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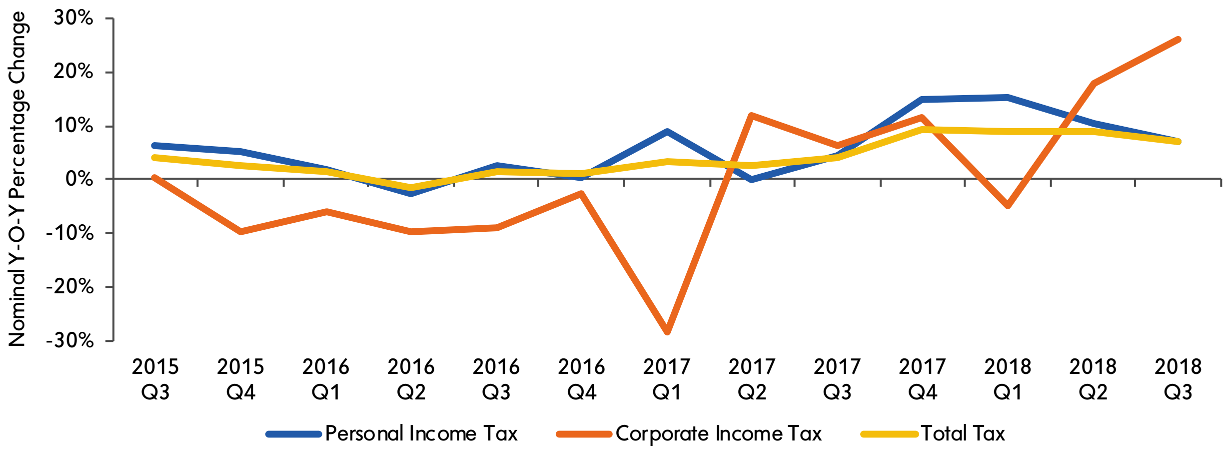
Are State Budgets Prepared For Lower Tax Revenues?

The U.S. Municipal Bond Team

State tax revenue growth has been exceptionally robust in the past few quarters. Although some of the growth is attributable to healthy economic expansion, a significant portion is due to the impact of the Tax Cuts and Jobs Act (TCJA) passed in December 2017. As the positive impact of the TCJA on state tax revenue fades, states now face decelerating revenue growth and, in some cases, declining revenues. While the incremental revenues from tax reform may seem unequivocally credit positive for the state sector, further analysis shows that there are some potential risks associated with increased revenues. Higher revenue volatility created by the TCJA, an expected slowdown in economic growth, uncertainty created by the federal government shutdown, and increased spending has created a challenging environment for states' budget management. These considerations take on more urgency as many states are beginning their fiscal year 2020 budget negotiation process.

Since most states incorporate federal tax code provisions into their own income tax structure, the TCJA boosted state tax revenues in two ways. First, the TCJA broadened the tax base for individuals and corporations but did not affect state tax rates, boosting both individual and corporate tax revenues. Second, the TCJA capped the annual itemized deduction for state and local taxes (SALT) at $10,000. This incentivized high-income taxpayers to accelerate state and local tax payments into December 2017 before the new law took effect in January 2018.

State Tax Revenue Growth



Source: United States Census Bureau

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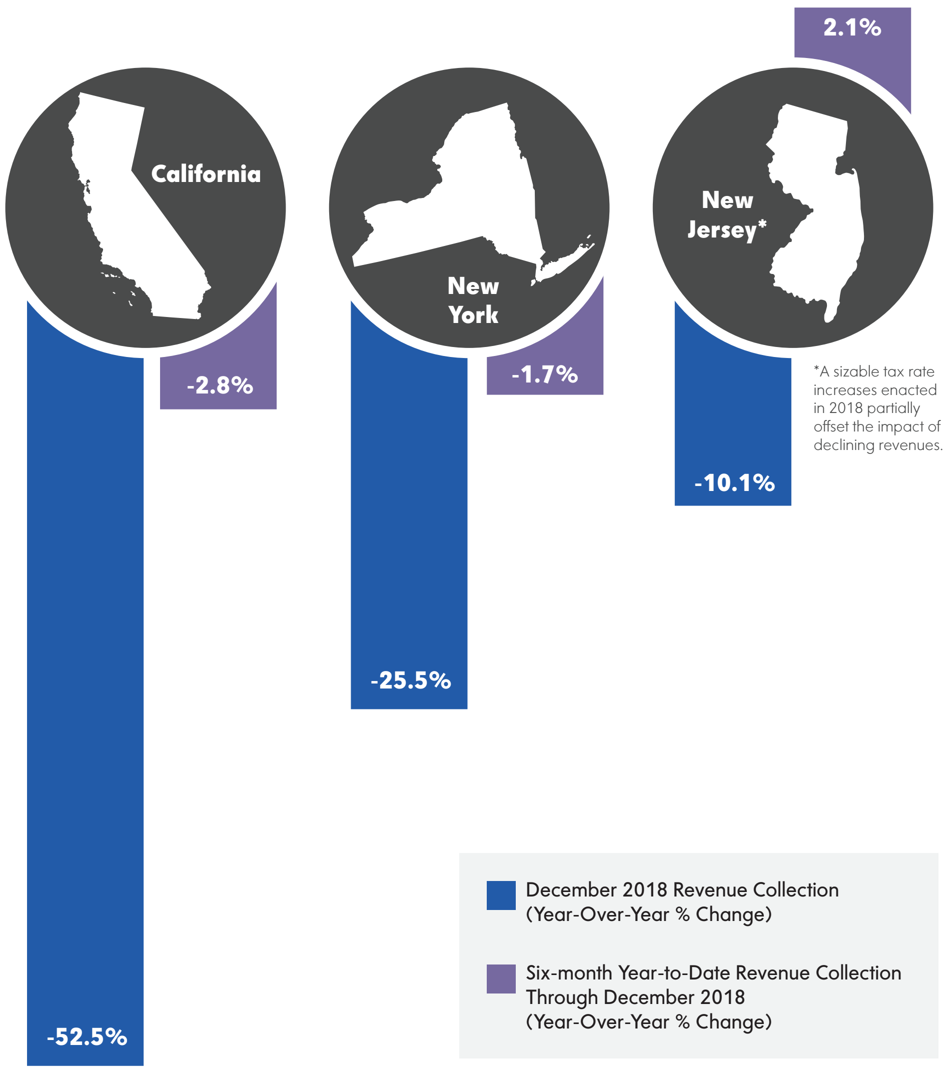
As shown on the previous page, state tax revenue shows an average growth of 8.4% in the last four consecutive quarters through the third quarter 2018, far exceeding the average of 2.0% between the second quarter 2015 and the third quarter 2017. With the impact of the TCJA fading, personal income tax revenue growth has declined from 15.3% in the first quarter 2018 to 6.9% in the third quarter of 2018.

Some states now report a material year-over-year decline in December 2018 tax collections, due largely to unusually high tax revenues collected in December 2017. Notwithstanding the impact of an accelerated tax collection in December 2017 due to the looming SALT cap, some states are reporting year-to-date revenue collections that fall short of their budgets, which could create an unexpected mid-year deficit. Some of the largest states with the highest income tax revenues experienced a material decline in December 2018 on a year-over-year basis, and the majority even experienced declines on a year-to-date basis.

High Income Tax States Revenue Trends



Source: California Department of Finance, New York Department of Taxation and Finance, New Jersey Department of the Treasury.

In the case of California, the state even underperformed its budget by 4.4% for the final six months through December 2018. For New Jersey, the impact of the TCJA anomaly was offset by sizable tax rate increases implemented in 2018. Nonetheless, year-to-date revenue collection through December 2018 was 5.4% below the budget.

While the TCJA has been the biggest driver of revenue trends over the past year, political and economic forces are beginning to come to the forefront. Before the partial shutdown of the US government began in December 2018, the US was already facing an uncertain economic outlook. The White House Council of Economic Advisers estimated that the shutdown would likely reduce economic growth by 0.13% per week.

Maryland, Washington DC, and Virginia were most affected by the shutdown. Maryland officials estimate the shutdown affected about 172,000 of its residents, which resulted in roughly $57.5 million less in combined state and local income tax withholding and $2.1 million less in sales tax collections every two weeks.[1] Federal jobs account for 11.2% of total Washington DC metro area employment, with an estimated decline of $12 million in tax revenue per week during the shutdown.[2]

2018 was clearly a very strong year for state revenue trends due mainly to the stimulative and structural elements of the TCJA. However, with the benefits of the TCJA now fading and the economic outlook uncertain, revenue prospects in 2019 are less favorable. States that used surpluses in recent years to build up their rainy day reserve funds, while also budgeting conservatively in anticipation of an increased revenue volatility, are likely to fare better than states that have ramped up spending with the expectation that revenues will continue to grow at previous rates. In addition to tracking actual revenue trends, we consider budget management practices in our review of state credit quality. With revenues fluctuating following the passage of the TCJA, we believe the insights gained from a close inspection state budget negotiations can help us detect any credit deterioration.

Endnotes

1. Comptroller of Maryland. Accessed at http://comptroller.marylandtaxes.gov/Media_Services/wp-content/upLoads/BRE-Shutdown-Memo-Jan-2019-.pdf on January 14, 2019.

2. Government of the District of Columbia. Accessed at https://mayor.dc.gov/sites/default/files/dc/sites/mayormb/release_content/attachments/OCFO%20Letter.pdf on January 22, 2019.