The Impact of Federal Tax Reform on the States

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Nicole Kaeding
Economist
Center for State Tax Policy

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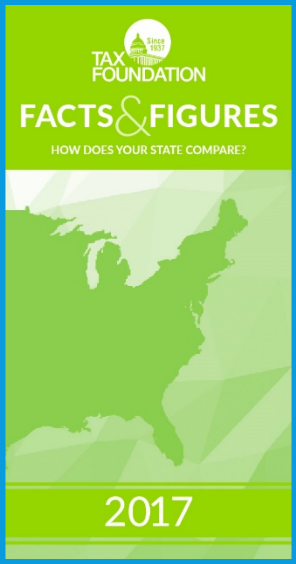

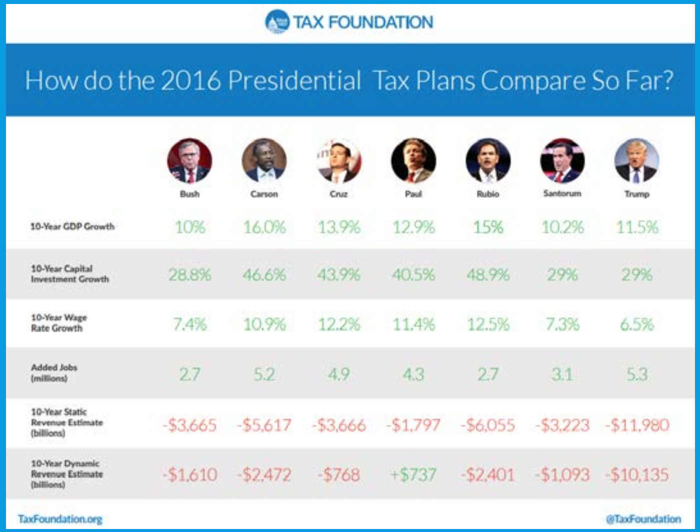

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How do the 2016 Presidential Tax Plans Compare So Far?

	Bush	Carson	Cruz	Paul	Rubio	Santorum	Trump
10-Year GDP Growth	10%	16.0%	13.9%	12.9%	15%	10.2%	11.5%
10-Year Capital Investment Growth	28.8%	46.6%	43.9%	40.5%	48.9%	29%	29%
10-Year Wage Rate Growth	7.4%	10.9%	12.2%	11.4%	12.5%	7.3%	6.5%
Added Jobs (millions)	2.7	5.2	4.9	4.3	2.7	3.1	5.3
10-Year Static Revenue Estimate (billions)	-$3,665	-$5,617	-$3,666	-$1,797	-$6,055	-$3,223	-$11,980
10-Year Dynamic Revenue Estimate (billions)	-$1,610	-$2,472	-$768	+$737	-$2,401	-$1,093	-$10,135

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AGENDA

- The Need for Federal Tax Reform
- Overview of Proposed Federal Tax Changes
- Impacts to the Federal Budget and the Economy
- Tax Conformity
- Tax Change Provisions of Interest for States
- Lessons from the 1986 and 2002 Federal Tax Reforms
- Possible Options for States
- Conclusion and Questions

THE NEED FOR FEDERAL TAX REFORM

- Last comprehensive federal tax reform was in 1986.
- Our tax rates and structures are uncompetitive internationally.
  - The top marginal corporate income tax rate is one of the highest in the world.
  - The top marginal tax rate on labor is 48.6 percent, higher than the average of industrialized nations at 46.3 percent.
  - Tax bases are also in need of revision with numerous tax expenditures.
- Individuals spent 8.9 billion hours in 2016 complying with the tax filing rules. Total tax compliance totaled $409 billion in 2016.

PROPOSED FEDERAL TAX CHANGES

INDIVIDUAL INCOME TAX

- Both plans would consolidate the current seven brackets into three, with rates of 12, 25, and 33 percent.

Table 1. Tax Brackets for Ordinary Income Under Current Law and the Two Proposals

Current Law	Trump	House GOP	Single Brackets	Married Brackets	Head of Household (n/a for Trump Proposal)
10%	12%	12%	$0 to $9,275	$0 to $18,550	$0 to $13,250
15%	12%	12%	$9,275 to $37,650	$18,550 to $75,300	$13,250 to $50,400
25%	25%	25%	$37,650 to $91,150	$75,300 to $151,900	$50,400 to $130,150
28%	25%	25%	$91,150 to $112,500	$151,900 to $225,000	$130,150 to $168,750
28%	33%	25%	$112,500 to $190,150	$225,000 to $231,450	$168,750 to $210,800
33%	33%	33%	$190,150 to $413,350	$231,450 to $413,350	$210,800 to $413,350
35%	33%	33%	$413,350 to $415,050	$413,350 to $466,950	$413,350 to $441,000
39.6%	33%	33%	$415,050+	$466,950+	$441,000+

PROPOSED FEDERAL TAX CHANGES

STANDARD DEDUCTION

- Both proposals alter the standard deduction and personal exemption.
  - House GOP Blueprint would nearly double the standard deduction from $6,300 for singles ($12,600 married) to $12,000 ($24,000 married). Personal exemptions would be changed to a $500 credit for dependents.
  - The Trump framework would double the standard deduction.

PROPOSED FEDERAL TAX CHANGES

ITEMIZED DEDUCTIONS

- The House GOP Blueprint eliminates all itemized deductions except the mortgage interested and charitable giving deductions.
  - The biggest eliminated deduction is the deduction for state and local taxes paid.
- Trump's campaign plan last September capped itemized deductions at $100,000. The newest plan appears to follow the GOP Blueprint.

PROPOSED FEDERAL TAX CHANGES
BUSINESS TAXES

- The House GOP Blueprint adopts a “destination-based cash-flow tax,” with a rate of 20 percent. The tax includes three key components:
  - Full expensing of capital investments
  - Elimination of the deduction for net interest expense
  - Border adjustment
- Trump’s newest tax framework would lower the corporate income tax rate to 15 percent and change to a territorial system.

PROPOSED FEDERAL CHANGES
PASS-THROUGH BUSINESSES

- Both plans change the tax treatment of pass-through businesses.
  - Trump's tax plan would lower the rate for pass-through businesses to 15 percent.
  - The GOP Blueprint would lower it to 25 percent.

IMPACT TO THE FEDERAL BUDGET

Table 3. Economic and Budgetary Impact of the Trump and House GOP Tax Proposals		
	Trump	House GOP
GDP (Change in level)	8.2%	9.1%
Wage Rate (Change in level)	6.3%	7.7%
Full-time Equivalent Jobs (in thousands)	2,155	1,687
Static Revenue Impact (in billions, over 10 years)	-$5,906	-$2,418
Static Revenue Impact (Percent, over 10 years)	-14%	-6%
Source: Tax Foundation Taxes and Growth Model, March 2016		

IMPACT ON STATES

CONFORMITY

- States rely heavily on the federal tax code. States do this for two reasons:
  - Ease for tax filers
  - Reduces administrative burden
- States conform in two ways, static or rolling.
  - Static means conforming as of a specific date, such as January 1, 2016.
  - Rolling means adopting changes as they occur.
  - Twenty states use static, 18 use rolling for their individual income tax.

IMPACT ON STATES
CONFORMITY

- States conform to federal definitions of income.
  - For individual income,
    - 26 states use federal adjusted gross income (AGI)
    - 6 states use federal taxable income
    - 3 states use federal gross income
  - For corporate income,
    - 41 states conform to corporate income, either before or after net operating losses.

IMPACT ON STATES
CONFORMITY

State Individual Income Tax Conformity

State	Individual Conformity	Individual Income Starting Point	Standard Deduction	Personal Exemption	Estate Taxes
Connecticut	Rolling	Federal AGI	Conforms to federal	State defined	$2 million exemption
Maine	December 31, 2015	Federal AGI	Conforms to federal	Conforms to federal	Federal exemption
Massachusetts	January 1, 2005	State calculation	State defined	State defined	$1 million exemption
New Hampshire	No tax	No tax	None	None	*No tax*
Rhode Island	Rolling	Federal AGI	State defined	State defined	$1.5 million exemption
Vermont	December 31, 2015	Federal taxable income	Conforms to federal	Conforms to federal	$2.75 million exemption

IMPACT ON STATES
CONFORMITY

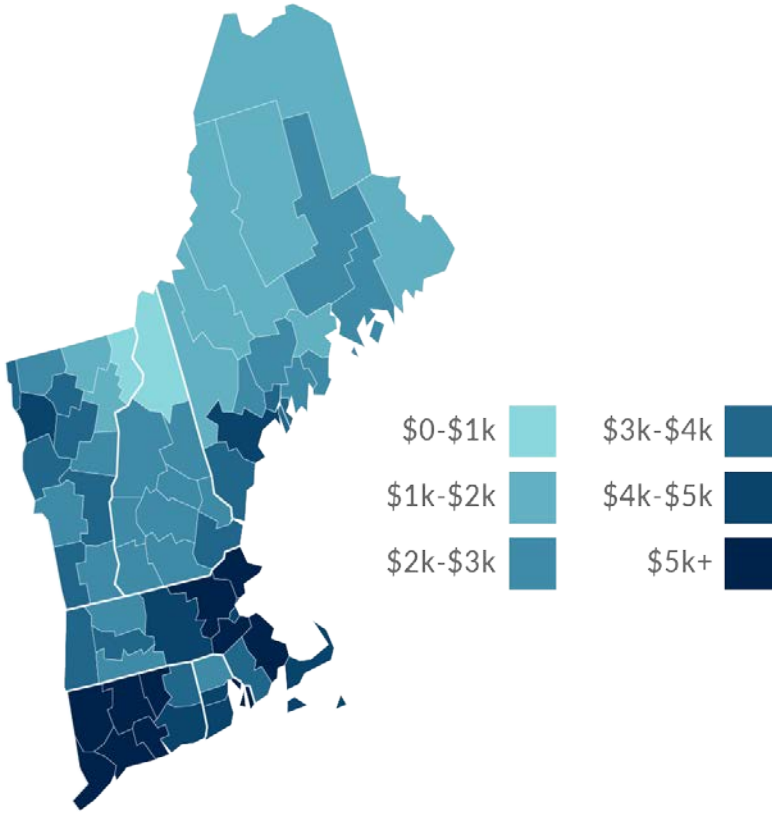
State Corporate Income Tax Conformity				
State	**Corporate Conformity**	**Corporate Income Starting Point**	**Allow Section 179**	**Allow Bonus Depreciation**
Connecticut	Rolling	Federal taxable income before NOL and special deductions	Yes	No
Maine	December 31, 2015	Federal taxable income	Yes	No
Massachusetts	Rolling	Federal taxable income before NOL and special deductions	Yes	No
New Hampshire	December 31, 2015	Federal taxable income before NOL and special deductions	No	No
Rhode Island	Rolling	Federal taxable income before NOL and special deductions	Yes	No
Vermont	December 31, 2015	Federal taxable income before NOL and special deductions	Yes	No

TAX CHANGES OF INTEREST FOR STATES

- Eliminating federal itemized deductions expands the base of taxable income in states that use federal AGI or taxable income.
- Without changes to state-level tax rates, individual income tax revenue would increase for states under these tax plans.
- This would be offset some by expanding the standard deduction for states that conform to that provision.
- Repealing the estate tax could pose changes as well to states that still have an estate tax.

TAX CHANGES OF INTEREST FOR STATES

- The elimination of the state and local taxes paid deduction is also quite contentious.
- The map shows the mean deduction for state and local taxes paid.
    - Fairfield County, CT has the fifth highest mean deduction at $14,262.



TAX CHANGES OF INTEREST FOR STATES

- The federal government uses a 10-year budget window to evaluate legislation and the ability to deficit-spend.
  - Full expensing is a front-loaded cost
  - Net interest deduction is a back-loaded cost
  - The federal government has the flexibility to handle this.
- State budget is less flexible. Forty-nine states have balanced budget requirements, and all states budget in a one- or two-year cycle.

TAX CHANGES OF INTEREST FOR STATES

- All told, it's quite likely that states would see an increase in revenue under the House GOP Blueprint and the Trump plan.
- The individual income tax base expansion is quite large. States that conform to the federal definitions of income would see an increase.
- The corporate income tax changes are less obvious.
  - Projecting the border adjustment's impact is quite difficult.

LESSONS OF THE 1986 AND 2002 TAX CHANGES

- In 1986, NASBO projected state revenues would increase by 8.3 percent, but with large variation. Connecticut’s revenue would increase by 48.1 percent, while Vermont would lose 9.3 percent.
- States responded in a number of ways. But on average, states moved towards the federal reforms.
- However, in 2002, states reacted differently. Congress accelerated depreciation rules, cutting both federal and state revenues.
  - Within one year, 29 states had limited or decoupled from the provision.

OPTIONS FOR STATES

- States have a number of options to mitigate any timing issues with federal tax reform impacts.
- The list includes:
  - Phase-In
  - Revenue Triggers
  - Contingent Enactment
  - Special Sessions
  - Concurrent Reform

FOR MORE INFORMATION

- **Questions?**

- **Nicole Kaeding**
- Economist
- kaeding@taxfoundation.org