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Fact-Checking Claims about Winners and Losers with New Tax Reform (Part II)

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Abstract

"Overall, the impact of the new tax law, judged independently, is not as dire as many public perceptions cast it."

Posting about how taxation legislation affects American citizens from *In All Things* - an online journal for critical reflection on faith, culture, art, and every ordinary-yet-graced square inch of God's creation.

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Fact-Checking Claims about Winners and Losers with New Tax Reform (Part II)

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Donald Roth April 12, 2018

In the last article, I started working through some of the more prominent claims of the massive number of articles about "who won/lost with the new tax law." In particular, I addressed a couple of claims that play to a sort of reverse-Robin Hood narrative about the nature of the Tax Cuts and Jobs Act of 2017. Today, we'll pick up where we left off with a couple of claims that are similarly popular, and I'll try to put a bow on all of this before assessing the new tax law in its broader political context for the last piece of this series.

Perception: This is a victory for Red States over Blue States.

Correction: The changes to the individual income tax are better for people who will claim the standard deduction and are more likely to mean less to people in high tax/high-cost states.

The biggest reason why many winner/loser tallies put blue states in the loser column is that Democrat-leaning states are more likely to have both a high cost of living and a high tax burden on residents. This is not universally true, but it is certainly true of states like California and New York, which lean so solidly left that Donald Trump wrote off California nearly entirely in his presidential bid. It's also not unreasonable to come to this reading based on the lingering open hostility between the President and the governing officials of California. However, the fit is not exact, and, if we look at the three factors that cause analysts to judge blue states as losers in the new law, we can have a better appreciation of what the target really is.

The three factors that led some to conclude that this law targets Democrat-leaning states are the changes to the Mortgage Interest Deduction, the limit on state and local tax deduction, and the distributive effects of doubling the standard deduction.

As I mentioned before, the new tax law significantly alters the way that the Mortgage Interest Deduction is calculated. It does so in two major ways: first, by reducing the cap on how much of a *new* mortgage (pre-2018 mortgages are grandfathered) is deductible down from $1 million

to $750,000, and, second, by doing away with a deduction for home equity loans which are not spent to improve an eligible home.

These changes will definitely impact people in high-cost locales like San Francisco, but it's inaccurate to think of these changes as targeting Democrat voters. First, while there are definitely a few cities and some states that have a median sale price nearing or exceeding that number, it's far less prevalent than a strict partisan analysis would suggest. Second, one of the defining features of a high-cost area is that more people rent homes, because the average person, Democrat or not, still can't afford a $1 million house.

In other words, if the law is targeting Democrats, it's going after the rich ones. Lastly, dropping the deductibility of cashing out a home equity loan has nothing at all to do with partisan politics.[1] None of this even takes into account that economists on both sides of the aisle generally hate the Mortgage Interest Deduction as a regressive[2] tax policy which only becomes more so

with the doubling of the standard deduction. In other words, the primary effect of the changes to the Mortgage Interest Deduction is to make the law less of a handout to the rich, not to punish Democrats.The new tax law also reduces the total deduction available for state and local taxes (SALT) to a cap of $10,000. The logic of the targeting theory is that the cap on this deduction will disproportionately affect states with higher tax burdens, and that the states with higher taxes lean Democrat. Interestingly enough, this isn't totally true. Based on information about the percentage of taxpayers who claimed the SALT deduction in 2014, we can see that several solid red states, like Utah and Georgia, had more than 30% of their residents claiming the deduction. When looking at the size of the average deduction claimed, solid blue states do top the list, but many swing states are not far off. Really, the better unifying logic about the cap on the SALT deduction is that it impacts the wealthy, who are the major benefactors of this strongly regressive tax benefit.

In other words, like the Mortgage Interest Deduction, the primary target of the SALT deduction limitation is again the wealthy, not specifically Democrats.

The last potential argument for why the new tax law is a loss for blue state residents is really derived from all the things we've talked about so far. Doubling the standard deduction means that many more taxpayers will be claiming that instead of itemizing in 2018. By the Tax Policy Center's projections, the total number of itemizers may drop by almost 60%, to as low as 11% of all taxpayers. As a result, many of the 26 million or so people who switch from itemizing to taking the standard deduction will see less of a drop in their tax bill than people who previously claimed the standard deduction. However, the distribution of itemizers who will see this lesser benefit is even less defined by partisan divides than the previous two issues.

Overall, the reality is that over 75% of Americans will see lower taxes under the new law, while only about 9% (progressively distributed) will see increases. Just like I mentioned when addressing the reverse-Robin Hood narrative, if the pie is after-tax income, almost everyone is getting more pie, and it's not necessarily losing to get more pie. Based on the factors we've discussed, it's more likely that individuals in high tax or high-cost states will receive less of a benefit, but the specific changes have largely progressive effects.

I guess if you're dead-set on saying that the new law targets Democrats, it's targeting relatively wealthy ones, but aren't those the people who say they can afford to pay more taxes anyway?

Perception: This is a big loss for charities.

Correction: Charitable giving may slightly decrease under the new tax law, but most people don't really choose to give based on the tax treatment of their donations.

The last big perception that I'll address is the concern that the changes to the tax law will result in less charitable giving. The roots of this concern lie in the large reduction in the number of people itemizing deductions, since you can only claim a deduction for giving if you itemize. Further, the reduction in overall tax rates means that the marginal tax value of each dollar donated is reduced. Lastly, the exemption from the gift and estate tax was doubled from $5 million to $10 million, meaning that only estates exceeding that amount (roughly 2,000 in the U.S.) are subject to taxation. The net effect of these changes is to remove or weaken a number of tax incentives that favor donating money to a charity, and the fear is that weakened incentives mean less giving and thus "devastation" for America's charitable organizations.

This conclusion is wrong for two major reasons: effect size, and underlying assumptions. The first leg of the "devastation" narrative is rooted in predictions by the Council on Foundations that the new tax law will cut charitable giving by $16-24 billion a year. This is a huge number, but it's only 4-6% of the $390 billion Americans are estimated to have given to charities in the past year. That's not an insignificant drop, but it won't be evenly distributed among charities, so an organization should first look to its donor base and determine whether they represent a class of people likely to alter their giving as a result of the tax changes. Looking to the underlying assumptions made in concluding that people will stop giving, it becomes clear that the affected class is likely to be rather small.

The devastation perception makes the glaring assumption here that people give because it gives them a tax benefit, but there are good reasons to doubt this assumption—based on both who is affected and why anyone gives.

First, the primary tax incentive only exists for those who itemize. Around 20% of the money given to charities comes from people who already claim the standard deduction, so that group is unaffected by the change. With respect to the rest, it is really individuals who make more than $500,000 a year who are most significantly impacted by tax changes. However, the

number of these taxpayers likely to stop itemizing is far, far smaller than the drop in overall itemizers. Second, the wealthiest individuals are also more likely to give a larger portion of their wealth away as they become increasingly wealthy, so the reduction in tax rate is partially offset by greater wealth. Lastly, the estate tax incentives already apply to a vanishingly small group, and giving as part of estate planning is a very small part of the overall giving that Americans do.

In other words, the tax changes may not affect the deductibility equation for most givers.

Even for the givers potentially affected by the new law, the assumption of reduced giving rests on the assumption that people who receive a tax benefit are motivated by that benefit. Of those making less than $500,000 a year, economic analysis suggests that these givers are much less motivated by tax incentives. This makes sense when 47% of charitable giving in the United States is directed to religious and educational institutions. In both of those cases, one would fully expect that spiritual incentives, institutional loyalty, or other personal motivators would far eclipse tax considerations in the decision of whether or not to donate. As I mentioned before, a 4-6% drop in giving won't be across the board, so there are many reasons not to buy the devastation narrative, especially for churches and schools.

Overall, the impact of the new tax law, judged independently, is not as dire as many public perceptions cast it. In fact, many, if not most, will probably benefit from it in immediate and tangible ways. I graded the law itself at a B-, which—at least in the era before grade inflation—was a mildly positive rating. And from the perspective of its direct impact, I think it's fair to maintain that conclusion.

However, this was not a law passed in a vacuum, and there are a number of factors in the broader political context of the Tax Cuts and Jobs Act of 2017 that I find far more sobering if not downright scary. We'll turn to those issues in the last piece of this series.

Footnotes

1. Instead, this change is actually a fix for a loophole created the last time we did tax reform. Prior to 1986, credit card interest was deductible. This was an undesirable incentive toward debt which was eliminated; however, the equity loan deduction that was added allowed for a workaround to the old system that let a taxpayer cash out a home equity loan and still enjoy deductibility of debt incurred to buy the same sorts of things. ↩

2. The benefit of the deduction is overwhelmingly for the wealthy and unclaimed by nearly 75% of Americans. ↩