Potential State Policy Impacts of the 2022 Midterm Elections

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In this article, Roberti and Sawyer examine the effect that the 2022 midterm election results — including shifts in control of several state legislatures and governorships — will have on state tax policy in the 2023 legislative sessions and beyond.

The 2022 federal and state midterm elections are likely to have state tax policy ramifications. The widely anticipated "red wave" did not materialize at either level, and despite a challenging economic climate, Democrats had more success at the federal level than the sitting president's party typically has during midterms. State Democratic candidates made substantial gains in various states but lost ground in others. These results — along with shifts in state supermajority control following 2022 redistricting and ongoing economic uncertainty — will affect not just the state political landscape, but also state tax policy for the foreseeable future.

Economic Backdrop

The elections came against an economic and fiscal backdrop that will continue to influence tax policy decisions in 2023. Nationally and internationally, inflation has caused prices of consumer goods and services to increase since January 2021. To address inflation concerns, the Federal Reserve increased interest rates several times in 2022, with an aim of slowing the economy — resulting in rising unemployment rates, slowing consumer demand, and reduced savings levels. With many economists predicting a recession for 2023, state lawmakers will need to carefully consider the revenue outlook as they formulate budgets for the next fiscal year.

Despite economic headwinds, states remain in a relatively healthy fiscal position. State revenues over the last two years have produced significant budget surpluses, and reserves are at the highest level across the country since 2008.[1] Even so, states are seeing the initial signs of a revenue crunch, with revenue growth slowing by 0.8 percent on a year-over-year basis from July through September,[2] and California and New York issuing official projections of budget shortfalls of $25 billion and $310 million, respectively, for fiscal 2023.[3]

While substantial rainy day fund balances will cushion many states against a short-term drop in revenue that could come from a recession, states still grapple with systemic budget issues. California, Connecticut, Illinois, and New York have outstanding balances on loans from the Federal Unemployment Account that now must be repaid with interest, and many states continue to face substantial pension and other long-term obligations. Further, states that have suspended or reduced their gasoline excise taxes to provide inflation relief may face shortfalls in dedicated funding for road repair and construction. What's more, some states have spending pressure coming from societal demands around environmental and social justice concerns — with programs to address these issues requiring new spending and potentially new funding mechanisms. As policymakers and stakeholders push to turn these and other social spending programs adopted during the COVID-19 pandemic into annual state expenditures, funding requirements and related pressure for revenue generation will increase.

The Elections

The November 8, 2022, elections were expansive from both state and federal perspectives. All seats in the U.S. House of Representatives and 35 U.S. Senate seats were up for a vote, though only a handful were regarded as critical races that could determine control of Congress. Democrats held control of the Senate — winning contested seats in Pennsylvania, Nevada, Arizona, and New Hampshire, among others — while Republicans took control of the House by a slim margin, in part because of pickups in New York and California. The split federal government is expected to result in less legislation being enacted other than critical measures — and only after substantial negotiation and compromise. What this means for state tax policy remains to be seen. Looming phaseouts and scheduled changes to various Tax Cuts and Jobs Act provisions — including the state tax credit limitation; full expensing; research and development credit amortization; and changes to interest expense limitation rules from earnings before interest, taxes, depreciation, and amortization to earnings before interest and taxes — could affect state IRC conformity decision-making. These scheduled changes could bring state attention back to conformity and provide an opening for states to consider the impact of — and possibly piggyback onto — the new corporate alternative minimum tax enacted under the Inflation Reduction Act, H.R. 5376.

While federal election results may indirectly affect state tax policy, state results will directly inform the direction of debate in many states. Of the 36 gubernatorial elections on November 8, eight were for open seats because of term limits and Massachusetts Republican Gov. Charlie Baker's decision not to run. Of these eight, three states (Arizona, Maryland, and Massachusetts) will move from

Republican to Democratic control, one (Nevada) will change to Republican control, and the remaining four will be controlled by the incumbent party. All 28 incumbent governors seeking reelection won.[4] Meanwhile, across 46 states, 6,279 of the nation's 7,383 legislative seats were up for election across 88 of the 99 state legislative chambers.[5] Entering the elections, Republicans controlled 62 chambers to Democrats' 36.[6] Following the elections, Democrats took control of four additional chambers (including the Michigan House and Senate, the Minnesota House, and the Pennsylvania House) and are on track to establish supermajorities in Vermont, Delaware, and Illinois.[7] Republican candidates made substantial gains as well, apparently eliminating New York Democrats' Senate supermajority and securing supermajority control in several other states, including Florida and Ohio.

These changes also affected single-party control of the executive and legislative branches in several states. Democrats gained a net three states of full control — securing Maryland, Massachusetts, Minnesota, and Michigan while losing full control of Nevada. Meanwhile, Republicans lost full control of one: Arizona. Because of power-sharing agreements, full Republican control of Alaska will not be known until the session starts in January.

Finally, a discussion of state elections would not be complete without mentioning ballot measures. Of the approximately 138 measures on state ballots, about 30 were related to tax. Key measures included proposals to impose additional individual tax rates on high-income earners in California, Colorado, and Massachusetts. In Massachusetts, Question 1, which had been in process over the past several years, passed and amends the state constitution to impose a new 4 percent surtax on income exceeding $1 million. A similar California measure that would have imposed a 1.75 percent additional rate on income exceeding $2 million to fund electric vehicle infrastructure and incentives failed. And a Colorado measure to expand the state's limitation on itemized deductions for individuals with more than $300,000 in income passed.

Proposals to legalize and tax marijuana were on the ballot in five states — winning approval in Missouri and Maryland and failing in Arkansas, North Dakota, and South Dakota. Finally, there were myriad local California measures on the ballot, including a new Los Angeles real property transfer tax on sales of property exceeding $5 million[8] and revisions to Oakland's gross receipts tax to establish a progressive rate structure on businesses with income in the city — both of which were approved.[9]

Key Issues to Watch in 2023

Combined with potential recessionary conditions, continued global trade and geopolitical disruption, and active legislative sessions in all 50 states (with associated balanced budget requirements), the midterm election results set the stage for states to have an active and meaningful 2023 legislative year. States that have seen significant shifts in the political landscape, their tax revenue pictures, or a combination of both will be particularly ripe for tax policy activity.

One set of states to watch in 2023 are those with partisan shifts in control from either gubernatorial or legislative results. First, Massachusetts Gov. Maura Healey (D) will come into office with both chambers of the legislature still under Democratic control. The state has been conducting a study of potential tax reform options over the past several years, and Healey will need to navigate both desired reforms from the legislature and complications arising from Question 1's new constitutionally mandated millionaire's tax. Passage of Question 1 itself leaves open questions concerning how it will be implemented, whether there will be clarifying implementing legislation, and how to address potential individual and business migration.

Maryland Gov.-elect Wes Moore (D) will also enter office in a state whose Democrat-controlled legislature has been active on tax policy over the past several years. One immediate issue to address will be ongoing litigation challenging the state's digital advertising tax. Because digital advertising tax revenue was earmarked for education, the litigation may prompt lawmakers to explore other available revenue raisers to fill the potential funding gaps. Moore will have to balance these legislative pressures against his stated priority of making Maryland more attractive for business investment.[10]

Finally, Minnesota will be interesting to watch as the Democratic-Farmer-Labor party takes control of the Senate, especially as the annual tax omnibus legislation is introduced and negotiated in 2023. For the past several years, a split Legislature has forced substantial negotiation over what has been in that measure. Also, House proposals to expand the state's treatment of both global intangible low-taxed income and the state water's-edge group definition were unsuccessful in the Republican-controlled Senate.

While these states may be primed for tax expansion, all are emerging from the last budget cycle with substantial surpluses as they propose budgets in 2023, raising the question whether they will amend tax policy for the sake of change or if there is a compelling need to raise additional revenue.

Other states will not change control in 2023, but will govern with narrower majorities. A prime example is New York, where the Democrat-controlled State Legislature came into the elections with a veto-proof supermajority in both chambers. While still in the majority following the election, Democrats may lose supermajority control of the Senate. This may shift the balance of power back to Gov. Kathy Hochul (D), who was elected to her first full term, because it would remove the Legislature's ability to override gubernatorial vetoes. And that may be critical in New York, where the State Division of the Budget's first quarterly fiscal 2023 budget update projected a $310 million deficit for 2023, rising to $6.2 billion by fiscal 2027 — owing in large part to a projected personal income tax revenue decline because of weakened economic conditions.[11]

Combined with this softening in projected revenue, New York still has an outstanding Federal Unemployment Account loan balance of approximately $7.7 billion,[12] and there are significant forces pushing for enhanced state funding for social services, including universal pre-kindergarten, which Hochul supports. These pressures are likely to inform not only the consideration of any extension of the temporary corporate business tax rate surcharge scheduled to expire after 2023, but also the exploration of other funding mechanisms to support social spending priorities.

Similar — but more dramatic — budget and revenue swings will affect California in 2023. In November the Legislative Analyst's Office issued updated fiscal estimates projecting a $25 billion budget shortfall for fiscal 2024, attributable in part to lower-than-projected revenue estimates.[13] Like New York, California has a large outstanding loan from the federal unemployment account[14] —

approximately $18 billion. Coupled with a projected budget shortfall, reports of businesses relocating out of state, and the current impact of technology sector workforce reductions in anticipation of a recession, the state may see its budget swing from record surpluses to a deficit posture. While California has funded its reserves to the tune of approximately $37.2 billion, standby responses to restricted revenue can be expected from the State Legislature — including potential credit and deduction suspensions and the postponement of any business-friendly legislative tax initiatives — if the governor and legislative leadership prioritize maintaining existing spending commitments.

In the rest of the country, ongoing policy trends are likely to continue into 2023. For example, Mississippi Gov. Tate Reeves (R) has already made repeal of the individual income tax a top issue for his budget, Louisiana legislators recently discussed expanding the sales tax base in exchange for individual income tax cuts, and Arkansas Gov. Sarah Huckabee Sanders (R) campaigned on further rate reductions and eliminating the individual income tax. Meanwhile, beyond the top-line tax issues, states are grappling with adapting their sales taxes to the modern economy, and multiple proposals are likely to address a range of digital products not expressly addressed in the tax code, such as cloud computing and services delivered digitally. Ongoing litigation and the Multistate Tax Commission's white-paper project have refocused attention on these issues. Studies on worldwide taxation in New Hampshire and Maine may bring the issue back to the forefront for lawmakers in other states, including Massachusetts and Minnesota. And for its biannual legislative session, Texas saw a host of tax-related measures prefiled in November to amend the sales tax, reform property taxation, and even adopt a value added tax regime.

Overall, the 2022 midterm elections will do much to shape future legislation in 2023 and beyond. With many new lawmakers, changes in legislative leadership, and 2023 being a budget year for most states, we can expect a range of new tax and economic development proposals — likely eclipsing the roughly 3,000 tax-related bills typically filed annually around the country. Many will be driven by recession-based concerns about uncertain revenue streams and the need to fund expanded government services, while others will be refreshed ideas to reform state tax systems or attract new economic investment.

FOOTNOTES

[1] National Association of State Budget Officers, Spring 2022 Fiscal Survey of States.

[2] Lucy Dadayan, "Monthly State Revenue Highlights," Urban Institute (Nov. 2022).

[3] California Legislative Analyst's Office, "California's Fiscal Outlook," Nov. 16, 2022; New York State Division of the Budget, "First Quarterly Update to the FY 2023 Enacted Budget Financial Plan."

[4] Associated Press, 2022 Race Calls.

[5] National Conference of State Legislatures, NCSL State Elections.

[6] *Id.*

[7] Ben Williams, "At Least Half of Legislatures Set to Have Veto-Proof Majorities," National Conference of State Legislatures (Nov. 11, 2022).

[8] City of Los Angeles Voter Information Pamphlet, Initiative Ordinance ULA, p. 27.

[9] Official Election Site of Alameda County, Measure T; City of Oakland, City Council File No. 22-0589.

[10] *See* Moore Miller for Maryland, "Work, Wages, and Wealth: Building a Growing and Thriving Economy That Lifts Up Every Maryland Family."

[11] New York State Division of the Budget, "First Quarterly Update to the FY 2023 Enacted Budget Financial Plan."

[12] United States Department of Labor Employment & Training Administration, UI Budget (reflecting outstanding loan balances from the federal unemployment account as of December 6, 2022).

[13] California Legislative Analyst's Office, "California's Fiscal Outlook" (Nov. 16, 2022).

[14] *Supra* note 12.

END FOOTNOTES