
How State Tax Cuts in Kansas Raised Municipalities' Borrowing Costs.

New research reveals that big tax cuts can sometimes be worse for the fiscal health of states and localities than previously estimated. This is the finding of a new paper entitled "State Tax Cuts and Debt Market Outcomes," to be presented at the 2018 Municipal Finance Conference at Brookings. In their paper, Komla Dzigbede of SUNY Binghamton and Rahul Pathak of Baruch College find that large tax cuts enacted in Kansas increased interest rates and reduced credit ratings on state and municipal bonds, compounding on the state's already significant fiscal woes. Utilizing the Kansas tax cuts as a natural experiment, the authors show that the state-wide tax cuts created spillover into local municipalities that made it harder for them to borrow money.

In 2012, the Kansas legislature passed a bill that reduced individual income tax rates, reduced the number of income brackets from three to two, and eliminated taxes on so-called pass-through businesses, or S-corporations. A year later, the legislature passed another bill further reducing income tax rates, raising the state sales tax, and reducing the standard deduction. Newly elected Governor Sam Brownback described the tax cuts as a means to accelerate economic growth and job creation, calling them "a shot of adrenaline into the heart of the Kansas economy." Despite increasing the state budget deficit by a wide margin, Brownback reasoned that an increase in economic growth spurred by the tax cuts would offset the initial decline in revenue. However, after facing significant budget shortfalls, the Kansas legislature in 2017 voted to override Gov. Brownback's veto, and raised taxes by $1.2 billion, effectively reversing the tax cuts of 5 years earlier.

While there is contention over whether or not tax cuts increase economic growth, the direct effects of lower revenues can lead the fiscal condition of a state or locality to worsen.

Dzigbede and Baruch's analysis expands upon the economic literature related to tax cuts and economic growth more broadly. While there is contention over whether or not tax cuts increase economic growth, the direct effects of lower revenues can lead the fiscal condition of a state or locality to worsen. This in turn could lead to higher borrowing costs and a lower credit quality of the securities issued by the borrowers, further compounding budgetary stress. If the effects on borrowing costs and credit quality are particularly large, the fiscal challenges of the state as a whole could also spill over into the fiscal picture of individual counties.

Utilizing data on individual bonds issued by the state of Kansas, as well as by Kansas municipalities, from 2005-2015, the authors estimate the change in total interest costs as well as changes in credit ratings after the tax cuts went into effect. The study compares the financing outcomes in Kansas to that of surrounding states. Controlling for factors related to the characteristics of each bond, the authors find that on average, the tax cuts led to an increase in interest rates for Kansas state-issued bonds of 0.43 percentage points and for local government-issued municipal bonds of 0.34 percentage points, compared to the neighboring states of Colorado, Nebraska, Missouri, and Oklahoma. In addition, the financial strain placed on the state and counties reduced the probability of municipal bonds receiving higher credit ratings (AA/Aa2 or above). This decline in credit ratings can account for roughly half of the increase in overall borrowing costs.

In light of these findings, the authors argue that the indirect financial implications of tax changes should be considered as part of states' budget constraints when assessing the merits of any major tax policy. Additionally, the results from bond issuances among local municipalities suggest spillover effects from state to local financing conditions. Therefore, the authors argue localities should be given a voice in major state-level tax changes.

The Brookings Institute

Michael Ng and David Wessel

Monday, July 16, 2018