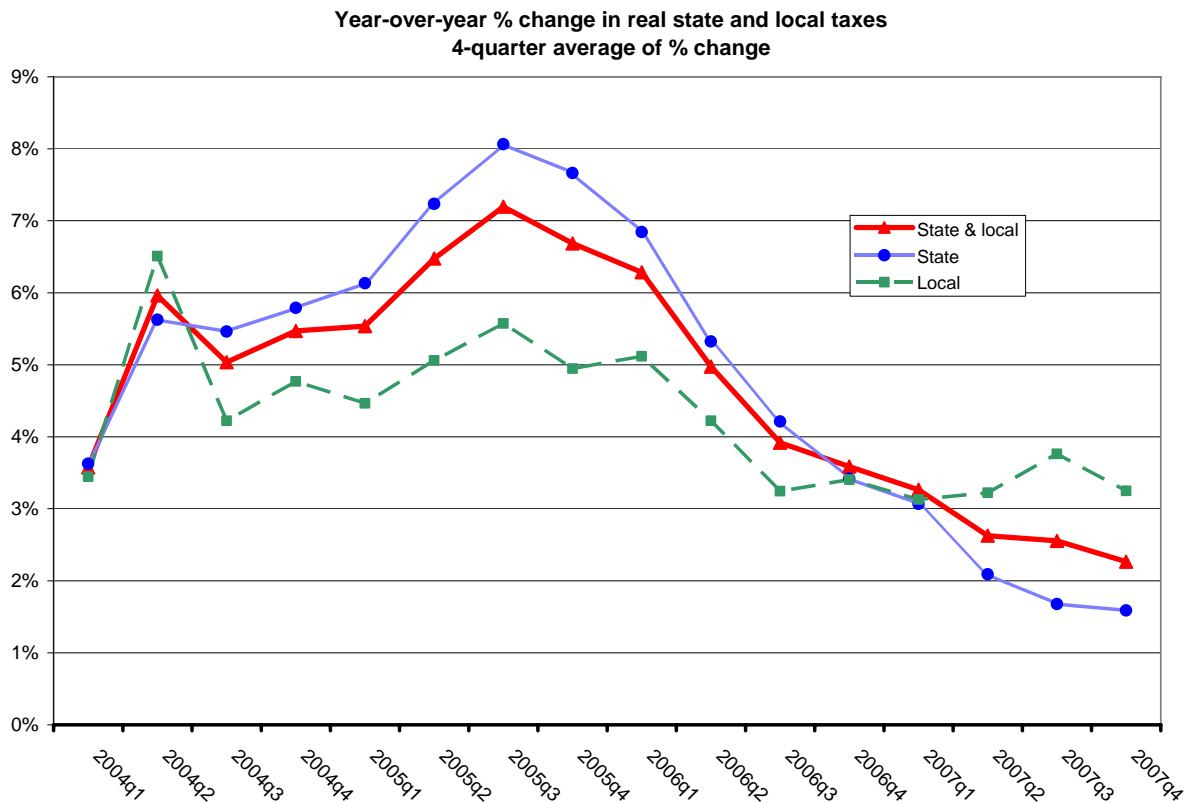
State and local tax revenue, October-December 2007 vs. year ago

	State & local taxes	State taxes	Local taxes
Growth in reported taxes	4.9%	3.5%	6.2%
Growth in real (inflation-adjusted) taxes	2.2%	0.9%	3.5%

Source: U.S. Bureau of the Census, Bureau of Economic Analysis

Because tax revenue can be very bouncy from quarter to quarter, it is important to examine current data in the context of longer-term trends in ways that do not put too much weight on any single data point. Figure 2 does this by averaging each new quarter with the three prior quarters, so that conclusions are not influenced too heavily by new data. It shows that real state tax revenue growth has been slowing sharply, while local tax revenue has been holding up somewhat better – so far.

Figure 2 State taxes have been slowing more sharply than local taxes



The main reason that local tax revenue has held up better than state tax revenue is because most local governments have a very different revenue structure than the typical state government. States rely on income and sales taxes for about 67 percent of their tax revenue, and on property taxes for only about 2 percent. By contrast, local governments rely on property taxes for about 76 percent of tax revenue. This reliance on property taxes lends considerable stability to local government budgets. Local governments have faced difficulties in past recessions, to be sure, and will face difficulties in this recession, but compared with state governments the automatic impact on the typical local government’s budget is small. The current recessionary environment has led and will lead to substantial declines in property values in many parts of the country. This will lead to downward pressure on local property taxes, but in most areas the impact will not be rapid or automatic, and it will not be uniform throughout the country. This may be a topic of a future report.²

Figure 3 shows that the inflation-adjusted property tax growth of 4.1 percent was much stronger than the growth in other major tax sources.

Figure 3 Property taxes have been stronger than income, sales, or corporate taxes

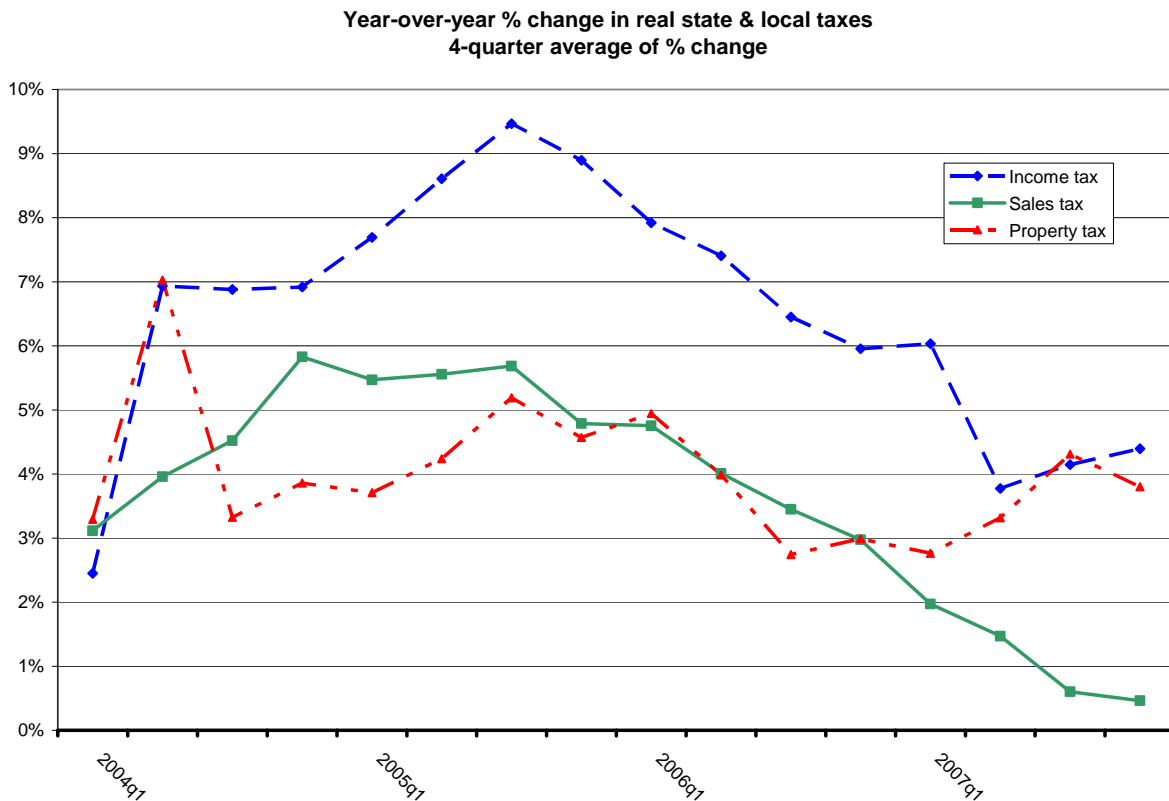
**Growth in major state and local taxes, inflation-adjusted
October-December 2007 vs. year ago**

Individual income taxes	2.3%
Corporate income taxes	-12.3%
Property taxes	4.1%
Sales and gross receipts taxes	1.0%
All other taxes	2.0%
<hr style="width: 20%; margin-left: auto; margin-right: 0;"/>	
Total	2.2%

Source: U.S. Bureau of the Census, Bureau of Economic Analysis

The relatively stronger performance of the property tax compared with income and sales taxes has persisted throughout the slowdown to date, as Figure 4 shows.

Figure 4 Sales taxes have slowed sharply, and income taxes have begun to slow



The Census Bureau data provide details on state government taxes for individual states, but do not provide these details for local government taxes.³ Figure 5 shows growth of state government tax revenue by region in the three major tax categories (income, sales, and corporate) and in several lesser categories that often are of interest, adjusted for inflation. (The data have been adjusted to remove the impact of estimates made by the Census Bureau that do not incorporate region or state-specific information. This adjustment results in very minor differences in national totals for state government tax collections from those discussed earlier using the full Census dataset.)⁴

Figure 5 State government taxes by region

State government taxes by major category and region
Year-over-year growth in inflation-adjusted revenue

	Total taxes	Individual income taxes	General sales and gross receipts taxes	Corporate income taxes	Tobacco taxes	Motor fuel taxes	Severance taxes
New England	1.0	5.9	2.3	(14.1)	4.1	(1.0)	n/a
Mid Atlantic	1.8	7.9	(0.7)	(18.8)	(1.1)	1.1	n/a
Great Lakes	0.9	2.1	1.0	(2.6)	(1.2)	(0.2)	13.8
Plains	2.7	3.9	0.4	(0.6)	15.9	(3.5)	70.9
Southeast	(3.6)	(0.0)	(3.8)	(19.9)	4.0	(1.1)	2.2
Southwest	3.8	(7.1)	3.0	(29.6)	72.1	0.5	21.0
Rocky Mountain	9.6	8.2	9.8	8.5	(0.7)	(2.0)	54.7
Far West	2.9	(5.3)	5.5	(1.5)	(0.8)	(0.6)	192.1
United States total - EXCLUDING values estimated by Census Bureau	1.1	1.9	1.1	(11.8)	8.3	(0.7)	51.8

Source: U.S. Bureau of the Census, Bureau of Economic Analysis

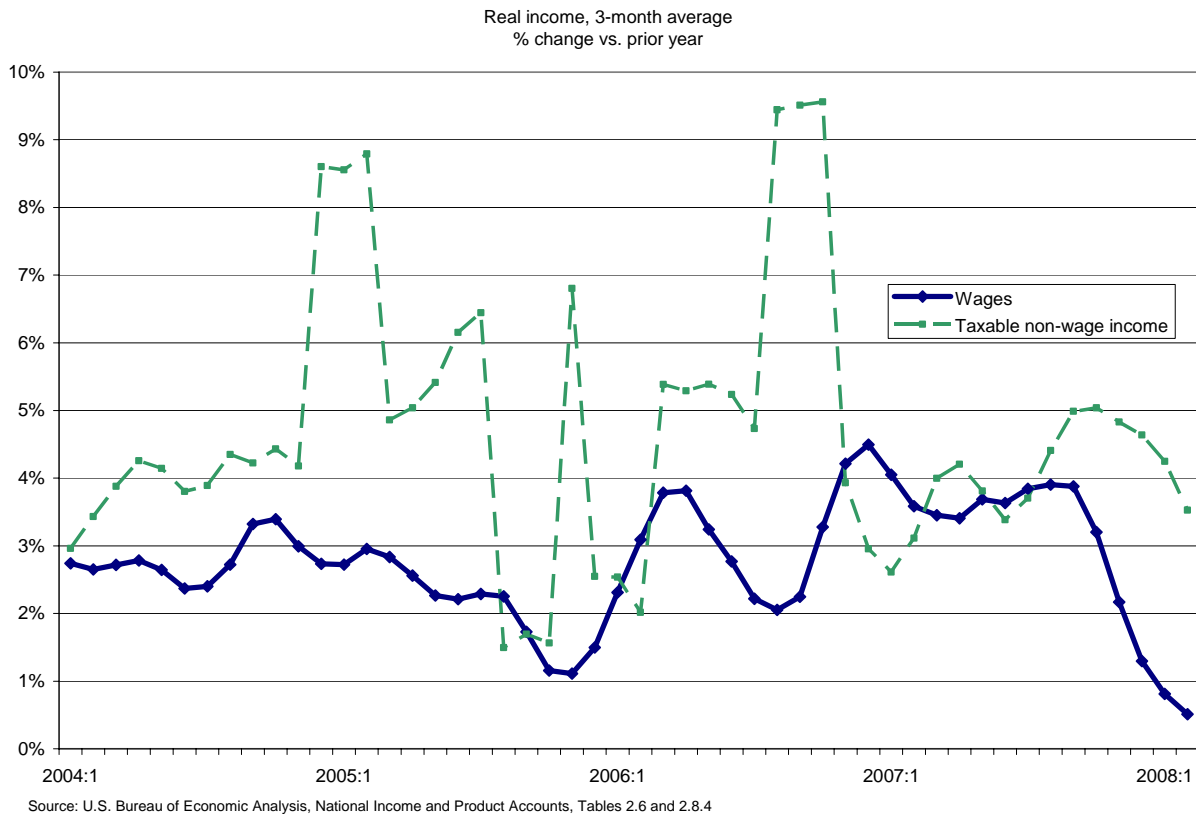
Tax revenue growth has been strongest by far in the Rocky Mountain region, reflecting an economy that has performed better than the national average, plus extraordinary growth in severance taxes. The southeast has been suffering greatly from the real estate bust, a weakening economy more generally, and declines in the sales tax. Motor fuel taxes have been weak throughout the nation, in large part reflecting the impact of higher gas prices on consumption.

Contributing factors

Individual income taxes are imposed on both wage and nonwage income. Wage growth has slowed dramatically in recent months, as Figure 6 shows. Much of the slowdown occurred late in the October-December quarter and in the current quarter (the graph ends in February 2008). Between the lateness of the slowdown and lags between economic activity and tax collections, states are likely to feel a much greater pinch from this in the January-March quarter than in the October-December quarter.

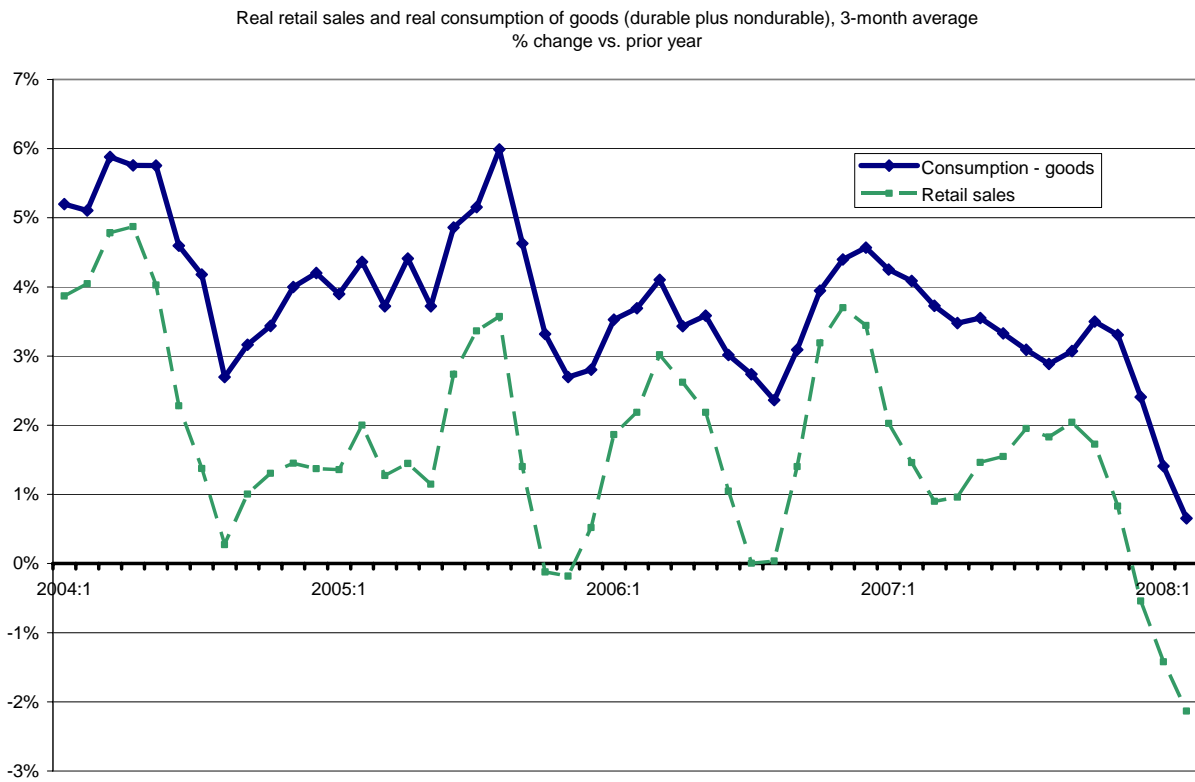
Figure 6 also shows the taxable elements of nonwage income. This income is very bouncy, but appears to have slowed somewhat. Other forces at work, such as declines in interest rates and weakening in the ability of corporations to pay dividends are likely to lead to further slowing. Also, capital gains, which are not included in these data, could decline sharply in 2008 as a result of economic weakness and stock market declines, but the tax impact of this may be felt most strongly a year from now when 2008 tax returns are filed.

Figure 6 Wage growth has slowed significantly, and nonwage income growth appears to have slowed



State and local sales taxes typically are imposed upon a broad range of goods, and relatively few services. Two contemporaneous measures that provide some insight into the base of the sales tax are consumption of goods, and retail sales.⁵ As shown in Figure 7, the growth rate of each has slowed substantially, especially in the last two months for which data are available (January and February 2008).

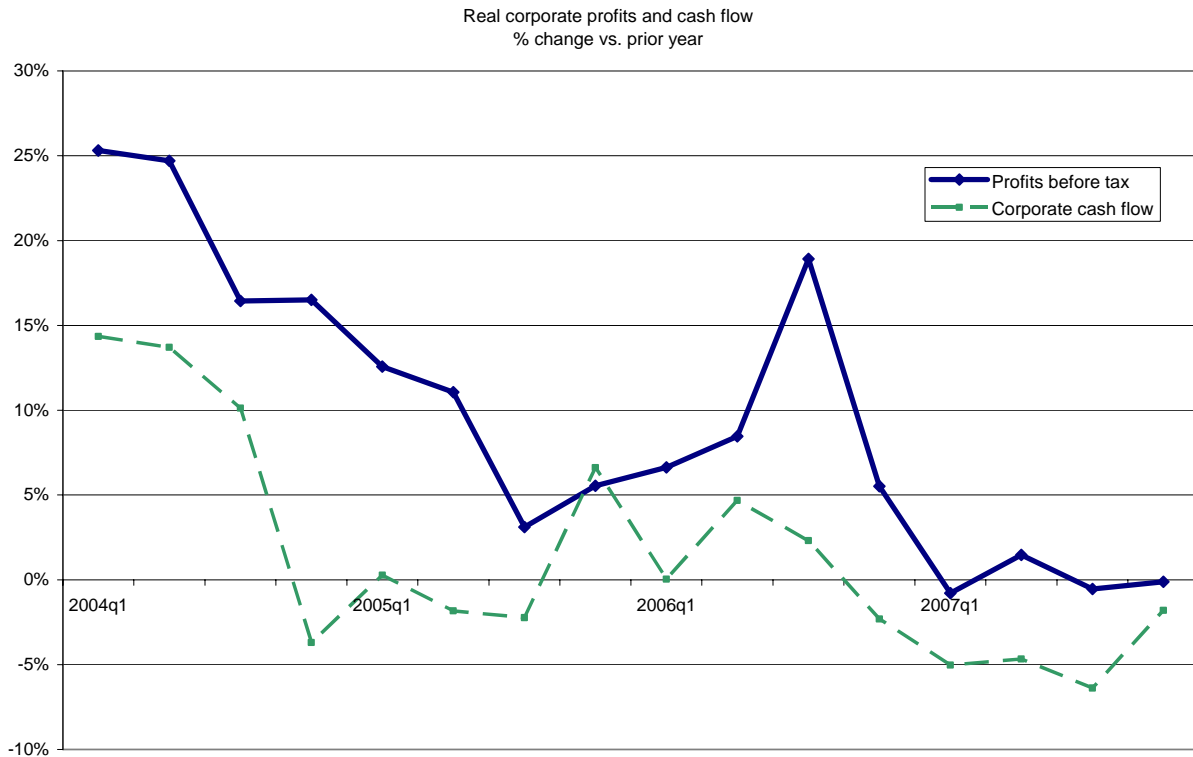
Figure 7 Retail sales and consumption of goods have slowed



Source: U.S. Bureau of Economic Analysis, National Income and Product Accounts, Tables 6U, 2.8.6, and 2.8.4

Finally, while the typical state does not rely heavily on corporate taxes, those that do have already felt the impact of declining corporate profits. Figure 8 shows that corporate profits have slowed to a standstill and cash flow has declined on a year-over-year basis. The link between these variables and corporate tax payments is tenuous, but the data do suggest continued weakness in corporate tax revenue.

Figure 8 Corporate profits and cash flow are deteriorating



Source: U.S. Bureau of Economic Analysis, National Income and Product Accounts, Tables 1.12 and 1.1.4

What to look for next

The graphs presented above showed that wage growth was slowing considerably late in the October-December quarter, as was consumption growth. In addition, nonwage income growth is likely to slow for reasons given above, suggesting further weakness. The January-March quarter for state tax collections probably will be even weaker than the October-December quarter.

But for most state governments, the April-June quarter will be even more important. States that rely on income taxes often experience huge swings in tax revenue as a result of tax returns that are due on April 15. Figure 9 shows spikes in April-June income tax collections compared with average growth.

Figure 9 Large upward and downward income-tax spikes frequently occur in April-June

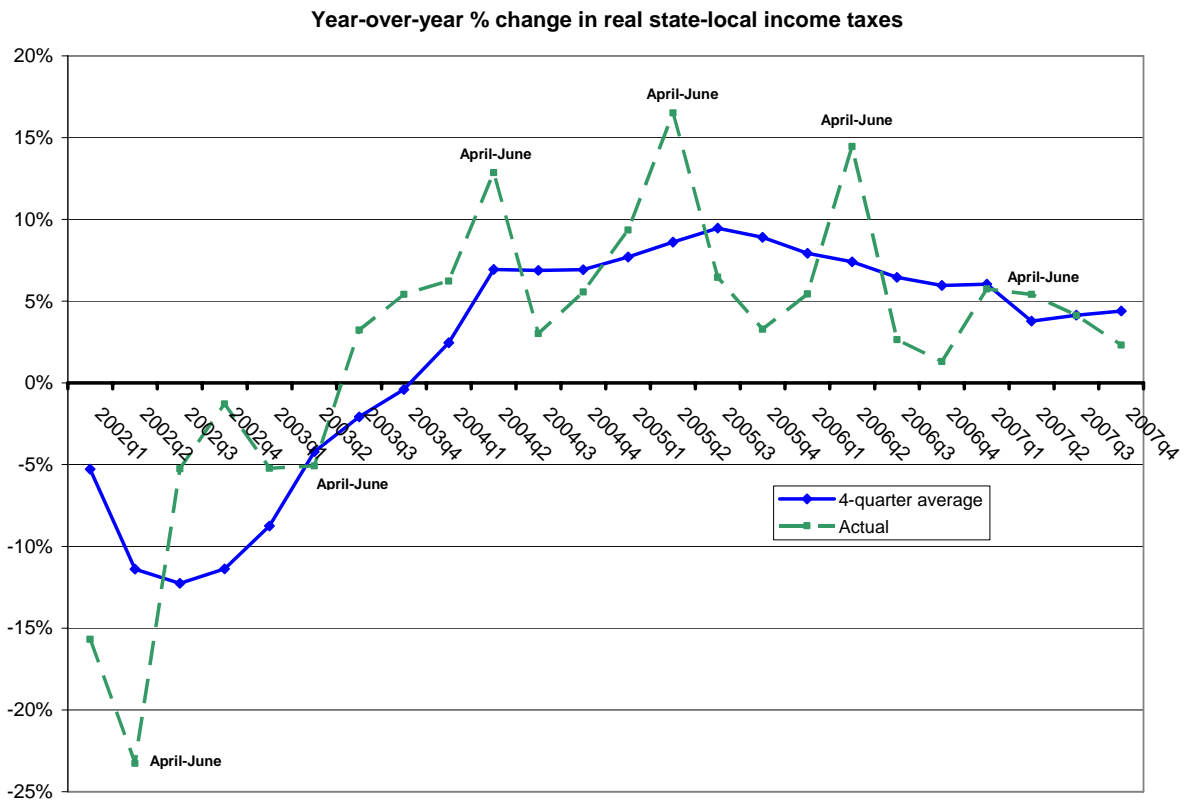
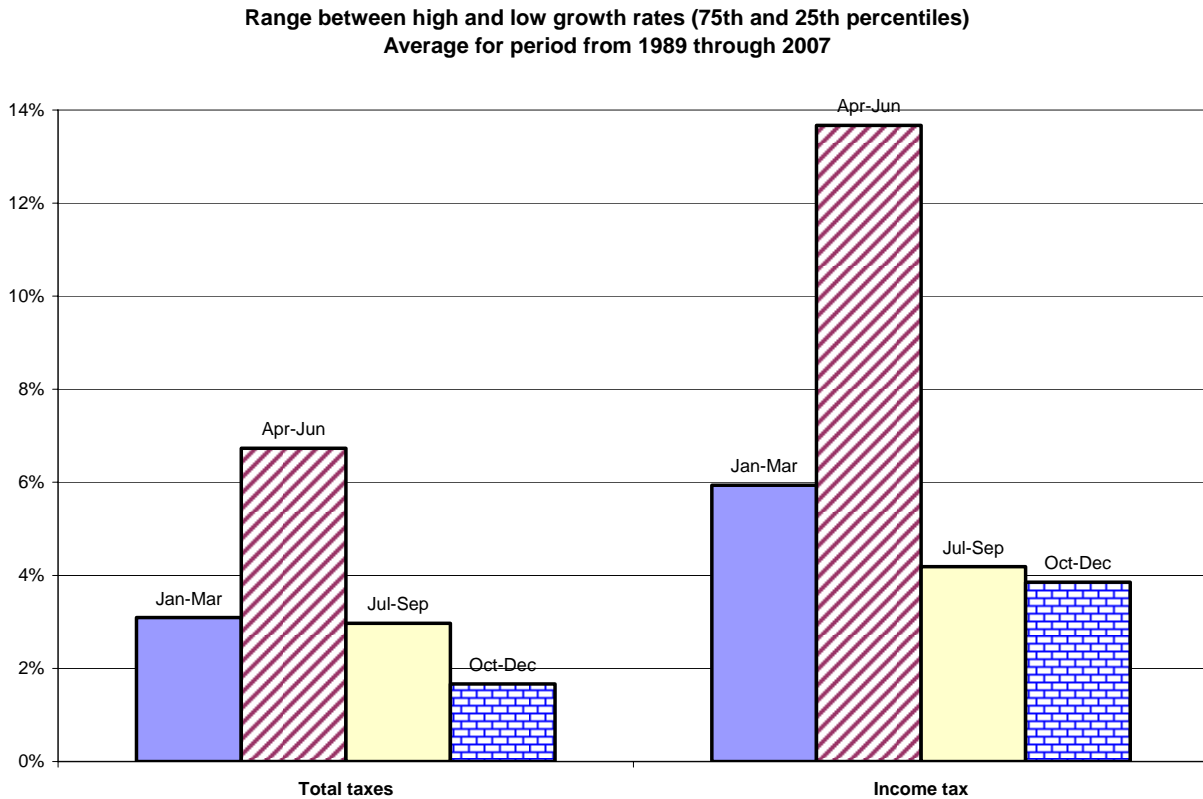


Figure 10 gives a measure of the variability in tax revenue growth in each quarter for total taxes and income taxes, based on averages over approximately the last 20 years. This figure also shows that income taxes in the April-June quarter are more volatile than in any other quarter, and as a result overall tax collections are far more volatile in that quarter as well. Observers of state government finances need to pay extra attention to tax collections in the April-June quarter.

Figure 10 April-June quarter is most volatile, driven by income tax volatility



The volatility of the April-June quarter is a more-important phenomenon for state governments than it is for the typical local government. Figure 11 shows the distribution of revenue from major taxes across the four quarters, for state governments and local governments. The April-June quarter is the biggest for state governments (29.5 percent of total collections), but it is a relatively small quarter for the average local government (21.6 percent). The October-December quarter historically has been the largest quarter for local governments, driven by significant property tax collections.

Figure 11 April-June typically is important for state governments, October-December for locals

Quarterly tax revenue as % of fiscal year total, average since 2000

	Total tax revenue	Individual income tax	Corporate income tax	Property tax	General sales tax
State tax revenue					
Jul-Sep	23.0	22.4	21.7	21.8	23.8
Oct-Dec	23.4	22.8	19.9	28.7	24.7
Jan-Mar	24.2	23.2	21.8	24.7	25.0
Apr-Jun	29.5	31.6	36.6	24.8	26.6
	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>
Local tax revenue					
Jul-Sep	19.6	21.7	22.1	18.1	24.6
Oct-Dec	32.8	22.9	18.5	35.6	24.9
Jan-Mar	26.0	26.5	29.3	26.2	25.1
Apr-Jun	21.6	28.9	30.1	20.1	25.5
	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>

Source: U.S. Bureau of the Census Quarterly Tax Survey

Conclusions

The slowdown in state and local tax revenue growth continued in the October-December quarter. State governments have been far more affected than local governments so far, although the local property tax is under pressure.

Wages, retail sales, and corporate profits all have been weakening considerably in recent months. In addition, many states are finding that the economy is worsening faster than their economic forecasts have presumed. All of this suggests that tax collections are likely to worsen in the January-March quarter. Beyond that, the April-June quarter is particularly important for finances in states that rely on income taxes, and bears especially close watching.

Appendix: About the data

This report is based upon the U.S. Bureau of the Census’s Quarterly Survey of State and Local Tax Revenue (www.census.gov/govs/www/qtax.html). The Census Bureau now is able to release these data approximately 90 days after the close of a quarter, which is faster than before, making the data very useful for gaining insights into state and local government finances and into underlying economic growth.

Another well-known source of quarterly data on state government tax revenue is the Rockefeller Institute of Government’s quarterly state revenue report. Each data source has strengths and weaknesses and together they can provide valuable insights. The table below summarizes key elements of each data source.

Figure 12 Comparison of Census Bureau and Rockefeller Institute Quarterly Tax Data Sources

	Census Bureau Quarterly Tax Data	Rockefeller Institute Quarterly Tax Data
Governments covered	50 states individually, District of Columbia, and summary data for United States local governments in aggregate	50 states individually. No data for District of Columbia or for local governments.
Taxes covered	Data are available for 25 separate tax categories including personal income tax, general sales tax, corporate income tax, property tax, motor fuel taxes, motor vehicle taxes, tobacco products taxes, alcohol taxes, estate and gift taxes, plus 16 other categories and taxes in total	Personal income tax, sales tax, corporate income tax, and taxes in total. In addition the Institute includes the withholding and estimated-tax components of the personal income tax, which can provide very valuable information on underlying forces affecting tax revenue.
Governmental funds covered	Includes taxes collected in all funds of each state	Primarily includes taxes collected in the general fund or highway funds. Because the taxes in covered funds tend to be more volatile than those not covered, the reported estimate of total taxes tends to be more volatile than the Census Bureau’s comprehensive measure of total taxes.
Timeliness	Available 3 months after the close of a quarter	Available 2-1/2 to 3 months after the close of a quarter

	Census Bureau Quarterly Tax Data	Rockefeller Institute Quarterly Tax Data
Time periods covered	Data are available continuously from the first quarter of 1963 through most recent quarter, allowing analysis of government finances over most post-war recessions and recoveries	Data on growth rates (rather than tax levels) are available from the first quarter of 1991 through most recent quarter
Adjustments made	In general, the Census Bureau does not adjust the tax data provided by governments, but it does prepare estimates to fill in missing data. This report adjusts the data to exclude items estimated by the Census Bureau in cases where no state-specific information was used to develop the estimate.	The Rockefeller Institute works with state governments to adjust data to remove the effects of administrative anomalies and legislative changes. These adjustments help the Institute data provide a clearer picture of underlying economic trends.
Use of estimates	If a state has not submitted timely acceptable information, the Census Bureau typically will fill in estimates for the missing state, commonly by using national growth rates. If data for one or several taxes are missing for a state that has submitted information, the Census Bureau typically will fill in estimates for missing data by using past values for that state of the tax in question.	Rockefeller Institute data generally do not include estimates in cases where data have not been reported.
Revisions	With the release of each new quarter of data the Census Bureau typically issues revised data for as many as 5 or 6 previous quarters. Revisions tend to be small for the older quarters.	Rockefeller Institute data generally are not revised.

	Census Bureau Quarterly Tax Data	Rockefeller Institute Quarterly Tax Data
Quality and accuracy	The Census Bureau engages in an extensive data gathering effort with all state governments, and with a sample of local governments, using uniform definitions across states. The time required for this process means that data for some states are not complete at time of initial release, in which case the Census Bureau may use mechanically generated estimates of missing data, sacrificing some accuracy in initial estimates. By the first or second revision, Census Bureau data are likely to be highly complete and accurate.	Rockefeller Institute data are designed to produce good estimates of tax revenue relatively soon after each quarter ends. To achieve this, they allow each state to use its own definitions and reporting forms for data on individual taxes, sacrificing some uniformity across states in the interest of speed.

Endnotes

¹ Data were adjusted using the gross domestic product price index, NIPA Table 1.1.4 (B191RG3). Because state and local government tax data are not adjusted for seasonality, growth rates used in this report (and growth rates typically reported by governments) are computed on a year-over-year basis rather than a quarter-to-quarter basis. For comparability, growth rates in this report for economic data also are computed on a year-over-year basis, rather than the quarter-to-quarter basis commonly reported in the press. As a result some growth rates reported here for economic data may appear different from rates readers are familiar with from press reports. The growth rates reported here are appropriate for the purpose of this report.

² Local governments will be affected adversely by economic weakness in other ways as well. Major cities often have revenue structures that rely more-heavily on economically sensitive tax sources. Furthermore, and especially important for many school districts, many local governments rely heavily on state and federal aid, which can be cut in recessions.

³ Future reports may include data for each state, in addition to regions, if readers would find this information useful.

⁴ These differences are very minor, as the table below shows:

	Total taxes	Individual income taxes	General sales and gross receipts taxes	Corporate income taxes	Tobacco taxes	Motor fuel taxes	Severance taxes
United States total - reported	0.9	1.9	1.1	(11.9)	8.3	(0.8)	51.8
United States total - EXCLUDING values estimated by Census Bureau	1.1	1.9	1.1	(11.8)	8.3	(0.7)	51.8

⁵ It is not simple to construct a proxy for the sales tax base of any given state from economic data. Different states tax services to varying degrees. Some tax food and some do not. Some tax residential energy and some do not. Most tax purchases by businesses at least to some degree. The measures presented here lend insight into forces affecting sales taxes, but will not correspond directly to the sales tax base in any given state.