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Post-Pandemic State Tax Policies Are a Kaleidoscope in Motion

KPMG's Daniel De Jong and Harley Duncan examine factors taxpayers should consider as the state fiscal policy landscape shifts in response to falling state tax revenue.

State legislatures, buoyed by burgeoning revenue and growing reserves, enacted some significant tax cuts during the Covid-19 pandemic recovery. From 2021 to 2023, 25 states reduced personal income tax rates, 13 cut corporate income tax rates, and two reduced sales tax rates. And that's not counting the myriad tax cuts through structural changes in deductions, credits, and so on.

In 2023, however, state revenue growth tailed off substantially, particularly when the effects of inflation are factored in. The question for taxpayers is whether states can sustain ongoing tax reductions or whether some states overshot the mark and created a structural imbalance that may force tax and expenditure adjustments.

The answer isn't a simple matter of arithmetic. Factors such as the overall economy, federal government actions, and certain state-unique factors will influence the outcome, which is important to practitioners as they advise their clients and anticipate actions that may affect them.

Half-Empty or Half-Full?

From a glass half-empty perspective, two factors loom large. The lack of an orderly annual budget process creates a continuing shadow of possible federal government shutdowns and increases economic uncertainty.

The growing federal debt also remains largely unaddressed and casts a pallor of risk over long-term economic performance. These and other factors create risk and uncertainty for the US economy, the path of which has an enormous impact on state taxes and budgets.

The American Rescue Plan Act of 2021 made about \$200 billion available to states to assist with the economic and budgetary effects of Covid-19 through 2024. To date, about 40% of the federal aid has been devoted to ongoing

operating programs to offset revenue lost to the pandemic—an allowable use under the federal rules.

The concern is that if the expiration of the federal money in 2024 requires replacement with state funds, this could further stress an already tight budget picture. An in-depth [review](#) by the National Association of State Budget Officers indicates that states have been cautious in protecting against this, but any additional demands in a time of waning receipts may be troublesome.

In the glass half-full category, the US economy is performing well, with strong overall growth, continuing job gains, a rising stock market, improving consumer confidence, and reduced recession worries among national forecasters. States also have taken advantage of their fiscal good fortunes post-pandemic to build up reserves to cushion possible negative events.

An annual NASBO [survey](#) showed that at the end of fiscal year 2022, state ending balances—both reserved and unreserved—amounted to 38% of expected fiscal year 2024 expenditures, an all-time highwater mark.

Indicative of the sensitivity of one-time balances, they are forecast by NASBO to drop to about 24% of spending at the close of fiscal year 2024, as states have chosen to spend down some of those balances via tax cuts or spending increases.

What to Watch

States differ widely in their fiscal outlooks, but overall, they seem to be in a reasonable, manageable position in 2024 and 2025, barring any significant disruption to the US economy.

Reports from states such as Arizona, California, Minnesota, Tennessee, and New York indicate some anticipated fiscal stress in the form of possible budget deficits or other indicators of predicted revenue declines.

Others, such as Kansas, Mississippi, New Mexico, Ohio, and South Dakota continue to contemplate further tax reductions, including elimination of the personal income tax in some cases.

Given the diversity in fiscal pictures, tax advisers should consider asking the following questions to better understand state fiscal activity:

- What did the governor say in their state of the state address? How did legislative leaders respond?
- Has the state enacted tax cuts recently? Were they one-time, phased-in, automatic, or dependent on achieving specified revenue targets?
- Does the state use a single revenue estimate that is agreed to by the legislature and executive, or does each branch develop its own?
- What is the state's budget horizon? Do the forecasts incorporate known and contingent tax and expenditure changes over a three-year period or longer? What does the forecast tell you about structural imbalances?
- If budget adjustments were needed, what are the most likely candidates for adjustment? Are those important to you? How do you assess the risk of those budget and tax areas that are most important to you?

A clear-eyed assessment of these questions, along with a knowledge of your situation and what is transpiring in the state, can help tax advisers and their clients choose the best path forward—at least until the exogenous gods assert themselves and upset all the best-laid plans.

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Author Information

[Daniel De Jong](#) is managing director in KPMG's Washington National Tax state and local tax group, assisting clients with a variety of complex state and local tax issues.

[Harley Duncan](#) is a consultant to KPMG's Washington National Tax state and local tax group. He has a 40-year career in state and local tax policy and administration.

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To contact the editors responsible for this story: Daniel Xu at dxu@bloombergindustry.com; Rebecca Baker at rbaker@bloombergindustry.com

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