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Rockefeller Institute: State and Local Finances Face Continued Challenges

Proposed Federal Tax Reform Fuels Uncertainty

Albany, NY — State and local government revenue from major taxes tracked by the U.S. Census Bureau declined by 0.5 percent in the second quarter of 2016 compared to a year earlier. This represents a substantial slowing from the 5.0 percent average growth for the four previous quarters.

Total state tax revenue from all sources declined by 2.1 percent, driven by: declines in 2015 income tax returns, declines in estimated and final payments of income tax, and slowing growth in sales tax.

The just-released *State Revenue Report* from the Nelson A. Rockefeller Institute of Government provides detailed analysis of state government tax revenues in the second quarter of 2016 and provides preliminary data for the third quarter. The report also includes the latest revenue forecasts available from state governments. Finally, the report outlines potential behavioral responses by taxpayers in anticipation of post-election federal tax reform, and notes how these responses could affect state tax revenue.

Although oil-producing states were hardest-hit by slowing revenue growth in the second quarter, other states had declines as well, apparently driven by the weak stock market performance and associated declines in personal income tax collections.

Preliminary data for the third quarter of 2016 indicate weak growth in state tax revenue of only 1.2 percent. State tax revenue growth is likely to remain slow and highly uncertain throughout the remainder of fiscal year 2017.

States are forecasting weak revenue growth for fiscal year 2017, with only 4.0 percent growth in the income tax and 4.2 percent growth in the sales tax. States are likely to reduce their forecasts when they next update them.

States face yet another major new budgetary uncertainty for the 2017 fiscal year: the impact of federal tax reform, which may be enacted early in the new administration. "States will need to worry about at least three kinds of effects, all of which are highly uncertain: (1) the impact of tax reform on the economy; (2) the direct impact of tax reform on state government tax bases in cases where states conform to federal tax law; and (3) indirect impacts on state tax revenue as taxpayers change their behavior in anticipation of, and in response to, federal tax reform. The first two effects are not likely to occur until the 2018 state fiscal year, even if a bill is enacted early. But the third can and probably will affect tax revenue long before a bill is enacted."

President-elect Trump has proposed significant cuts in top income tax rates, elimination of the Affordable Care Act's investment income tax, and substantial increases in the standard deduction, among other things. The likelihood of lower tax rates in 2017 creates a large incentive for high-income taxpayers to push income from wages, interest, and other sources out of 2016 into 2017, and to accelerate deductions into 2016, depressing taxable income in 2016. The elimination of the Affordable Care Act investment tax provision creates an incentive for high-income taxpayers to push capital gains out of 2016 into 2017, when the provision would not be in effect, and the increase in the standard deduction creates a modest incentive for middle-income taxpayers to accelerate itemized deductions into 2016, when these deductions will be most useful.

"Even if a bill is not enacted, or is delayed, or is enacted in substantially different form than expected, taxpayers are likely to change their behavior in anticipation of legislation, in ways that could have profound and hard-to-interpret impacts on state tax revenue. States will need to do their best to understand and estimate these potential impacts, and then buckle up for the ride," states report authors Lucy Dadayan and Donald J. Boyd.

To read the *State Revenue Report*, go to
www.rockinst.org/pdf/government_finance/state_revenue_report/2016-11-30-srr_105.pdf.

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