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Fitch: State Tax Changes May Have Uncertain Post-Recovery Effects

Fitch Ratings-New York-06 May 2021: Fifteen state legislatures are considering or have implemented tax policy revisions, including changes to tax rates and tax rebates, as part of FY 2022 budget negotiations coming out of the pandemic, says Fitch Ratings. Most of the tax changes are a small percentage of total revenues and would have a negligible effect on states' operating funds. We do not expect any near-term rating changes as a result of enacted or proposed tax changes.

States that introduced substantial tax cuts, including Idaho, Iowa, Nebraska and Oklahoma, have healthy reserves and strong budgetary flexibility, which should enable them to adapt to any revenue stresses that may emerge in the near to medium term.

However, changes that affect future tax revenue in an environment of heightened economic and revenue uncertainty may have unintended budgetary consequences in the out-years. The greater the policy shift, the larger and more challenging the future budget-adjustment measures could be if revenues do not perform as anticipated.

Tax collections for FY 2021 for most US states are tracking well above initial projections, with further solid growth likely for FY 2022. Direct aid of $195.3 billion to states under the American Rescue Plan provides a significant one-time revenue boost that states must use by YE 2024.

Major shifts in business and consumer spending in response to the federal stimulus and the aftermath of the pandemic, however, could lead to material short-term swings in tax receipts. Sales taxes, for example, which generally outperformed in 2020 as consumers spent a large portion of discretionary income on tangible goods, could decline in FY 2022 and FY 2023 as spending shifts away from goods to services, which are less likely to be taxed.

Tax policy changes are mixed in terms of their likely fiscal effect. Oklahoma, Iowa, Idaho, Utah and Tennessee have all proposed a mix of income, sales and property tax cuts and/or credits, with Georgia and Nebraska recently signing personal income tax (PIT) cuts into law. The size of the cuts is less significant as a percentage of budget for Georgia, Tennessee and Utah but are more sweeping and material for Iowa and Nebraska.

Iowa seeks to accelerate previously-enacted tax cuts by scrapping required revenue triggers. This would result in a $1.3 billion decline in tax revenues over four years, with a FY 2027 decline equal to 4.7% of general fund (GF) revenues. Iowa's measure faces considerable resistance in the state house of representatives and is unlikely to be fully implemented.

Nebraska's measure will substantially expand existing income and property tax credits, reducing state revenues by $770 million over the next biennium, an annualized amount equal to 7.5% of budgeted FY 2022 GF revenues. Both Iowa and Nebraska possess healthy rainy-day reserves and substantial cash balances, which will cushion any short-term negative revenue effects that may emerge.

Other states have either proposed or implemented noteworthy tax increases. New York's April 2021 temporary increase to the top marginal tax rate, along with a smaller temporary surcharge to the corporate tax rate, will raise substantial revenue, with the PIT surcharge alone estimated to raise $2.8 billion in FY 2022. Risks include a potentially slower recovery from the pandemic resulting from lower consumer spending due to the tax increase.

Hawaii's legislature has likewise proposed raising the highest income tax rate to 16% from 11% along with higher capital gains and corporate income taxes (CIT) but the chances of full adoption are unclear. Minnesota's legislature has pushed back against the governor's proposed CIT increase and other tax changes that would raise total GF revenues by more than 3%, causing the governor to modify his plan.

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