The Revenue Effects of Conformity to Federal Personal Income Tax Expenditures

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Outline

- Background
- Simulation and findings
- Why it matters
The 1986 Experience

• Tax Reform Act of 1986
  • Broadened the base (repealed/limited certain deductions)
  • Increased standard deduction and personal exemptions
  • Expanded EITC
  • Reduced rates
The 1986 Experience

• States:
  • $5 billion projected revenue increase (~7% of PIT revenue)
  • States mostly adopted the base changes. But what to do with the revenue?
    - Increase standard deductions/personal exemptions
    - Reduce rates
    - Keep some
Goals

- A measure of how connected states are to federal tax expenditures
- Illustrate how federal changes can impact states
- Not a reform proposal
Simulation

Federal changes:

• Repealed the majority of federal non-business PIT expenditures:
  • 42 of 169 TEs
  • 80% of the tax expenditure dollars

• Repealed AMT

• Revenue neutral: reduced tax rates across the board by 40%
Simulation

States

- Revenue impact is calculated based on their current (2013) conformity to federal law.
- i.e. conformity is held constant. States that conformed in 2013 are assumed to maintain that conformity and follow the federal repeal.
Simulation

Model

• Microsimulation of federal and state PIT systems for 2013.
• Captures the linkages between state and federal systems.
• Based on CPS, with imputations from other sources, and targeted to IRS data.
Findings

• All but one state links in some way to federal TEs.

• Total state PIT revenue increased by:
  • 34% nationwide
  • $100 billion
Findings

- The average percentage increase was 39%
- Ranged from 2% to over 60%
Findings

• 37 states and DC link to federal exclusions and adjustments

• 31 states and DC use federal itemized deductions

• 23 states and DC piggyback on the EITC
Findings

• 15 States and DC linked to all three of these categories
  - All had revenue increases above 30%
  - Average percentage increase was 46%

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Findings

- 14 states link only to exclusions/adjustments and itemized deductions

- All had revenue increases above 25%
- Average percentage increase was 44%
Potential Sources of Variation

• Nuances in conformity
• Other features of state tax systems
• Demographic and economic factors
Impacts by Tax Expenditure Class

Share of nationwide increase in state revenue from repeal of selected federal tax expenditures, by category

- Other provisions and interaction effects: 6%
- Earned income tax credit: 3%
- Capital gains and dividends tax preferences: 10%
- Itemized deductions: 20%
- Employer-provided health insurance exclusion and deductions for self-employed health plans: 36%
- Pensions and savings tax preferences: 25%
Federal Revenue Impacts
Federal Revenue Change by State

Number of States in Each Percent Change Category

-10% to -7.5%
-7.5% to -5%
-5% to -2.5%
-2.5% to 0%
0% to 2.5%
2.5% to 5%
5% to 7.5%
7.5% to 10%
> 10%

Percent Change in Federal Revenue

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Why should policymakers care?

• Some changes may be harder to decouple from

• Conformity is a choice for states and involves tradeoffs:
  • Revenue
  • Enforcement
  • Simplicity
  • Compliance
  • Reduce administrative costs
  • Let the Feds do the hard work of defining income
Tax Code Connections: How Changes to Federal Policy Affect State Revenue

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