

# Leaving Money on the Table

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Across the nation, state governments are coping with huge fiscal challenges in 2010, and face the prospect of increasing taxes on already-hurting middle- and low-income families. In most states, lawmakers seeking to balance budgets in a fair way can increase income taxes on upper-income families—but in the small minority of states that do not currently levy broad-based income taxes, this is not an option.

Seven states—Florida, Nevada, South Dakota, Tennessee, Texas, Washington and Wyoming—have chosen to make up for the lack of an income tax by increasing their reliance on general sales taxes.<sup>1</sup> The result is an “upside down” state tax system, which imposes higher effective tax rates on middle- and low-income families than on the best-off taxpayers. But this policy choice also has an important, often-overlooked, impact on the federal taxes paid by residents of these seven states. Uniquely among the major state taxes, the income tax can be substantially “exported” to the federal government due to a federal tax break allowing federal itemizers a deduction for their state and local taxes.

This federal tax rule amounts to a matching grant from the federal government to states. But the few states without income taxes get much less “bang for the buck” out of this matching grant than do the more typical states that levy the tax. For states facing difficult budgetary choices in 2010 and beyond, this creates an opportunity for states without income taxes that is not as available to lawmakers in the rest of the nation: these states could actually provide needed tax cuts for the fixed-income families hurt hardest by the current

downturn without reducing state tax collections by a dime, by shifting away from their current reliance on sales taxes towards the personal income tax.<sup>2</sup>

This report shows how the interaction between state and federal taxes creates a clear incentive for states to rely on the progressive income tax—an incentive that these seven states have unaccountably ignored for decades—and estimates the potential benefit to middle- and low-income taxpayers from shifting toward the progressive income tax.

## Sources of State and Local Tax Revenue

Nationwide, the most important source of state/local tax revenue in fiscal year 2007 was the property tax, which represented 30 percent of state and local taxes combined. On average, the sales tax and the income tax were effectively tied for second place, each representing around 23 percent of state/local tax revenue. The tendency to rely roughly equally on these three sources is known as the “three-legged stool” approach to taxation.

However, some states depart notably from this general tendency. Five states (Alaska, Delaware, Montana, New Hampshire, and Oregon) do not levy state sales taxes at all. Three of these states make up for this by levying above-average income taxes, while Alaska and New Hampshire make up for the lack of a sales tax with higher taxes on natural resources and property taxes, respectively. In addition, nine states (Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington and Wyoming) do not levy a personal income tax. These states generally rely

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<sup>1</sup> Two other states, Alaska and New Hampshire, have neither income nor sales taxes at the state level.

<sup>2</sup> In several of these states, the state constitution would have to be revised, either to allow the imposition of an income tax (Florida, Nevada, Wyoming) or to allow income tax revenues to be used for sales tax reduction (Texas).

much more heavily than the average state on sales taxes. For example, Washington State derives almost half of its state and local tax revenue from the sales tax.

### **A Short History of Federal Deductions for State Taxes**

Since the modern federal income tax was enacted in 1913, the law has always allowed taxpayers who itemize their deductions to deduct the value of certain state and local taxes. Forty years ago, itemizers could write off any of the three major taxes levied by state and local governments—income, sales, and property taxes—as well as state gasoline taxes (the gas tax deduction was eliminated in 1978). This meant that when states levied these taxes, part of the cost would be directly picked up by the federal government: states got all of the revenue, but state residents only picked up part of the tab.

The 1986 Tax Reform Act eliminated the sales tax deduction, but left the income and property tax deductions largely unchanged. This meant that in the wake of the 1986 Act, the federal government was, in effect, operating a “matching grant” for states that levied income taxes, which was unavailable to those few states not levying an income tax. This gave state lawmakers a clear incentive to increase their reliance on progressive state income taxes, and to pare back sales taxes.

The 2004 American Jobs Creation Act temporarily restored the itemized deduction for state and local sales taxes, with one important condition: itemizers have to choose between claiming the sales tax deduction or the income tax deduction. Since the 2004 legislation, the sales tax deduction has been temporarily extended several times. The deduction expired on January 1, 2010, although it is considered likely that Congress will act in 2010 to extend the deduction through the end of the year.

### **Who Benefits from Itemized Tax Deductions?**

One basic criticism that can be applied to all itemized deductions is that they amount to “upside down” tax subsidies, giving the largest benefits to the wealthiest taxpayers. This criticism can be applied equally to deductions for state taxes, charitable contributions, mortgage interest, and other minor deductions. This upside down tendency in itemized deductions is the product of two features of income tax filing:

▶▶ **Most lower- and middle-income families don’t itemize.** These families are far more likely to take the basic standard deduction (currently \$5,700 for singles and \$11,400 for married couples), because the combined value of the available itemized deductions is less than this basic standard deduction amount. Better-off Americans are far more likely to itemize their federal income taxes, because they incur more of the expenses (including charitable contributions, mortgage interest, and state taxes) that are eligible for itemization.

▶▶ **The benefit you get from itemized deductions depends directly on how high your top marginal rate is.** If you’re one of the many middle-income taxpayers whose top income tax rate is 15 percent, then the biggest benefit you can hope for from (for example) claiming a deduction for a \$100 charitable contribution is 15 percent of that \$100, or \$15. By contrast, if you’re an upper-income taxpayer who pays at least some tax at the 35 percent top rate, the same \$100 charitable contribution can knock \$35 off of your taxes (35 percent of \$100). More generally, this means that itemized deductions have much bigger “bang for the buck” for the very-wealthy taxpayers who pay at the top tax rates.

This upside-down subsidy works in pretty much the same way for all itemized deductions—including the deduction for state and local taxes. Taxpayers at any income level can claim the deduction if they itemize, but the

resulting federal tax cut will be biggest for the upper-income families who pay the higher federal income tax rates.

This is an important reason why the sales tax consistently offers less “bang for the buck” than does the income tax for itemizers: the upper-income families who are most likely to itemize generally pay a lot more income taxes than sales taxes, so they will generally choose to claim the income tax deduction.

People who claim the sales tax deduction generally do so because they live in a state that has no income tax to deduct: in 2007, more than half of all sales tax deductions were taken by residents of the seven states discussed in this report. If any of these states had an income tax, most of the taxpayers currently claiming the sales tax deduction would immediately find that the income tax deduction was a much better deal. This can be seen by looking at the distribution of benefits from each deduction in the 42 states that currently have both a sales tax and an income tax:

- ▶▶ In 2007, taxpayers in these states with Adjusted Gross Income (AGI) over \$100,000 who took the income tax deduction enjoyed an average deduction of \$15,295.
- ▶▶ Taxpayers in the same income group who took the sales tax deduction saw an average deduction of \$4,468—almost four times smaller than the average income tax deduction.
- ▶▶ This gap is even bigger for residents of these 42 states earning over \$200,000 a year: sales tax claimants in this group claimed an average of \$9,202, while income tax claimants got a deduction averaging more than four times bigger: \$38,698 per return.

This should not be a surprising result: state income taxes are, in general, progressive—the more you earn, the more of your income you pay in tax. But state sales taxes are exactly the opposite—the more you earn, the less of your

income you pay in tax. The upper-income taxpayers for whom itemized deductions are most important simply won’t claim the sales tax deduction, in general, unless they have no other choice. And the lower-income families for whom sales taxes are most burdensome generally aren’t rich enough to itemize at all.

Put another way, when states choose to rely heavily on sales taxes, they are raising their tax revenue primarily from low-income families who aren’t likely to itemize, and who almost certainly pay at very low federal income tax rates. And when states choose to rely heavily on income taxes, they’re relying more heavily on upper-income families who frequently itemize and pay at higher rates—and therefore get much more “bang for the buck” from itemized deductions for state taxes.

### **Designing a Tax Shift to Take Advantage of the “Federal Offset”**

This section estimates the impact on state taxpayers of a revenue-neutral (that is, leaving total state and local tax collections unchanged) “tax swap” from sales taxes to income taxes in the seven states that currently lack a broad-based income tax and rely heavily on sales taxes. The analysis shows the impact of two “standard” income taxes on such a shift, including a flat-rate tax with small exemptions and a graduated-rate tax with larger exemptions and deductions. This dual approach is taken because in some of these states, a flat-rate income tax may be the only legally (or politically) attainable approach to income taxation, but also to demonstrate the additional leverage against federal taxes that can be obtained from imposing a graduated rate structure.

The table on the next page shows the estimated federal income tax change from enacting each of these “tax swaps” at 2009 income levels. The table shows that enacting a flat-rate income tax of 3 percent, with generous exemptions and a stand-

## Federal Tax Cut (in \$Thousands) from Revenue-Neutral Tax Swap: Enact Income Tax, Cut Sales Tax

State	Flat Tax	Graduated-Rate Tax
Florida	(505,000)	(1,807,000)
Nevada	(64,000)	(281,000)
South Dakota	(11,000)	(43,000)
Tennessee	(82,000)	(338,000)
Texas	(897,000)	(2,362,000)
Washington	(164,000)	(652,000)
Wyoming	(14,000)	(57,000)
<b>Seven-State Total</b>	<b>(1,737,000)</b>	<b>(5,540,000)</b>

ard deduction based on federal rules, and using the added state revenue to reduce sales taxes “across the board” would reduce the combined federal income taxes paid by residents of these seven states by \$1.7 billion a year. Implementing the more typical progressive graduated-rate income tax (with rates ranging from 4.5%-6.5%) in a revenue-neutral way would actually cut residents’ federal income tax payments by \$5.5 billion in these states.<sup>3</sup>

### Other Arguments for the Personal Income Tax

This paper has drawn attention to an important, yet underappreciated argument for making the personal income tax a central part of state tax systems. But if the “federal offset” has gone almost unnoticed in most policy discussions of how best to balance state budgets, it’s largely because there are more compelling reasons to rely on the progressive income tax:

► **Fairness.** Among the three main taxes levied by state and local governments (income, sales and property taxes), both the sales and property taxes inherently fall most heavily on low- and middle-income families. Only the income tax can easily be designed to provide at least a modicum

of sensibility and fairness to an otherwise-upside-down tax system.

► **Sustainability.** Neither property taxes nor sales taxes tend to grow at a pace that keeps up with the cost of the public investments they are meant to pay for. Only the personal income tax grows in a way that can allow lawmakers to adequately fund public investments without frequently changing tax rates.

► **Simplicity.** The income tax is simple to administer. Almost all states levying an income tax take the time-saving step of conforming their income definitions to federal rules, which means that states can piggyback on federal efforts to enforce income tax collection.

### Conclusion

At a time when state lawmakers face wrenching budget decisions at every step, the choice by states without income taxes to rely more heavily on sales taxes for revenue amounts to leaving money on the table in the fiscal tug of war between state and federal governments. Federal itemized deductions for state income and sales taxes amount to a revenue-sharing agreement between Washington and the states—but an agreement that reserves the most favorable

<sup>3</sup> These estimates take into account the impact of the federal Alternative Minimum Tax, which in some cases can reduce or eliminate the benefit of itemized deductions for federal income taxes. If not for the AMT, the “bang for the buck” from these itemized deductions would be even higher in some cases.

terms for states relying on progressive income taxes.

This paper has shown that the seven states that currently are most flagrantly ignoring the benefits of this important source of tax fairness could use this revenue-sharing agreement to provide valu-

able tax cuts to many state residents without depleting state coffers by a dime. Or, alternatively, states could raise substantial amounts of new revenue without imposing a dime of additional taxes on most state residents, by shifting their tax system away from regressive sales taxes and toward the progressive personal income tax.

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**The Institute on Taxation and Economic Policy** is a non-profit, non-partisan research and education organization that works on government taxation and spending policy issues.

**United for a Fair Economy** is a national, non-profit, non-partisan organization that helps people of all races, ethnicities and classes work to reduce economic inequality. The **Tax Fairness Organizing Collaborative**, a project of UFE, is a network of statewide grassroots organizations in 24 states edu-

# **Appendix**

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## **Tax Fairness Impact of Revenue-Neutral Income-for-Sales Tax Swap: Combined State/ Federal Tax Change as % of Income From Two Approaches, 2009 Income Levels**

**Impact of Two Revenue-Neutral “Tax Swaps” on Tax Incidence in 2009 in the Following States:**

- 1. Florida**
- 2. Nevada**
- 3. South Dakota**
- 4. Tennessee**
- 5. Texas**
- 6. Washington**
- 7. Wyoming**

## Tax Fairness Impact of Revenue-Neutral Income-for-Sales Tax Swap: Combined State/Federal Tax Change as % of Income From Two Approaches, 2009 Income Levels

### Option 1: Flat-Rate 3% Income Tax, Federal Exemptions and Standard Deductions

State	Low 20%	2nd 20	Mid 20	4th 20	Nxt 15	Nxt 4	Top 1
Florida	-3.1%	-2.1%	-1.2%	-0.2%	0.7%	1.4%	1.8%
Nevada	-1.5%	-0.5%	0.0%	0.5%	1.2%	1.6%	1.9%
South Dakota	-3.1%	-2.0%	-1.2%	-0.2%	0.5%	1.1%	1.8%
Tennessee	-2.7%	-2.2%	-1.2%	-0.4%	0.6%	1.3%	1.8%
Texas	-3.0%	-2.2%	-1.1%	-0.1%	0.8%	1.4%	1.8%
Washington	-3.3%	-1.9%	-0.9%	0.0%	0.7%	1.2%	1.7%
Wyoming	-2.4%	-1.2%	-0.5%	0.3%	0.9%	1.4%	2.0%

### Option 2: Graduated-Rate Income Tax, Top Rate 6.5%, 25% Earned Income Tax Credit

State	Low 20%	2nd 20	Mid 20	4th 20	Nxt 15	Nxt 4	Top 1
Florida	-7.6%	-4.8%	-2.6%	-0.6%	1.1%	2.8%	4.0%
Nevada	-4.4%	-1.7%	-0.4%	0.6%	2.1%	3.3%	4.3%
South Dakota	-6.2%	-4.1%	-2.5%	-0.5%	0.8%	2.3%	3.9%
Tennessee	-6.5%	-5.0%	-2.4%	-0.7%	0.9%	2.7%	4.0%
Texas	-7.7%	-5.1%	-2.4%	-0.4%	1.4%	2.9%	4.0%
Washington	-7.1%	-4.0%	-1.9%	-0.3%	1.1%	2.6%	3.8%
Wyoming	-5.7%	-2.8%	-1.2%	0.3%	1.4%	2.9%	4.3%

### Net (Post-Federal Offset) State/Local Tax Incidence, Current Law

State	Low 20%	2nd 20	Mid 20	4th 20	Nxt 15	Nxt 4	Top 1
Florida	13.5%	10.4%	9.0%	7.2%	5.7%	4.2%	2.1%
Nevada	8.9%	7.0%	6.4%	5.7%	4.5%	3.2%	1.6%
South Dakota	11.0%	9.3%	7.8%	7.1%	5.5%	4.0%	1.9%
Tennessee	11.7%	10.8%	9.3%	7.2%	5.8%	4.2%	3.1%
Texas	12.2%	10.2%	8.4%	7.2%	5.8%	4.4%	3.0%
Washington	17.3%	12.7%	10.8%	8.8%	6.7%	4.7%	2.6%
Wyoming	8.3%	6.9%	6.1%	4.8%	4.0%	2.8%	1.5%

### Net (Post-Federal Offset) State/Local Tax Incidence, After Implementing Option 1

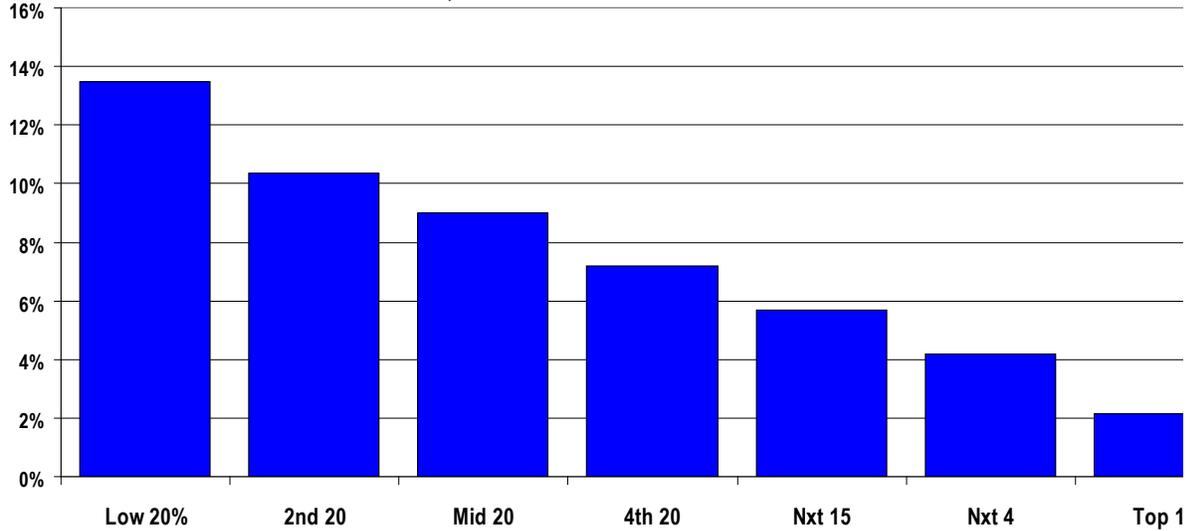
State	Low 20%	2nd 20	Mid 20	4th 20	Nxt 15	Nxt 4	Top 1
Florida	10.4%	8.2%	7.8%	6.9%	6.4%	5.5%	3.9%
Nevada	7.3%	6.5%	6.4%	6.1%	5.7%	4.9%	3.6%
South Dakota	8.0%	7.3%	6.6%	6.9%	6.0%	5.1%	3.7%
Tennessee	9.0%	8.6%	8.1%	6.8%	6.4%	5.5%	4.9%
Texas	9.2%	8.0%	7.2%	7.0%	6.6%	5.7%	4.8%
Washington	14.0%	10.8%	10.0%	8.8%	7.3%	5.9%	4.3%
Wyoming	5.9%	5.6%	5.6%	5.1%	4.9%	4.2%	3.4%

### Net (Post-Federal Offset) State/Local Tax Incidence, After Implementing Option 2

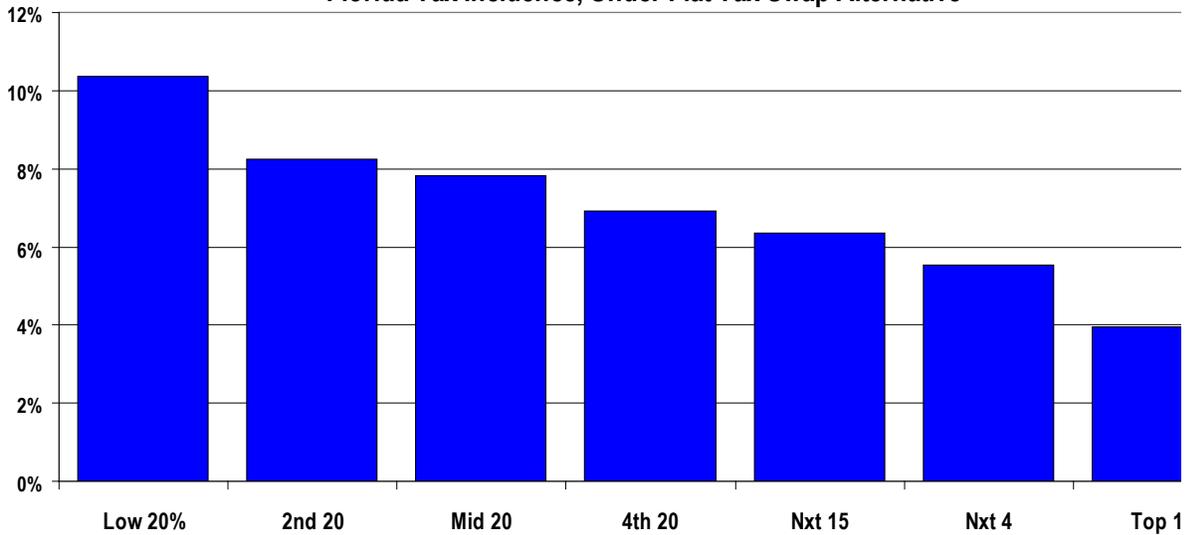
State	Low 20%	2nd 20	Mid 20	4th 20	Nxt 15	Nxt 4	Top 1
Florida	5.9%	5.5%	6.4%	6.5%	6.8%	7.0%	6.1%
Nevada	4.5%	5.2%	5.9%	6.3%	6.5%	6.5%	5.9%
South Dakota	4.9%	5.2%	5.3%	6.6%	6.3%	6.3%	5.8%
Tennessee	5.2%	5.8%	6.9%	6.5%	6.8%	6.9%	7.1%
Texas	4.5%	5.1%	6.0%	6.8%	7.1%	7.3%	7.0%
Washington	10.1%	8.7%	9.0%	8.5%	7.8%	7.3%	6.4%
Wyoming	2.6%	4.0%	4.9%	5.1%	5.4%	5.6%	5.7%

# Impact of Two Revenue-Neutral "Tax Swaps" on Florida Tax Incidence in 2009

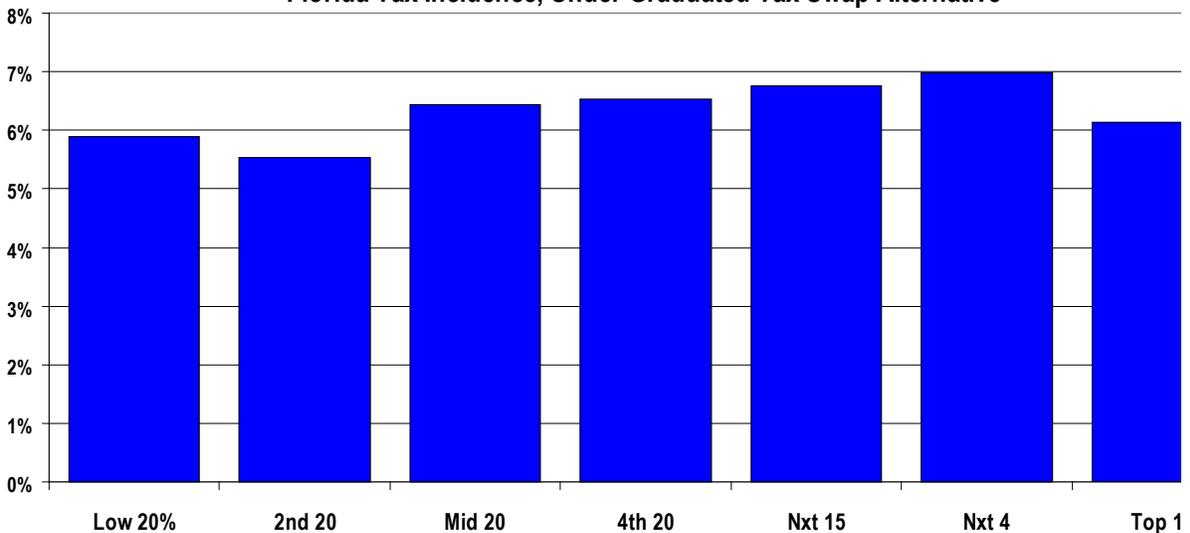
## Florida Tax Incidence, Current Law: State/Local Taxes as % of Income in 2009



## Florida Tax Incidence, Under Flat Tax Swap Alternative

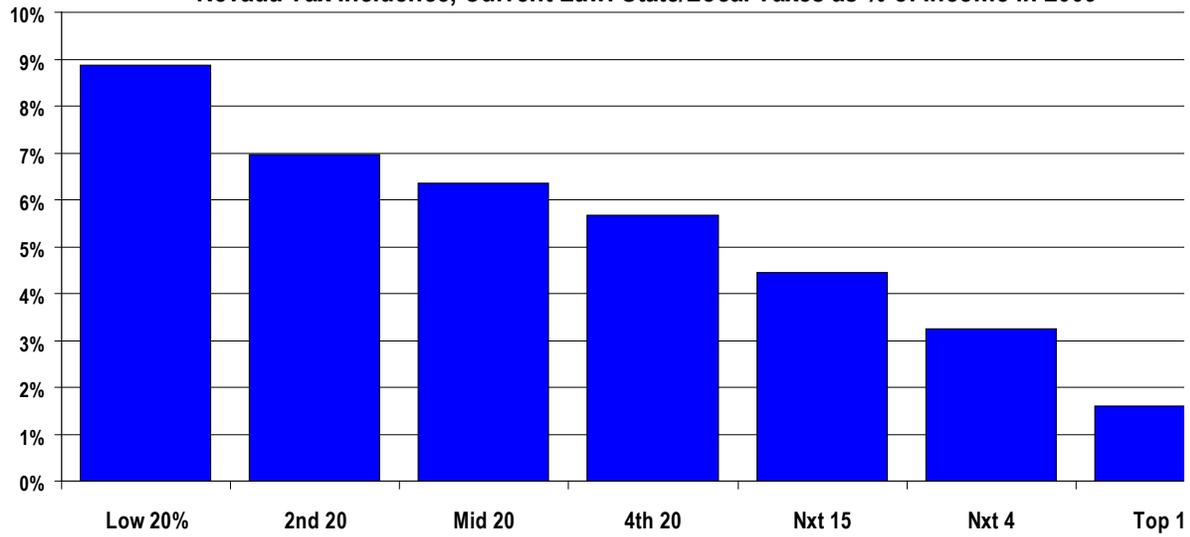


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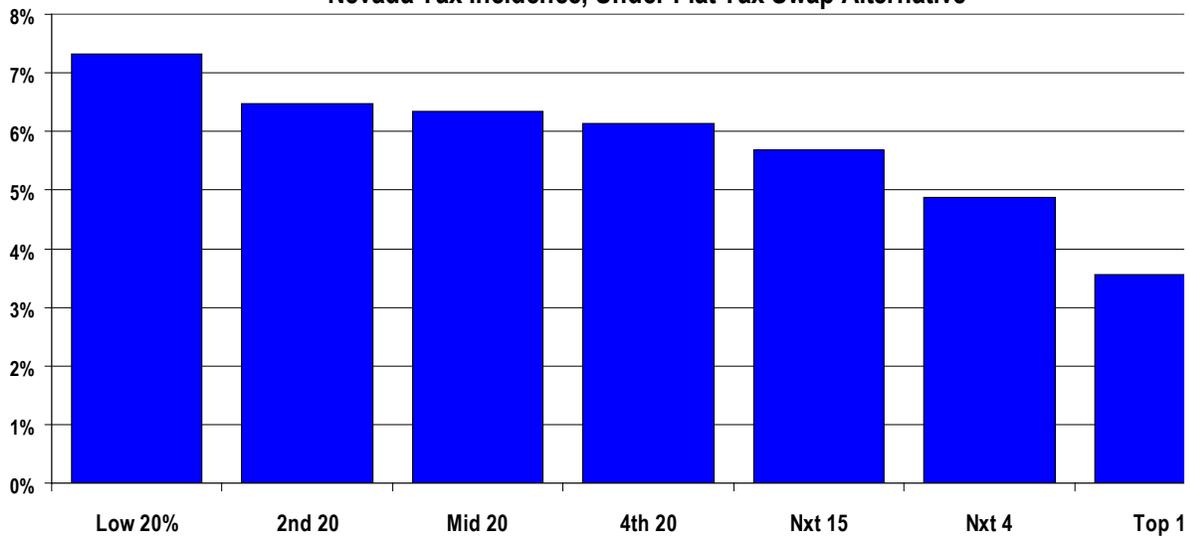


# Impact of Two Revenue-Neutral "Tax Swaps" on Nevada Tax Incidence in 2009

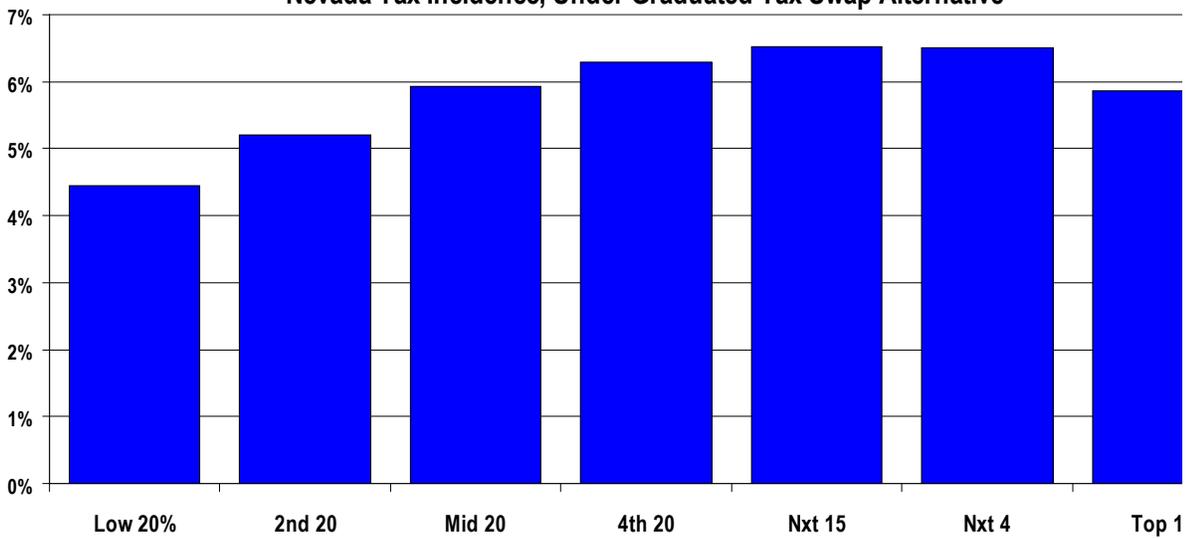
## Nevada Tax Incidence, Current Law: State/Local Taxes as % of Income in 2009



## Nevada Tax Incidence, Under Flat Tax Swap Alternative

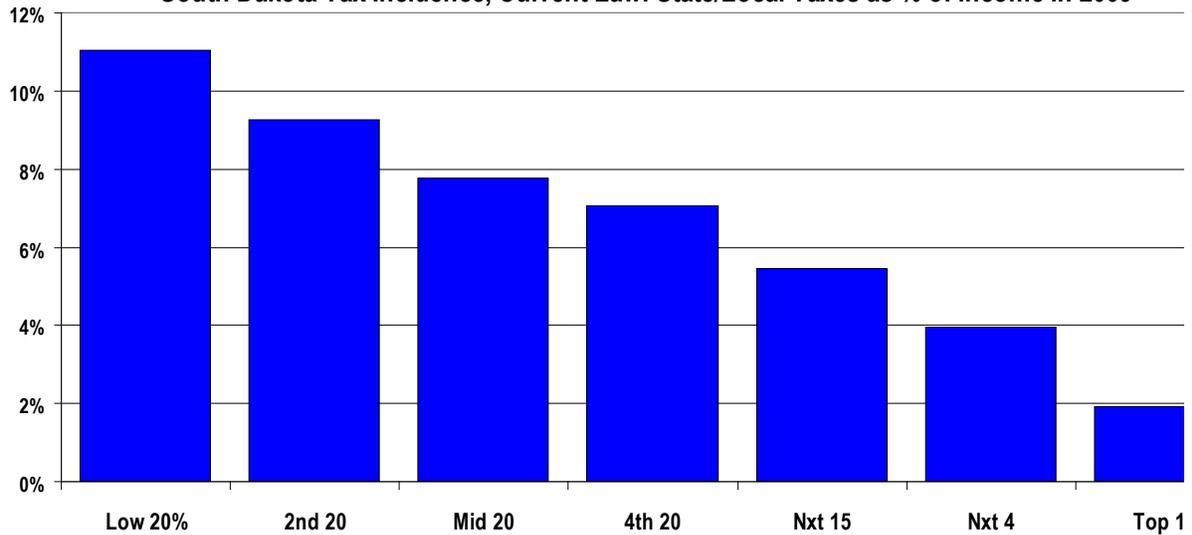


## Nevada Tax Incidence, Under Graduated Tax Swap Alternative

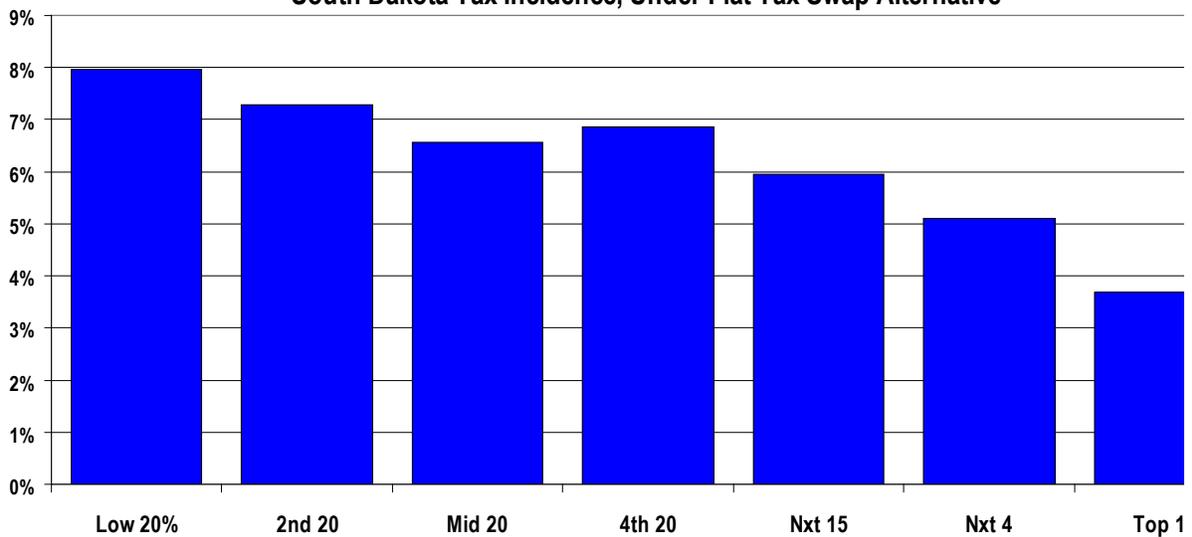


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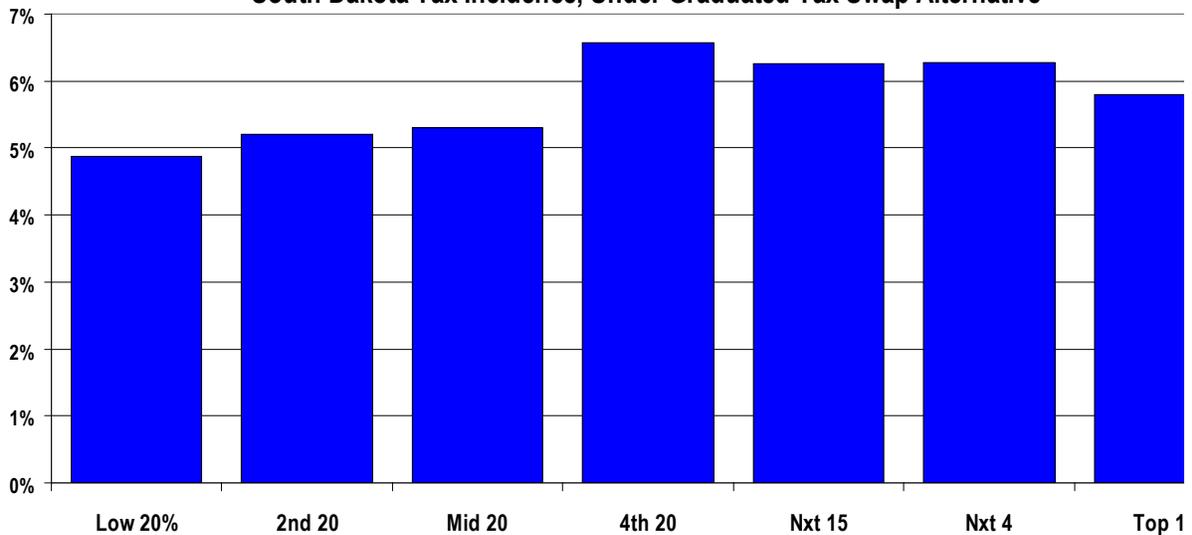
### South Dakota Tax Incidence, Current Law: State/Local Taxes as % of Income in 2009



### South Dakota Tax Incidence, Under Flat Tax Swap Alternative

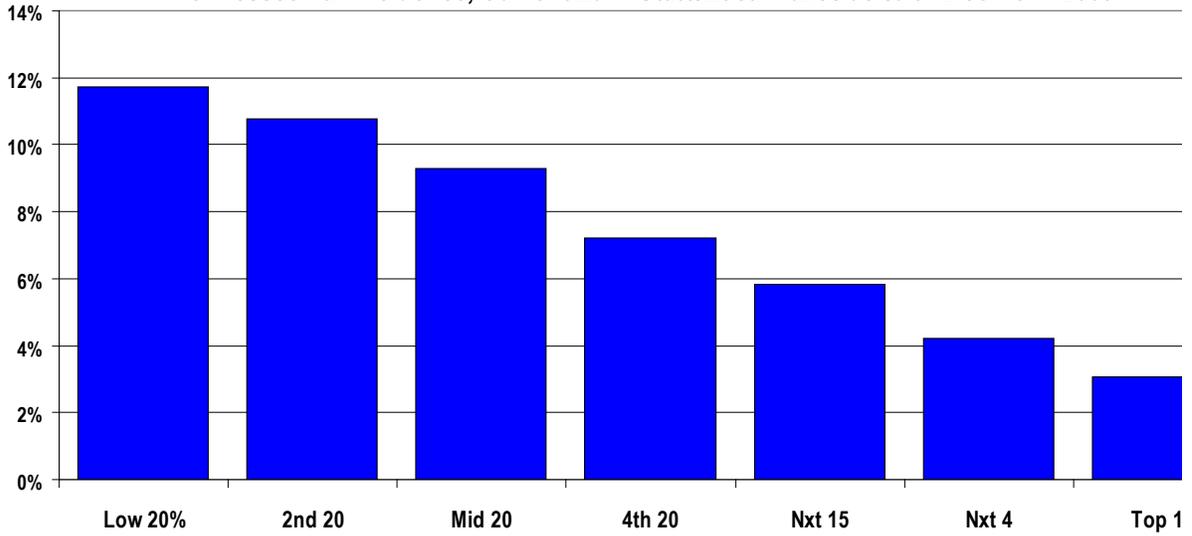


### South Dakota Tax Incidence, Under Graduated Tax Swap Alternative

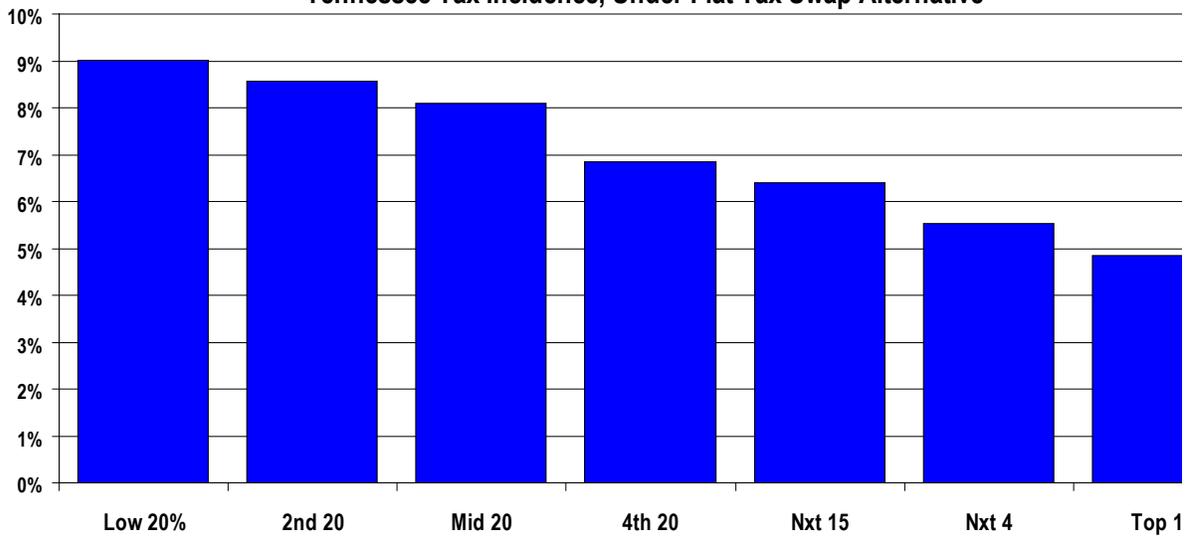


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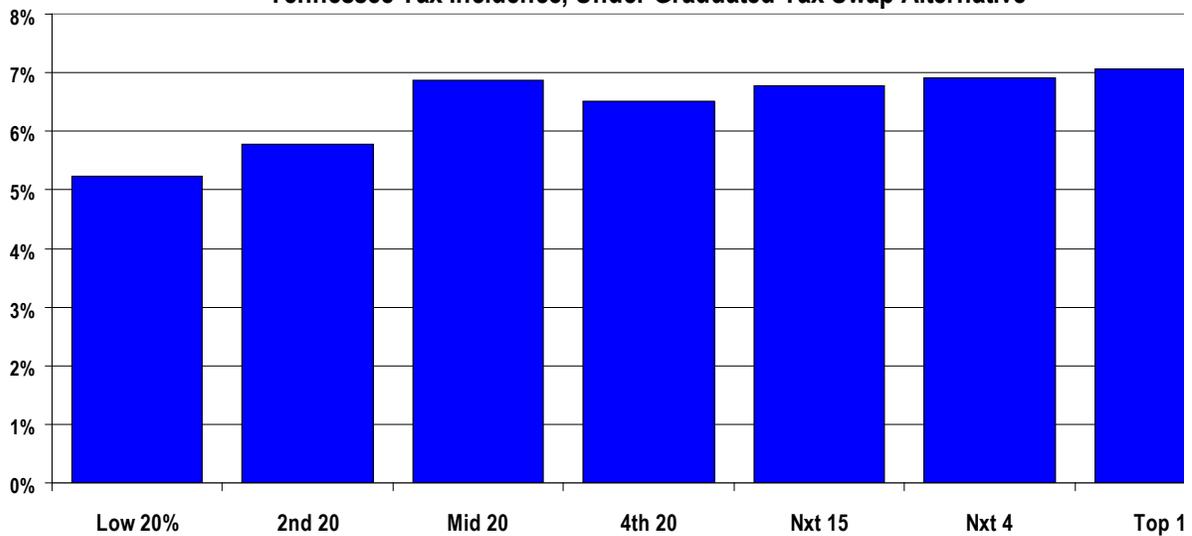
## Tennessee Tax Incidence, Current Law: State/Local Taxes as % of Income in 2009



## Tennessee Tax Incidence, Under Flat Tax Swap Alternative

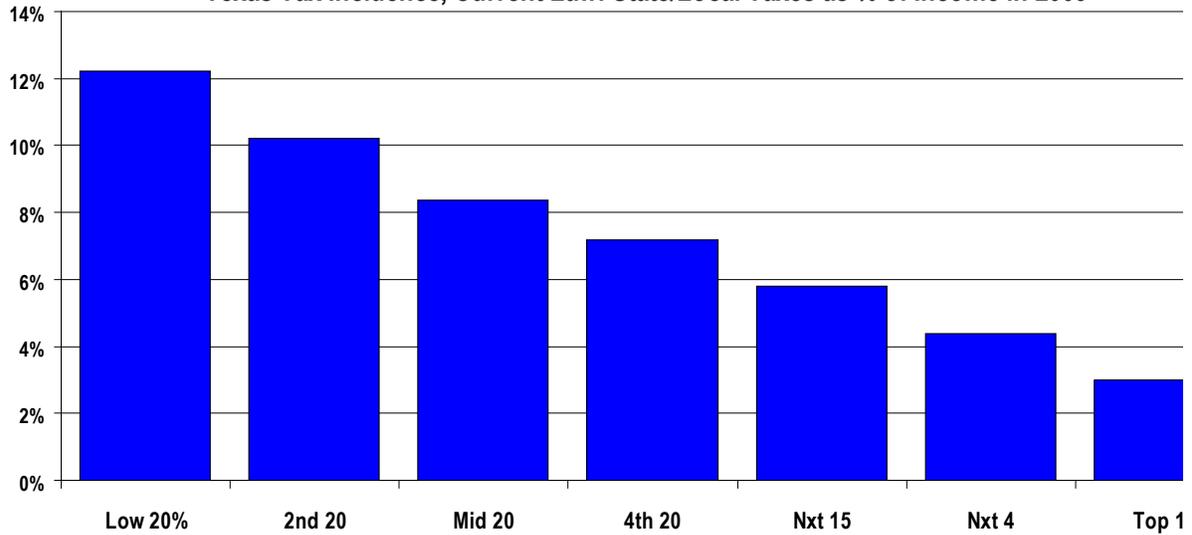


## Tennessee Tax Incidence, Under Graduated Tax Swap Alternative

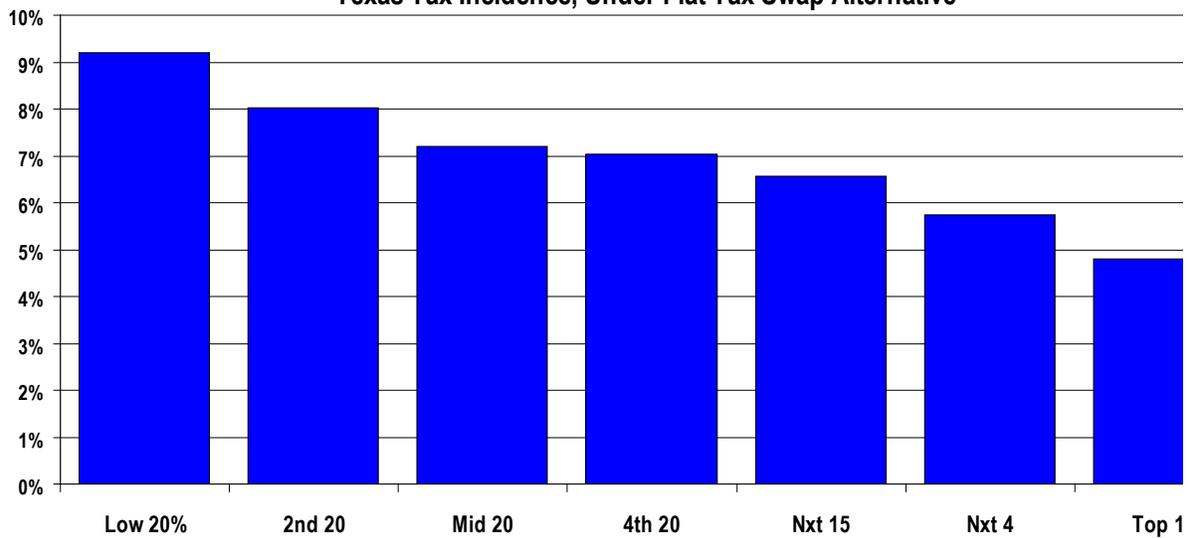


# Impact of Two Revenue-Neutral "Tax Swaps" on Texas Tax Incidence in 2009

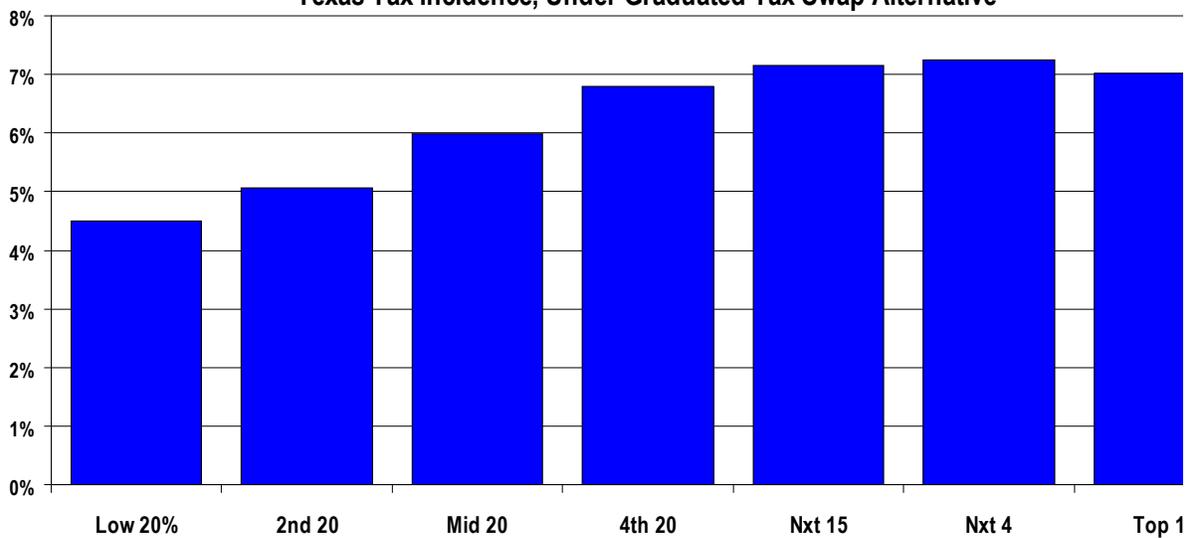
## Texas Tax Incidence, Current Law: State/Local Taxes as % of Income in 2009



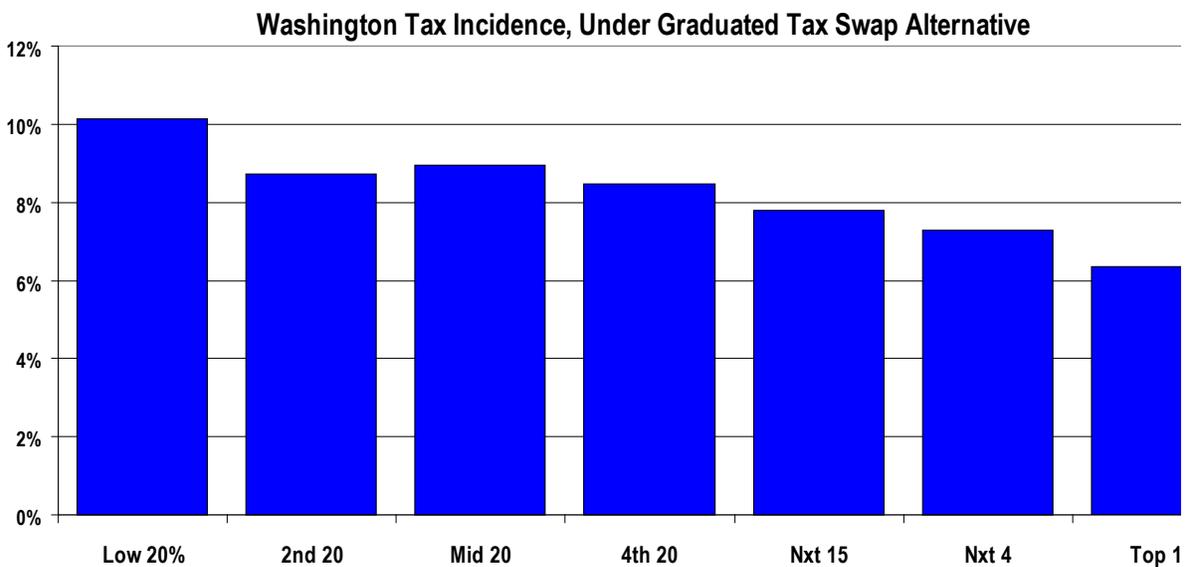
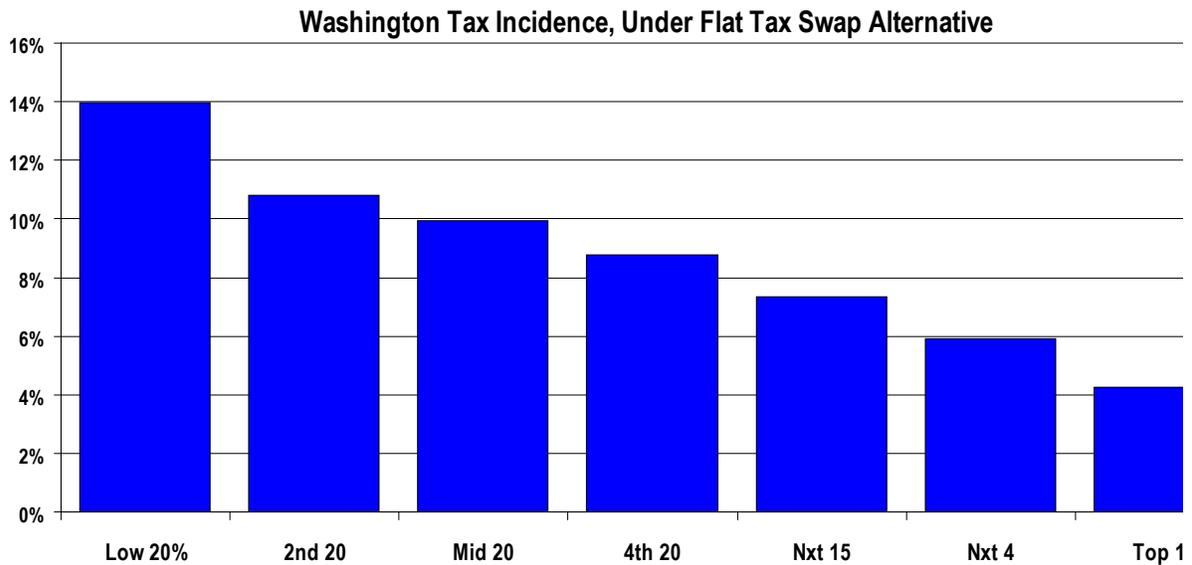
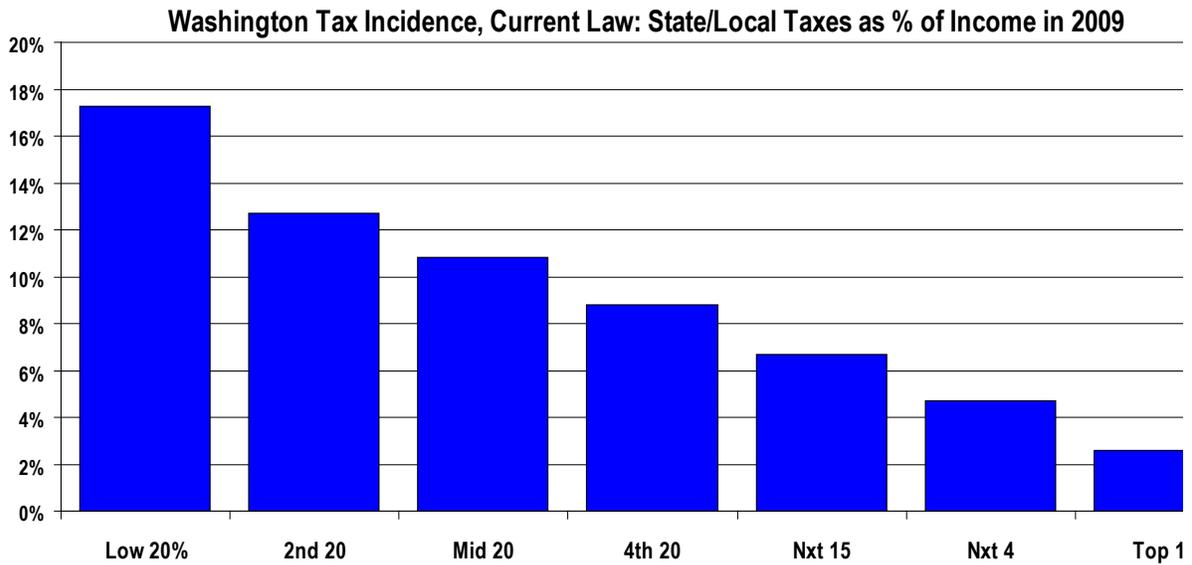
## Texas Tax Incidence, Under Flat Tax Swap Alternative



## Texas Tax Incidence, Under Graduated Tax Swap Alternative

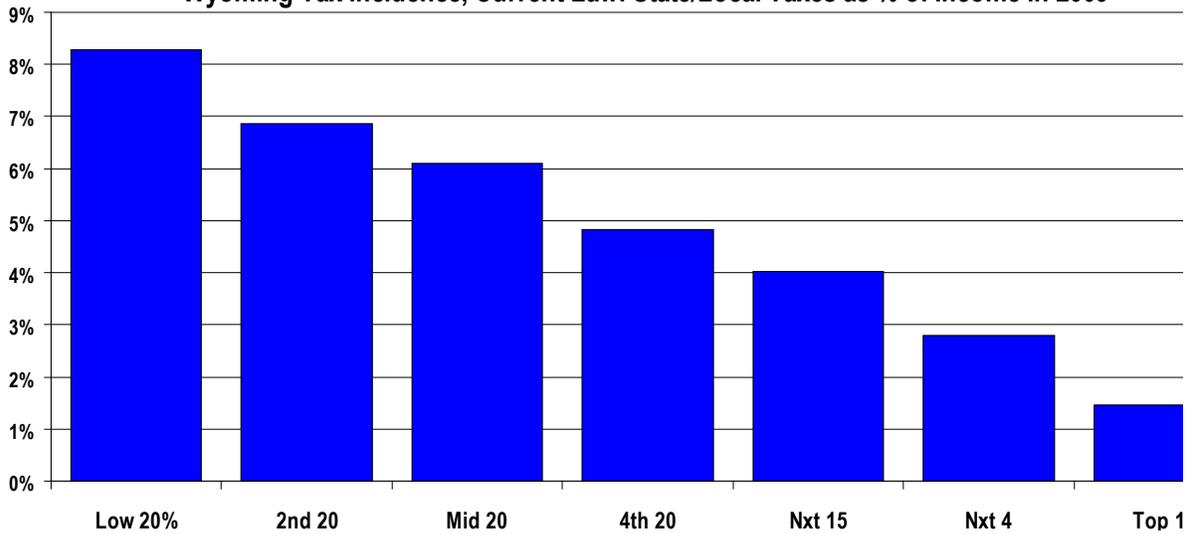


## Impact of Two Revenue-Neutral "Tax Swaps" on Washington Tax Incidence in 2009

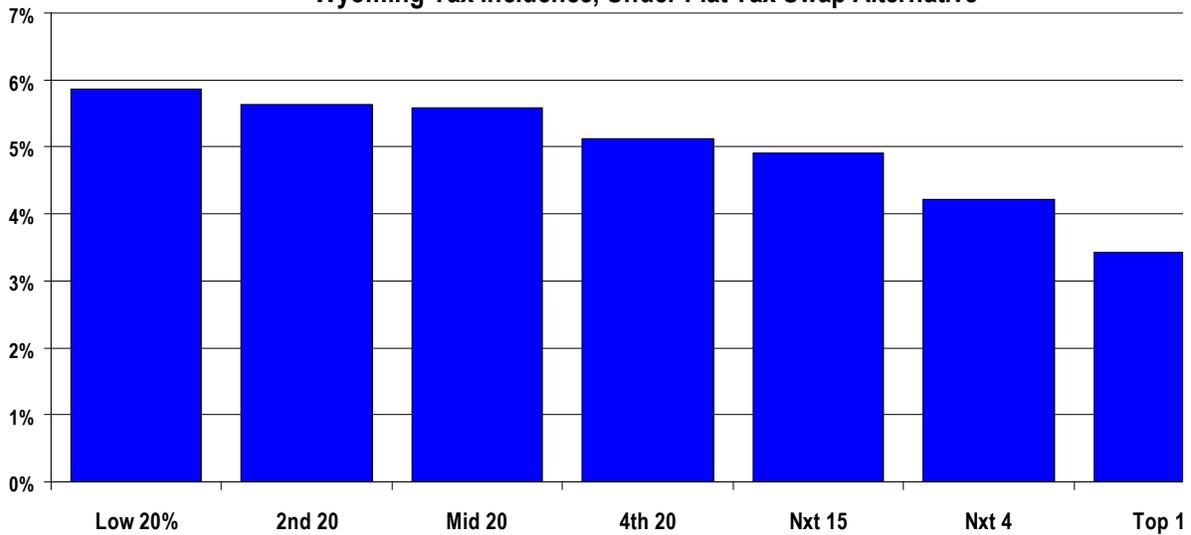


## Impact of Two Revenue-Neutral “Tax Swaps” on Wyoming Tax Incidence in 2009

### Wyoming Tax Incidence, Current Law: State/Local Taxes as % of Income in 2009



### Wyoming Tax Incidence, Under Flat Tax Swap Alternative



### Wyoming Tax Incidence, Under Graduated Tax Swap Alternative

