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UNIVERSITY AT ALBANY
State University of New York

July 14, 2010

F I S C A L S T U D I E S

Data Alert

New Retail Sales Data Portend Continuing Weakness for State Tax Collections

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Today's retail sales data for June continue a string of recent news that portends continued weakness in state tax collections.

The good news is that retail sales and food services were up 4.8 percent from their level a year ago, albeit by less than in the prior two months. This continues the year-over-year growth we have seen since November 2009, as shown in Figure 1. State governments rely on general sales taxes for just under a third of their tax revenue, and retail sales are an important driver of these taxes. (As we noted in our April *Revenue Report*, however, sales taxes have declined more steeply than retail sales in this recession.) This means that state sales taxes are likely to show some year-over-year growth now and in coming months.That's the good news: The glass is at least partly full.

Unfortunately, the glass is at least half empty. When compared with the previous month rather than a year ago, retail sales are down now for a second month in a row after having risen sharply for about a year: the incipient economic recovery has weakened. Furthermore, and particularly depressing for state governments, retail sales remain more than 7 percent below their pre-recession peak after adjusting for inflation, as Figure 2 shows.[1] And as we noted in our April *Revenue Report*, real sales tax revenue has been even weaker than retail sales, and is down more than 10 percent from the prerecession peak.

Labor markets provide no solace for state governments. States rely on personal income taxes for just over a third of their tax revenue, and employment is a particularly important indicator of how these taxes will do.[2] (Employment also provides the wherewithal for consumers to spend money on goods and services subject to sales taxes.) Total nonfarm employment declined slightly in June relative to May, as Figure 3 shows, and private sector employment was virtually flat. Total employment remains more than 5 percent below the prerecession peak and the consensus outlook is for weak growth as the year progresses.

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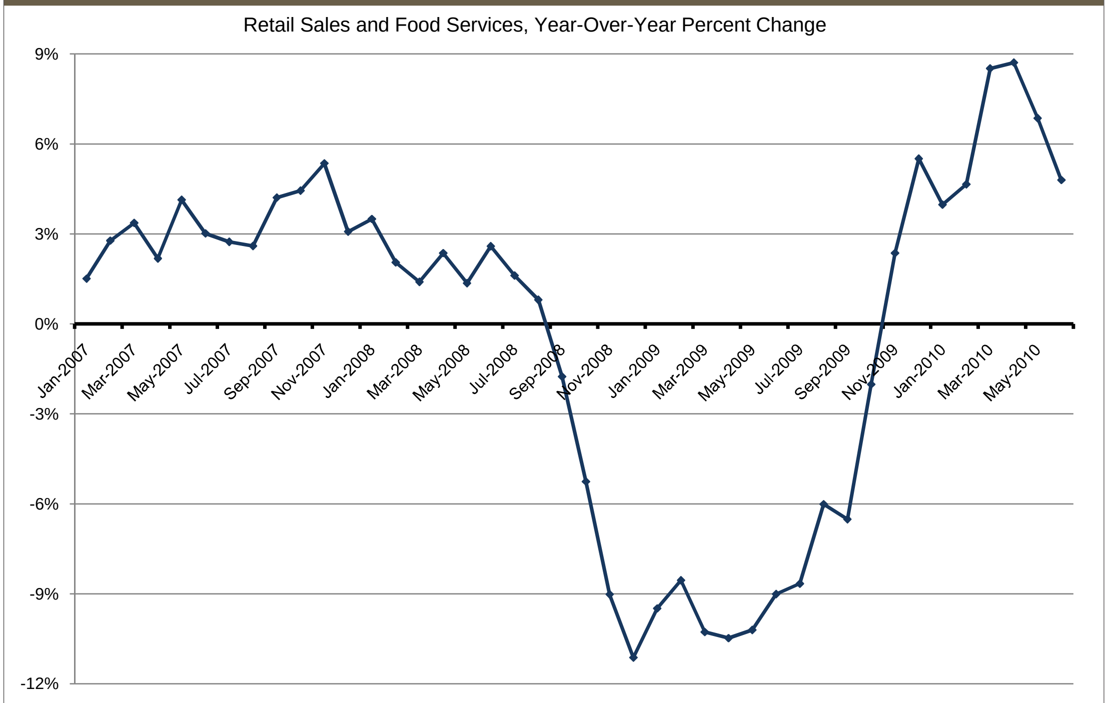
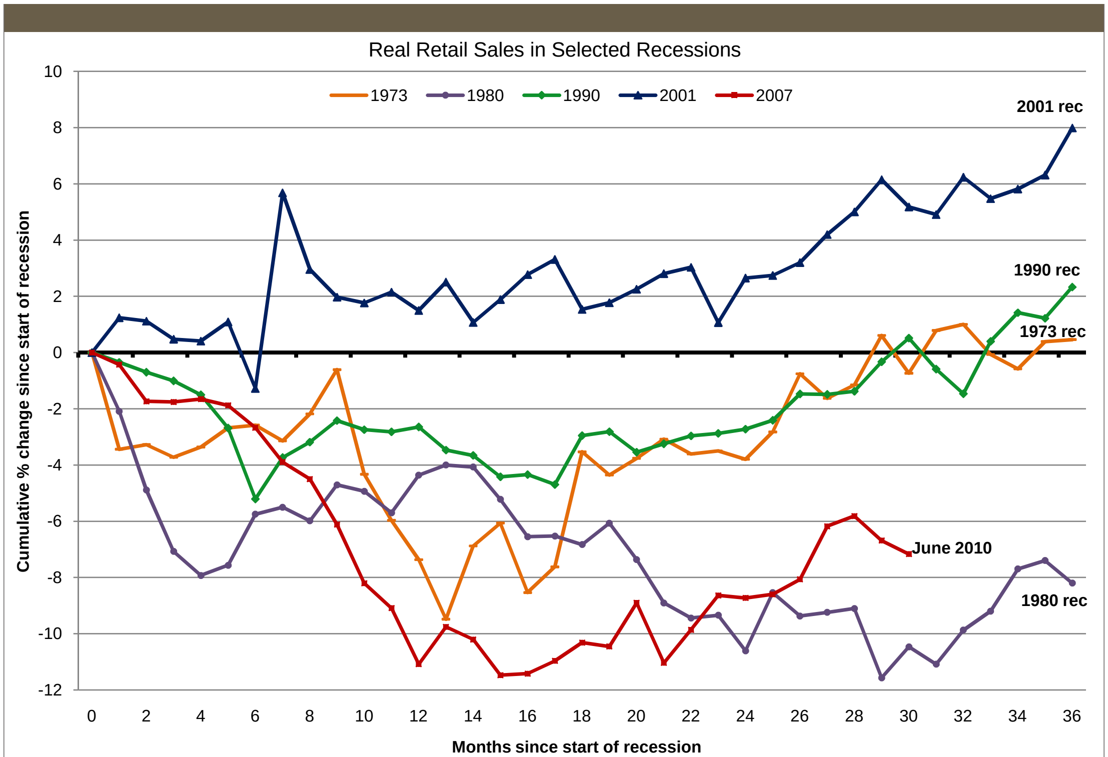
Figure 1. The Glass Is Partly Full: Retail Sales Are 4.8 Percent Above Year Ago



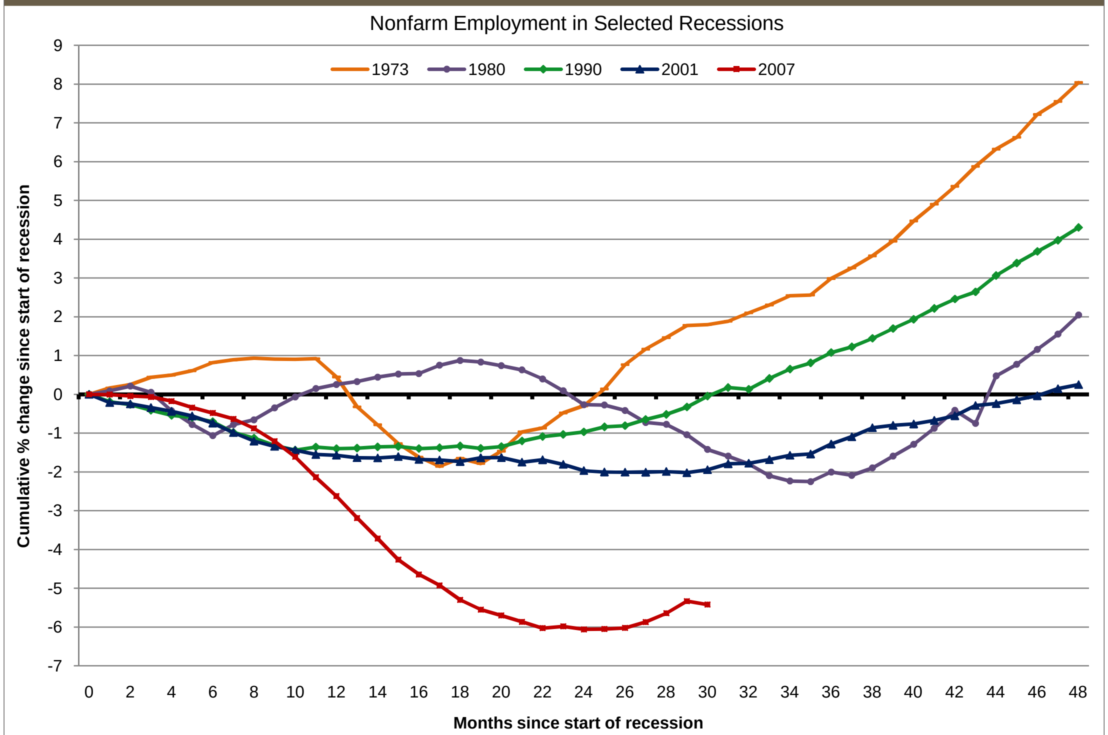
Source: U.S. Bureau of the Census, Estimated Monthly Sales for Retail and Food Services

Figure 2. The Glass Is At Least Half Empty: Real Retail Sales Have Declined for Two Months and Are 7 Percent Below Where They Were at the Start of the Recession



Sources: Cleveland Federal Reserve Bank (pre-1990 retail sales), Census Bureau (1990+), and Bureau of Labor Statistics (CPI).

Figure 3. Employment Remains More Than 5 Percent Below the Prerecession Peak, and Far Below Where It Was at this Stage in Other Recoveries



Source: Bureau of Labor Statistics (CES).

While the economy and state tax revenue have stopped falling off a cliff, both are well below their prerecession levels. The most likely outlook is for slow growth from these new low levels. In most states it is likely to take several years before inflation-adjusted tax revenue reaches levels that could support prerecession spending. While state governments have been cutting spending, they have not cut it by anywhere near as much as tax revenue has declined. Spending levels have been supported in part by the federal stimulus package, withdrawals from reserve funds, gimmicks and one shots, and some permanent and temporary tax increases.

Many of these resources — most importantly, federal stimulus — will go away after the 2010-11 fiscal year. Tax revenue has stopped falling off a cliff but it's at the bottom looking a long way up; meanwhile, states face a new cliff. Fiscal troubles for states are far from over.

Endnotes

1 We adjusted retail sales for inflation using the Consumer Price Index. That index is not yet available for June, and so June is estimated on the assumption that the price level was unchanged from May.

2 Wages are an even more important indicator, but wage data are less timely than employment data.