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Wisconsin Can Help Balance Its Budget By Reforming Itemized Deductions

In 2010, thirty one states and the District of Columbia allow a group of income tax breaks known as "itemized deductions." Itemized deductions are designed to help defray a wide variety of personal expenditures that affect a taxpayer's ability to pay taxes, including charitable contributions, extraordinary medical expenses, mortgage interest payments and state and local taxes. These deductions cost states billions of dollars a year while providing little or no benefit to the middle- and low-income families hit hardest by the current economic downturn.

This issue brief summarizes findings from ITEP's new report: *"Writing Off" Tax Giveaways: How States Can Help Balance Their Budgets by Reforming or Repealing Itemized Deductions* and presents estimates of the yield and tax fairness impact of five different approaches to itemized deduction reform in Wisconsin, each of which could raise significant revenue to fund vital public services. [1]

Option 1: Repealing Itemized Deductions Entirely

The most aggressive reform approach available to states is simply to repeal all itemized deductions and ensure that most middle- and low-income families are held harmless by simultaneously increasing the basic standard deduction available to all families, a step taken this year by the Rhode Island legislature. In Wisconsin **49 percent** of the state's taxpayers would receive a tax cut from the proposed reform, yet it still would raise an estimated **$242 million** a year. This option was designed to yield a state income tax increase of about **4 percent.**

	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Average Income in Group	$ 13,000	$ 27,000	$ 44,000	$ 67,000	$ 104,000	$ 204,000	$ 989,000
Tax Change as % Income	–0.0%	–0.1%	–0.1%	0.0%	0.3%	0.4%	0.2%
Average Tax Change	–4	–28	–32	+3	+276	+784	+2,176

% SD Increase=	12%

Option 2: Capping the Total Value of Itemized Deductions

Itemized deductions typically have no caps—so the well-off taxpayers who have the largest mortgages, for example, are able to use these deductions to an extent that is unavailable to lower- and middle-income taxpayers. Wisconsin could pare back deductions for the best-off taxpayers by limiting the total amount of itemized deductions of all kinds that can be claimed. This option shows the impact of capping itemized deductions at $40,000 for married couples ($20,000 for singles) in 2010. Enacting option 2 in Wisconsin would raise state income tax revenue by approximately **0.7 percent ($43 million)** and would impact **1 percent** of the state's taxpayers.

	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Tax Change as % Income	—	—	—	0.0%	0.0%	0.0%	0.1%
Average Tax Change	—	—	—	+2	+14	+83	+898

[1] Wisconsin's current credit structure was applied to options 1, 2, 4, & 5.

Option 3: Converting Itemized Deductions to Credits

Wisconsin itemizers currently convert federal itemized deductions into a credit equal to 5% of the taxpayer's allowable itemized deductions minus their Wisconsin standard deduction amount (sliding scale based on filing status and Wisconsin total income).

Option 4: Enacting Stand-Alone Phaseouts

States seeking to phase out itemized deductions for the best-off taxpayers can also choose to set their own income limits and phaseout rules in lieu of the constantly evolving federal rules. Option 4 in this report shows the impact of a reform that would create a disallowance of the deductions starting at $150,000 of federal AGI for married couples ($75,000 for single taxpayers), and would reduce the total amount of itemized deductions by 5 cents for each dollar of AGI over these thresholds. Option 4 would completely disallow most itemized deductions for the best-off taxpayers. Enacting option 4 in Wisconsin would raise state income tax revenue by approximately **0.7 percent ($45 million)** and would impact **5 percent** of the state's taxpayers.

	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Tax Change as % Income	—	—	—	—	0.0%	0.0%	0.1%
Average Tax Change	—	—	—	—	+2	+75	+1,237

Option 5: Decoupling from Federal Pease Repeal

The most straightforward (and lowest-yield) step available to state lawmakers seeking to make their itemized deductions less unfair is to "decouple" from the federal tax change that gradually repealed the Pease provision which put limits on the amount of itemized deductions that could be claimed. This could be done by enacting a law specifying that the state's itemized deduction phaseout will follow federal law as of January 1, 2001—before the Bush tax cuts were enacted. Of course, if Congress enacts a tax change that brings back the full Pease provision as it existed before 2005, most states will realize the full yield of this option without having to enact anything. Enacting option 5 in Wisconsin would raise state income tax revenue by approximately **0.4 percent ($26 million)** and would impact **3 percent** of the state's taxpayers.

	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Tax Change as % Income	—	—	—	—	—	0.0%	0.1%
Average Tax Change	—	—	—	—	—	+29	+790

Conclusion

Itemized deductions are costly, inequitable, and ineffective, depriving Wisconsin millions of dollars in needed funds and making state income taxes less fair. In the current fiscal and economic climate, Wisconsin policymakers cannot afford to maintain these tax breaks in their current form. Reforming itemized deductions is a sensible strategy for raising revenue and improving tax fairness by allowing policymakers to fund vital public services without placing additional responsibilities on those individuals and families hit hardest by the current tax system.

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