March 11, 2022

States With Temporary Budget Surpluses Should Invest in People, Not Enact Permanent Tax Cuts

By Ed Lazere

Policymakers in at least 14 states are using temporary budget surpluses to call for costly and permanent tax cuts targeted more to wealthy people and profitable corporations than to those who need help.¹ That’s a bad choice. States should be careful to protect their long-term ability to provide funding for high-quality schools, access to affordable health care, and other public services, which these tax cuts would badly erode. Instead of permanent tax cuts, states should use the surpluses for needed one-time supports for people and businesses or to seed longer-term investments, especially those targeted to the communities most harmed by the COVID-19 pandemic.

The surpluses largely reflect substantial — but temporary — federal funding provided in relief bills enacted in 2020 and 2021; those relief bills also boosted state economies and thus state revenues as well, further improving state fiscal conditions. Many of these federal relief efforts have ended, including stimulus payments and expanded unemployment benefits. States have appropriated much of the direct fiscal aid they received from the federal government, which must be spent within five years.

Enacting permanent tax cuts in response to short-term conditions would create problems in just a few years that could force states to cut education, health care, and more. Some of the proposed tax cuts far exceed the state’s expected revenue growth, which means budget holes could open up soon. For example, Iowa policymakers are considering tax cuts that would reduce revenues by $2 billion annually when fully implemented in five years, yet revenues are expected to grow just $150 million next year. (No projections are available beyond 2023.) This level of tax reduction is clearly unaffordable.

The deep tax cuts several states are considering would fritter away the opportunity to use the short-term surpluses to help residents and strengthen state economies. Research shows that state tax cuts don’t produce the economic boom their proponents promise — especially tax cuts focused on higher-income residents, such as cutting the top income tax rate. In contrast, using one-time surpluses to help residents or to invest in services that strengthen the state’s economy — such as in

¹ The states that have adopted or are considering tax cuts include Arizona, Georgia, Idaho, Indiana, Iowa, Kentucky, Michigan, Mississippi, Missouri, Nebraska, Oklahoma, South Carolina, Utah, and West Virginia. For more information see the Appendix, “Major State Tax Cut Actions and Proposals.”
education, housing, or infrastructure — could have long-term benefits when properly designed and targeted. Examples include affordable housing construction, school building improvements, initiatives to help students make up for lost learning time, or premium pay for those who performed essential work during the pandemic. Direct aid to residents and businesses — even short-term support during a crisis — can create stronger communities, reduce expenses for families, and support a state’s long-term economic health.

States may also wish to use a portion of today’s temporary surpluses to seed long-term investments, especially those aimed at communities that public policy has long neglected and those hit hardest by the pandemic and its economic effects. Expanding high-quality preschool programs, making child care more accessible and affordable, and improving workforce development initiatives can produce stronger and more equitable state economies, making these uses worth the investment. Temporary funds can’t finance these investments over the long term, but states can, at that point, decide whether it makes sense to find the resources to maintain them; investments that prove ineffective can be reversed through the annual appropriations process. That’s very different from tax cuts, which can be reversed only with new legislation or (in some cases) by altering the state constitution, both of which tend to be politically challenging.

The choice between cutting taxes and investing surpluses back into people and communities is a matter not just of fiscal responsibility but also of economic and racial equity. Most of the current state tax proposals, such as eliminating the income tax, would provide the greatest benefit to higher-income residents, most of whom are white, while forcing future cuts in services that would have the greatest impacts on people with low incomes and Black and brown people. Investing state surpluses in areas that expand opportunity, in contrast, would enable a state to make progress in addressing long-standing racial inequities in housing, education, health care, and more.

**State Surpluses Are Likely Temporary**

When COVID-19 began to rapidly spread in the U.S. in March 2020, the economy quickly shed more than 20 million jobs. Amid intense fear and hardship, the federal government took strong action in both 2020 and 2021 to put in place relief measures that boosted the economy, provided much-needed help to families and businesses, and provided direct fiscal support to states as well as localities, U.S. Territories, and tribal governments. This robust policy response helped make the pandemic-induced recession the shortest on record and brought unemployment down from 14.8 percent in April 2020 to 4.0 percent in January 2022. A measure of annual poverty that takes into account a broad array of public benefits declined by the most on record in 2020, in data going back to 1967, and the number of uninsured people remained stable, rather than rising as typically happens with large-scale job loss. While annual data for 2021 are not yet available, the robust relief measures are expected to have a sizable impact on poverty and lack of health coverage in 2021 as well.

This remarkable economic turnaround also buoyed state revenues. When the pandemic first hit, state revenues plummeted as job losses and business closures lowered people’s incomes and consumption, resulting in less income and sales tax revenue for states. As a result of the pandemic and its economic impacts, states and localities shed 1.5 million jobs and cut back on services.

---

worsening the downturn. But as the federal response kicked in and the economy began to recover, state revenue projections improved markedly.

In the fall of 2020, states were still projecting general fund revenues would be down 10.8 percent in fiscal year 2021 (which began July 1, 2020, in most states) compared to pre-pandemic projections. By the time governors wrote their budgets in early 2021, revenue projections for that fiscal year had improved markedly, though they remained 3.3 percent below pre-pandemic projections. The state revenue outlook at that time was also highly uncertain, with some predicting a double-dip recession without further federal action. The American Rescue Plan, adopted in March 2021, succeeded in sustaining the economy's recovery. According to an analysis by Mark Zandi and his colleagues at Moody's Analytics, states and localities would have shed an additional 1.2 million jobs without the Rescue Plan.

In the end, thanks in large part to federal government support for the economy, state revenues in fiscal years 2020 and 2021 combined were actually 1.3 percent above pre-pandemic projections — an amazing accomplishment so soon after the pandemic shut down the economy. And in the current year (fiscal year 2022), state revenues continue to come in above projections in many states, leaving most states running surpluses, often at historically high levels. But those surpluses very likely won't last long.

For one, the temporary federal pandemic response included substantial transfer payments such as economic stimulus payments and emergency federal unemployment benefits, both of which have now ended. These transfer payments were responsible for a great deal of the personal income growth states experienced, and therefore played a key role in supporting people’s consumption and temporarily boosting state sales tax revenue. Across all states, increases in income assistance to people and small businesses accounted for more than half of the growth in state income, according to personal income data from the Bureau of Economic Analysis. For example:

- In Iowa, where policymakers have proposed especially deep tax cuts, personal income grew 5.9 percent in 2020, even though earnings from work grew just 1.9 percent. The primary reason for this gap is that income from transfer payments grew 28 percent; this increase accounted for 87 percent of income growth in Iowa in 2020.

---


6 Ibid.

7 This is based on CBPP analysis of Bureau of Economic Analysis annual personal income data by state in 2019 and 2020.
In Arkansas, which enacted substantial tax cuts in 2021, personal income grew 5.8 percent in 2020, even though net earnings rose just 1.9 percent. Growth in transfer payments accounted for 90 percent of the state’s income growth in 2020.

State sales tax revenue also received a temporary boost due to the pandemic-induced increase in the consumption of goods (most of which are taxed by states) and simultaneous decline in consumption of services (many of which are tax-exempt in most states). As the pandemic cases, consumption is likely to return to normal, ending the temporary increase in state sales tax revenues.

The Federal Reserve also acted aggressively to support the economy, including cutting its short-term policy interest rate target essentially to zero and purchasing large quantities of government bonds to keep money and credit flowing in the economy and meet its maximum employment goal. These actions supported the overall economy and likely contributed to substantial increases in the stock market, vastly increasing the wealth of stockholders and further boosting state income tax revenues (which include taxes on capital gains in most states). The Standard & Poor’s stock index grew 41 percent between February 2020 and December 31, 2021. Such extraordinary gains are unlikely to continue in 2022, however. The stock market has already fallen significantly due to several factors, including the Russian invasion of Ukraine and indications that the Federal Reserve will likely raise interest rates several times in 2022 and wind down quantitative easing.8

Federal support for the economy also included substantial — but temporary — direct fiscal aid to states, localities, tribal nations, and territories: $150 billion under the Coronavirus Aid, Relief, and Economic Security (CARES) Act of 2020 (just to states and large localities); $350 billion under the Rescue Plan’s Fiscal Recovery Funds in 2021; and an increase in the federal share of Medicaid funding, which strengthened states’ overall fiscal picture while protecting health coverage for millions of people. These funds enabled states and localities to get by with fewer layoffs and much smaller service cuts than they otherwise would have imposed. It also greatly helped them cover the unanticipated cost of fighting the pandemic and the soaring demand for public services. In these ways, the fiscal aid acted in tandem with other federal efforts to support the economy at a dangerous time, limit the harm to families and communities, and generate a strong recovery.

However, states could only spend the CARES Act aid for costs occurred before the end of 2021, and states have appropriated almost 60 percent of the Rescue Plan aid. As they write their budgets for fiscal year 2023, states will likely allocate most of the remaining funds. At any rate, the funds won’t last much longer; they must be obligated by December 31, 2024, and spent by December 31, 2026.

All this suggests that state economic growth — and revenue growth — will cool to more normal rates, state budget surpluses will soon shrink, and states will have fewer federal resources to support

---

8 Other factors that increased state revenues are likely temporary too, including higher inflation (which pushed some households into higher tax brackets) and a surge in businesses raising revenue from initial public offerings. See Lucy Dadayan, “Five Reasons Why States Should Proceed with Caution Despite Soaring Revenues,” Urban Institute and Tax Policy Center, February 8, 2022, https://www.taxpolicycenter.org/taxvox/five-reasons-why-states-should-proceed-caution-despite-soaring-revenues.
key state functions. In December 2021, the Federal Reserve predicted real U.S. GDP will grow 2.2 percent in 2023 and 2.0 percent in 2024, down from 5.5 percent in 2021 and 4.0 percent in 2022.²

Further, while the federal government’s emergency fiscal support for states has done a great deal to limit the pandemic’s damage to families and communities, some of the pandemic’s impact will likely outlast the federal aid, leaving states with increased costs over a longer period. For example, it will take years and substantial effort for schools to help children recover from the schooling they’ve lost, and the pandemic-induced increase in mental health issues may raise state costs well into the future.

**Several States Proposing Unaffordable Tax Cuts**

While some recent proposals for deep tax cuts may appear affordable because they include phase-ins or the state is running a surplus, they would swamp expected increases in state tax revenues in coming years, quickly undermining the state’s strong fiscal condition. In the future, these states likely would be forced to impose severe cuts in funding for important services — or reverse the tax cuts — to balance their budgets. Other recent tax-cut proposals are less extreme but would still absorb much if not all the expected state revenue growth in coming years, potentially forcing cuts in schools, health care, and other services. Since providing those services costs more each year because of inflation and population growth, states will need revenues to grow simply to continue paying for existing services, let alone to make new investments. By using up all or nearly all of states’ revenue growth, the tax cuts — which tend to favor high-income and high-wealth individuals and households — would divert resources that could address important problems facing states and communities. These range from lack of affordable housing to the need to invest in early, K-12, and higher education in order to expand opportunity and grow the state’s economy over the long term.

Also, some of the proposed tax cuts would be phased in over a longer period than that for which the state has projected revenues, so policymakers cannot know whether they are affordable. Very few states project revenues or the cost of maintaining current services for more than a few years.¹⁰ Cutting taxes deeply without that information is like flying blind.

It’s important to note that even without new tax cuts, many states’ revenue systems face structural deficits, or the chronic inability of state revenues to grow in tandem with economic growth and the cost of government.¹¹ For example, state corporate income taxes have become less effective as the economy has globalized, but the methods for allocating corporate profits to states have not adapted.

---


And state sales taxes have not done enough to expand to cover services to keep up with the long-term shift in consumption from goods to services.\textsuperscript{12}

As noted, some sponsors of deep tax cuts have masked the impact by proposing to phase them in over several years. But the tax cuts are so large that it is clear they would seriously weaken state revenues when fully phased in.\textsuperscript{13}

- In Iowa, general fund revenues are projected to grow $150 million next year, yet the state has adopted phased-in tax cuts with annual costs rising to $1.9 billion five years from now.\textsuperscript{14} If state revenues grow at the current rate for five years, they will be just $780 million higher five years from now without any tax cuts.

- In Kentucky, lawmakers have introduced legislation to cut the income tax rate from 5 percent to 4 percent immediately, at a cost of $1.1 billion in 2023, with deeper cuts phased in over time. State revenues, before considering the tax cuts, are expected to grow just $294 million in 2023.

- In West Virginia, lawmakers are considering cutting income tax rates by 10 percent across the board and gradually \textit{eliminating} the personal income tax, which now accounts for nearly half of the state’s general budget. The plan would be unaffordable right from the start: it would cost an estimated $265 million in year one,\textsuperscript{15} but the state expects zero revenue growth in 2023 and only $210 million growth in 2024.\textsuperscript{16} (See Figure 1.)

\textsuperscript{12} While this shift was temporarily reversed during the pandemic due to health-related concerns associated with many services, the long-term trend of growth in services over goods will likely return as pandemic-induced consumption changes recede.


\textsuperscript{16} For state revenue estimates, see Sean O’Leary, “Low Revenue Estimates Are Not a Reason to Pursue Tax Cuts,” West Virginia Center on Budget and Policy, January 26, 2022, \url{https://wvpolicy.org/low-revenue-estimates-are-not-a-reason-to-pursue-tax-cuts/}. 
Even states considering more modest tax cuts are putting their finances at risk. For example:

- Idaho policymakers just adopted the largest tax cut in the state’s history, costing $250 million a year. However, before the tax cuts, state revenues were expected to grow just $270 million next year. Thus, the tax cuts will consume nearly all of the new revenue, leaving very little to address rising costs, ongoing impacts of the pandemic, or long-standing needs.

- Some South Carolina policymakers are proposing cutting the top income tax rate by one percentage point, which would reduce revenues by $800 million annually by 2026. Yet under current state revenue forecasts, annual revenues by 2025 (2026 figures are not available) will be just $900 million above 2022 levels. Here, too, the tax cut would consume nearly all of the new revenue.

---


Some States Using Surpluses Responsibly to Help Residents

Some states are using their currently strong finances to make investments to help residents and strengthen the state, and to fund priorities that have been hard to pay for in the past.

In Oregon, for example, Governor Kate Brown’s proposed budget includes a number of important investments, some of which would be funded with the state’s $2 billion surplus:

- $400 million one-time investment in affordable housing;
- $200 million for an innovative workforce development program focused on serving people in marginalized communities (this funding would allow the program to operate for several years, at which point the state could choose whether to extend it);
- $100 million to expand child care options for families; and
- $100 million to develop housing for people with mental health and substance use needs.

The budget would also hold $500 million in reserve for the next biennium in case state revenues weaken.

These budget choices would support the state’s ongoing recovery from the pandemic, help residents harmed by the pandemic, and make some structural changes that would have long-term benefits while still leaving the state in a strong financial position.

Proposals Would Largely Benefit Wealthy, Force Spending Cuts That Hurt Residents

Choosing to cut taxes rather than invest short-term surpluses would have long-term implications for states, both by creating avoidable budget shortfalls that would likely prompt cuts in services and by widening economic and racial inequities.

Neither the empirical data nor the academic literature supports the idea that cutting personal income taxes aids long-term prosperity or growth. Over the past decade, in fact, the states with the highest top income tax rates had faster economic growth than the states with no income tax.19

Moreover, many of the proposed tax cuts — particularly those to slash the personal income tax or eliminate it entirely — would help residents with high incomes, most of whom are white, far more than those with lower incomes, who are disproportionately people of color. In Arizona, for example, an estimated 91 percent of the benefit from massive tax cuts enacted in 2021 will go to the highest-income 20 percent of residents. Households of color represent 1 in 3 Arizona residents but will receive only 21 percent of the tax cuts.20 That’s consistent with past income-tax cuts in other states:

---


in North Carolina, Black residents received only 10 percent of personal income tax cuts enacted in 2013, though they made up 22 percent of the state population.21

By contrast, the state spending cuts that tax cuts would likely require would affect all state residents but fall hardest on households with low incomes and on historically excluded communities. Revenue losses due to tax cuts would limit states’ ability to address the ongoing impacts of the pandemic — including housing instability, food insecurity, and educational and mental health challenges for students — which have taken a particularly heavy toll on people of color. Those revenue losses would also prevent states from making forward-looking investments to address long-standing racial and economic inequities that worsened in the pandemic. And they would undermine states’ key role as the primary funders of the country’s educational system, much of its health care infrastructure, and most of its public infrastructure (including clean water facilities and transportation networks, for example).

States Should Use Surpluses for Immediate Needs, Seeding Long-Term Investments in People and Communities

State policymakers have far better options for using their short-term surpluses. These include one-time or short-term investments to address the pandemic’s ongoing impacts or to better position the state for the future, such as:

- **Helping people and businesses still struggling due to the pandemic and economic fallout.** The need for food assistance and emergency rental assistance remains high in many communities, and the ongoing pandemic puts pressure on some industries. States can use their budget surpluses to provide additional one-time aid in these and related areas. This would not only help residents struggling the most but also support the economy’s long-term vitality.

- **Addressing the pandemic's long-term damage.** Even as the economy recovers, many impacts of the pandemic linger. The pandemic created enormous mental challenges for youth and adults. Remote learning left some students failing to thrive. One-time surpluses can support additional tutoring or afterschool programs, strengthen access to mental health services, provide continued protection against evictions, and more.

- **Addressing racial inequities.** Long-standing, systemic racism has denied opportunities for Black and brown residents to build wealth and income and has created huge inequities in education, health care, and many other areas. States can use one-time surpluses to provide emergency cash assistance, reduce or eliminate debt from fines imposed on people who can’t afford to pay them, build housing and support small businesses in areas of disinvestment, or invest in green space or other environmental projects in communities that have been neglected, among other things.

- **Investing in infrastructure.** Many K-12 school buildings are in bad shape, which makes it harder for students to learn and in some cases can damage their health, such as through

---

21 This is because the North Carolina tax-cut package was designed to reduce income tax rates for higher-income taxpayers, and Black households in the state generally had less income due to inequities caused by the legacy of racism and continued discrimination. See Tharpe and Leachman, op. cit.
mold or unhealthy air quality.\textsuperscript{22} In addition, communities across the nation face a shortage of affordable housing, including insufficient new construction. States can use their surpluses to rebuild schools, develop new affordable housing, and make other infrastructure investments that enhance economic opportunity and foster more inclusive state and local economies.\textsuperscript{23}

- **Providing one-time tax cuts targeting residents with low incomes.** States where policymakers are committed to tax cuts could use surpluses for one-time cuts, ideally targeted to residents with low and moderate incomes, such as a one-time rebate.

In some cases, states may want to extend the investments funded with a one-time surplus. This could happen, for example, if the cost for a new or expanded initiative is relatively small and easy to incorporate into future budgets. Other investments planned to be short term — like bolstering K-12 educational services for students who are struggling, investing in higher education, or expanding health care in underserved communities — may prove worth extending. Temporary funds can’t finance these investments over the long term, but states could, at that point, decide whether it makes sense to find the resources to maintain them. Avoiding deep tax cuts would help states sustain effective investments they choose to make with their current surpluses.


\textsuperscript{23} The bipartisan federal infrastructure bill enacted in 2021 provides substantial funds for various kinds of infrastructure projects, but states will likely need to supplement that federal support with their own funds to fully meet their infrastructure needs. The bill does not include any funds for school construction, for example.
Appendix: Major State Tax Cut Proposals and Actions

**Arizona:** Tax cuts enacted in 2021 could reduce revenues by nearly $2.5 billion annually once fully phased in by 2025. Implementation of the largest cut is on hold due to a pending ballot initiative to overturn it, although some lawmakers have proposed alternative tax cuts to circumvent the ballot process. The state could lose further revenue if a voter-approved tax increase from 2020 is thrown out in an ongoing court challenge.

**Georgia:** Governor Brian Kemp has proposed $1.6 billion in one-time income tax refunds. The House speaker has introduced legislation that would cut income tax revenue $1 billion annually by 2024.  

**Idaho:** On February 4, Governor Brad Little signed into law $251 million in permanent income tax cuts for individuals and corporations, including a reduction in income tax rates.

**Indiana:** On January 20, the House approved income and business tax cuts that would cost $1.2 billion annually once fully phased in in 2026, although it has encountered opposition in the Senate due to concerns about using temporary budget surpluses for permanent tax cuts.

**Iowa:** The state has adopted a plan to replace the state’s graduated personal income tax with a flat-rate income tax of 3.9 percent, fully eliminate the income tax in five years, and cut corporate income taxes. The plan will cost $1.9 billion annually once fully phased in over five years.

**Kentucky:** House leaders have introduced a bill to immediately reduce the state’s flat-rate income tax from 5 percent to 4 percent, at an annual cost of $1.1 billion, and then gradually eliminate the income tax as specified triggers are met.

**Michigan:** On January 26, a Senate committee approved a package of personal and corporate income tax cuts, which could cost $2.3 billion a year starting in 2023.

**Mississippi:** The Senate has adopted tax cuts that would reduce revenues $350 million annually by 2026, while the House has adopted a different plan that would cost $1.5 billion annually once fully phased in.

---


Governor Tate Reeves has repeatedly called eliminating the personal income tax his top priority.

Missouri: On January 27, a Senate panel approved two measures to eliminate the corporate income tax and gradually phase down the personal income tax. Together, the measures would cost $1.3 billion annually by 2025.

Nebraska: Governor Pete Ricketts has prioritized a proposal to cut rates on both personal and corporate income, at a potential cost of $179 million a year by 2025.  

Oklahoma: Governor Kevin Stint voiced support in his recent State of the State address for phasing out that state’s personal income tax. A proposal to accomplish that goal is currently moving through the House.

South Carolina: Lawmakers are considering multiple income tax cut proposals, including one to gradually drop the state’s top personal income tax rate to 6 percent from 7 percent, at an estimated annual cost of about $800 million by 2026.

Utah: On January 28, the Senate approved a cut in the state’s flat income tax rate to 4.85 percent from 4.95 percent, at an estimated cost of $160 million annually.

West Virginia: Lawmakers are weighing a plan to cut all income tax rates by 10 percent and gradually eliminate the personal income tax, which accounts for nearly half of the state’s general budget. The plan would cost $265 million in year one and increasing amounts over time.

---


31 Mary Green, “Republican lawmakers, governor back push to lower SC’s top state income tax rate,” WCSC, February 4, 2022, [https://www.live5news.com/2022/02/05/republican-lawmakers-governor-back-push-lower-scs-top-state-income-tax-rate/](https://www.live5news.com/2022/02/05/republican-lawmakers-governor-back-push-lower-scs-top-state-income-tax-rate/).
