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## Fitch: Revenue Ramifications Emerge with US States Winding Down Large Tax Cuts

Fitch Ratings-New York-06 June 2024: The period of sizeable state tax cuts that began in early 2021 and peaked in 2022 is drawing to a close, with revenue implications for states becoming clearer, Fitch Ratings says. In some cases, actual revenue losses exceed state estimates, although credit quality remains stable as states have ample reserves and broad budgetary flexibility.

State legislatures have proposed or enacted an estimated $6.3 billion of new tax reductions in their 2024 legislative sessions, meaningfully less than the $26.1 billion and $40.2 billion of tax cuts, rebates and credits adopted in 2023 and 2022, respectively.

Ohio and Arizona are among the states with the largest shortfalls between forecasted and actual revenues so far in fiscal 2024. Ohio's fiscal 2024 tax collections were tracking $445 million (1.9%) below forecast through April 30, which the governor ascribes to the cumulative effects of personal income tax (PIT) rate cuts and bracket compressions in the last two biennial budgets. In Arizona, the state's Joint Legislative Budget Committee primarily attributed a $900 million downward revision in its fiscal 2024 revenue forecast in January to previously enacted income tax cuts.

Tax reductions over the past few years included a broad mix of both one-time and recurring tax policy actions. California enacted $10 billion of tax rebates in 2022 paid largely from surplus revenues, while Nebraska enacted nearly $1.4 billion of permanent PIT rate cuts and property tax credits. This will equal roughly 15% of fiscal 2021-2022 biennial revenues once the cuts are fully phased in by 2027.

Like Nebraska, other states including Georgia, Kentucky, Pennsylvania and West Virginia are phasing in previously enacted tax changes over multiple years. In some cases the associated revenue losses will not be fully realized, or even clear, until the early 2030s. The revenue effects of prior cuts through fiscal 2024 have so far been within these states' expectations.

Modest revenue underperformance compared to forecasts is unlikely to have a negative credit effect given that state rainy day funds and other counter-cyclical fiscal cushions have been greatly augmented since the pandemic. State rainy day funds averaged 13.8% of prior year revenues in fiscal 2023 compared with 7.9% in fiscal 2019 and only 5% prior to the 2008 Global Financial Crisis. However, the effects of recent years' tax cuts on revenues have not been tested by a cyclical downturn, which could have a more pronounced effect on collections.

Policymakers are reticent to enact further large, permanent tax cuts. In Oklahoma, the state senate recently resisted a gubernatorial proposal for an income tax rate cut even as the state eliminated its sales tax on groceries. In Virginia, the legislature rejected the governor's proposal for a broad tax restructuring that also included a sizeable PIT rate cut.

States are likely to forego substantial new tax reductions in the near term, and instead focus on making more marginal changes. These include expanding or revising existing tax credit programs such as the state earned income tax credit (EITC) and childcare tax credit. Additionally, we anticipate efforts to expand tax bases will include more services and digital goods, as well as broaden transportation fees and levies to compensate for declining fuel taxes.

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