AHEAD

TOPIC A

CASH-RICH STATES LOWER TAXES

The economic turnaround sparked a wave of cuts in state tax rates. But some say the efforts could backfire.

BY SANDRA BLOCK

DURING THE HEIGHT OF THE pandemic in early 2020, the economic downturn forced states to furlough employees and cut services. Faced with the prospect of a prolonged recession, state officials braced for steep declines in revenue from sales and income taxes.

But the past year and a half now looks like a horror movie that

ILLUSTRATION BY ROBERT NEUBECKER

abruptly turned into a musical. Ten states are so awash in cash that they've cut individual income taxes, with some of the tax cuts taking effect in 2021 and others scheduled to phase in over the next few years, according to the Tax Foundation, a tax policy research organization. Some people won't have to wait for tax relief: Idaho is sending every resident a tax rebate check for $50 or 9% of their 2019 tax bill, whichever is greater.

The dramatic turnaround in state finances was propelled by the economic rebound and revenue from federal stimulus packages. The stimulus legislation also delivered billions of dollars in stimulus checks to individuals, which enabled them to continue to spend money during the pandemic. That bolstered state sales tax revenues, says Katherine Loughead, senior policy analyst for the Tax Foundation's Center for State Tax Policy. Likewise, enhanced unemployment benefits lessened the economic impact of furloughs and layoffs.

The most common form of state tax relief is a reduction in top tax rates (see the box below), along with a consolidation of tax brackets. For example, Arizona's state legislature lowered taxes for residents with income of more than $250,000 ($500,000 for married couples filing jointly) starting this year; they will see their top marginal rate drop from 8% to 4.5%. Beginning in 2022, Arizona will also consolidate its four-bracket structure into two brackets, with a 2.55% rate for income up to $27,272 for single filers ($54,544 for married filers) and a 2.98% rate for income over that amount, down from the current marginal rate of 4.17% on income over $54,444 ($109,088 for married couples). Iowa consolidated its nine tax brackets into four and reduced its top tax rate from 8.5% to 6.5%, effective in 2023. The state had earlier approved tax cuts that depended on meeting certain revenue triggers; the legislation accelerated the reductions by eliminating those triggers.

Although a reduction in top tax rates primarily benefits high earners, other states enacted legislation that will lower taxes for middle- and lower-income taxpayers as well. For example, Montana increased its standard deduction to conform with the federal threshold, which will reduce taxes for taxpayers at the lower end of the income spectrum.

Windfall for High Earners

Higher-than-expected revenue for fiscal 2021 prompted these states to enact legislation that will lower individual income tax rates.

STATE	INCREASE IN REVENUE, FISCAL YEAR 2019 TO 2021	REDUCTION IN TOP INCOME TAX RATE	EFFECTIVE DATE
Arizona	21%	4.5% from 8%	2021
Idaho	35%	6.5% from 6.9%	2021
Iowa	13%	6.5% from 8.5%	2023
Louisiana	6%	4.25% from 6%	2022
Missouri	17%	4.8% from 5.4%	2028*
Montana	19%	6.5% from 6.9%	2024
New Hampshire	11%	0% from 5%†	2027*
Ohio	13%	4% from 4.8%	2021
Oklahoma	5%	4.75% from 5%	2021
Wisconsin	9%	5.30% from 6.27%§	2021

*Tax cut phased in over several years. †Tax on income from interest and dividends. §Second-highest tax rate; top rate remains the same. SOURCE: Tax Foundation

Too soon? Not all states are celebrating an increase in revenue. States that rely heavily on the hard-hit hospitality industry are still struggling to recover from the pandemic. "In Hawaii and Nevada, no one is talking about big income tax cuts," says Richard Auxier, senior policy associate at the Urban-Brookings Tax Policy Center, a tax research nonprofit. "They're talking about using funds to plug budget holes and prevent tax increases."

And even fiscally healthy states could see their tax revenues decline if the highly contagious delta variant of COVID-19 contributes to another hit on the economy. State finances have been volatile during the past two years, Auxier says, and states can no longer rely on federal assistance to get them through downturns. States that cut tax rates will need sustained economic growth to provide enough revenue to fund programs and services, he adds.

Perhaps with that in mind, several states have phased in their tax cuts over several years and/or tied them to revenue targets. Theoretically, that gives them the flexibility to postpone the reductions if they find themselves in fiscal difficulties.

Loughead contends that such a scenario is unlikely because she believes the tax relief will encourage economic growth. "These are reforms that will attract more people to these states, especially when there's a huge rise in remote work," she says.

Still, reducing taxes is much more politically palatable than raising them, and if states miss their targets, or find themselves in fiscal distress, Auxier doubts that lawmakers will roll back the scheduled tax cuts. "Anytime a policymaker says, 'We'll raise taxes later,' I raise an eyebrow," he says.