

Economic Effects of an Employer Compensation Expense Tax on New York Small Businesses

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Tax Cuts and Jobs Act of 2017

- Most significant reform to U.S. tax system since Tax Reform Act of 1986
- Addresses the tax code for both individuals and corporations



Tax Cuts and Jobs Act of 2017

- (Some) key provisions:
 - Lowers of corporate income tax rate from 35% to 21%
 - 20% deduction of business income for pass-through businesses
 - Modification of marginal tax rates for both single and joint filers (although keep seven brackets)
 - Doubling of standard deduction
 - Elimination of personal exemptions
 - Increase in child tax credit
 - Change in mortgage ceiling for homes to be eligible for mortgage interest deduction
 - Eliminates individual mandate of the Affordable Care Act
 - **Limits deductions of state and local taxes to \$10,000**

State Responses to TCJA

- Resistance to cap on state and local tax (SALT) deductions and search for “workarounds”
- Most resistance is from high income states who would be made less competitive
 - Higher taxes → States less attractive for workers
 - Lower quality labor pool → States less attractive for businesses
 - Pressure to lower state taxes
- Workarounds:
 - Lawsuit: NY, NJ, and CT v. United States
 - Tax credits for donating to charitable entity that support state and local programs (run by state government)
 - Employer payroll tax

State Workarounds: Lawsuit

- Governor Cuomo:

- December 2017:

"I'm on the side of the working man. This tax plan has nothing to do with the working man. It is a tax cut for the rich. And since it's a tax plan it deals with numbers. So we don't have to have a rhetorical debate. Look at the numbers. 50 percent of the benefit goes to the top one percent."

- January 2018:

"The elimination of full state and local deductibility is a blatantly partisan and unlawful attack on New York that uses our hardworking families and tax dollars as a piggy bank to pay for tax cuts for corporations and other states"

- 14th Amendment and 10th Amendment challenges



State Workarounds: Charitable Entity

- E.g., California Excellence Fund to which residents may make voluntary contributions and then claim full amount as credit against state income tax liability
- Tax Foundation: Case law and IRS regulations generally require charitable intent for a contribution to be deductible (*i.e.*, the individual does not receive a substantial benefit from the contribution).
- Sole purpose of the proposed contributions in lieu of state taxes is financial gain.

State Workarounds: Charitable Entity

- Treasury and IRS could also block the deductions

- Secretary Mnuchin:

“Let me just say again from a Treasury standpoint and IRS, I don’t want to speculate on what people will do, but I think it’s one of the more ridiculous comments to think you can take a real estate tax that you are required to make and dress that up as a charitable contribution. I hope that the states are more focused on cutting their budgets and giving tax cuts to their people in their states than they are in trying to evade the law.”



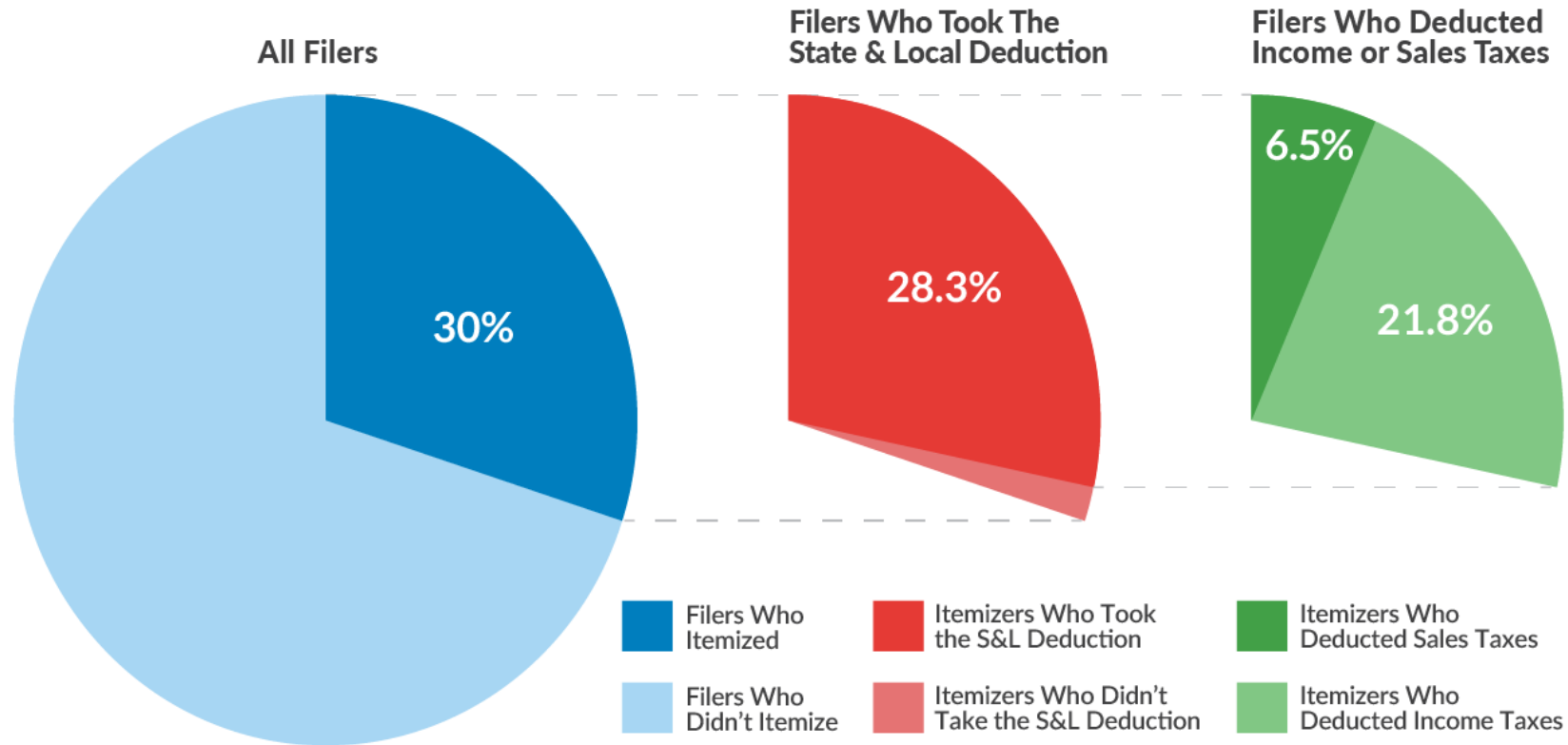
State Workarounds: Employer Payroll Tax

- Employer-side payroll tax swap for individual state income tax
- Legally, on firmer footing than charitable deduction workaround
- However, relied on dubious assumption that wages would adjust downward to keep both employer and employee whole
- Prices are “sticky” and wages are particularly “sticky downward”



Who Takes State and Local Tax Deductions?

What Percentage of Taxpayers Take the State & Local Deduction?



TAX FOUNDATION

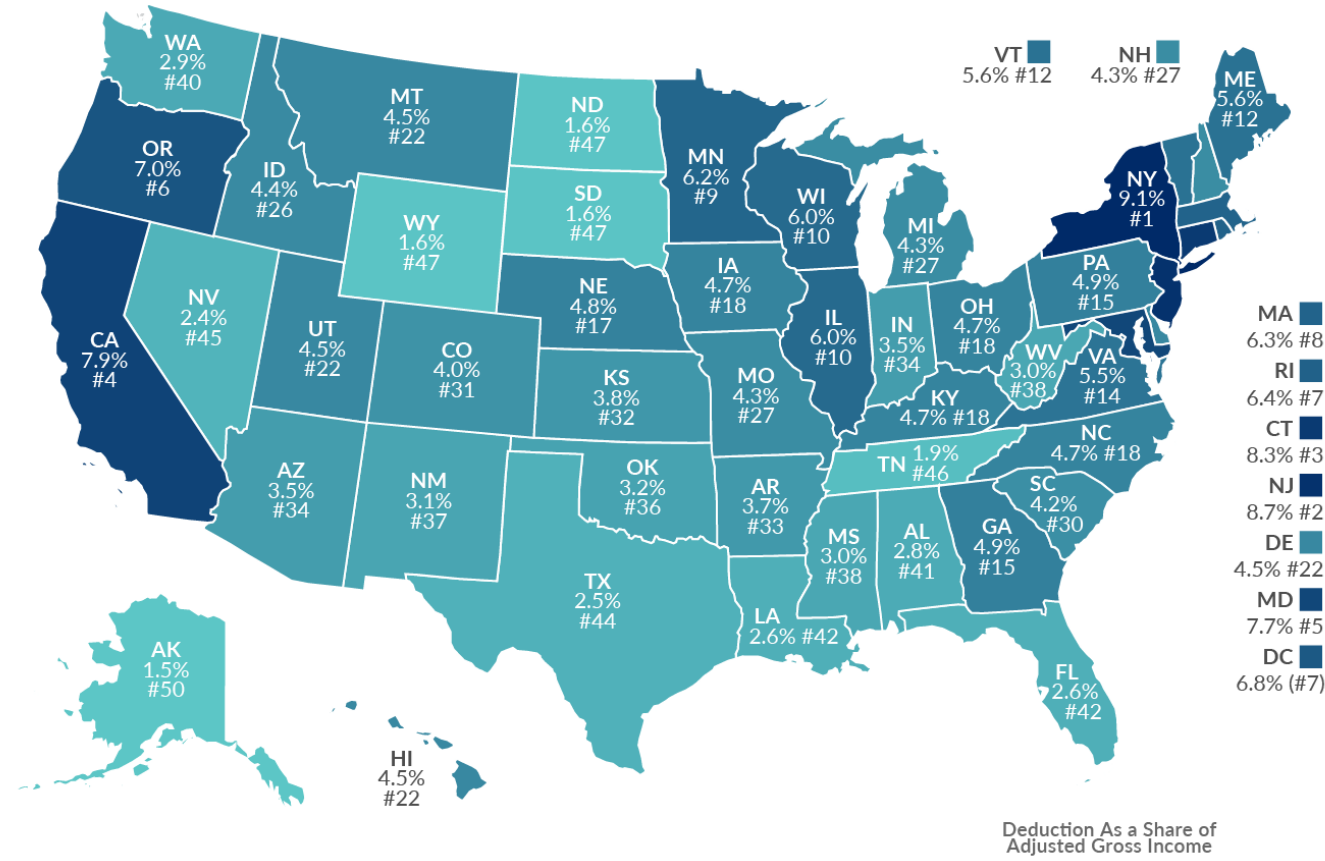
@TaxFoundation



CBO: 88% of benefits of SALT deductions go to taxpayers with incomes exceeding \$100,000
See: "Options for Reducing the Deficit: 2017 to 2026," Congressional Budget Office, Dec 2016

Which States Are Most Impacted by SALT Deduction Limits?

State & Local Tax Deduction As a Share of Adjusted Gross Income by State



Source: IRS Statistics of Income (2014)



State and Local Tax Deduction Shares and Value by State

State	AGI Per Filer	% of Itemizers	Deduction as % of AGI	State Share
California	\$73,938	33.90%	7.90%	19.60%
New York	\$79,268	34.20%	9.10%	13.30%
New Jersey	\$81,344	41.10%	8.70%	5.90%
Illinois	\$69,186	32.40%	6.00%	5.00%
Texas	\$67,253	23.00%	2.50%	3.90%
Pennsylvania	\$63,037	28.80%	4.90%	3.70%
Massachusetts	\$85,408	36.80%	6.30%	3.50%
Maryland	\$72,746	45.20%	7.70%	3.20%
Virginia	\$72,151	37.20%	5.50%	3.00%
Ohio	\$56,322	26.50%	4.70%	2.90%

Source: Tax Foundation; IRS Statistics of Income (2014)



Case Study: New York Employer Compensation Expense Tax

- NY Dept of Taxation and Finance: SALT deduction limits will cost NY taxpayers \$14.3B per year (Jan 2018)
- Competitiveness concerns and migration risk
- Governor Cuomo called for adjustments to NY tax laws in response to impact of federal tax reform
- One such adjustment (at the time) was an employer compensation expense tax outlined in an amendment to this year's budget bill



What Is an Employer Compensation Expense Tax?

- Employer-side payroll tax with 3-year phase-in
 - 1.5% in 2019; 3.0% in 2020, 5.0% from 2021 on for electing employers
- Employers must elect to participate
- Applies only to “covered” employees
 - An employee of an electing employer who receives annual wages and compensation from employer of more than \$40,000 per year
- Employer compensation expense tax is deductible for income tax purposes
- In the original budget amendment, employers **may not** pass on the tax burden to workers through lower compensation
- Employee-side credit equal to a fraction of the compensation expense tax paid



**How much will NY employers pay
in additional tax?**



Variable 1: Additional Taxes Paid by Employers

Covered Workers: Currently Eligible

- Only wage and salary in excess of \$40,000 per year is taxed
- CPS data: 4.3 million New Yorkers made more than \$40,000 in wage and salary in 2016
- Average worker in this category made \$55,000
- In total: \$237.7 billion in wage and salary income



Variable 1: Additional Taxes Paid by Employers

Potential Covered Workers: Income Dimension

- Wage growth:
 - Assume NY wages and salaries continue to increase at historical growth rate since 2009Q3
 - BLS compensation data for private sector wages and salaries for Northeast Census Region
 - Average year-over-year increase between 2009Q3 and 2017Q3 is 2.1%
- Clearly, can extrapolate future wage/salary levels of workers currently earning \$40K+
- But what about workers currently earning <\$40K who will become eligible covered workers within 10 years?

Wage and Salary Income Distribution of New Yorkers Earnings at Least \$33,000 per Year in 2016

Percentile	Annual Wage and Salary Income	Percentile	Annual Wage and Salary Income
---	-----	50	\$60,000
5	\$35,000	55	\$62,000
10	\$37,000	60	\$67,000
15	\$40,000	65	\$72,000
20	\$40,500	70	\$79,000
25	\$44,700	75	\$85,000
30	\$46,000	80	\$97,000
35	\$50,000	85	\$108,490
40	\$51,000	90	\$128,000
45	\$55,000	95	\$165,000

Source: Current Population Survey



Variable 1: Additional Taxes Paid by Employers

Potential Covered Workers: Income Dimension

- Working backward with 2.1% growth rate →
- A worker earning slightly under \$33,000/year in 2019 will see wage/salary compensation grow to >\$40K by 2028
- In 2016, 19.8% of workers who earned wage/salary in excess of \$33K were in the \$33K to \$40K income bracket
- Not taking into account this set of workers may lead to a material underestimation of wage and salary eligible for the employer compensation expense tax

Variable 1: Additional Taxes Paid by Employers

Potential Covered Workers: Ageing In and Ageing Out

- Inflow: Younger workers entering the workforce
- Outflow: Older workers retiring
- Current average U.S. retirement age: 62 y.o.
- ~30% of New Yorkers earning at least \$33K in wage/salary will reach age 62 by 2028
- X-factor: Increasing average retirement age and elderly workers staying longer in workforce



Age Distribution of New Yorkers Earning at Least \$33,000 in Wage and Salary per Year in 2016

Percentile	Age	Percentile	Age
---	----	50	45
5	25	55	47
10	28	60	49
15	30	65	51
20	32	70	53
25	34	75	55
30	36	80	57
35	38	85	59
40	41	90	61
45	43	95	65

Source: Current Population Survey



Variable 1: Additional Taxes Paid by Employers

Potential Covered Workers: NY Population Trends

- NY population is stable and growing (and so too ought to be NY's labor force given certain assumptions)
- Contrary to reports in popular media that NY population has actually declined in recent years
- Utilize baseline NY population estimates in REMI model

Population Estimates of New York State: 2010 to 2017

	2010	2011	2012	2013	2014	2015	2016	2017
NY Population	19,405,185	19,526,372	19,625,409	19,712,514	19,773,580	19,819,347	19,836,286	19,849,399

Source: Census Bureau



Variable 1: Additional Taxes Paid by Employers

Potential Covered Workers: NY Labor Force Trends

- Assume relative competitiveness of NY remains unchanged in a post-TCJA world
- Any perceived deleterious effects on NY's competitiveness resulting from TCJA assumed to be addressed at state level
- No out-migration of working age individuals who relocate in search of better opportunities

Variable 1: Additional Taxes Paid by Employers

Potential Covered Workers: New Entrants and Retirees

- In 2016, there were 2.83 million New Yorkers between 12 y.o. and 22 y.o.
 - Individuals with higher than average probability of entering labor force within 10-year time frame
 - Current LFPR of 63% → ~1.78 million new entrants
- Compare to 2.87 million New Yorkers between 52 y.o. and 62 y.o.
 - Individuals with higher than average probability of retiring within 10-year time frame
 - Some 1.95M of this group earns wage/salary
 - Some 1.15M earned at least \$40K/year

Variable 1: Additional Taxes Paid by Employers

Potential Covered Workers: Our Assumptions

- Ageing of U.S. workforce
- Retirement age going up: 59 y.o. in 2010 to 62 y.o. in 2014
- Gallup (Riffkin 2014): Americans currently in workforce expect to retire at 66 y.o., not 62 y.o.
- We assume that retirement ages will continue to increase as Gallup data suggest
- Assume inflows and outflows to labor force due to new entrants and retirements cancel out



Variable 1: Additional Taxes Paid by Employers

How many employers will elect in?

- Some argue that the incentives are wrong for meaningful take-up by employers and that little-to-no tax revenue will result
- Opposing view: lawmakers are knowledgeable and crafters of effective policy, so the incentives should be right and there will be high take-up
- Our assumption: place faith in lawmakers' ability to craft good policy → assume 100% of employers with eligible covered employees will elect in

Variable 1: Additional Taxes Paid by Employers

- 3-year phase-in of 1.5%, 3.0%, 5.0%
- Initially \$949M in 2019 growing to \$3.8B in 2028 assuming 2.1% wage/salary growth rate
- Inputted into the BSIM **twice**:
 - Firm side: “non-compensation labor cost” distributed according to employment weights built into the model
 - Reminder: Under this bill, firms cannot lower existing compensation
 - State government: Revenue fully distributed as tax credit to covered employees (discussed later)

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Est. Tax Base	\$253.2B	\$258.5B	\$264.0B	\$269.6B	\$275.3B	\$281.2B	\$287.1B	\$293.2B	\$299.4B	\$305.8B
Est. Tax Revenue	\$3.797B	\$7.776B	\$13.200B	\$13.480B	\$13.766B	\$14.058B	\$14.356B	\$14.660B	\$14.971B	\$15.288B



How much will NY employers be able to deduct for income tax purposes?

Variable 2: Tax Deductions for Electing Employers

- Given tax revenue, need tax rate to calculate value of deductions
- TCJA just passed so lack of post-TCJA data to estimate new effective marginal rates
- Estimates of pre-reform business tax rates range from 23% to 35% with aggregate average of 27.9%
- We assume a tax rate of 25%
- Also, assume that all electing employers are sufficiently profitable so that they can take the full amount of the deduction

Variable 2: Tax Deductions for Electing Employers

- Deduction for income tax purposes is the only direct offset to tax available to employers
- Recall: according to the original bill, employers are not permitted to lower compensation to be made whole

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Est. Tax Revenue	\$3.797B	\$7.776B	\$13.200B	\$13.480B	\$13.766B	\$14.058B	\$14.356B	\$14.660B	\$14.971B	\$15.288B
Est. Employer Tax Deduction	\$949M	\$1.939B	\$3.300B	\$3.370B	\$3.441B	\$3.514B	\$3.589B	\$3.665B	\$3.743B	\$3.822B



Variable 2: Tax Deductions for Electing Employers

- Input the deduction as a cut in production costs
- Does not affect the relative costs of factor inputs
- This choice reflects the principle of cost neutrality that appears fundamental to the new tax:
 - Despite compensation expense tax being an explicit tax on labor, this new cost on labor for employers ought to be offset through the code vis-à-vis deductibility for income tax purposes (according to policymakers)
 - We avoid changing the relative cost of labor to other factors of production in our modeling

**How much will NY employees
receive in the form of a tax credit?**



Variable 3: Employee Tax Credit

Officially:

$$\begin{aligned} \text{Employee Credit} = & \\ & (\text{Wages/salary in excess of } \$40\text{K}) \times \\ & (\text{employer compensation expense tax rate}) \times \\ & [1 - [(\text{pre-credit income tax})/(\text{taxable income})]] \end{aligned}$$

For simplicity, we assume employee credit equal 100% of tax revenue generated through the compensation expense tax.

Policy variable used: "Compensation Rate" since no govt policy var available that distributes according to employment weights

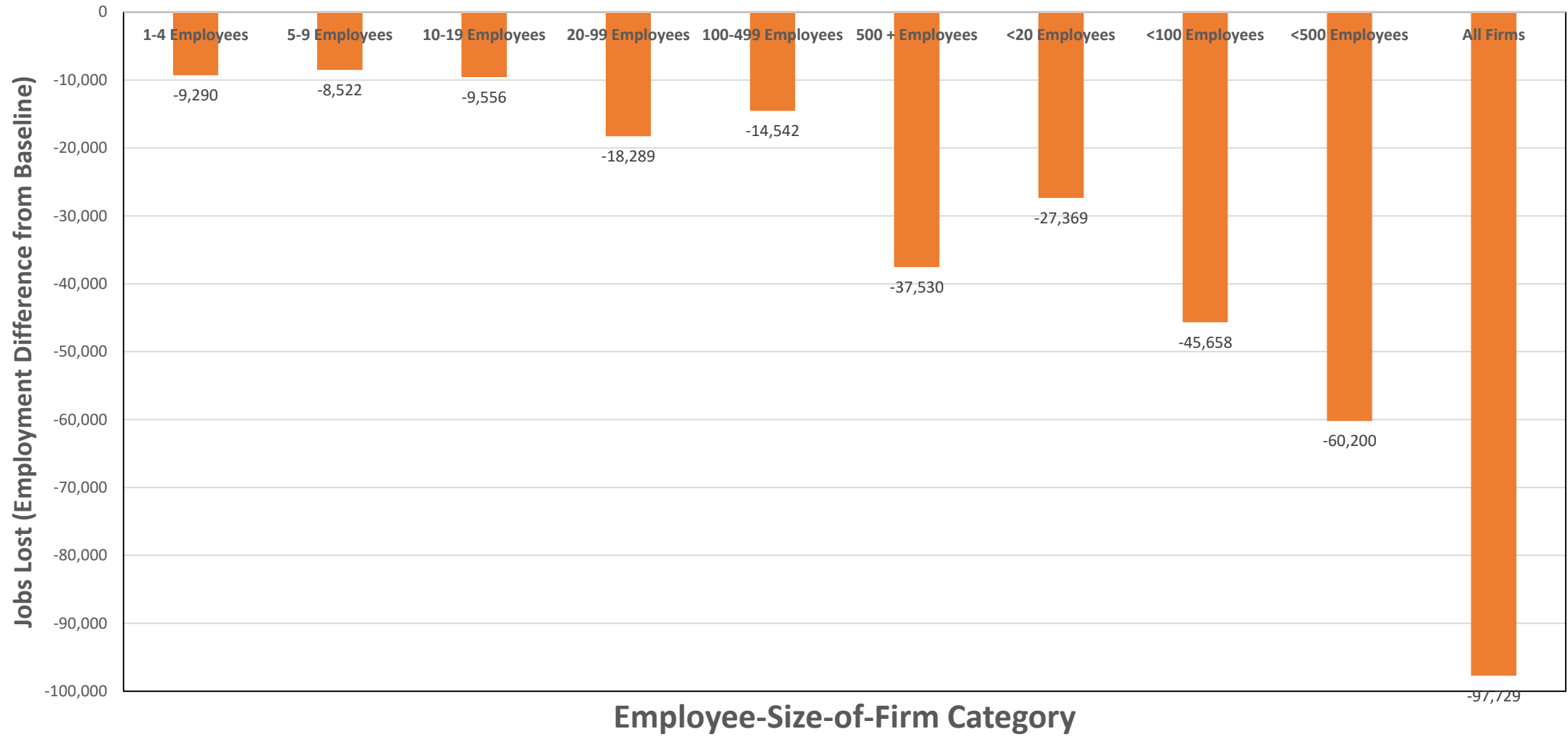


The Employer Compensation Expense Tax Makes New York Less Competitive

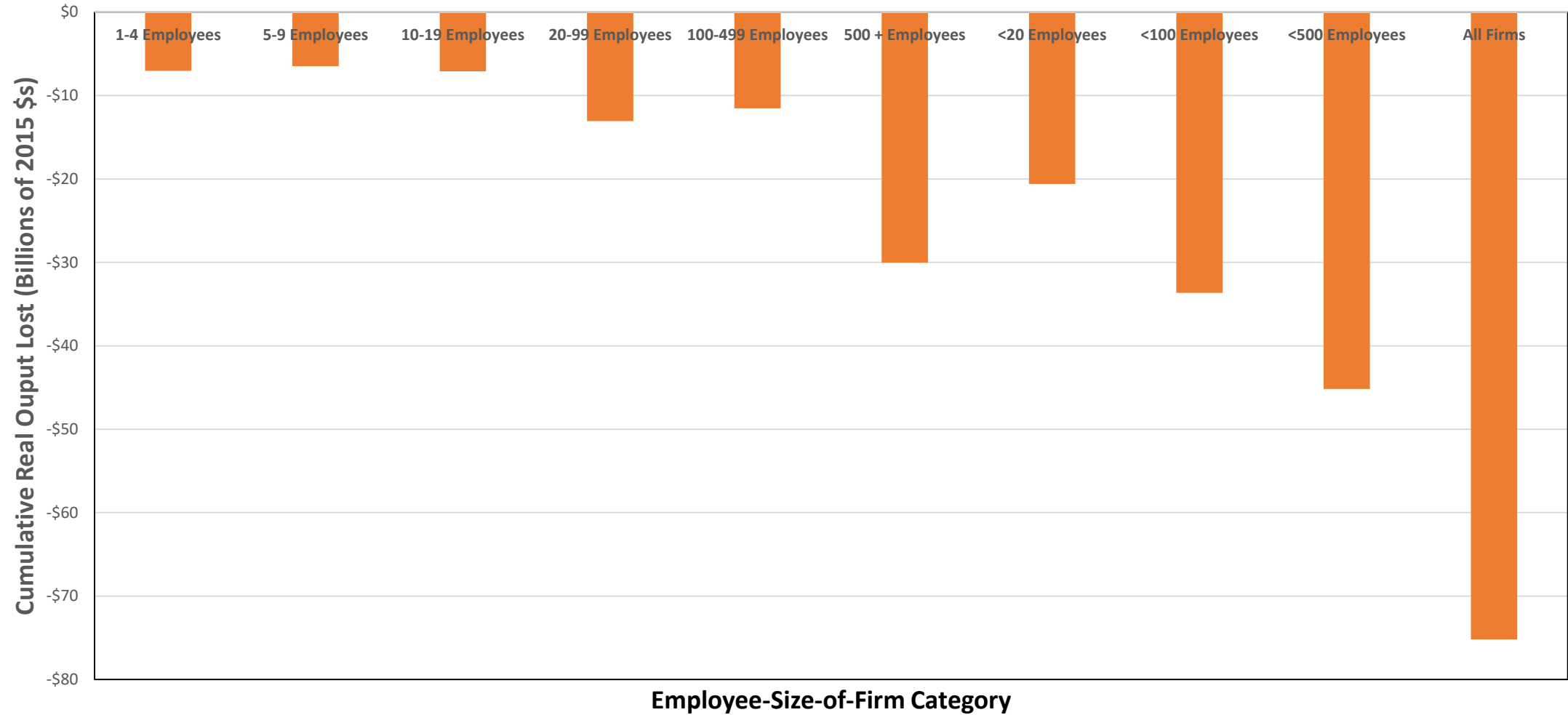
- Over 97,000 NY private sector jobs lost
- 62% of lost jobs in small business sector
- Including public sector, total employment down by nearly 107,000
- Out-migration: over 172,000 NY residents would leave the state



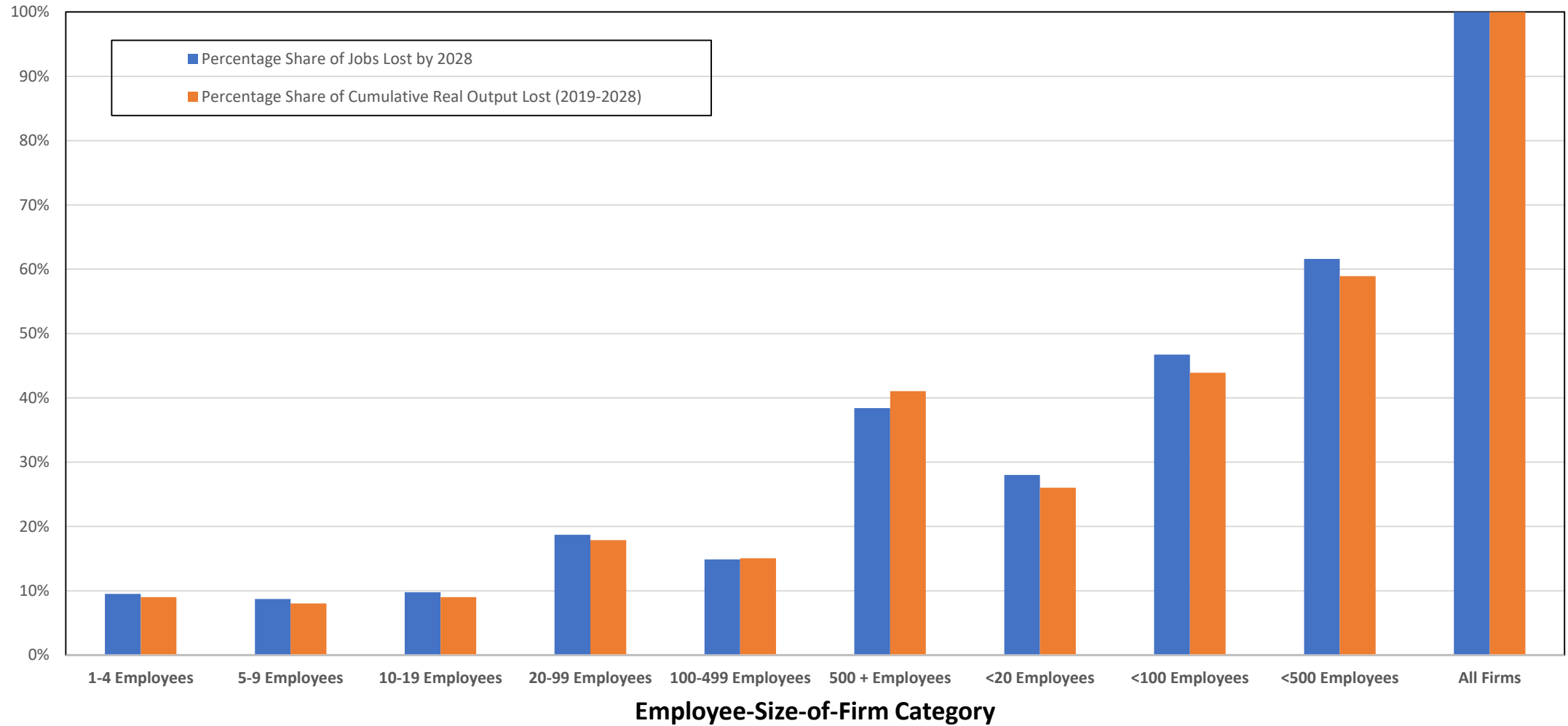
NY Private Nonfarm Employment: Difference From Baseline (in Number of Employees) in 2028



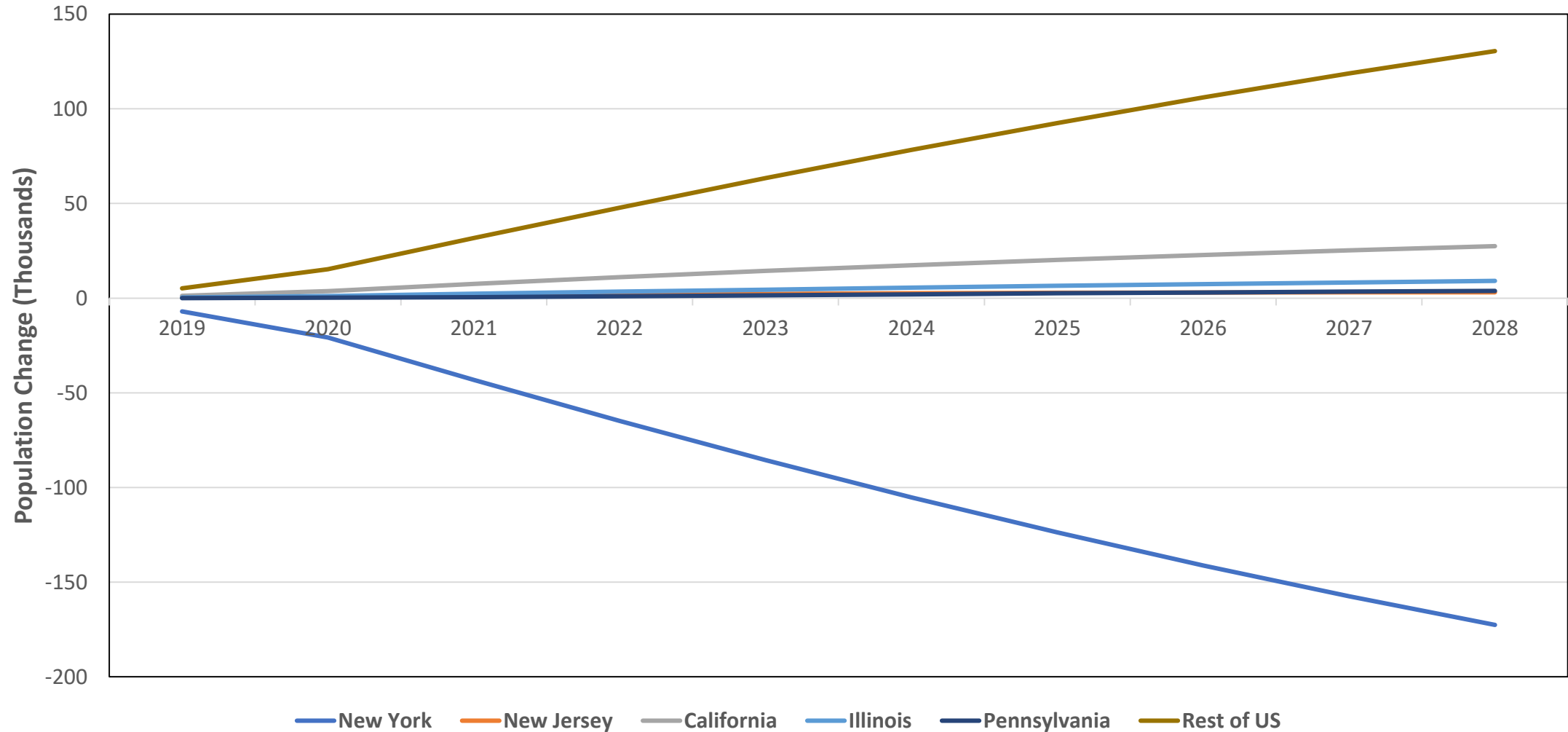
New York Real Output: Cumulative Difference From Baseline (in Billions of 2015 \$s) by 2028



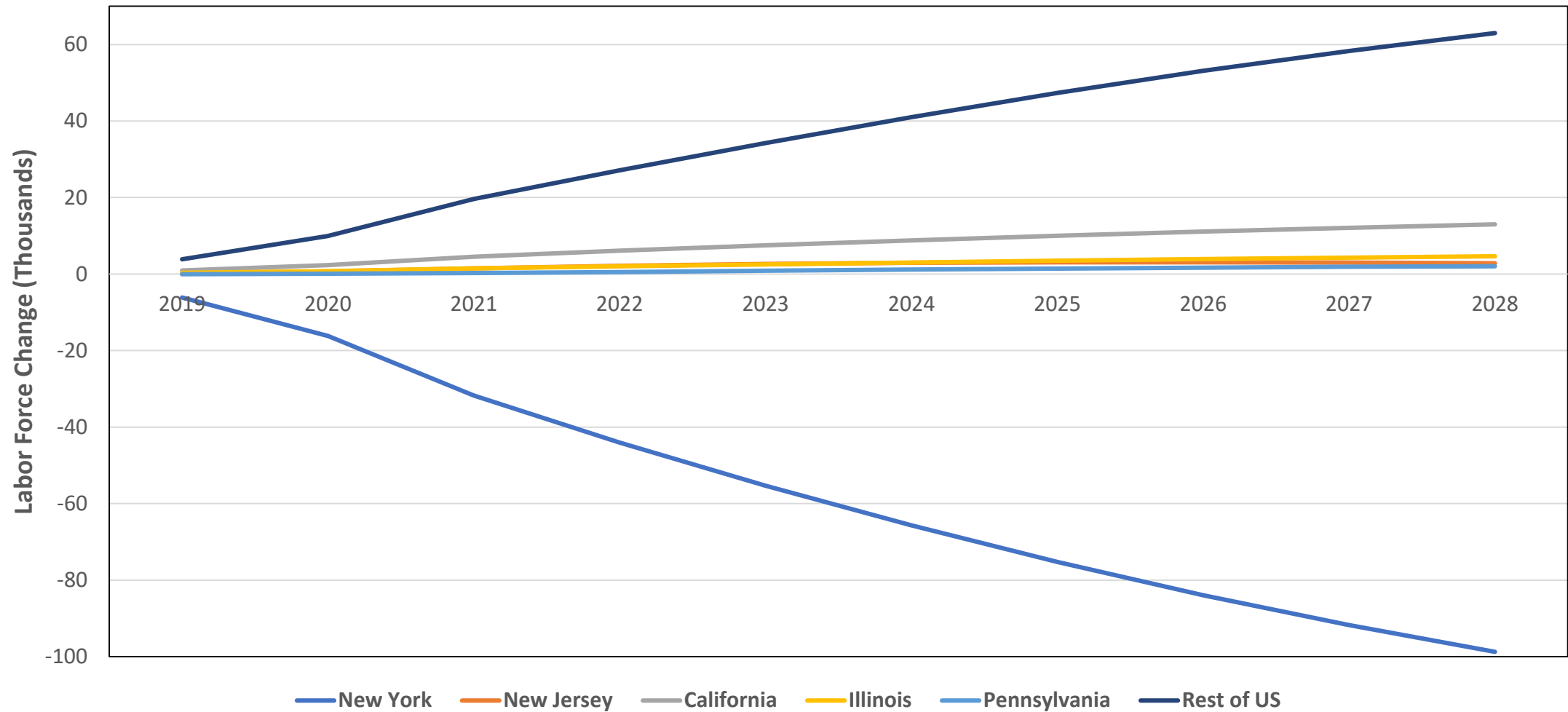
Percentage Shares of Jobs Lost and Cumulative Real Output Lost if New York Enacts an Employer Compensation Expense Tax



Population Change as a Result of New York's Proposed Employer Compensation Expense Tax (2019-2028)



Labor Force Change as a Result of New York's Proposed Employer Compensation Expense Tax (2019-2028)



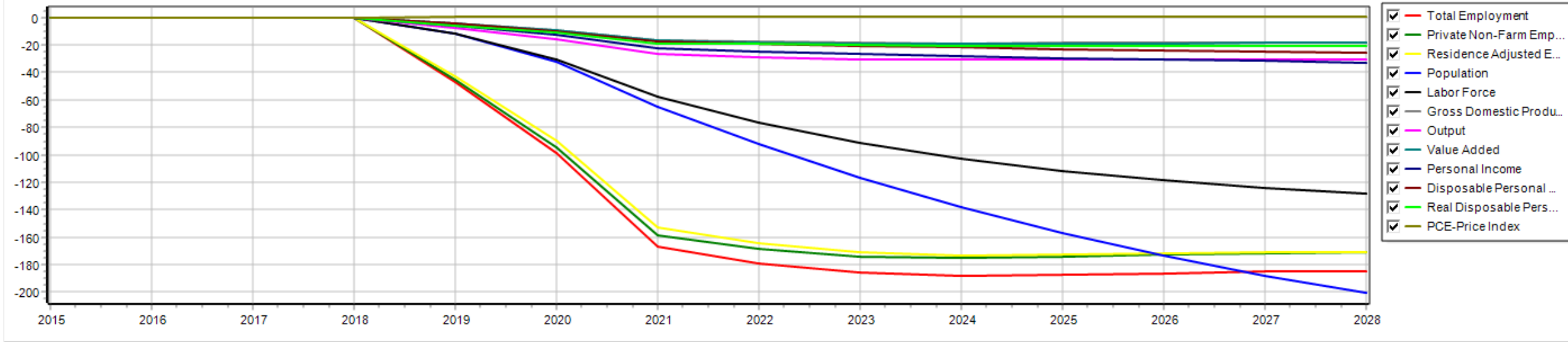
What If Additional Payroll Taxes Can Be Offset by Lower Wages/Salary?

- Question about realism: Prices are sticky, and wages are particularly sticky downward.
- But, in practice, one could do this in the model.
- Relevant policy variable(s): compensation, wage bill
- Approach accounts for consumption decrease due directly from reduced income.

Making Employers Whole: Cut "Compensation"

Region		2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
New York															
Category	Units	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Total Employment	Thousands (Jobs)	0.000	0.000	0.000	0.000	-47.046	-98.527	-166.831	-178.829	-185.831	-188.028	-187.387	-186.531	-185.268	-184.647
Private Non-Farm Employment	Thousands (Jobs)	0.000	0.000	0.000	0.000	-45.380	-94.270	-158.917	-168.672	-174.157	-175.377	-174.158	-172.921	-171.411	-170.608
Residence Adjusted Employment	Thousands	0.000	0.000	0.000	0.000	-42.912	-89.963	-152.506	-164.004	-170.909	-173.202	-172.751	-172.080	-171.043	-170.626
Population	Thousands	0.000	0.000	0.000	0.000	-11.940	-32.678	-65.002	-92.067	-116.645	-138.295	-157.039	-173.411	-187.757	-200.451
Labor Force	Thousands	0.000	0.000	0.000	0.000	-11.903	-30.376	-57.875	-76.487	-91.461	-103.037	-111.886	-118.653	-123.942	-128.200
Gross Domestic Product	Billions of Fixed (2015) Dollars	0.000	0.000	0.000	0.000	-4.508	-9.544	-16.345	-17.706	-18.506	-18.771	-18.687	-18.551	-18.395	-18.342
Output	Billions of Fixed (2015) Dollars	0.000	0.000	0.000	0.000	-7.338	-15.582	-26.717	-29.024	-30.369	-30.824	-30.752	-30.593	-30.401	-30.378
Value Added	Billions of Fixed (2015) Dollars	0.000	0.000	0.000	0.000	-4.578	-9.692	-16.598	-17.983	-18.795	-19.065	-18.979	-18.841	-18.682	-18.627
Personal Income	Billions of Current Dollars	0.000	0.000	0.000	0.000	-5.931	-12.761	-22.361	-24.733	-26.689	-28.235	-29.476	-30.604	-31.699	-32.846
Disposable Personal Income	Billions of Current Dollars	0.000	0.000	0.000	0.000	-4.601	-9.904	-17.352	-19.219	-20.759	-21.968	-22.931	-23.808	-24.660	-25.551
Real Disposable Personal Income	Billions of Fixed (2015) Dollars	0.000	0.000	0.000	0.000	-5.648	-11.318	-18.970	-19.513	-20.108	-20.435	-20.613	-20.759	-20.892	-21.049
PCE-Price Index	2009=100 (Nation)	0.000	0.000	0.000	0.000	+0.191	+0.338	+0.538	+0.456	+0.424	+0.399	+0.381	+0.371	+0.365	+0.360

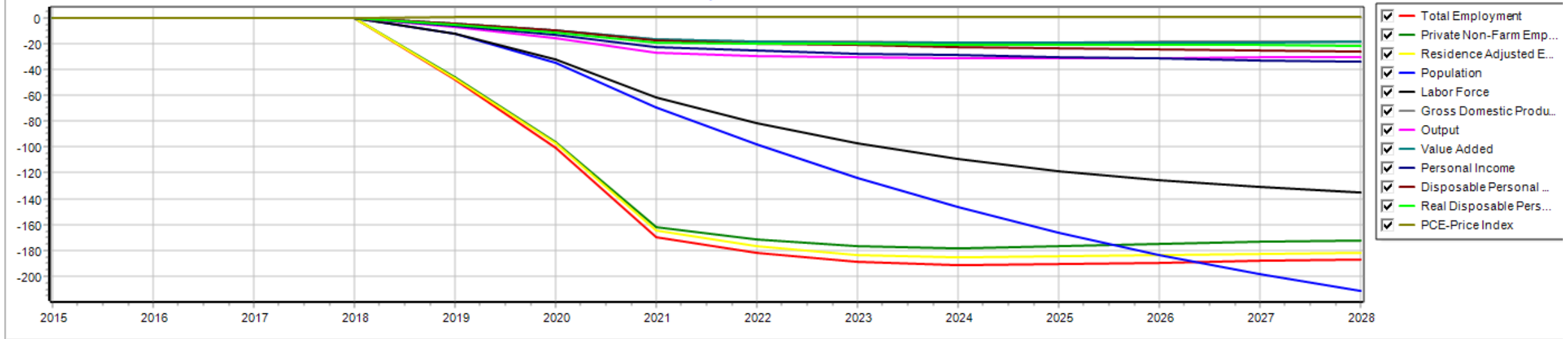
Economic Summary - New York



Making Employers Whole: Cut "Wage Bill"

Region		2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
New York															
Category	Units	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Total Employment	Thousands (Jobs)	0.000	0.000	0.000	0.000	-47.941	-100.411	-170.009	-182.160	-189.164	-191.250	-190.430	-189.387	-187.954	-187.192
Private Non-Farm Employment	Thousands (Jobs)	0.000	0.000	0.000	0.000	-46.214	-96.000	-161.808	-171.637	-177.075	-178.155	-176.741	-175.310	-173.626	-172.682
Residence Adjusted Employment	Thousands	0.000	0.000	0.000	0.000	-46.668	-97.513	-165.018	-176.553	-183.363	-185.434	-184.704	-183.763	-182.450	-181.778
Population	Thousands	0.000	0.000	0.000	0.000	-12.717	-34.825	-69.242	-97.958	-123.878	-146.607	-166.206	-183.260	-198.151	-211.279
Labor Force	Thousands	0.000	0.000	0.000	0.000	-12.695	-32.439	-61.794	-81.604	-97.405	-109.543	-118.771	-125.777	-131.214	-135.554
Gross Domestic Product	Billions of Fixed (2015) Dollars	0.000	0.000	0.000	0.000	-4.600	-9.739	-16.679	-18.061	-18.866	-19.122	-19.020	-18.865	-18.691	-18.623
Output	Billions of Fixed (2015) Dollars	0.000	0.000	0.000	0.000	-7.487	-15.900	-27.260	-29.602	-30.952	-31.392	-31.290	-31.099	-30.876	-30.829
Value Added	Billions of Fixed (2015) Dollars	0.000	0.000	0.000	0.000	-4.671	-9.890	-16.938	-18.344	-19.162	-19.422	-19.318	-19.160	-18.982	-18.912
Personal Income	Billions of Current Dollars	0.000	0.000	0.000	0.000	-6.122	-13.185	-23.119	-25.593	-27.626	-29.229	-30.515	-31.675	-32.799	-33.974
Disposable Personal Income	Billions of Current Dollars	0.000	0.000	0.000	0.000	-4.748	-10.233	-17.939	-19.887	-21.489	-22.744	-23.742	-24.646	-25.522	-26.436
Real Disposable Personal Income	Billions of Fixed (2015) Dollars	0.000	0.000	0.000	0.000	-5.775	-11.582	-19.425	-20.001	-20.623	-20.965	-21.152	-21.301	-21.436	-21.594
PCE-Price Index	2009=100 (Nation)	0.000	0.000	0.000	0.000	+0.191	+0.336	+0.532	+0.447	+0.414	+0.388	+0.369	+0.359	+0.353	+0.348

Economic Summary - New York



Normative and Other Concerns

- Equity – Pre-tax reform regime might be viewed as tantamount to cross-state subsidization by taxpayers for national interests (*e.g.*, the common defense, social security, etc.).
- With unlimited SALT deductions, are individuals in states with high state and local taxes paying their “fair share” to the federal government?
- Debt reduction

Thank You!

