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Tax Code Connections

How changes to federal policy affect state revenue

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Overview

States have a great deal at stake when federal policymakers are considering tax policy changes, whether full-scale reform or targeted revisions. Of the 41 states (plus the District of Columbia) with broad-based personal income taxes, 40 states and the District connect in some way to the federal system by incorporating a range of federal tax expenditures—exclusions, deductions, and credits—into their state tax codes.[1] These linkages to federal law, also known as conformity, mean that changes at the federal level can affect state tax collections and can increase total federal taxes paid in some states and decrease them in others, even if federal revenue remains unchanged nationwide.

To help policymakers at both the state and federal levels better understand the extent to which states are connected to and affected by changes to federal individual income tax expenditures, this analysis illustrates the state revenue impact of eliminating the large majority of federal tax expenditures. It also reduces federal tax rates by roughly 40 percent to achieve revenue neutrality—that is, to maintain pre-reform revenue levels.[2] Importantly, the scenario is not a tax reform proposal, nor does it endorse any particular plan or a revenue-neutral approach to tax reform.

> “Of the 41 states (plus the District of Columbia) with broad-based personal income taxes, 40 states and the District connect in some way to the federal system by incorporating a range of federal tax expenditures—exclusions, deductions, and credits—into their state tax codes.”

This analysis used a model of federal and state individual income tax systems that includes state conformity as of 2013 and simulates tax returns for all 50 states and the District for the same year. Based on those state linkages, the analysis found that federal changes had the following effects on state revenue:

- Overall state individual income tax revenue increased by about 34 percent.[3]
- Revenue increases varied widely across the 40 states (plus the District) that have significant linkages to federal tax provisions, ranging from less than 5 percent to more than 50 percent and reflecting the broad range of conformity.
- Eliminating tax expenditures related to health insurance and retirement had the largest impact on state revenue because many states conform to them, they include a large amount of untaxed income, and they benefit a significant portion of the population.

In addition to state revenue impacts, this analysis estimates the effect on federal revenue within each state and finds that even if a federal reform is designed to be revenue neutral overall, the impact can vary by state.[4] Because tax filers differ across states, total federal tax collections could increase in some states and decrease in others. In this analysis, federal income taxes paid rose in 29 states and fell in 21 and the District. Most of these revenue changes were not dramatic, with nearly all totaling 10 percent or less. This variation could contribute to diverse economic impacts by changing residents’ disposable income in different ways across states.

Federal tax changes present state policymakers with a series of decisions. First, conformity is a policy choice for states, so they must weigh whether to continue to link to a changed provision. This analysis assumes that policymakers choose to maintain their states' existing levels of conformity and accept the federal changes, so eliminating federal tax expenditures causes their revenue to rise. (See "Conformity in This Analysis" on Page 3.) In that case, they would then need to decide how to use the new revenue—by increasing spending or lowering tax rates, for example. Alternatively, they could opt not to accept the changes to federal provisions, but that decision could make filing more complex, reduce compliance, and raise administrative costs.

> "State linkages to federal tax law, also known as conformity, mean that changes at the federal level can affect state tax collections and can increase total federal taxes paid in some states and decrease them in others, even if federal revenue remains unchanged nationwide."

Reducing or eliminating tax expenditures is sometimes called "broadening or expanding the tax base" because it increases the types or amount of income (the "base") that is subject to tax. To capture as many of the links between state and federal tax systems as possible, the hypothetical expansion of the base that is included here exceeds that of most tax reform proposals and has the effect of significantly increasing state revenue. This analysis presents one example of federal tax changes, but the effect on states of a given policy proposal would depend on the specifics. Other types of changes could have different outcomes. For instance, more modest federal changes would have smaller effects on states. And federal changes that increase the value or number of tax expenditures—by adding or expanding deductions, for example—would reduce federal taxable income and revenue and could reduce revenue in conforming states.

Understanding the extent to which state income taxes are linked to the federal system is important for policymakers at both levels of government when evaluating federal revisions or reforms. In considering reforms, federal policymakers should realize that changes can affect state revenue, requiring states to decide whether to revise their tax policies; state leaders need to weigh the trade-offs of linking to federal tax expenditures, given the possible impacts of revisions; and both should recognize that the effect on federal revenue will vary by state. Identifying the depth and breadth of the connections between state and federal tax policy would help inform a wide range of tax policy debates at both levels of government.

Conformity in This Analysis

This analysis assumes that states that linked to federal provisions in 2013 would maintain their conformity—that is, they would follow the federal repeal. For example, if a state piggybacks on the federal earned income tax credit (EITC) for low-income workers, this analysis assumes that repeal of the federal credit would result in repeal of the state's credit. Likewise, states that use one of two federal income definitions—"adjusted gross income" and the further modified "taxable income"—as starting points for their income taxes are assumed to maintain that linkage if the federal definition is expanded. States that did not conform to federal tax expenditures as of 2013 are assumed not to adhere to the changes to those expenditures modeled in this analysis.

Conformity to some federal tax expenditures is explicit, such as credits or deductions, for which state filers are directed to copy amounts from their federal forms with occasional further adjustment. When such provisions are abolished, conforming states are assumed to follow the repeal. Other cases are more implicit. For example, states that use a federal starting point are generally linked to the exclusions and adjustments included in those income definitions. This analysis assumes that, if these exclusions were eliminated and the income was included in the federal definitions, states that use federal starting points would be linked to the resulting expansion in income. However, some states that use a federal starting point present exceptions to this rule: They "selectively decouple"—that is, unlink their tax codes—from specific exclusions or adjustments by, for example, adding those amounts back into income, in which case the state is assumed to remain decoupled from those expenditures for the purposes of this analysis.

Additionally, some assumptions were made to simplify the functioning of states' conformity in the scenario. Information on states' tax structures and conformity was collected primarily from their tax forms, but in some cases the linkage is not clear from the forms. For instance, a small number of states do not explicitly use a federal starting point but still closely mirror federal income. This analysis assumes that these states follow the repeal of federal exclusions and adjustments except in cases where the tax forms explicitly indicate nonconformity to a specific tax expenditure.

Finally, states may use rolling or fixed-date conformity. Those that use rolling conformity incorporate revisions to federal law into their tax systems automatically as those changes become effective. States that use fixed-date conformity link to federal law as it stood on a specific date, and state lawmakers must pass new legislation to conform to any federal changes. This analysis makes no distinction between the two forms of conformity and assumes that federal changes affect states with both types.

For more information on conformity, see the technical appendix.

Federal tax changes could have broad and varied impacts on state revenue

Many proposals would limit or eliminate various federal tax expenditures, including deductions, credits, exclusions, and other provisions that decrease federal revenue by allowing taxpayers to reduce their income taxes.[5] Reform proposals often use some or all of the revenue gained from limiting tax expenditures to implement offsetting tax rate reductions.[6]

For this analysis, Pew used a scenario that broadened the federal tax base by eliminating 42 major personal income tax expenditures[7]—which together accounted for roughly 80 percent of the total forgone federal revenue associated with personal income tax expenditures from 2015 through 2024—and repealed the alternative minimum tax.[8] (For a complete list of the tax expenditures repealed, see the technical appendix.) The scenario then reduced federal tax rates by 40 percent across all tax brackets to maintain revenue neutrality.[9]

Tax Calculation Model

To perform this analysis, Pew used a model that calculated state and federal personal income tax returns for a representative set of households in the 2013 tax year. The computer model incorporated the major ways the tax codes of each state and the District were linked to the federal system in that year to identify how federal and state tax liability for each household would change under a given reform scenario. Those household-level calculations were then added up to estimate overall changes in federal and state collections for each state. (See the technical appendix for more detail.)

Changes to federal income tax policy directly affect states that have income taxes connected to federal provisions. Forty-one states and the District of Columbia have broad-based income taxes. Of those, 40 states and the District link to federal policy and, not surprisingly, all of these had an associated increase in total revenue in this analysis.[10] States linked to federal tax expenditures see their tax bases expand in tandem with the federal base and thus see increased collections. The federal rate reduction did not affect state revenue because states do not link to federal tax rates.[11] Seven states have no income taxes, and two have very limited ones with no significant conformity.

In total, state individual income tax revenue was about 34 percent (or roughly $100 billion) higher because of the repeal of the federal tax expenditures, but the increases varied widely across the states, from less than 5 percent to more than 50 percent. Twenty-two states experienced an increase of 40 percent or greater, 15 states and the District had an increase between 20 percent and 40 percent, and three states saw an increase of less than 20 percent. (See Table 1.) This variation was driven largely by the differences in conformity across the states.

Table 1

Federal Tax Reform Could Have Widely Varied Effects on State Revenue

Percent change in state individual income tax revenue, by state and nationwide, 2013

State	State revenue increase (%)
United States total	34.5
Alabama	19.1
Alaska	No income tax
Arizona	43.1
Arkansas	44.3
California	36.7
Colorado	35.2
Connecticut	21.8
Delaware	38.0
District of Columbia	33.9
Florida	No income tax
Georgia	44.7
Hawaii	51.6
Idaho	47.1
Illinois	24.8
Indiana	26.9
Iowa	61.4
Kansas	40.9
Kentucky	43.3
Louisiana	57.4
Maine	39.1
Maryland	47.4
Massachusetts	20.2
Michigan	25.8
Minnesota	45.8
Mississippi	12.6
Missouri	48.0
Montana	54.9
Nebraska	57.2
Nevada	No income tax
New Hampshire	Limited income tax
New Jersey	2.1
New Mexico	50.4
New York	40.0
North Carolina	46.0
North Dakota	28.1
Ohio	29.2
Oklahoma	44.2
Oregon	49.3
Pennsylvania	0
Rhode Island	40.4
South Carolina	49.8
South Dakota	No income tax
Tennessee	Limited income tax
Texas	No income tax
Utah	37.2
Vermont	48.7
Virginia	39.1
Washington	No income tax
West Virginia	35.7
Wisconsin	37.1
Wyoming	No income tax

Notes: The revenue impacts in this table are estimates and are based on a reform scenario that eliminated the majority of federal tax expenditures and reduced federal tax rates to keep total federal revenue constant. For impacts in dollars, see Table A.1. New Hampshire and Tennessee tax only interest and dividend income.

Source: Pew's analysis based on Quantria Strategies' federal and state microsimulation model

Impacts on Federal Revenue Vary by State

Much attention is given to the effect that federal policy changes can have on federal tax collections across income groups, but the impact on state-by-state federal collections tends to receive less consideration. Even if a federal reform is designed to be revenue neutral in the aggregate, the effect can vary by state.* In this analysis, federal tax collections increased in 29 states and decreased in 21 and the District of Columbia, but most of the changes were not dramatic: Although the largest rise was 18 percent, nearly all were 10 percent or less. Likewise, the largest decline in revenue was 10 percent, with most falling less than 5 percent.

This occurred because changes in federal tax provisions have differing impacts on the tax bill for each household, with some filers paying more than before and some less. Because filers differ across states, these effects can in turn alter total tax collections within a state. The resulting impacts on residents' total disposable income could contribute to different economic consequences across states.†

The variation in federal revenue impacts could be due to a number of factors, such as income and other demographic differences across states. For example, to the extent that income varies across states, the amount of revenue associated with tax expenditures that are correlated with taxpayer income—such as itemized deductions (claimed more by high-income filers) and the EITC (claimed by lower- and moderate-income workers)—will likewise vary across states.

* Although the revenue-neutral scenario used in this analysis is instructive, many real-world reform proposals have additional goals relating to the impact on filers of different income groups. A scenario that was designed to account for such considerations would have different federal revenue impacts by state than those seen here.

† This analysis focuses on the net increase or decrease in federal taxes within each state. The economic impact on states would depend on other factors as well, such as whether the tax changes vary by income level. Federal reform could have other fiscal and economic state impacts as well. For example, changes to specific tax expenditures, such as those available to homeowners, could affect the housing market.

State conformity is the major determinant of revenue impact

States conform to federal policy in different ways; many have numerous linkages to the federal system while others have very few. States link to three major categories of federal tax expenditures: exclusions and adjustments, itemized deductions, and credits. (See Figure 1.)

Figure 1

States Link to the Federal Income Tax in Various Ways

Federal income taxes are calculated in a series of steps, and most state income taxes are linked to that system. States incorporate various federal provisions—such as exclusions, deductions, and credits—into their tax calculations, a practice known as conformity. Of the 41 states (plus the District of Columbia) with income taxes, 40 and the District have at least one of the linkages shown here.

Step 1: Income

All taxable income sources are totaled. Certain sources, called exclusions, are not counted and therefore are not taxed.

Taxable income sources

+ Wages
+ Investment income, such as capital gains
+ Retirement income
+ Other

= **Gross income**

Exclusions:

- The value of employer-provided health insurance
- Pre-tax retirement savings contributions and earnings
- A portion of Social Security and other retirement income
- Other

Step 2: Adjustments

Adjustments allow certain expenses to be deducted from gross income.

- Student loan interest
- College tuition
- Individual retirement account contributions
- Other

= **Adjusted gross income**

37 states and the District of Columbia link to federal taxable income sources, exclusions, and adjustments, usually by using a federal income starting point.

Step 3: Deductions and exemptions

Deductions and exemptions allow further reductions for certain expenses and for each household member.

- Itemized deductions → 31 states and the District link to federal itemized deductions.

or standard deduction

- Personal exemptions

= **Taxable Income**

Step 4: Tax rates

Tax rates are used to calculate liability based on taxable income.

x Tax rates

= **Initial tax liability before credits**

Step 5: Tax credits

Tax credits reduce liability on a dollar-for-dollar basis.

- Earned income tax credit (EITC) → 23 states and the District offer a tax credit based on the federal EITC.
- Child tax credit
- Higher education tax credits
- Other

= **Final federal tax liability**

Notes: This table highlights the major state linkages to federal policy discussed in this analysis. However, some nuances in how states conform to these tax expenditures are not included in this table. The table also omits linkages that are not discussed in the analysis. See Table 2 and the technical appendix for more information.

Generally, the more a state's tax law conforms to these categories, the higher the revenue impact under this simulation. In the 15 states (plus the District) that have significant linkages across the three categories listed above, revenue increases were over 30 percent. By contrast, in the three states with fewer significant linkages—for example, connecting only to itemized deductions or the EITC—revenue increases were less than 20 percent. (See Table 2.)

Table 2

States With More Linkages to Federal Policy Saw Larger Revenue Increases

Conformity to selected federal tax expenditures, by percentage increase in individual income tax revenue, 2013

	State revenue increase (%)	Federal exclusions and adjustments*	Federal itemized deductions	Federal earned income tax credit
Iowa	61.4	Yes	Yes	Yes
Louisiana	57.4	Yes	Yes	Yes
Nebraska	57.2	Yes	Yes	Yes
Montana	54.9	Yes	Yes	No
Hawaii	51.6	Yes	Yes	No
New Mexico	50.4	Yes	Yes	Yes
South Carolina	49.8	Yes	Yes	No
Oregon	49.3	Yes	Yes	Yes
Vermont	48.7	Yes	Yes	Yes
Missouri	48.0	Yes	Yes	No
Maryland	47.4	Yes	Yes	Yes
Idaho	47.1	Yes	Yes	No
North Carolina	46.0	Yes	Yes	Yes
Minnesota	45.8	Yes	Yes	No†
Georgia	44.7	Yes	Yes	No
Arkansas	44.3	Yes‡	Yes	No
Oklahoma	44.2	Yes	Yes	Yes
Kentucky	43.3	Yes	Yes	No

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	State revenue increase (%)	Federal exclusions and adjustments*	Federal itemized deductions	Federal earned income tax credit
Arizona	43.1	Yes	Yes	No
Kansas	40.9	Yes	Yes	Yes
Rhode Island	40.4	Yes	No	Yes
New York	40.0	Yes	Yes	Yes
Virginia	39.1	Yes	Yes	Yes
Maine	39.1	Yes	Yes	Yes
Delaware	38.0	Yes	Yes	Yes
Utah	37.2	Yes	Yes§	No
Wisconsin	37.1	Yes	Yes§	Yes
California	36.7	Yes	Yes	No
West Virginia	35.7	Yes	No	No
Colorado	35.2	Yes	Yes	No
District of Columbia	33.9	Yes	Yes	Yes
Ohio	29.2	Yes	No	Yes
North Dakota	28.1	Yes	Yes	No
Indiana	26.9	Yes	No	Yes
Michigan	25.8	Yes	No	Yes
Illinois	24.8	Yes	No	Yes
Connecticut	21.8	Yes	No	Yes
Massachusetts	20.2	Yes	No	Yes
Alabama	19.1	No	Yes	No
Mississippi	12.6	No	Yes	No
New Jersey	2.1	No	No	Yes
Pennsylvania	0	No	No	No
New Hampshire	0	Limited income tax‖		
Tennessee	0	Limited income tax‖		

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	State revenue increase (%)	Federal exclusions and adjustments*	Federal itemized deductions	Federal earned income tax credit
Alaska	0	No income tax		
Florida	0	No income tax		
Nevada	0	No income tax		
South Dakota	0	No income tax		
Texas	0	No income tax		
Washington	0	No income tax		
Wyoming	0	No income tax		

Notes: Conformity based on 2013 tax law. The revenue impacts in this table are estimates and are based on a reform scenario that eliminated the majority of federal tax expenditures and reduced federal tax rates to keep total federal revenue constant.

* Most of these states are linked to exclusions and adjustments through their use of either federal adjusted gross income or taxable income as their starting point. However, many make modifications to specific income sources or additional adjustments. A few states do not explicitly use a federal starting point but nonetheless substantially mirror federal income. For purposes of this analysis, these states are generally assumed to be conformed to the repeal of federal exclusions and adjustments, except in cases where the tax forms explicitly indicate that they are not conformed.

† Minnesota has a working families tax credit that is similar to the federal EITC but it is not linked to it.

‡ Arkansas' tax forms reference certain federal income sources, such as farm and rental income, but not others. For purposes of this simulation, the state is assumed to conform to the repeal of the federal exclusions and adjustments.

§ State allows a credit based on federal itemized deductions.

‖ State taxes only interest and dividend income.

Source: Pew's analysis based on Quantria Strategies' federal and state microsimulation model

Exclusions and adjustments

Exclusions are types of income that are not counted in gross income and so are not taxed, including some of the largest tax expenditures, such as the exclusion of employer-paid health insurance premiums and tax preferences for retirement savings.[12] Adjustments are reductions to gross income for certain expenses such as college tuition and student loan interest. Because exclusions and adjustments are applied to gross income, they are captured in the federal adjusted gross income and taxable income definitions, and states that use one of these as their starting points conform to these provisions unless they selectively decouple.

Thirty-seven states and the District link to federal exclusions and adjustments. When these tax expenditures are eliminated, federal income increases and tax collections in conforming states rise. In these states and the District, revenue grew more than 20 percent under this scenario.

Itemized deductions

Federal itemized deductions comprise various expenses, the largest of which include home mortgage interest and charitable giving; smaller deductions include those for medical costs and unreimbursed work expenses.[13] States adopt federal itemized deductions in two general ways, either by directing filers to copy their federal deductions onto their state forms or, as is the case in six states, by using federal taxable income as their starting points, which necessarily captures federal itemized deductions as well as exclusions and adjustments.

As with exclusions, when federal itemized deductions were eliminated in this analysis, state tax bases expanded in conforming states, and their revenue increased. Thirty-one states and the District allowed filers to subtract federal itemized deductions on their state returns, and all had revenue increases of at least 13 percent in this analysis.[14] In Alabama and Mississippi, itemized deductions were the only major linkage to federal tax expenditures, and these states had revenue impacts of 19 percent and 13 percent, respectively. The remaining 29 states and the District also link to exclusions and adjustments, and all of these had revenue increases above 28 percent.

Credits

Some states directly link to certain federal tax credits. Most notably, 23 states and the District offer an EITC, which is usually calculated as a matching percentage of the federal credit. When that credit is eliminated in this simulation, those states also lose their credits, and their revenue increases. No obvious relationship was evident between a state's conformity to EITC and its total revenue change, because although the EITC is one of the largest federal credits, its effect was overwhelmed by the larger tax expenditures in the simulation.

Other state factors influence revenue effects

Although states' degree of linkage to the federal system is the primary factor determining their revenue impacts under this scenario, those with comparable levels of conformity can see different revenue increases. For example, Delaware and Nebraska have similar linkages, but the policy changes had significantly differing effects on their tax collections, yielding increases of 38 percent and 57 percent, respectively. Variation such as this may be due to a number of factors.

First, the model includes nuances in conformity that are not represented in Table 2 but can result in distinct revenue impacts across states. For example, each state sets its own EITC matching percentage, and those with federal starting points sometimes disallow specific federal adjustments. In another case, Nebraska and Delaware both start their tax calculations with federal adjusted gross income, but Delaware makes a further modification: Rather than follow the federal partial exemption for Social Security income, the state fully exempts this income. In the simulation, the federal exemption is repealed and all Social Security income is included in federal income and fully taxed. As a result, Nebraska's taxable income and revenue increase, but Delaware's do not because the state is decoupled from the federal policy, and Social Security income remains exempt for Delaware filers.

Second, elements of state tax systems that are independent of federal policy, such as tax rates, can play a role. For example, for taxpayers in a 5 percent tax bracket, the repeal of a $1,000 deduction increases their taxes by $50, but for those in a 10 percent bracket, the tax increase is $100. Therefore, if all else were equal, two states with different tax rates and brackets could experience different revenue effects from the same change to federal income or deductions.

In addition, six states—Alabama, Iowa, Louisiana, Missouri, Montana, and Oregon—permit filers to deduct their final federal income tax liability from their state taxable income.[15] For individual filers in these states, this deduction has the effect of partly offsetting a federal tax increase or decrease: An increase in their federal taxes would result in a larger deduction, lowering their state liability, while a federal cut would mean higher state taxes. So, all else being equal, total revenue impacts in states that allow this deduction could differ from those in states that do not.

Finally, differences in the characteristics of tax filers across states, such as age and income, also have an effect. For example, a state where average incomes are higher would probably be more affected by the repeal of federal itemized deductions, all else being equal, because higher-income filers are more likely to take those deductions, their deductions tend to be larger, and they fall into higher tax brackets—factors that increase the revenue gain resulting from the repeal of the deductions.

State revenue-neutral rate reductions are another measure of the effect of conformity

To provide an additional measure of the extent to which states are connected to federal tax expenditures, this analysis calculated how much each state could reduce its income tax rates if policymakers decided to completely offset the revenue increase resulting from federal tax changes.[16]

Offsetting the revenue increases would require rate reductions of 30 percent or more in 14 states, between 20 percent and 30 percent in 19 states and the District, and less than 20 percent in seven states. A state's revenue-neutral rate reduction is directly related to its revenue impact: The larger the initial increase, the larger the possible reduction. For example, Oklahoma's revenue increase of 44 percent translated into a 30 percent across-the-board reduction in the state's tax rates. Alabama's 19 percent increase resulted in a 15 percent rate reduction. (See Table 3.)

Table 3

Tax Rate Changes Reflect States' Level of Conformity to Federal Provisions

Percent change in state individual income tax revenue and revenue-neutral rate reductions, by state, 2013

State	State revenue increase before state tax rate reduction (%)	State revenue-neutral tax rate reductions (%)
Alabama	19.1	14.8
Alaska	No income tax	
Arizona	43.1	28.7
Arkansas	44.3	29.4
California	36.7	25.6
Colorado	35.2	25.3
Connecticut	21.8	18.4
Delaware	38.0	26.1
District of Columbia	33.9	25.1

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State	State revenue increase before state tax rate reduction (%)	State revenue-neutral tax rate reductions (%)
Florida	No income tax	
Georgia	44.7	30.5
Hawaii	51.6	30.7
Idaho	47.1	28.7
Illinois	24.8	19.3
Indiana	26.9	20.3
Iowa	61.4	43.9
Kansas	40.9	28.0
Kentucky	43.3	29.2
Louisiana	57.4	33.5
Maine	39.1	26.7
Maryland	47.4	31.2
Massachusetts	20.2	19.4
Michigan	25.8	19.1
Minnesota	45.8	32.2
Mississippi	12.6	10.5
Missouri	48.0	30.0
Montana	54.9	33.0
Nebraska	57.2	34.1
Nevada	No income tax	
New Hampshire	Limited income tax	
New Jersey	2.1	1.7
New Mexico	50.4	32.0
New York	40.0	26.8
North Carolina	46.0	30.4
North Dakota	28.1	20.9

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State	State revenue increase before state tax rate reduction (%)	State revenue-neutral tax rate reductions (%)
Ohio	29.2	22.0
Oklahoma	44.2	29.8
Oregon	49.3	30.6
Pennsylvania	0	0
Rhode Island	40.4	25.8
South Carolina	49.8	30.1
South Dakota	No income tax	
Tennessee	Limited income tax	
Texas	No income tax	
Utah	37.2	23.4
Vermont	48.7	31.4
Virginia	39.1	26.8
Washington	No income tax	
West Virginia	35.7	26.1
Wisconsin	37.1	23.9
Wyoming	No income tax	

Notes: The revenue impacts in this table are estimates and are based on a reform scenario that eliminated the majority of federal tax expenditures and reduced federal tax rates to keep total federal revenue constant. For impacts in dollars, see Table A.1. New Hampshire and Tennessee tax only interest and dividend income.

Source: Pew's analysis based on Quantria Strategies' federal and state microsimulation model

Beyond Conformity: Other Federal Tax Provision Changes That Affect State Budgets

This paper focuses on the impacts of federal tax policy changes on state tax systems that are attributable to state linkages with federal law. However, federal tax changes can have implications for states that are unrelated to conformity.[*]

The first of these is the federal deduction for state and local taxes paid. Federal tax filers who claim itemized deductions are able to deduct state and local property taxes and income or sales taxes, reducing the overall cost of those taxes for these filers. Repealing or limiting these deductions would essentially make state and local taxes more expensive for those taxpayers, which experts suggest could affect states' own tax policy decisions, including the level and mix of taxes they use to finance spending priorities.[†] This analysis includes the elimination of this tax expenditure but does not estimate the effect on state policy decision-making.

The second provision is the federal exemption for interest income from state and local bonds, sometimes called the municipal bond exemption. State and local governments borrow money by selling bonds and then paying interest to the investors who buy them. Although the federal government generally taxes interest income, interest from these bonds is not taxed. This makes borrowing cheaper for state and local governments because they can offer bonds with lower interest payments while still remaining competitive with higher-interest taxable bonds, such as corporate bonds. Expert analysis indicates that modifying the municipal bond interest exemption to partly or fully tax this interest could increase the cost of borrowing for state and local governments.[‡] This analysis includes the repeal of the municipal bond exemption but does not estimate any impact on state borrowing costs.

Finally, federal tax changes can affect state revenue by altering taxpayer behavior. For example, if federal capital gains tax rates were set to increase, taxpayers might sell investment assets before the new rates were implemented in order to avoid paying higher taxes, increasing state tax revenue before the rate increase becomes effective and decreasing it afterward. Likewise, changes to the mortgage interest deduction could influence individuals' homeownership decisions and the housing market broadly. This analysis does not include these types of behavioral or economic effects.

* The benefit that filers receive from a deduction or exemption depends in part on their tax rates. So even without a direct modification to the tax expenditures discussed here, changes in federal rates could alter how these provisions affect state finances.

† Frank Sammartino, "Federal Support for State and Local Governments Through the Tax Code: Testimony Before the U.S. Senate Committee on Finance," Congressional Budget Office (April 25, 2012), http://www.cbo.gov/publication/43047; and Steven Maguire and Jeffrey M. Stupak, "Federal Deductibility of State and Local Taxes," Congressional Research Service (Sept. 18, 2015), http://www.fas.org/sgp/crs/misc/RL32781.pdf.

‡ Sammartino, "Federal Support for State and Local Governments Through the Tax Code," 5–6; and Joint Committee on Taxation, *The Federal Revenue Effects of Tax-Exempt and Direct-Pay Tax Credit Bond Provisions* (July 16, 2012), https://www.jct.gov/publications.html?func=fileinfo&id=4469.

Federal tax expenditures have differing effects on states

The federal tax provisions eliminated in this analysis varied substantially in their individual contributions to the total state revenue impact. For example, health insurance-related tax expenditures, including the untaxed value of employer-provided health insurance and deductions for premiums paid by the self-employed, accounted for 36 percent of the scenario's total effect on state revenue. Tax preferences for retirement plans, such as 401(k) accounts and pensions, accounted for 25 percent. (See Figure 2.) These particular tax expenditures have large impacts for three reasons: They benefit a significant portion of the population, include a large amount of untaxed income, and reduce federal income, which most states use as a starting point. Therefore, eliminating these tax expenditures significantly increases taxable income and revenue across the states.

The next-largest group is itemized deductions. Their repeal accounted for about 20 percent of the nationwide state revenue impact. This relatively large impact is driven by the fact that many states conform to federal itemized deductions, which, as a group, include a significant amount of income.

> "Understanding the ways and extent to which federal tax changes affect states provides important context for federal and state policymakers as they evaluate the full impact of tax proposals."

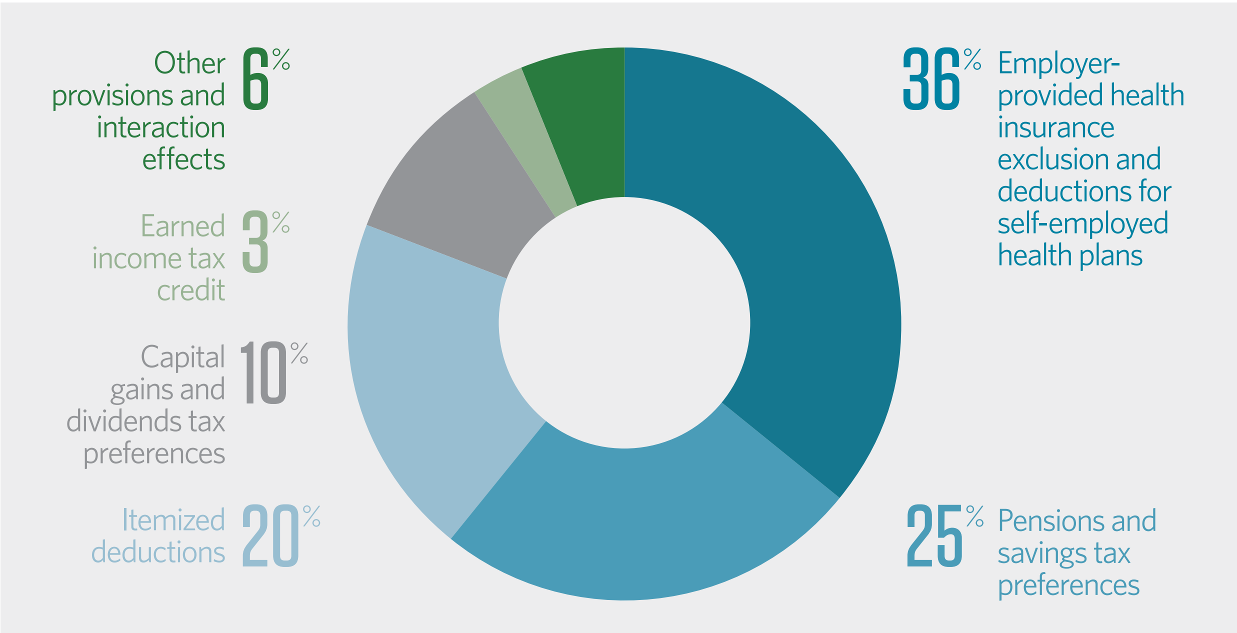
The repeal of federal tax preferences for capital gains—such as the exclusions for a portion of gains from home sales and inherited assets—accounted for about 10 percent of the total state revenue increase in this analysis. The simulation also eliminated the special reduced federal capital gains tax rates, but states' rates on capital gains are generally the same as their ordinary income tax rates and are independent of the federal rates. Therefore, no states were directly affected by the federal rate increase.

Of the several federal tax credits repealed in the simulation, the EITC is the only large one to which a significant number of states connect. Although the EITC is one of the largest federal tax credits, it is substantially smaller than the other types of tax expenditures discussed in this paper and so accounts for a relatively small portion—about 3 percent—of the state revenue impact.

Figure 2

Tax Expenditures Related to Health Insurance and Retirement Had the Largest Impacts on State Revenue

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



Notes: Results are estimates and are based on a reform scenario that eliminated the majority of federal tax expenditures and reduced federal tax rates to keep total federal revenue constant. See the technical appendix for a list of the tax expenditures included in each of these categories.

Source: Pew's analysis based on Quantria Strategies' federal and state microsimulation model

Policymakers face trade-offs when deciding whether to conform

State policymakers set their states' tax laws and determine the nature and extent of conformity to federal law. Policymakers may choose to conform for a number of reasons: Generally, the more a state's tax return resembles the federal return, the easier it is for residents to file their state taxes, increasing compliance and reducing errors. By conforming to federal law, states also benefit from federal tax administration and enforcement practices, such as withholding, auditing, and reporting requirements.[17] Finally, conformity is a way for state policymakers to reinforce goals they share with the federal government.[18]

However, linking to the federal tax system may have unintended consequences. In particular, it increases the likelihood that changes to federal policy will directly affect state revenue.[19] State policymakers can respond to a federal change by passing legislation to decouple, for example, but legislatures may not always be in a position to react immediately because of political constraints, the timing of legislative sessions, or other factors.[20] Further, decoupling from federal law may mean forgoing some of the benefits of conformity, such as administrative efficiency.

Policymakers had to weigh these trade-offs after the last major federal tax reform in 1986. Among other changes, the legislation reduced personal income tax rates, limited and repealed several deductions, increased the standard deduction and personal exemption, and expanded the EITC. As a result of conformity, some states projected revenue increases. One study from early 1988 estimated that total state revenue would increase by about $5 billion if states incorporated the federal changes into their tax codes.[21] Policymakers in most states accepted the bulk of the changes and then faced the choice of what to do with the added revenue. Some simply retained the increase, while others offset it by reducing tax rates or expanding personal exemptions, standard deductions, or credits. Still other states used the federal reform as an occasion to substantially restructure their own tax systems.[22]

Conclusion

This report illustrates that major changes to federal tax law could significantly affect states. Based on state conformity to federal law as of 2013, base-broadening federal tax revisions would increase state revenue. These impacts would be higher in states with more conformity to federal law and lower in states with fewer linkages, although other factors such as state tax rates and tax-filer characteristics would also play a role.

State policymakers would then face a series of choices regarding how to use this revenue. If they chose to stay conformed, they could retain the revenue increase to fund government services, return it to taxpayers, or a combination of both. Alternatively, they could avoid a revenue impact by choosing not to accept the federal changes.

Understanding the ways and extent to which federal tax changes affect states provides important context for federal and state policymakers as they evaluate the full impact of tax proposals.

Appendix

Table A.1

Federal and State Individual Income Tax Revenue Effects of the Federal Base-Broadening Scenario

State	State tax revenue				Federal tax revenue		
	Baseline revenue (in millions)	Revenue increase before state rate reductions (in millions)	Revenue increase before state rate reductions (%)	Revenue-neutral tax rate reduction (%)	Baseline revenue (in millions)	Revenue change (in millions)	Revenue change (%)
United States total	$290,308	$100,147	34.5		$1,228,148	-$207	0
Alabama	$3,051	$582	19.1	14.8	$13,121	$551	4.2
Alaska	No income tax				$3,327	-$338	-10.2
Arizona	$3,240	$1,396	43.1	28.7	$18,303	$301	1.6
Arkansas	$2,560	$1,134	44.3	29.4	$6,901	$695	10.1
California	$64,538	$23,660	36.7	25.6	$170,908	$2,570	1.5
Colorado	$5,305	$1,866	35.2	25.3	$23,316	-$984	-4.2
Connecticut	$8,150	$1,775	21.8	18.4	$25,588	-$1,174	-4.6
Delaware	$1,084	$412	38.0	26.1	$3,223	$63	2.0
District of Columbia	$1,516	$514	33.9	25.1	$4,514	-$257	-5.7
Florida	No income tax				$68,170	$1,318	1.9
Georgia	$8,501	$3,800	44.7	30.5	$28,153	$1,216	4.3
Hawaii	$1,657	$854	51.6	30.7	$4,203	$265	6.3
Idaho	$1,238	$583	47.1	28.7	$3,912	$226	5.8
Illinois	$16,181	$4,011	24.8	19.3	$53,817	-$197	-0.4
Indiana	$4,806	$1,291	26.9	20.3	$19,660	$52	0.3
Iowa	$3,362	$2,064	61.4	43.9	$11,779	$57	0.5
Kansas	$2,136	$874	40.9	28.0	$12,303	-$658	-5.4
Kentucky	$3,628	$1,570	43.3	29.2	$10,482	$835	8.0

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State	State tax revenue				Federal tax revenue		
	Baseline revenue (in millions)	Revenue increase before state rate reductions (in millions)	Revenue increase before state rate reductions (%)	Revenue-neutral tax rate reduction (%)	Baseline revenue (in millions)	Revenue change (in millions)	Revenue change (%)
Louisiana	$2,599	$1,492	57.4	33.5	$15,846	-$195	-1.2
Maine	$1,472	$575	39.1	26.7	$3,901	$104	2.7
Maryland	$6,745	$3,197	47.4	31.2	$27,999	$648	2.3
Massachusetts	$12,180	$2,460	20.2	19.4	$39,295	-$2,443	-6.2
Michigan	$7,935	$2,045	25.8	19.1	$32,037	-$442	-1.4
Minnesota	$8,728	$3,998	45.8	32.2	$24,396	$308	1.3
Mississippi	$1,321	$166	12.6	10.5	$5,592	$1,010	18.1
Missouri	$5,130	$2,462	48.0	30.0	$19,925	$751	3.8
Montana	$1,010	$554	54.9	33.0	$3,266	$100	3.0
Nebraska	$2,035	$1,164	57.2	34.1	$8,401	$462	5.5
Nevada	No income tax				$9,703	-$418	-4.3
New Hampshire*	$95	$0	0	0	$5,983	-$176	-2.9
New Jersey	$11,616	$248	2.1	1.7	$51,553	-$2,177	-4.2
New Mexico	$1,206	$607	50.4	32.0	$5,486	$340	6.2
New York	$30,253	$12,107	40.0	26.8	$98,142	$2,633	2.7
North Carolina	$10,774	$4,959	46.0	30.4	$26,962	$1,601	5.9
North Dakota	$626	$176	28.1	20.9	$4,601	-$432	-9.4
Ohio	$9,389	$2,744	29.2	22.0	$40,041	-$140	-0.4
Oklahoma	$2,760	$1,220	44.2	29.8	$12,588	-$324	-2.6
Oregon	$5,951	$2,933	49.3	30.6	$12,661	$249	2.0
Pennsylvania	$10,477	$0	0	0	$51,957	-$1,562	-3.0
Rhode Island	$1,039	$420	40.4	25.8	$4,039	$378	9.4

Continued on the next page

State	State tax revenue				Federal tax revenue		
	Baseline revenue (in millions)	Revenue increase before state rate reductions (in millions)	Revenue increase before state rate reductions (%)	Revenue-neutral tax rate reduction (%)	Baseline revenue (in millions)	Revenue change (in millions)	Revenue change (%)
South Carolina	$3,222	$1,604	49.8	30.1	$10,732	$1,423	13.3
South Dakota	No income tax				$3,458	-$137	-4.0
Tennessee*	$253	$0	0	0	$18,802	$177	0.9
Texas	No income tax				$102,347	-$4,452	-4.4
Utah	$2,715	$1,011	37.2	23.4	$8,221	$354	4.3
Vermont	$633	$308	48.7	31.4	$2,166	$49	2.3
Virginia	$10,508	$4,110	39.1	26.8	$38,862	-$1,475	-3.8
Washington	No income tax				$28,789	-$740	-2.6
West Virginia	$1,724	$616	35.7	26.1	$4,304	$145	3.4
Wisconsin	$6,962	$2,583	37.1	23.9	$21,207	-$91	-0.4
Wyoming	No income tax				$3,209	-$273	-8.5

Notes: The revenue impacts in this table are estimates and are based on a reform scenario that eliminated the majority of federal tax expenditures and reduced federal tax rates to keep total federal revenue constant. This table reports baseline revenue estimates as produced by the 50-state model.

* New Hampshire and Tennessee have limited income taxes that apply only to interest and dividend income and have no significant conformity to federal policy for purposes of this analysis.

Source: Pew's analysis based on Quantria Strategies' federal and state microsimulation model

Endnotes

1 Forty-one states and the District of Columbia have broad-based income taxes that apply to wages and other types of income. New Hampshire and Tennessee tax interest and dividend income only.

2 The federal reform scenario implemented in this analysis was revenue neutral in aggregate but did not hold constant the distribution of taxes by income level.

3 This analysis measures the state and federal revenue impacts as a percent change in individual income tax revenue. The significance of a given percent change for a state's overall budget may differ across states because some are more reliant than others on personal income tax revenue.

4 A package of revisions can be revenue neutral if changes that increase revenue, such as repealing deductions, are accompanied by changes that decrease revenue, such as reducing tax rates. For example, the Joint Committee on Taxation estimated former House Ways and Means Committee chairman Dave Camp's Tax Reform Act of 2014 to be revenue neutral on a static basis over the 10-year budget window. See Joint Committee on Taxation, "Estimated Revenue Effects of the Tax Reform Act of 2014" (Feb. 26, 2014), https://www.jct.gov/publications.html?func=fileinfo&id=4562.

5 Tax expenditures are defined by the Congressional Budget Act of 1974 as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." For more background on tax expenditures, see U.S. Office of Management and Budget, "Fiscal Year 2016 Analytical Perspectives of the U.S. Government" (Feb. 2, 2015), http://www.gpo.gov/fdsys/pkg/BUDGET-2016-PER/pdf/BUDGET-2016-PER.pdf.

6 For example, see House Committee on Ways and Means, "Tax Reform Act of 2014, Discussion Draft, Section-by-Section Summary" (February 2014), http://waysandmeans.house.gov/UploadedFiles/Ways_and_Means_Section_by_Section_Summary_FINAL_022614.pdf; Debt Reduction Task Force, "Restoring America's Future," Bipartisan Policy Center (November 2010), http://bipartisanpolicy.org/wp-content/uploads/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf; and the National Commission on Fiscal Responsibility and Reform, "The Moment of Truth" (December 2010), https://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf.

7 The two largest nonbusiness personal income tax expenditures that were not repealed in this simulation are the exclusions for imputed rental income and for untaxed Medicare benefits. Because the model covers tax year 2013, the refundable premium assistance tax credit for insurance purchased through a health insurance exchange, which was established in the Patient Protection and Affordable Care Act of 2010 and took effect in 2014, was not included in the simulation. The scenario does not repeal any business-related personal income tax expenditures. For a complete list of the expenditures repealed, see the technical appendix, Table 1.

8 The tax expenditures repealed in this simulation represent about 80 percent of forgone revenue from all individual income tax expenditures from 2015 through 2024 (including the effect on outlays of refundable credits), as measured by the Office of Management and Budget. Most of the 169 tax expenditures identified by the Office of Management and Budget are relatively small, with the 10 largest accounting for about 63 percent of the forgone revenue associated with all tax expenditures. Summing tax expenditures often provides a reasonable estimate of the total cost of groups of tax expenditures, though it does not capture potential interactions among them or behavioral responses if any single one is modified or repealed. For more detail on the provisions eliminated under the scenario, see the technical appendix. Pew analysis based on U.S. Office of Management and Budget, "Fiscal Year 2016 Analytical Perspectives of the U.S. Government."

9 So for example, the top income tax rate fell from 39.6 percent to about 23.9 percent, while the lowest tax rate dropped from 10 percent to 6 percent.

10 Pennsylvania is the only state with a broad-based income tax that was identified as having no significant conformity to federal policy for purposes of this analysis, and therefore the state had no change in state revenue. Two other states, New Hampshire and Tennessee, have limited income taxes that apply only to interest and dividend income and no significant conformity to federal policy for purposes of this analysis and are not counted among the states with broad-based income taxes. Seven states—Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming—do not levy an income tax and thus saw no state revenue impact in this analysis.

11 Six states permit filers to deduct their final federal income tax liability from their state taxable income and thus can be indirectly affected by federal tax rate changes. For more information, see "Other state factors influence revenue effects" on Page 11.

12 Employer-provided health insurance is a form of untaxed employee compensation, which is not considered part of an individual's taxable income and therefore qualifies as a tax expenditure within the personal income tax.

13 The deductions for various state and local taxes are also among the largest federal itemized deductions. Most states that allow filers to deduct federal itemized deductions also disallow the federal itemized deductions for state and local taxes paid.

14 The 31 states include Utah and Wisconsin, which allow a state credit based on the value of federal itemized deductions.

15 The deduction is capped in Missouri and Oregon. Montana's deduction is capped, available only to filers who claim itemized deductions, and was assumed to remain in effect as the state's only itemized deduction in the simulation.

16 Most states have graduated tax rates that increase with a filer's income. The revenue-neutral rate reductions in this analysis were applied as proportional decreases across all of a state's income tax rates. As with the federal revenue-neutral rate reductions, the state rate reductions keep total state revenue constant but do not hold constant the distribution of taxes by income level. Other options for returning the additional revenue to taxpayers include increasing standard deductions, personal exemptions, or credits.

17 Ruth Mason, "Delegating Up: State Conformity With the Federal Tax Base," *Duke Law Journal* 62, no. 7 (April 2013): 1279–1288, http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=3382&context=dlj.

18 Allison L. Westfahl Kong, "The Effects of Federal Tax Expenditure Policy on the States," *State Tax Notes* 58, no. 7 (November 2010): 476, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1673602.

19 To address this issue, some states conform to the federal tax code as it stood on a specific date (known as "fixed-date conformity") rather than automatically conforming to federal changes. Conformity to federal law in these states is updated legislatively on a periodic basis. But policymakers in these fixed-date states still must examine the federal changes accrued since their last updates and decide which to accept based in part on the revenue consequences.

20 Kong, "The Effects of Federal Tax Expenditure Policy on the States," 480–481.

21 Advisory Commission on Intergovernmental Relations, "The Tax Reform Act of 1986—Its Effect on Both Federal and State Personal Income Tax Liabilities" (January 1988): 6, http://www.library.unt.edu/gpo/acir/Reports/staff/SR-8.pdf.

22 Steven D. Gold, "The State Government Response to Federal Income Tax Reform: Indications From the States That Completed Their Work Early," *National Tax Journal* 40, no. 3 (September 1987): 438–442, http://connection.ebscohost.com/c/articles/4586544/state-government-response-federal-income-tax-reform-indications-from-states-that-completed-their-work-early.

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