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Fitch: US Tax Bill Adds Pressure to States, Locals and Higher Ed.

Fitch Ratings-New York-20 December 2017: The final version of the US tax bill may affect some states' and locals' revenues and could add pressure to colleges and universities, says Fitch Ratings. However, the long term effect is uncertain due to the complicated interrelationships of the law changes and since many of the provisions will expire in the next decade.

The federal tax changes could limit tax raising flexibility for state and local governments, particularly for states that charge higher taxes, as the bill will cap the federal tax deduction for state and local taxes at $10,000. This will cause an increase in the impact of state and local taxes. Residents in states with comparatively high taxes, including California, Connecticut, New Jersey and New York, will be more affected and may have less tolerance for higher state and local taxes in the future. Less revenue-raising flexibility could limit growth in state and local spending and have negative implications for entities that rely on government support including school districts, public higher education institutions and healthcare providers with high Medicaid exposure.

The proposed tax rate reductions for higher-income taxpayers and changes to the individual Alternative Minimum Tax are most likely to affect tax payers that benefit from the current deduction for state and local taxes and could somewhat offset the immediate impact. Most states are not in a position to lower taxes in response to the change due to tepid revenue growth and ongoing spending pressures.

If the lowered caps on the deductions related to mortgage interest, property taxes and home equity loans reduce the incentive to buy houses, property values in areas with high average home prices could see lowered growth or even decline, reducing the amount of property tax local governments collect. This change could result in lower revenue growth prospects for local governments absent tax rate increases.

Fitch notes taxpayer action to minimize aggregate tax payments in advance of the federal tax changes, such as managing the timing of discretionary income and/or prepaying taxes, is likely to skew revenue results in the current and coming fiscal years. States will also need to consider the implications of the federal changes on state revenue streams given existing linkages to the federal tax code, and may choose to make modifications in upcoming legislative sessions.

More broadly, the elimination of tax-exempt advance refunding bonds will modestly limit financial flexibility but is not expected to have a significant effect on municipal issuers' credit quality.

The 1.4% excise tax on net income from the largest private colleges' endowments would be an incremental financial stress but would likely not have significant near-term credit effects on Fitch-rated colleges or universities. The impact under the final law is narrow. The Chronicle of Higher Education, using data from 2014 and 2015, estimates fewer than 30 private colleges and universities meet the enrollment and endowment per student levels in the bill that would trigger the tax. However, it could lower the incentives for donors to fund endowments and raise the possibility of higher and more onerous taxes on endowments in the future. The incentives for donors could also be pressured by the rise in the standard deduction if it lowers the number of taxpayers who itemize charitable deductions.

The long term effects of these provisions of the tax bill, and the federal changes overall, is uncertain. Many provisions are set to expire in 2025 and will likely be up for political debate in the interim. On the spending side, future federal action to close projected deficits could affect areas such as Medicaid, a key area of vulnerability for states.