Retirement News Highlights

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The Biggest Public Finance Issues to Watch in 2023

STATE SURPLUSES ARE UP. SO TOO ARE APPETITES FOR MORE SPENDING AND TAX CUTS. BUT INFLATION HAS REARED ITS UGLY HEAD AND THE POSSIBILITY OF A RECESSION IS VERY REAL. GOVERNING SORTS OUT THIS YEAR'S FINANCIAL PICTURE.

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Editor's note: These public finance briefs originally appeared in our annual Issues to Watch, which was published on Jan. 10. You can read the entire article here.

Last year, state lawmakers were able to have their cake and eat it too, vigorously cutting taxes and substantially increasing spending, while still able to rack up record savings in their rainy-day funds. The good times are still around — most states are seeing surpluses — but there are reasons to be nervous. Inflation may have slowed a bit, but it's still eating into real revenue growth. And the prospect of a struggling economy – what economist Mark Zandi is calling a "slowcession," if not a full-blown recession — is also making some legislators wary.

Still, there's a considerable appetite both for new spending and continued tax cuts. "No doubt, 2022 will go down in the record books as one of the most successful tax-cutting years in history," says Jonathan Williams, chief economist at the conservative American Legislative Exchange Council. Given sizable surpluses, he expects to see more. As the year begins, there are promises of major cuts coming not only in the capitols of red states, including Iowa and Texas, but from Democratic governors in states such as Connecticut, Kansas and Wisconsin.

Even as the desire to cut taxes continues, spending is also going up. State lawmakers are enjoying not only their own healthy revenues but lots of extra money from Washington in areas such as infrastructure, clean energy and public health. While they continue to spend money on big-ticket items such as broadband, they're also having to increase salaries to remain competitive in tight labor markets. To better understand the impact of budgets, inflation and taxes on this year's legislative agenda, here's our forecast for public finance.

Budgets

It's one of those best of times/worst of times situations. Right now, state budgets are in excellent shape. Many states are enjoying surpluses and their rainy-day funds are at record highs.

But in contrast to the free-and-easy party time that extra federal money created for them last year, lawmakers are nervous about inflation and the better-than-decent chance that the economy will fall into recession during this calendar year.

States have tripled the amount of money in their rainy-day funds over the past couple of years, leaving them with a grand total of $343 billion in reserve. “We’ve been fortunate in Arkansas that we’ve been able to cut taxes and have $1.2 billion in our catastrophic reserve fund, and a $1.6 billion surplus on top of that,” says Matthew Shepherd, speaker of the Arkansas House. “But we understand that the picture can change in the future.”

Lots of other states are now enjoying a bounty. Wisconsin is sitting on an all-time record surplus of $6.6 billion. Georgia happens to have a surplus matching that exact dollar amount. Texas has a Texas-sized surplus of $27 billion, which will likely translate into a major property tax cut.

Ten mostly red states cut individual income tax rates in 2022. More will follow this year. North Dakota Gov. Doug Burgum released a budget proposal in December that would give his state the lowest flat-rate income tax in the country, at 1.5 percent.

Some economists warn that states should not turn temporary surpluses into a permanent reduction in rates. They tend to favor the approach taken in a number of blue states last year, offering sales or gas tax holidays and one-time credits and rebates. “I always think there’s a danger when things are going well, that states tend to cut taxes and then that creates problems later,” says Ron Fisher, an economist at Michigan State University.

The same holds true for spending. States have been doing a lot of that. General fund spending increased by 18 percent in fiscal 2022, according to the National Association of State Budget Officers. It’s set to climb another 7 percent in the current fiscal year.

The rainy-day balances have positioned most states pretty well for any downturn, but they still have to worry about rising costs. Low unemployment and staffing shortages are putting upward pressure on wages for state employees, while inflation and supply chain problems have made infrastructure projects more expensive. One big warning sign is California, which already faces a $24 billion shortfall heading into the next fiscal year, starting on July 1. Tax receipts are way down there, even though employment has increased substantially in the state.

Fitch Ratings reviewed the fiscal conditions of the 15 largest states between July and September and found that California was the only one seeing tax receipts decline, compared to the previous year. But the national revenue picture was already starting to soften by the fall. Although total state tax receipts continued to go up, they declined in real terms, due to inflation. “It seems to me, in times of uncertainty, it’s better for governments to be stable and not make a lot of changes,” Fisher says.

— Alan Greenblatt

Inflation

Even though economic indicators are returning to pre-pandemic levels, last year’s spike in the consumer price index, the highest in 40 years, threatens to upend the recovery. There is no shortage of opinions as to what caused the recent rise in inflation. Whether it was a flood of federal money tied to COVID-19 relief, a sudden rise in consumer demand, supply chain issues, or more likely, a combination of factors, states and localities are left to deal with the consequences. But not without help.

The latest federal stimulus bill, President Biden’s $1.9 trillion American Rescue Plan, includes $350 billion in emergency funding for state, local and tribal governments, intended for use in COVID-19 recovery efforts, maintenance of vital government services and the support of long-term economic growth. Much of the money was used to make up for anticipated lost tax revenue due to the pandemic, rather than new spending. Recipients are obligated to use the funds by the end of 2026.

Besides the stimulus money, states have also benefited from increased sales and income tax revenue, a result of the inflated prices paid for goods and services and higher wages. Several states have seen double digit increases in taxes collected over previous years, creating budget surpluses. Thanks to higher interest rates, states have seen the value of their investments grow exponentially. However, fluctuating property taxes from an uncertain housing market, combined with diminished federal assistance and the rising cost of providing services and capital projects, will make it difficult to maintain the status quo.

Since 2020, the cost of construction materials has risen significantly faster and higher than the consumer price index. These unexpectedly higher prices, supply issues and a workforce shortage have forced states to rethink projects and how to pay for them. Last year Virginia set aside an additional $200 million for anticipated inflation-related cost overruns for highway projects, in order to protect the contractors it relies on to do the work.

After several rounds of federal help and higher-than-expected tax collections, many states are tapping into rainy-day funds and budget surpluses, sending inflation relief checks to their taxpayers. To date, almost half of the states have already offered one-time rebates and expanded tax credits, or expect to do so in the coming year. Most of the relief money comes from budget surpluses and is being distributed by legislative edict or as automatic rebates. Some economists worry that the payments will do little to offset the pain of inflation, and could even end up exacerbating the problem.

By the end of January, California will have sent inflation relief payments ranging from $200 to over $1,000 to more than 23 million qualifying taxpayers. Colorado had planned to return $400 to every taxpayer in 2023, but thanks to the state’s strong economy, the amount was increased to $750 and moved up a year. Last summer, families in New Mexico received a combination of rebates and tax credits totaling up to $1,500.

At record levels after two years of growth, state rainy-day funds and budget surpluses are not expected to continue at the same pace. Lawmakers will have to deal with an uncertain economy and significantly less federal aid. Continued high rates of inflation diminish government spending power and threaten the COVID-19 recovery.

— David Kidd

Taxes

After the roller coaster of the early COVID-19 days, states have seen tax revenues stabilize and even grow more quickly than they were before the pandemic began. The relatively healthy financial picture for states has led to a trend of tax cuts and rebates. But 2023 holds a lot of unknowns for the economy, and thus for state tax policies.

Over the past two years, states have enacted “an unprecedented level of tax-rate reductions,” says Jared Walczak, vice president of state projects at Tax Foundation, a right-leaning think tank. According to Walczak, 27 states have cut a major tax and 21 states have reduced income tax rates. Another mini trend has been the switch from graduated-rate income taxes to flat taxes in a handful of states. The potential for a recession makes it likely that the pace of tax cuts will at least slow down in 2023. But states now have a broader tax base than they did before the Tax Cuts and Jobs Act of 2017, Walczak says, and the baseline they’ll return to after an eventual downturn is higher than before.

It's been difficult for states to advance "novel new taxes" like digital services taxes, stock-transfer taxes and other taxes on the wealthy while their revenue collections have been so high, Walczak says. But some of those ideas could gain steam again if an economic downturn leads to lower revenues. Many economists are predicting at least slower growth if not overall recession in 2023, and a generally "gloomier outlook" for state revenues than over the past few years.

There have been notable exceptions to the trend of state tax cuts and rebates. In Massachusetts, voters approved the so-called Fair Share Amendment which raises taxes on people with incomes over $1 million a year. The proceeds of that tax are intended to support investments in transportation and public education. Walczak says the close vote — the tax won by 52 percent while Democrat Maura Healey won the governor's office by 64 percent — shows that voters generally are suspicious of wealth taxes and "need to be convinced" that they are worthwhile, even in progressive states like Massachusetts. A proposal to raise taxes on people earning more than $2 million in California was soundly defeated in November, even while Los Angeles voters approved a mansion tax to support homelessness efforts.

Generally, states are moving in two different directions on tax policy, says Aidan Davis, state policy director at the left-leaning Institute on Taxation and Economic Policy. Those trends, which roughly align with party control, are likely to stay in place. But the across-the-board preference for tax cuts over the last two years could quickly change if the economy goes into recession. Amid strong collections and federal COVID-19 relief funds, many state-level cuts were enacted without broad political acknowledgment of what was being sacrificed long term, Davis says. Polling shows that Americans generally favor higher taxes on the wealthy. It's possible another wave of progressive tax increases could materialize in the event of a downturn and reduced state collections.

— Jared Brey

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