Bond Case Briefs

Municipal Finance Law Since 1971

U.S. Tax Reform: Legislation Lays Groundwork For Reshaping The Federal-State Fiscal Relationship.

SAN FRANCISCO (S&P Global Ratings) Dec. 4, 2017–With passage in the U.S. Senate of the Tax Cut and Jobs Act on Dec. 2, the federal-state fiscal relationship is poised to undergo a transformational overhaul, in S&P Global Ratings' view. The first step in this process is the likely enactment of tax legislation that sharply curtails the state and local tax (SALT) deduction. But the effect of the broader tax package on the federal budget trajectory may prove even more consequential for the states. Projections from the Joint Committee on Taxation and the Congressional Budget Office indicate the tax legislation could increase the federal deficit by $1.0 trillion to $1.47 trillion over 10 years. Prospects for enlarged fiscal deficits may provide federal lawmakers renewed cause to consider making policy changes that rein in projected federal spending, particularly in the entitlement programs. Assuming these efforts once again focus on health care, we believe it's plausible they could culminate in a capping of the federal commitment to Medicaid.

If lawmakers pursued it, eliminating Medicaid's open-ended entitlement status would have significant fiscal implications to state finances. As much as Medicaid is a safety net health insurance program, it's also a mechanism for the delivery of countercyclical federal fiscal aid to states. Since its inception, the increased federal aid to states that occurs when enrollments rise, such as during economic downturns, has been automatic because Medicaid is a federal entitlement. Countercyclical federal aid arguably played an underappreciated role in stabilizing state finances and credit quality in the immediate aftermath of the Great Recession. Curtailing or eliminating this dynamic could expose the states to large Medicaid-driven budget deficits in economic downturns, likely necessitating difficult offsetting fiscal adjustments. Potential adjustments states may consider include some combination of limiting coverage, diverting resources from other programs, or raising taxes. The latter of these policy options is likely to be more constrained for some states in light of the reduced SALT deduction.

As we have previously noted, capping the SALT deduction will also likely widen the existing balance of payment disparities among the states. That is, for those states that raise and contribute more in federal tax revenue than they receive in federal spending, the net imbalance is likely to grow. And by increasing the tax burden for high income taxpayers that itemize their federal taxes, the capped SALT deduction will attenuate the fiscal policy options available to these states. The states are also likely to face marginally higher future debt service costs because the legislation also ends their ability to advance refund previously issued bonds on a tax-exempt basis

We have described the states' fiscal integration with the federal government as an institutional advantage that over time has contributed to strong credit quality in the sector. In our view, the tax legislation working its way through Congress may represent the first phase in an unwinding of this implicit backstop that cushions state finances during times of economic stress. Already, we have seen an increase in rating volatility in the state sector over the past two years as a consequence of demographic and structural economic pressures. Elevated rating turbulence, including with ratings continuing to reach lower down the rating scale, may emerge as the norm rather than an exception given the direction of federal policy.