The Intended and Unintended Consequences of TCJA on the States

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Overview

- It has been almost 1 ½ years since the passage of the Tax Cuts and Job Act (TCJA).

- The most radical provisions concerned corporate and international taxation. These will have some indirect effects on the states.

- Primarily changes to personal tax taxation, will have most direct effects on the states

Overview (continued)

- The primary effects on the states come from:
  - The limitation to $10,000 of the state and local tax deduction
  - The increase in the standard deduction to $12,200 for singles ($24,400 married)
  - For some locales, new Opportunity Zone incentives
- Indirect effects on state corporate tax from some new international provisions.

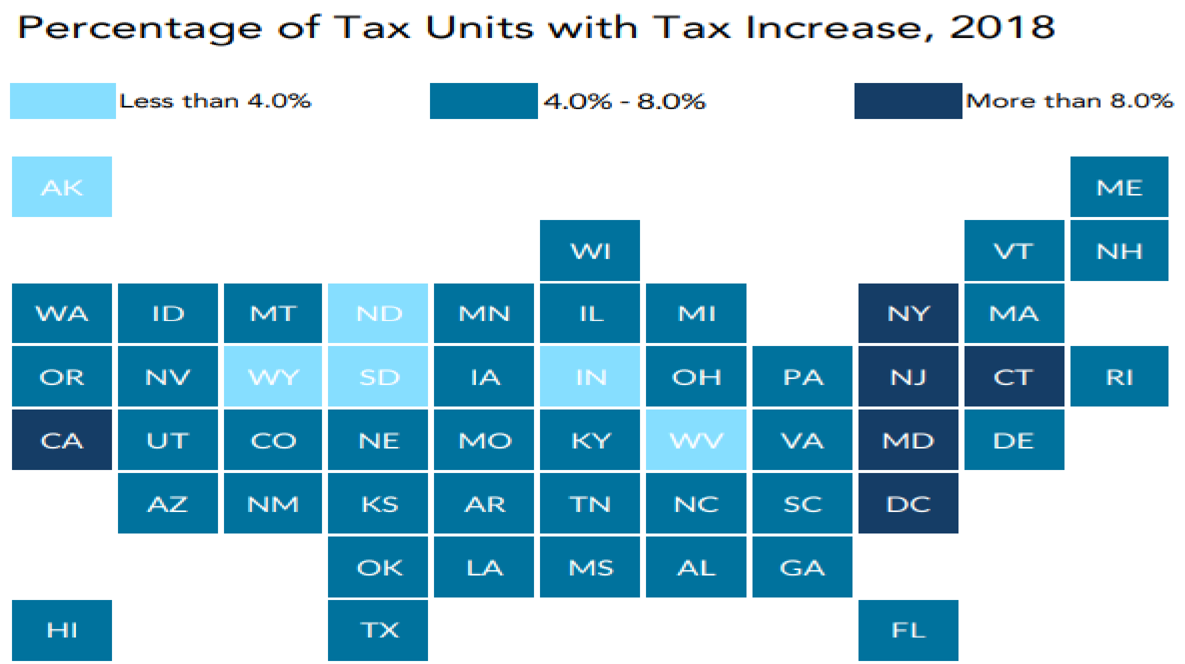
State and Local Tax Limitation

- Historically, the SALT deduction was viewed as a tax expenditure, geared toward the wealthy and an obstacle to a broader base and lower rates.

- But with the TCJA, it was viewed partly in a punitive light because of its uneven impacts.

Disparate Impacts

- Because of SALT limitation, disparate impacts across states. See chart below from Kim Rueben



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0217-1), Table T18-0029.

[The Effect of The TCJA Individual Income Tax Provisions Across Income Groups and Across the States]

Memories of Winner-Loser States

- Federal spending in states minus federal taxes paid 2014 (per capita and rank).

Colorado	-144	34
Arkansas	-161	35
Wisconsin	-241	36
California	-318	37
Kansas	-327	38
North Dakota	-603	39
Texas	-1224	40
Rhode Island	-1376	41
Ohio	-1690	42
New York	-2263	43
Illinois	-2710	44
Massachusetts	-3426	45
Connecticut	-3515	46
Nebraska	-3639	47
New Jersey	-5308	48
Minnesota	-8019	49
Delaware	-9071	50

States Tried to Work Around Limitation

- **Charitable deduction in exchange for state tax credits** – Provide a state tax credit for charitable contributions to a state created public purpose fund, with donation qualifying as federally tax deductible.

  Enacted: New York, New Jersey, Oregon, Suffolk County (passed, waiting for signature)

  Considered: California, Illinois, Rhode Island

Treasury Responds to Charitable Strategy

- Previously, whether you took a charitable deduction or SALT deduction did not matter UNLESS you were subject to the AMT.
- But the new strategies threatened to undo the SALT limitation that was designed to raise money to offset other tax reductions.
- Treasury now took the view that receiving a state tax credit was of the same nature as receiving a meal at a charity event and its value should be subtracted from the amount allowed to be deducted for charity. Quid pro quo
- Applied to existing state education tuition programs which would otherwise would now get a new tax break
- This enhanced Treasury credibility

Other Potential Work Arounds

- **<u>Switch payroll taxpayer from employee to employer</u>.** Employer can deduct without limitation.

  New York (optional) Employer Compensation Expense Tax – Low enrollment (< 0.1% of state's employers)

  - An optional tax.
  - If an employer elects to pay this tax, a state credit will be available to the employee, reducing the employee's New York personal income tax,
  - Limited take-up

<u>Pass-through Entity Tax</u>

- Shifts state tax on business income from owners to entity

  Connecticut (mandatory) Wisconsin (optional)

State Lawsuit Filed

- CT, MD, NJ, NY filed complaint 7/17/18 in US District Court in Manhattan
- Accuses federal government of unconstitutionally intruding on state sovereignty by imposing the cap.
- By imposing cap, Congress was able to "exert a power akin to undue influence" over states by interfering with their authority to decide taxes and fiscal policy
- Lawsuit ongoing, but states unlikely to prevail

Political Implications of SALT Limitation?

- Previously, households who itemized deductions did not pay the full price of their state and local taxes.
- Paid only the cost after their tax deduction (as much as a 37% discount)
- Now, on the margin, almost all households will pay the full price.
- Implications for state and local governments?
- How much more sensitive will taxpayers be in resisting state income and property taxes?

Mixed evidence from past studies

- A number of empirical studies have found a measurable effect of the SALT deduction on the <u>mix</u> of state and local taxes,

- But only a few of them also have found an effect of the deduction on either <u>total</u> state and local revenues or expenditures.

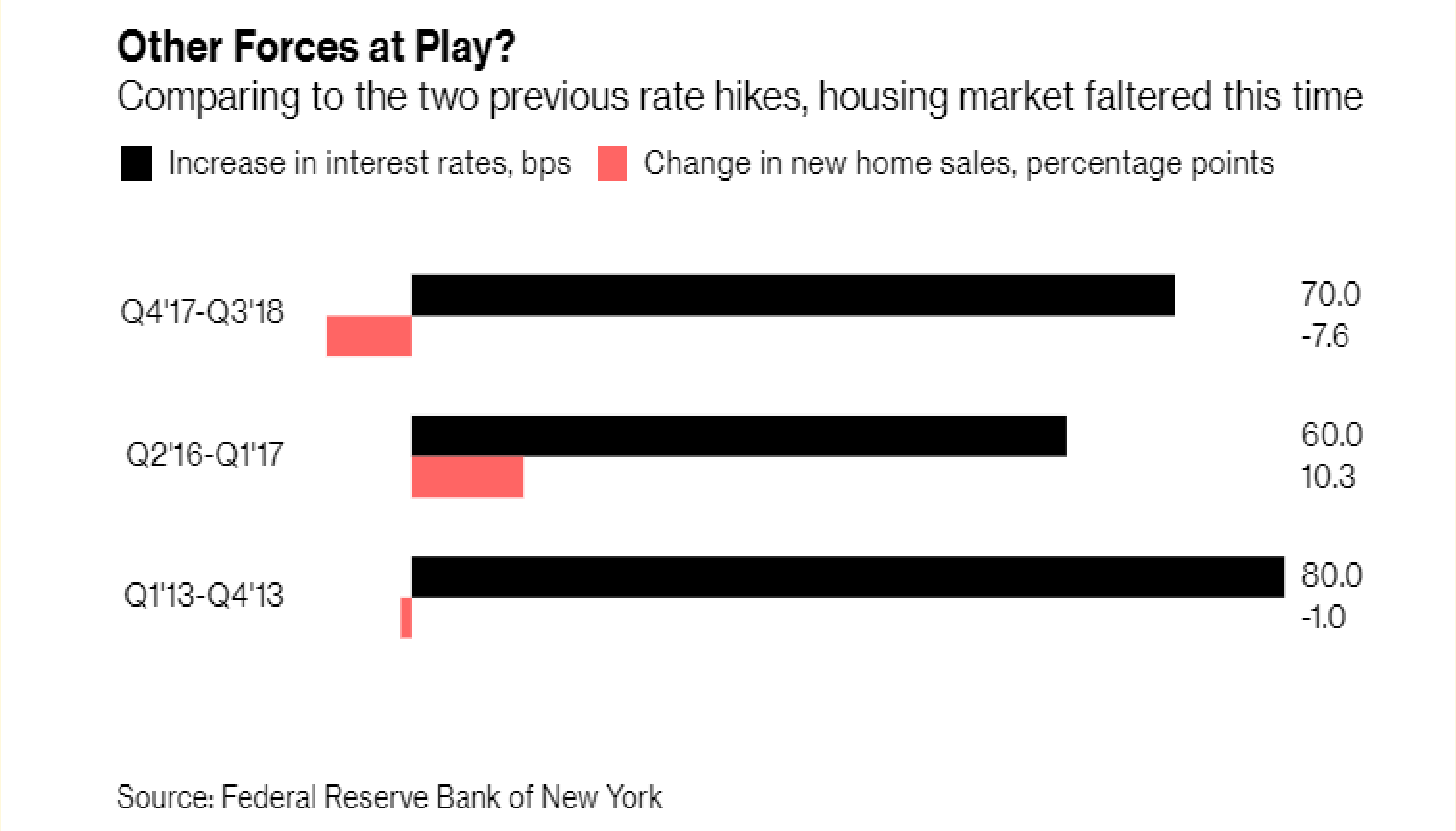
Increase in Standard Deduction

- Major change to our tax code
- Along with SALT limitation reduces itemizers down to 11.4 percent of taxpayers (from about 29 percent pre-TCJA)
- This means that many fewer taxpayers will benefit from mortgage interest deductions and charitable deductions.
- Impact will primarily be households in the upper-middle class who previously itemized

What Could this Entail for Housing?

- Owner-occupied housing tax-favored over renting.
- Can deduct mortgage interest and taxes but no inclusion of imputed income.
- Subsidy increases with tax rate.
- TCJA reduced the subsidy through:
  - Lowered tax rates
  - Capped SALT deduction
  - Raised standard deduction
  - Lowered cap on mortgage interest to $750K

Have We Seen the Effects?



Regional Changes

Percent Change in New Home Sales by Region and Price Range					
2017:Q4 to 2018:Q3 (Percent)					
	U.S.	Northeast	Midwest	South	West
Total	**-7.6**	**-28.2**	**0.0**	**-5.2**	**-12.1**
Price Range					
Up to $200K	-8.3	N/A	-13.4	-6.4	-7.4
$200K to $300K	-4.0	-53.8	15.4	0.3	-20.7
$300K to $500K	-5.0	-7.7	21.2	-9.6	-2.8
Over $500K	-11.4	-26.2	-13.4	3.0	-21.7

In Long Run Housing Market Could Change

- Fewer itemizers could diminish enthusiasm for buying homes and living in more square footage.

- Both in terms of economics and psychology

- Since upper-middle affected most, may undercut political support for mortgage interest deduction

- Since business not affected, rentals may be more favored.

Some Other Impacts of TCJA on States

- **Opportunity Zones**
  - Another place-based policy (mixed results historically)
  - Tax breaks on unrealized capital gains for investing in zones, reductions for holding. and possibly elimination.
  - Where will the funds actually go? Help the poor or just spur gentrification?
  - New money?

- **Extra International Income Reported on State Corporate Tax Returns**
  - Deemed repatriation tax (returning funds overseas)
  - GILTI (Global intangible low tax income)
  - Many states either not taxing or limiting taxation of this income. Complex issues.

Individual Provisions Expire After 2025

- What system should states want after provision expire in 2025?
  - Traditionally, the SALT deduction was viewed as a typical upside down subsidy. Repealing cap is highly anti-progressive.
  - Higher standard deduction simplifies the tax code

- How to restore SALT deduction given revenue constraints?
  - Lower the standard deduction?
  - Lower bracket ranges?
  - Restore Alternative Minimum Tax and full deductibility?
  - Leave out property taxes from the SALT limit but cap it, or phase it out as income rises?
  - Leave TCJA provisions in place?

A Reckoning for the Impacted States

- They presumably want to enjoy the benefits of TCJA with lower taxes rates, diminished AMT, and the higher standard deduction.

- But also want the SALT limitation removed. But this costs considerable revenue.

- Is there a budget neutral change that states would prescribe?

One Last Consideration

- Prior to TCJA, in a recession decreases in state income tax payments would lead to partly offsetting increases in federal taxes.
- With the SALT limitation, itemizers will have typically $10,000 in deductions which do not change. No offsetting federal tax increase.
- This means more stabilization.
- In some recent work, we found an important role for reduced federal tax payments stabilizing state economies.