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Testimony of George Sweeting
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To the New York City Council Finance Committee
Oversight Hearing on the Effects of Recent Federal Tax Law Changes

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Good afternoon Chairman Dromm and members of the committee. I am George Sweeting, deputy director of the Independent Budget Office. Thank you for the opportunity to appear before you today as you consider the effects of the recently enacted Tax Cuts and Jobs Act (TCJA) on taxpayers in New York City.

The act will affect most New York City taxpayers in diverse ways, some positive and some negative. It also brings significant economic and fiscal risks for New York City and New York State. Some of these problems are readily addressed by straight-forward changes to the personal and business income tax laws of the city and state. Others could require more significant changes to our tax system that would benefit from careful vetting and analysis before proceeding, particularly because many of the taxpayers who are negatively affected are benefitting from other provisions in the act.

The single largest federal tax cut in the act accrues to businesses thanks to the sharp reduction in the federal rate from 35 percent to 21 percent. That change has no direct effect on state and local business taxes, but other changes will, particularly the treatment of foreign income earned by U.S. businesses. The Governor's 30-day amendments to the Executive Budget legislation addresses one consequence of the business tax changes: the deduction for repatriated foreign dividends for state tax purposes. The city may also need to address business tax changes at the city level.

On the personal income tax side, the most important changes to the federal tax code are:

- nearly doubling the standard deduction
- removing the personal exemption while expanding the child credit
- capping the state and local tax deduction and lowering the cap on the mortgage interest deduction
- introducing a 20 percent deduction on income from some types of pass-through businesses
- modest reductions in tax rates
- raising the thresholds for the alternative minimum tax.

The deduction changes have understandably drawn the most attention. The Governor's 30-day amendments propose changes to the state and city standard deductions in order to sidestep what would otherwise have been large state and city tax increases for many taxpayers. Enacting these changes means forgoing tax windfalls for the city and state budgets and it seems likely that they will become law.

Deductibility of state and local taxes, or SALT, has been part of the structure of the federal income tax since its inception over 100 years ago, based on the premise that the income should not be taxed twice. However, the deduction also has the effect of shifting the federal tax burden from states with high taxes, which tend to have taxpayers with higher incomes, to states with lower taxes, which tend to have taxpayers with lower incomes. Although regressive, SALT deductibility is deeply embedded in our country's structure of fiscal federalism and is not easily altered without compensating adjustments elsewhere. Unfortunately, the TCJA offers little evidence of concern for the many states and localities that will be profoundly affected by this shift.

Capping SALT deductions at $10,000 poses long-term threats to the city and state economies and will have immediate consequences for many city taxpayers. But the number of taxpayers affected may be less than frequently discussed. Virtually all city taxpayers with adjusted gross income (AGI) below about $75,000, who account for two-thirds of all city taxpayers and one-half of city taxpayers claiming SALT, will get a tax cut—at least until 2026—thanks to the larger standard deduction and lower rates. For those with AGI between $75,000 and about $125,000, average SALT deductions were about $12,000. Most of these taxpayers, too, will come out ahead thanks to the larger standard deduction and lower rates.

Among taxpayers with AGI between $125,000 and about $500,000 the story is somewhat different. Many, if not most, had already lost their SALT deduction because they were subject to the federal alternative minimum tax (AMT). Thus, there is no change due to TCJA. But because the burden of the AMT falls for households with AGI above $500,000, it is primarily these 56,000 taxpayers who will be most affected by the loss of SALT deductibility; although they are only 2.6 percent of all city taxpayers, they account for 53 percent of city income tax revenue. While this change will increase their federal taxes, other changes in the TCJA such as the 20 percent deduction for pass-through income, the corporate rate reduction, and higher thresholds for the AMT, all of which disproportionately benefit households in this income range, should result in offsetting some or all of the loss of the SALT deduction. Our office is working to develop a more comprehensive estimate of the changes facing these taxpayers.

The Governor's 30-day amendments include two proposals for limiting the effect of the SALT change for the federal tax liability of New York residents. One would create trusts to receive donations from state and local taxpayers of payments for various public purposes. Taxpayers would then receive a new state tax credit equal to 85 percent of the donations made to such trusts. Because charitable contributions remain deductible for federal tax purposes, taxpayers would regain much of the benefit they had previously received through the SALT deduction. It remains to be seen whether the Internal Revenue Service would be willing to treat such donations as legitimate charitable donations. The second proposal by the Governor would create a new optional employer payroll tax in the state. The tax would be 5 percent on wages of employees who earn over $40,000. The employees would then receive a credit for the tax paid by their employers to be used against their state personal income tax. Because payroll taxes remain deductible for federal business taxes, employers would be held harmless. There are several potential complications that could undermine how well such a system works, not to mention the question of whether the federal government would allow it to stand.

Let me conclude with some observations about the broader effects of these changes. First, while most economic forecasters have raised their forecasts for economic growth somewhat for the next few quarters, few outside the Trump Administration are projecting a major long-term boost to growth attributable to the act. With the economy near full employment there is little reason to expect that the tax cuts can stimulate much new growth, particularly with the tax cuts tilted toward high-income households who have a greater propensity to save than households with lower incomes. And despite headlines about firms paying bonuses and hiking wages, more careful analysis suggests that so far more of the tax savings are going into stock buybacks and dividends.

Second, although the act has officially cost the federal government $1.5 trillion over 10 years, the true cost is more likely to be $2.5 trillion assuming the personal income tax changes are not allowed to expire as scheduled after 2026. Most of this cost will be borrowed, thereby adding to the national debt and prompting alarmed calls from Congressional leaders about the need to cut spending. Proposed targets include Medicaid, food stamps, and other safety net programs that primarily benefit lower income households—the households that receive the smallest benefits under the TCJA. The nonpartisan Tax Policy Center in Washington has analyzed the distributional effects of some possible spending reduction plans and found that the combined effects of the act and potential spending reductions range from regressive to extremely regressive. If such federal spending reductions are enacted, demands to replace the federal dollars would present very difficult choices for both New York City and State.

Thank you again for the opportunity to testify and I would be happy to answer your questions.