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[Fitch Ratings: SALT-Linked US State Revenue Volatility to Decline]

Fitch Ratings-New York-11 March 2019: Recent US state tax revenue data affirms Fitch Ratings' view that the passage of the federal Tax Cuts and Jobs Act (TCJA) in December 2017 would contribute to abnormal state revenue volatility and uncertainty. We expect volatility to continue in 2019, but lessen over the next several years as taxpayers and states adjust to the changes, particularly the cap on State and Local Tax (SALT) deductions. Long-term state credit implications from the TCJA should be broadly limited but there are risks of variable effects depending on the state and reduced revenue-raising flexibility.

State personal income tax (PIT) revenue data for January showed a notable deterioration. The median change in PIT revenue for 33 reporting states was basically flat, growing only by 0.1% yoy. A significant majority (29) of those states showed either a deceleration in the rate of PIT revenue growth or an outright yoy contraction. The weak PIT data for January was a marked contrast to the same period in 2018, where 100% of reporting states showed acceleration in revenue growth and the median growth rate was 8.8% yoy.

PIT revenue data also contrasted with sales and use taxes (SUT), which broadly increased. For reporting states, median SUT revenue grew by 4.6% yoy in January versus 3.3% in January 2018. Furthermore, 34 of 36 reporting states that have a SUT showed an increase in the SUT revenue growth rate in January.

The contrasting trends in PIT and SUT revenue growth and the significant volatility on the PIT side point to direct state revenue effects from the TCJA. It is notable that PIT revenue, on average, declined even as economic growth and labor market indicators showed positive trends during the period – factors which likely contributed to the improving SUT revenue trends.

The scale of PIT revenue growth change between January 2018 and 2019 is highly abnormal and points to specific taxpayer incentives caused by the TCJA, namely the $10,000 cap on SALT deductions. Taxpayers were incentivized to push non-withholding income into calendar and tax year 2017 to maximize deductions in the last year of uncapped SALT deductions, which bolstered December 2017 and January 2018 PIT revenue dramatically. Without this incentive, taxpayers may now push non-withholding income to the end of the tax filing season in April and May 2019. Under the pre-TCJA unlimited SALT deduction, taxpayers always had the incentive to pay their taxes by December 31 versus later in the tax filing season to bring the benefits of the deduction forward. Stronger capital markets performance in 2017 and sharp declines in December 2018 also contributed to these trends.

PIT revenue volatility is leading to uncertainty for state revenue outlooks this year. States generally anticipated some level of decline in PIT collections from last year's record highs but the depth of the decline in December and January was a surprise. Some states experiencing yoy declines in PIT revenue through January, such as California, are anticipating strong rebounds in PIT collections by the end of the fiscal year. Other states, such as Maryland, are revising revenue forecasts downward to account for relative weakness seen to date. April and May revenue results will be particularly informative for states as they could confirm a significant shift in timing of tax filings and payments. In most cases, the data will come in before final budgets for fiscal 2020 are enacted, allowing states to make any final budgetary adjustments before the start of the new fiscal year.

We believe the recent revenue volatility is not likely to be sustained and should not have a direct, long-term fundamental credit effect for states, as TCJA results on PIT non-withholding collections peter out. However, unintended and indirect effects from the TCJA could have consequences for states. In particular, the SALT cap could affect revenue growth prospects and revenue-raising flexibility. Uncertainty over how individuals and companies adjust to the changes imposed by the TCJA could also lead to lingering complications for states' revenue forecasting, making the budgeting process more unpredictable.

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