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Fitch: Tax Reform Raises Questions for Most U.S. States' Revenues.

Link to Fitch Ratings' Report(s): What Federal Tax Changes Mean for State Revenue

Fitch Ratings-New York-10 April 2018: Recently enacted federal tax changes (H.R. 1) are making budgeting and revenue forecasting more complex for many U.S. state governments, according to Fitch Ratings in a new report.

"While most of the ripple effect will play out over time, provisions including the cap on SALT deductions are a likely trigger behind a spike in state revenue collections for the current fiscal year," said Director Eric Kim. In Massachusetts for example, individual income tax collections through January 2018 were up nearly 12% from the prior year, this after the commonwealth recorded just 3% annual growth in January 2017. "Many states are seeing robust year-over-year gains in revenue collections, though this will likely amount to little more than a one-time boost with income tax collections set to level off for the rest of the fiscal year," said Kim.

Fundamentally, changes in the federal tax code will directly affect state revenue collections because of how state tax codes link to the federal tax code. The linkages are numerous and difficult to generalize. These direct state revenue effects are clearly unintended consequences of federal action. "These are not the tax policy changes states would have designed on their own", said Kim. The federal bill moved through Congress and to the President's desk so quickly, states are still trying to figure out what it means for their budgets and tax collections – even as its provisions went into effect several months ago.

So far, 25 of the 28 states that have reported at least a preliminary estimate of direct revenue effects from H.R.1 to Fitch assume state revenue growth next fiscal year (before the effects of any state legislative responses). At least 11 other states reported to Fitch that they are still evaluating what the federal bill means for them before coming up with an estimate.

One example of a federal and state tax code linkage likely to drive changes in state revenue will be for those states that allow a deduction for federal taxes paid on state individual income tax returns. Since H.R. 1 reduces the federal tax liability for many individuals, their state deduction will decrease and the resulting state tax liability will increase. This is a pivotal reason a state like Louisiana, for example, is forecasting a roughly $230 million increase in individual income tax revenues in fiscal 2019 as a result of H.R. 1.

While being proactive in addressing the impact of H.R. 1 certainly has its benefits, simply making knee-jerk changes without adequately analyzing the long-term effects could lead to more uncertainty for states in their forecasting and collections. Assessing the long-term implications of H.R. 1 will not be an easy task due to the complicated interrelationships of the law changes and because many of the provisions are scheduled to expire within the next decade. Yet-to-be finalized federal regulations around the tax bill and the possibility of additional federal legislation add more complexity and risk for states.

‘Federal Tax Changes and State Revenue Implications’ is available at www.fitchratings.com or by clicking on the above link.

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