Center on Budget and Policy Priorities

202-408-1080
center@cbpp.org
www.cbpp.org

CBPP STATEMENT

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Contact:
Trevor Smith, 202-408-1080, tsmith@cbpp.org

States Need Comprehensive Response to New Federal Tax Law

Statement by Nick Johnson, Senior Vice President for State Fiscal Policy

Many state policymakers are justifiably concerned that the new tax law's cap on the federal deduction for state and local taxes (SALT) will make it harder for them to invest in schools, roads, and other building blocks of strong state economies. Some are exploring ways to restructure their tax code to protect taxpayers from the cap. States heavily affected by the SALT cap should give such "workarounds" thoughtful consideration — and should do so as part of a *more comprehensive* response to the law's effects.

Here's the big picture: the new tax law primarily benefits large corporations and wealthy households and will substantially expand federal deficits. Proponents claim that these top-heavy tax cuts will sharply boost economic growth, but the evidence doesn't support that.

The new law also affects most states' tax codes, which are linked in various ways to the federal code. One prominent example is the new law's $10,000 cap on the SALT deduction, which will make it harder for states to raise revenue, especially high-income states where relatively large shares of taxpayers will hit the cap.

Workarounds might diminish the SALT cap's harm, though implementing them involves significant technical and legal challenges and states should be careful in structuring them. Most of the direct beneficiaries of workarounds — taxpayers paying over $10,000 in state and local taxes — are relatively well-off, and many will get an overall federal tax *cut*. Giving them a still larger federal tax cut through a SALT workaround may be justifiable as part of a broader state policy response to protect state revenues — especially progressive revenue sources — but workarounds shouldn't be a state's *only* response.

The new tax law could also inadvertently create new loopholes that affect state tax rules, as well as the federal code, and make state tax systems less fair and less able to fund needed services. It's extremely difficult now for states to estimate accurately the law's impact on their revenues. Many important details on the law won't be clear until the IRS issues rulings on them, and tax lawyers and accountants will likely develop new tax-avoidance techniques that could cause significant further state revenue losses. Unfortunately, the ultimate impact will likely prove more unfavorable than initial estimates may suggest.

CBPP is working hard to determine to the fullest extent possible the potential impacts of this hastily drafted measure on the states. In many states, legislation will be needed to protect state tax codes.

Beyond the essential effort to defend their tax systems, states can explicitly reject the new law's misguided economics by recouping part of the tax windfall that it gives to corporations and wealthy families and investing it in families and needed infrastructure. This approach should *both* promote more broadly shared prosperity *and* protect states from the impact of potential budget cuts in federal support for important state services. Some Republican congressional leaders have called for addressing the enlarged federal budget deficits the tax law will cause by shrinking federal support for various services and programs, such as Medicaid.

States can consider steps such as restoring, at the state level, all or part of the tax law's ill-advised tax break for "pass-through" income, establishing a strong minimum corporate income tax, closing loopholes that profitable corporations use to avoid state taxes, or raising top income tax rates for the wealthiest households.

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