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Fitch: Leaning Into Tax Cuts Could Pressure Some U.S. States Over Time

Fitch Ratings-New York-31 October 2022: Most U.S. states will be able to absorb the short-term revenue effects brought on by more aggressive 2022 tax cuts even when confronted with a mild U.S. recession next year; however, a small number of states with more expansive tax reduction packages could experience budgetary pressure, according to a new report by Fitch Ratings.

A total of 31 U.S. states adopted tax cuts in some form during the 2022 legislative sessions, a dramatic increase over 18 states that cut taxes in 2021. Fitch expects the combination of rate reductions, tax holidays and tax exemptions adopted by states will translate into short-term revenue losses and a slowdown in the pace of revenue growth for a number of states. Fitch, however, expects the collective revenue effects will be small compared to the overall size of the budgets for most states that implemented tax cuts in 2022.

“Faster population growth generally translates into more rapid growth in tax collections, which will help states with more rapid population growth to better withstand the revenue declines, or in some cases slowdowns in the pace of new revenue formation, associated with tax cuts,” said Director Michael D’Arcy. This is good news for states seeing rapid population growth such as South Carolina and Idaho.

Iowa and Nebraska, in particular, would face more risk in a severe downturn and could be forced to rely on reserves as a “bridging measure” to absorb shortfalls until the economy recovers. This is because Iowa and Nebraska have enacted several rounds of tax reductions since 2020 and their populations are growing at a rate below the US average. By contrast, Idaho and South Carolina, which have also enacted sizable tax cuts that don’t include revenue triggers or other guardrails, may fare better given their strong job markets and rapidly growing populations.

Fitch’s “States Lean into Tax Cuts as Revenue Surge Continues” is available at www.fitchratings.com.

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