TALKING TAXES

How the Bush Tax Cuts Affect State Tax Revenues

Less than one month from now, federal tax cuts pushed through by President George W. Bush are scheduled to expire—and Congressional tax writers have spent much of this year debating how these tax cuts should be extended. This debate has huge implications for the nation's fiscal health, but also has often-overlooked implications for state revenues. This policy brief discusses the ways in which the resolution of the debate over the Bush tax cuts could affect state tax revenues in coming years.

State Tax Cuts Primarily Benefitting Upper-Income Families

Estate tax: Until 2001, having an estate tax was one of the few things every state could agree on. Every state levied such a tax, and most states had a "pickup tax" designed to exactly equal the amount of a federal estate tax credit against state taxes. When the federal estate tax was repealed as a result of the 2001 tax cuts, this federal credit was repealed too—which means that most states' "pickup tax" disappeared as well. If estate tax repeal is made permanent, many of these states will permanently lose their entire stream of estate tax revenue.

Itemized deduction phaseout: Starting in the early 1990's, federal income tax law included a provision that limits the value of certain itemized deductions by up to 80 percent for the very best-off taxpayers. This provision, known as the "Pease" provision, was repealed by the 2001 Bush tax cuts. Almost 30 states base their own itemized deductions on federal law—so federal Pease repeal also has the effect of repealing similar provisions in these states. If the Bush tax cuts are made permanent, this will amount to an automatic state tax cut for a handful of the best-off taxpayers in each of these states, and will therefore reduce state revenues. (An August 2010 ITEP report, *Writing Off Tax Giveaways*, discusses options for states seeking to avoid this revenue loss.)

Personal exemption phaseout: Pre-Bush law included a provision limiting the exemptions available to upper-income families. Eight states that use federal exemption rules in their own tax laws—Colorado, Idaho, Minnesota, New Mexico, North Dakota, Rhode Island, South Carolina, and Vermont—"piggybacked" on this federal provision, reducing the exemptions available to their best-off residents. The Bush tax cuts repealed this provision, cutting income taxes for the best-off taxpayers at the federal level and in these states. For the federal government, and for seven of these states, permanent extension of the Bush tax cuts would mean an additional tax cut for upper-income taxpayers.

State Tax Cuts Primarily Benefitting Low- and Middle-Income Families

Standard deduction: The Bush tax cuts increased the basic "standard deduction"—the no-tax floor used by middle- and low-income families who don't itemize on their federal income tax returns—for married couples to make the married deduction equal to twice the deduction for singles. This change, which eliminated a small "marriage penalty" in the standard deduction, gives a small but progressive tax cut to married couples who take the standard deduction. Ten states—Colorado, Idaho, Minnesota, Missouri,

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Nebraska, New Mexico, North Dakota, South Carolina, Utah and Vermont—base their standard deductions on current federal law, which means that if this element of the Bush tax cuts is extended, these states will lose additional revenue from that change—albeit in the name of a sensible, inexpensive tax cut for low-income families.

Earned Income Tax Credit: One of the few provisions in the Bush tax cuts that was designed to benefit low-income families expanded the Earned Income Tax Credit (EITC) for some married couples. The EITC is phased out for families above the poverty line; the 2001 Bush tax cuts increased this phaseout by $3,000. In the twenty four states that allow an EITC based on federal rules, extending this part of the Bush tax cuts would reduce taxes somewhat because it would automatically increase the cost of state EITC's. Of course, this "automatic" tax cut for states would likely be less upsetting than most for state lawmakers given that EITC's are generally recognized as the most effective anti-poverty tax policy measure available to states.

Other Minor Provisions: Federal law allows an income tax credit for working parents who pay for child care expenses. The Bush tax cuts increased the amount of child care expenses eligible for the credit, and also hiked the maximum rate of the credit. A number of states have enacted similar credits based on the value of the federal credit—which means that if the Bush cuts are extended, these states will lose additional tax revenue.
The Bush tax cuts also included minor provisions increasing federal subtractions for student loan interest and education expenses. Since these subtractions reduce federal Adjusted Gross Income (AGI), the many states that use federal AGI as a starting point for their own income taxes will see income taxes shrink if these provisions are extended.

Tax Increases

State tax deduction for federal income taxes: Six states (Alabama, Iowa, Louisiana, Missouri, Montana, and Oregon) allow an unusual income tax break: a deduction for federal income tax payments. This is generally not a great deal for low- and middle-income taxpayers who pay little or no federal income tax, but can be a bonanza for the best-off residents of these states. If the Bush tax cuts are extended, upper-income taxpayers in these states will lave less federal income taxes to deduct, so their state income taxes will increase. Unlike the other provisions discussed in this paper, this feature of state law will result in a noticeable and progressive state income tax hike in these six states.

Options for State Policymakers

Some of the ways in which the Bush tax cuts would affect states actually fit nicely with the objectives of those seeking sensible state tax tax reform. Increasing state EITCs and the standard deduction would reduce income taxes in a targeted, inexpensive way in more than half the states if these elements of the Bush tax cuts are extended. But other elements of the Bush tax cuts, in particular the repeal of limits on itemized deductions and exemptions for the best-off Americans and the repeal of the estate tax—would, if extended, reduce state tax revenues in the name of new tax cuts for the very wealthiest residents of each state. State lawmakers can "decouple" from each of these provisions by enacting their own estate taxes or by creating their own limits on the value of itemized deductions or exemptions.

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