Tax Reform Debate Won't End Anytime Soon

by Ronald C. Fisher and Robert W. Wassmer

Ronald C. Fisher

Robert W. Wassmer

Ronald C. Fisher is a professor of economics at Michigan State University, and Robert W. Wassmer is a professor of public policy and administration at California State University, Sacramento

In this edition of State Fiscal Affairs, Fisher and Wassmer say that with the potential for various responses by states and localities, the debate over federal tax reform is likely to continue for a while.

Congress' adoption and President Trump's signing of the new federal income tax bill in December 2017 may lead one to conclude that tax discussion is over, but it's just the beginning. Although federal tax revenue is substantial (about $1.9 billion in 2015), state and local tax revenue (from income, sales, property) affected by federal tax law is nearly as substantial (about $1.5 billion that same year). What will happen to that subnational tax revenue affected by federal income tax reform — as well as state and local government spending dependent on subnational tax reform — is a continuing story.

We expect two types of state and local responses to the federal tax law changes. In the short run, states whose income tax provisions and definitions are tied to federal income tax law will have to decide whether to make adjustments to avoid automatic changes, sometimes decreases and sometimes increases, in state and local income tax revenue. In the long run, states and localities may consider changes to both the structure and amount of their own income, sales, and property taxes, with resulting implications for the financing of subnational government services.

The greatest effects on state and local taxes seem likely to arise from the elimination of the federal personal exemption and the substantial increase in the federal standard deduction. The latter will affect states that use the current federal definition of a standard deduction and substantially reduce the number of taxpayers who itemize deductions. Equally important are the new $10,000 limit on how much state-local taxes can be deducted on a federal personal income tax return and the change in federal marginal tax rates. Both reduce the value of the SALT deduction, even if one still itemizes.

Short-Run Responses

Some new federal provisions are likely to affect state taxes immediately as a result of common tax definitions or procedures. The complexity and diversity of state income taxes, as well as legislative changes, contributes to confusion about these effects. The National Association of State Budget Officers provides a current, comprehensive, and understandable summary of these relationships.[1]

For example, eliminating the federal personal exemption and the nontaxable nature for alimony, as well as lower federal taxes for the six states that permit a deduction for federal tax paid, will

[1] John Hicks, "New Federal Tax Law: Individual State Conformity Laws Will Impact State Taxable Income," National Association of State Budget Officers, Jan. 8, 2018.

automatically increase state taxes. Michigan is one of 16 states that use the number of federal personal exemptions tied to a state-defined exemption amount; another eight states use the federal personal exemption amount. Without changes to state law, eliminating the exemption for the federal tax would also remove it for the state tax, leading to an automatic state tax increase. Michigan Gov. Rick Snyder (R) has proposed adopting a state-defined personal exemption equal to the existing federal amount, effectively a revenue-neutral change. But the Michigan Legislature is calling for a larger state-defined exemption, which would amount to an explicit state income tax reduction.

Also, the increase in the federal standard deduction and change in the treatment of some types of passthrough income automatically decrease state taxes without state action. In 2015, 12 states used the federal standard deduction for the state income tax, including some that base the state tax on federal taxable income (effectively using the federal standard deduction). Other states require taxpayers to use a state standard deduction if they take the federal standard deduction. Absent a change in state law, the higher federal standard deduction and more taxpayers using the standard deduction approach will cause an automatic reduction in state income tax.

Long-Run Reactions

The potential long-run adjustments to state fiscal affairs are perhaps even more interesting, uncertain, significant, and less well understood.

State responses to federal tax changes in the past may offer a guide to expected long-run effects. There is strong research evidence that states have adopted more progressive tax structures as a result of the effect of federal income tax deductibility of state income and property taxes primarily. Consequently, the decreased number of federal income tax itemizers and the limit on the amount of the SALT deduction for those who still itemize may induce state and local governments to reduce the progressivity of their own tax structures by changing the rate structure of state income taxes, eliminating or reducing so-called millionaire's taxes, or relying less on property taxes, for examples.

Most analyses of the federal tax changes suggest they will reduce the federal income tax's progressivity. If states follow suit and reduce the progressivity of their tax structures, the overall effect clearly will result in a relatively greater overall tax burden on lower-income taxpayers.

The effect of federal income tax deductions of state and local taxes on aggregate state and local spending is less clear. Some research shows that reductions in the value of federal tax deductibility reduce revenue from the deductible taxes, but have no effect on nondeductible taxes or fees, and thus net revenue to subnational governments declines. Other research shows that states typically make the short-run adjustments noted earlier to avoid automatic revenue decreases and may move toward other mechanisms to export the tax burden. Therefore, the effect of federal tax reform on state and local spending and services is ambiguous, especially in light of the fact that demand for healthcare, education, and infrastructure investment — three functions where states have primary responsibility — is not likely to decline.

Perhaps the most radical long-term effect is the potential movement toward a different fiscal structure for states and localities. Some states are already discussing providing public services through charitable foundations, with state tax credits for amounts contributed to those foundations. By substituting dollar-for-dollar charitable contributions (which remain fully tax deductible) for state taxes (whose deductions are limited), individuals may avoid increases in the net cost of state and local services. Of course, such a structure would change the character of local governments, especially with foundations having an important — and presumably independent — role in public service provision.

Another dramatic long-term response being considered is a complete change to the structure of state taxes. State and most local personal income taxes are collected directly from individuals, but some localities use payroll taxes collected from employers. So, one option is for states to change taxation of labor income from personal income taxes to business payroll taxes, which are fully deductible business expenses for firms.

Similarly, most state and local sales taxes are "retail" taxes levied at the point of sale. But a few states (Hawaii, Ohio, and Washington especially) collect substantial gross receipts taxes or value added taxes (as did Michigan with the single business tax) from businesses. It would be ironic if one effect of federal tax reform was to induce states to move toward VATs instead of retail sales taxes to tax sales or consumption, as the VATs collected from business would be a deductible business expense and could apply to a much broader set of businesses (including services) than most state sales taxes.

Implications

At least two conclusions stand out from the fiscal connections between the federal and state-local governments combined with tax reforms. First, this may be an example in which attempts at tax simplicity (from conformity of federal and state tax laws) lead to complexity. The downside of conformity is a lack of control.

Second, it seems clear that the ultimate effect of federal tax reform lies with state legislatures and governors, rather than Congress and the president. States can enhance the tax reduction amount, reduce it, or completely reverse it. They can exacerbate the distributional impact of federal tax reform or offset it. States might even be able to address long-standing tax policy issues by restructuring their tax systems. In short, tax reform is far from over. ■