

income tax bracket you're in. A taxpayer in the 10 percent federal tax bracket can write off, at most, 10 percent of the cost of her state income and property taxes. But wealthier taxpayers who pay at the top marginal rate of 35 percent can deduct up to 35 percent of these taxes.

Evaluating State Tax Proposals: Federal Interaction Matters

The federal offset has clear implications for proposals to increase (or cut) state income and property taxes. When state income taxes go up, part of that tax hike will not come out of state residents' wallets at all, but instead will be paid by the federal government in the form of federal tax cuts for itemizers. State income tax cuts have a similar offsetting effect: when state income taxes go down, so does the amount of state income tax that can be written off by itemizers on federal tax forms—and federal income taxes go up as a direct result.

Just how much of a state tax hike will be paid by the federal government depends on two factors: how progressive the state tax hike is, and which type of tax is being increased. Since wealthy taxpayers are most likely to itemize, and pay at higher federal income tax rates, the most effective way to export a state tax hike to the federal government is to focus the tax hike on wealthier taxpayers. Property taxes generally take only a small part of the wealthiest taxpayers' income, so the federal offset from a property tax change will be fairly small. But state income taxes are progressive, requiring wealthier taxpayers to pay more of their income in tax. So the federal offset from an income tax change will be larger—and the more the state income tax change targets the wealthiest taxpayers, the bigger the offset will be.

From the perspective of individual taxpayers, the federal offset makes state income tax hikes a good deal—and state income tax cuts a lousy deal. State lawmakers face the same basic math (even if they don't recognize it). The federal offset gives lawmakers a chance to decide whether tax cuts ought to go to state residents or to the federal government. When lawmakers enact income tax cuts targeted to wealthy taxpayers, they're essentially choosing to send up to 35 percent of the tax cut to Washington, D.C. But when lawmakers enact targeted low-income tax relief, they're targeting all of their surplus tax dollars to state residents.

Sales and Excise Taxes Are Generally Not Deductible

Unlike income and property taxes, sales and excise taxes are generally not deductible on federal tax forms. Sales taxes used to be deductible, but have not been since the passage of the 1986 Tax Reform Act, in part because it was very difficult for people to keep track of what they actually paid in sales taxes. Temporary federal legislation allows an optional itemized deduction for sales taxes in lieu of income taxes—this optional deduction is available only available through 2009, and will be used almost entirely by residents of the few states that do not currently levy state income taxes.

Because these taxes generally can't be written off on federal tax forms, every dollar of sales tax that is paid initially by state residents ultimately comes out of their pockets—and every dollar of a sales tax cut that goes to state residents remains in their pockets. In this sense, income and property taxes are effectively less costly to state residents than are sales and excise taxes—an important point to remember as lawmakers decide which taxes to increase or cut.

Federal Deductibility—A Neglected, but Important Tool

Lawmakers who cut state income taxes give away billions of dollars of state tax revenue to the federal government, rather than to their constituents. And lawmakers hiking sales and excise taxes are imposing huge tax hikes on low- and middle-income taxpayers, with little or no offsetting federal tax relief. Greater awareness of the federal offset can help state policymakers to prevent mistakes in the future by better targeting tax relief to their own constituents.

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To find out more about this issue, contact ITEP at (202) 299-1066