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Taxation

Changes to Federal Tax Code Could Impact Revenues of Most States

by Lynn Hume
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WASHINGTON – Comprehensive or targeted reform of the federal tax code could significantly impact the revenue of most states, The Pew Charitable Trusts found in a report released Wednesday.

That's because, of the 41 states and the District of Columbia with broad-based personal income taxes, 40 states and D.C. have incorporated a range of federal tax expenditures, including the exclusion for tax-exempt bond interest, into their state tax codes.

"Understanding the extent to which state income taxes are linked to the federal system is important for policymakers at both levels of government when evaluating federal revisions or reforms," the report said. "In considering reforms, federal policymakers should realize that changes can affect state revenue, requiring states to decide whether to revise their tax policies …. State leaders need to weigh the trade-offs of linking to federal tax expenditures, given the possible impacts of revisions."

Pew looked at how the state and D.C. tax systems conformed to the federal tax code in 2013 and then simulated the repeal of 42 major nonbusiness individual tax expenditures, which account for roughly 80% of the total forgone federal revenue associated with all personal tax expenditures from 2015 to 2024.

In the simulation, federal taxes also were reduced by about 40% to offset the expected revenue increase resulting from the repeal of the tax expenditures.

Additionally, the alternative minimum tax was repealed to reduce interaction effects. The analysis assumed that the states linked to federal provisions in 2013 would maintain their conformity also follow the federal government by also repealing the tax expenditures.

One of tax expenditures repealed was the exclusion of tax-exempt muni bond interest. The report said that, even for states that don't conform to the federal tax code, the repeal or restriction of the federal exclusion of tax-exempt interest from muni bonds would increase borrowing costs for state and local governments. However, it did not estimate the impact on borrowing costs.

But for the states and the District that conform to the federal tax code, the report found that overall, state individual income tax revenue would increase by about 34% or $100 billion. The revenue increases ranged widely, from about 5% to 50%, depending on the degree of state conformity to the federal tax code.

State revenues increased the most for: Iowa, up 61.4%, Louisiana, up 57.4%, and Nebraska, up 57.2%. Each of these states conforms to the federal tax code for exclusions and adjustments, federal itemized deductions and federal earned income tax credit.

The lowest percentage increase was New Jersey, up only 2.1%. That state only conforms to the federal tax code for federal earned income tax credit. The next lowest increase was Mississippi, up 12.6%. That state only conforms for federal itemized deductions.

The report also found that repeal of the tax expenditures related to health insurance and retirement had the largest impact on state revenue because many states conform to them, they include a large amount of untaxed income, and they benefit a significant portion of the population.

Repeal of the employer-provided health insurance exclusion and deductions for self-employed health plans would account for 36% of the revenue increases for all of the states. The repeal of pension and savings tax preferences would account for 25% of the state revenue gains.

The simulation also showed federal income taxes paid rose in 29 states and fell in 21 states and D.C. Most of the revenue changes were not significant, with all of them totaling 10% or less. Nevertheless, the variations could contribute to the diverse economic impacts by changing the disposable income in different ways across the states, according to the report.

Pew found some federal tax code changes that can have implications for states that are unrelated to conformity, one of which was the exclusion of tax-exempt bond interest. This category also included the federal deduction for state and local taxes paid. Federal tax filers who claim itemized deductions are able to deduct state and local property taxes and income or sales taxes, reducing the overall cost of those taxes for these filers. Repealing or restricting these deductions would make state and local taxes more expensive for those taxpayers.

Other federal tax code changes could affect state revenue by altering taxpayer behavior, according to the report. For example, it said, if federal capital gains rates were to rise, taxpayers might sell investments beforehand to avoid paying higher taxes.
