The Maryland Public Policy Institute

Maryland Policy Report

No 2017-06 December 20, 2017

FEDERAL TAX REFORM: LIKELY BENEFITS AND COSTS FOR MARYLAND

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FOR THE FIRST TIME IN MORE THAN THREE DECADES, LAWMAKERS IN Washington have produced some semi-significant tax reform. Maryland will enjoy considerable direct tax relief from the plan, totaling more than $3 billion annually over the next decade based on the size of the tax cut and Maryland's share of national economic output.[1] However, some Marylanders—especially those living in the wealthy suburbs of Washington, DC—may end up paying more in federal taxes.

The direct tax effects on individual taxpayers is just part of the story. The core features of the tax package are intended to boost the economy. This should yield an indirect positive effect on Maryland because of changes in the macroeconomic environment and because certain provisions would have a greater-than-average effect on the state.

Published by the Maryland Public Policy Institute
One Research Court | Suite 450 | Rockville, Maryland 20850 | Telephone 240.686.3510 | mdpolicy.org

IN A NUTSHELL...

Here are some of the more important provisions of the final tax package:

- **Lower corporate tax rate:** The tax plan will reduce the federal corporate tax rate from 35 percent to 21 percent.
- **Lower personal tax rates:** Most taxpayers will benefit from lower tax rates, with the top tax rate falling from 39.6 percent to 37 percent.
- **Personal exemption(s) are repealed and standard deductions double:** Single taxpayers won't have to pay tax on the first $12,000 of income and married couple won't have to pay tax on the first $24,000 of income.
- **Limits on deductibility of state and local taxes:** Taxpayers will no longer be able to fully deduct all income and property taxes paid to state and local governments. Starting in 2018, that write-off will be capped at $10,000.
- **Chained CPI:** The expanded standard deduction will be adjusted for inflation, but a new measure of the Consumer Price Index will be used, resulting in smaller increases of the deduction over time, as well as smaller adjustments to tax brackets.
- **Tax relief for small business:** The effective top tax rate on entrepreneurs will be reduced to 29.6 percent because eligible small businesses will be able to deduct 20 percent of their income.

One unfortunate feature of the legislation is that most of the provisions directly affecting households are temporary.

In addition to those major provisions, the final bill includes these noteworthy changes:

- Reduction of the estate tax burden by increasing the amount of assets that are exempt from the tax.
- Limitation on the amount of interest payments that can be deducted by businesses.
- Deemed repatriation for the overseas earnings of multinational companies.
- Lower taxes on new business investment for the next five years.
- Repeal of the corporate alternative minimum tax and reduction of the scope of the alternative minimum tax for households.

There are dozens of additional measures in the bill, but those provisions have not generated much controversy and are not expected to have significant effects on either the national or state economy.

TEMPORARY TAX RELIEF FOR HOUSEHOLDS?

One unfortunate feature of the legislation is that most of the provisions directly affecting households are temporary. As a general rule, the parts of the bill that affect businesses are permanent and the parts that affect households will expire at the end of 2025. As a result, the changes in tax rates and the increased standard deduction are temporary. The same is true for the limitation on deductions and the loss of personal exemptions.

The good news is that these provisions presumably will be extended (and hopefully made permanent) at some point before 2026, just as many of the 2001 and 2003 tax cuts were made permanent at the end of 2012. The bad news is that this creates some degree of uncertainty for taxpayers.

MOSTLY TAX REFORM RATHER THAN A TAX CUT

The legislation is being characterized as a major tax cut. Supporters claim this in hopes of generating support from voters who want to pay less in taxes, while opponents claim this in hopes of scaring voters about the prospect of higher federal deficits.

Both sides are exaggerating. The tax reform plan is projected to reduce tax revenues by $1.456 trillion over the next 10 years. According to the Congressional Budget Office, baseline revenues during the same period will be more than $43 trillion under the status quo.[2] So the entire tax controversy is over less than 3.5 percent of currently expected revenues.

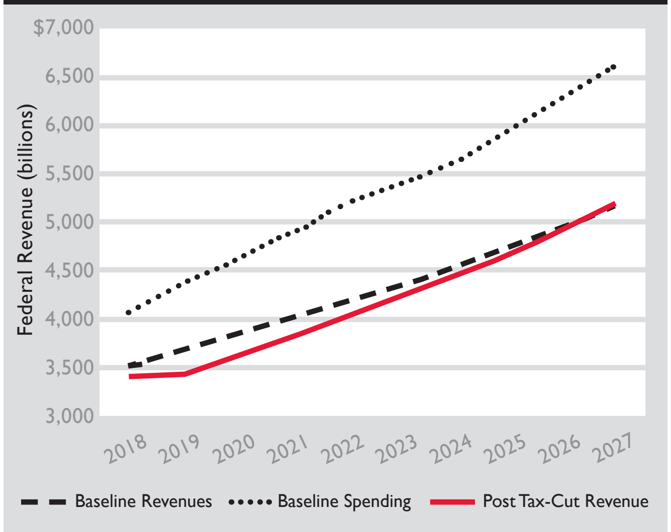
Moreover, the tax cut portion of the legislation will only be temporary, as noted in Figure 1.[3] The budget rules guiding the legislative process prohibit a net tax cut after the initial 10-year period. This is why certain tax cuts expire at the end of 2025; after that, Congress would have to vote to maintain the cuts if lawmakers want to extend them. Further, both bills include several tax-raising provisions (repeal of state/local tax deductibility, switch to chained CPI, limits on interest deductibility, deemed repatriation, etc.) to offset the amount of lost revenue from the tax cuts.

In other words, it's more accurate to view the proposal as tax reform rather than a tax cut. Tax reform that makes the federal tax code more rational, less byzantine, and more conducive to economic activity has long been needed. To be sure, the legislation isn't nearly as bold or potentially beneficial as a truly comprehensive reform initiative such as a flat tax, but it is a step in the right direction.

MACROECONOMIC EFFECT

Most advocates of tax reform want a system that generates revenue in a manner that is least distortive to the economy. The goal is to have the greatest possible incentives for work,

FIGURE 1 A SMALL TAX CUT THAT DISAPPEARS IN THE 10TH YEAR



saving, investment, and entrepreneurship for any given amount of money that is collected.

The core principles to achieve those goals are:

- **A low tax rate:** High tax rates penalize whatever is being taxed, which is why politicians levy high rates on items such as tobacco. It is economically harmful, however, to impose high tax rates on productive behavior. The goal of the current tax reform is a very low tax rate, or at least lower rates than what are currently in place.
- **No double taxation:** The current tax code has a bias against income that is saved and invested. Indeed, such income can be taxed four separate times because of the capital gains tax, corporate tax, double tax on dividends, and estate tax. The goal of tax reform is to tax all income only one time, or at least reduce the degree of double taxation.
- **No distorting tax preferences:** Credits, deductions, exemptions, exclusions, and other loopholes are inserted into the tax code because interest groups want to tilt the playing field. Such preferences undermine economic performance because they encourage taxpayers to make choices based on tax considerations rather than economic benefits.

Given these guidelines, the tax reform plan almost certainly will result in more economic growth. Individual tax rates are only reduced by small amounts, but the corporate rate will be substantially reduced and there will be less double taxation of saving and investment. Moreover, tax loopholes are being curtailed, which will improve economic efficiency.

Economists have a tough time agreeing on the amount of additional growth that will result from the proposed tax changes. For instance, the congressional Joint Committee on Taxation estimates that tax reform would produce a 0.8 percent boost to long-run economic activity,[4] while the independent Tax Foundation predicts the economy ultimately will be 1.7 percent larger.[5]

TABLE 1 TAX FOUNDATION PREDICTED EFFECTS OF TAX BILL

	Estimated Full Time-Equivalent Jobs Created	Estimated Gain in After-Tax Income for Middle-Income Family
United States (total)	925,000	$2,598
Maryland	17,322	$3,245

THE EFFECT ON MARYLAND

Because there are many pro-growth provisions in the tax plan, all states should enjoy significant benefits from an improved "macroeconomic" climate. According to a Tax Foundation estimate based on the Senate version of the bill, the reforms should result in the creation of more than 17,000 additional jobs in Maryland. Further, middle-income families in the state will enjoy more take-home pay—an annual increase of $3,200 by the 10th year—thanks to a combination of faster growth and lower taxes.[6]

If the Joint Committee on Taxation's estimate of additional growth is more accurate, fewer additional jobs will be created and the increase in after-tax income will be more modest. Independent analyses suggest, however, that the Tax Foundation's estimate is likely to be more accurate because it does not arbitrarily and incorrectly assume the United States has a closed economy. Rather, it recognizes that foreign investors will respond to lower U.S. tax rates by increasing their investment in the United States.[7]

There are also two important "microeconomic" effects of the tax bill for Marylanders:

1. **How Maryland will benefit disproportionately:** Maryland is a comparatively rich state; the Census Bureau reports that the state has the highest average household income in the nation.[8] Households with higher incomes are more likely to own financial assets. This strongly suggests that Maryland residents will benefit directly from the tax bill because the legislation includes policies—such as a lower corporate rate and estate tax relief—that will benefit owners of capital. Residents also will indirectly benefit because the new policies are expected to generate more investment and faster growth for everyone.

2. **How Maryland will lose disproportionately:** Marylanders pay a lot of tax to their state government. The new tax bill significantly reduces the deduction for state and local taxes. Under the new rules, taxpayers will only be able to deduct the first $10,000 of income and prop-

erty taxes. This means that taxpayers in the richer parts of Maryland will no longer be able to use state and local taxes to reduce their federal tax burden. Indeed, four of Maryland's congressional districts will be among the 20 hardest hit by this change.[9]

On net, the average Marylander will receive a significant tax cut over the next 10 years from the tax plan. But that does not mean every resident will pay less tax. Low-income residents currently don't pay income taxes and won't pay income tax under the new legislation. Middle-income residents generally will enjoy a modest tax cut, mostly because of the increased standard deduction, child preferences, and modest cut in tax rates.

Upper-income residents may or may not get a tax cut depending on their circumstances. If they own a small business, they probably will see some tax relief. And there will be a modest reduction in the top tax rate on individual income. Otherwise, there will not be many provisions that directly benefit wealthy households. However, they should benefit indirectly because their financial assets will become more valuable and the investment climate will be more favorable. On the other hand, if those households currently benefit from the deduction for state and local income tax and/or they have a very large property tax burden, they may wind up with a net tax increase.

A NEW POLITICAL ENVIRONMENT?

Even taxpayers with larger tax liabilities in 2018 may still benefit in the long run if Maryland lawmakers change their behavior following the curtailment of the deduction for state and local income taxes and property taxes.

Under current law, the deduction shields taxpayers from the full burden of any taxes imposed inside the state because those payments can be used to reduce federal taxable income. For instance, upper-income taxpayers who pay $100 in taxes to the state can reduce their federal tax bill by almost $40. In other words, a $100 tax increase only reduces take-home pay by about $60 under current state law.

However, because the deduction will now be limited to the first $10,000 of state and local taxes, a $100 tax payment to Annapolis above that level would reduce take-home pay by the full $100. The federal tax code would no longer be subsidizing high tax rates at the state and local level.

This will give taxpayers a greater incentive to advocate lower tax rates and/or resist higher tax rates at the state and local levels. This would be especially meaningful for Maryland's I-95 Corridor and the Upper Eastern Shore, where many taxpayers would be affected (with the average annual federal deduction for those taxes is more than $5,000).[10]

Many Marylanders would be affected by the limit on this deduction. The net effect of the change for these households is hard to predict, however, because it is unclear how these same taxpayers will benefit from the tax-cutting provisions of the legislation. And it also is impossible to predict the degree to which state officials will respond to the capping of the deduction. Last but not least, it's unclear whether this provision will be extended past 2025.

CONCLUSION

Maryland will be a net winner if federal tax reform is enacted. Taxpayers will enjoy annual tax relief averaging more than $3 billion during the first 10 years, and they also will benefit from better economic performance in the short and long run. To maximize the benefits for residents, however, state lawmakers should reduce tax rates in response to the new limit on the state and local tax deduction.

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