The Effects of the Bush Tax Cuts on State Tax Revenues

President Bush's proposed reductions in federal taxes are now under consideration in Congress. They include sharp cuts in personal income tax rates, new income tax breaks, and complete repeal of the federal estate tax. Although the tax cuts have been slightly scaled back in size by the congressional budget resolution, they still are expected to cost the federal government some $1.7 trillion over the next decade (including higher interest payments).

State and local governments, which rely on federal payments and programs for significant shares of their revenues, could find those funds endangered should the Bush tax cuts be enacted. The President's budget outline, for example, projects that to pay for the cost of the tax cuts, federal appropriations will fall by a sixth as a share of the gross domestic product over the next decade. Domestic appropriations could be cut even more given the President's apparent desire to increase defense outlays.

Lost federal funding may be the largest problem facing the states under the Bush tax program. But there is another, very important issue: the effects of the Bush tax cuts on state tax collections.

States stand to lose upwards of $35 billion dollars a year in revenues by 2012 if the Bush tax plan is adopted. The Bush program threatens to undermine funding for important public services and/or shift the burden of state taxation even further onto middle- and lower-income families—because virtually all of the endangered state revenues involve estate taxes and income taxes currently paid by the states' wealthiest taxpayers.

1. Estate Tax Repeal & the States—Up to $18.5 Billion a Year in Direct Costs

Every state shares in a portion of the federal estate tax, through a mechanism commonly called the "pickup tax." This is essentially a revenue-sharing tool by which the federal government gives each state about 26 cents for each dollar in net federal estate tax paid by a state's residents.

In addition, 12 states impose supplemental estate or inheritance taxes.

Under the Bush tax plan, the revenue-sharing accomplished through "pickup taxes" would be repealed. In addition, states that impose supplemental estate or inheritance taxes would probably face heavy pressure to repeal them.

States Potentially Losing the Largest Dollar Amounts from Repeal of the Federal Estate Tax

State-by-State Estimates for the year 2012, $-millions

	State "Pickup" Tax Lost	Endangered Other Inheritance Tax	Total Lost or Endangered	% of Natl Loss
California	$ 2,661	$ —	$ 2,661	14.4%
Florida	1,860	—	1,860	10.0%
Pennsylvania	521	1,260	1,781	9.6%
New York	1,530	—	1,530	8.3%
New Jersey	495	655	1,150	6.2%
Texas	832	—	832	4.5%
Ohio	522	211	733	4.0%
Illinois	714	—	714	3.9%
Connecticut	306	374	680	3.7%
North Carolina	283	307	590	3.2%
Totals, 10 states:	**$ 9,724**	**$ 2,808**	**$ 12,533**	**67.7%**

When the Bush estate tax

repeal is fully in place in 2012 (as the House proposes), the loss of the pickup tax alone would cost state governments a total of $15.2 billion. If state supplemental estate and inheritance taxes are lost as well, the annual direct revenue loss to the states would grow to $18.5 billion.

In terms of dollars, the largest revenue losses would (or could) be experienced by:

- California: $2.7 billion in 2010 (pickup tax only).
- Florida: $1.9 billion (pickup only).
- Pennsylvania: $1.8 billion, including $521 million from the lost pickup tax and potentially $1,260 million in endangered supplemental inheritance tax.
- New York: $1.5 billion (pickup only)
- New Jersey: $1.2 billion, including $495 million from the lost pickup tax and potentially $655 million in endangered supplemental inheritance tax.
- Texas: $832 million (pickup only)
- Ohio: $733 million, including $522 million from the lost pickup tax and potentially $211 million in endangered supplemental inheritance tax.
- Illinois: $714 million (pickup only)
- Connecticut: $680 million, including $306 million from the lost pickup tax and potentially $374 million in endangered supplemental inheritance tax.
- North Carolina: $590 million, including $283 million from the lost pickup tax and potentially $307 million in endangered supplemental inheritance tax.

Just the five biggest potential losers, California, Florida, Pennsylvania, New York and New Jersey, represent almost half of the total potential revenue loss nationwide.

As shares of total state tax revenues, the biggest direct losses from estate tax repeal

States Potentially Losing the Largest Shares of Total Tax Revenues from Repeal of the Federal Estate Tax
State-by-State Estimates for the year 2012, $-millions

Shares of total state tax revenues in danger	"Pickup" Tax	Endangered Other Inheritance Tax	Total Lost or Endangered	$-mill.
New Hampshire	1.9%	2.6%	4.5%	$ 146
Pennsylvania	0.8%	2.0%	2.9%	1,781
Connecticut	1.2%	1.5%	2.7%	680
New York	2.7%	—	2.7%	1,530
Florida	2.6%	—	2.6%	1,860
New Jersey	0.9%	1.2%	2.2%	1,150
Vermont	2.0%	—	2.0%	62
Delaware	1.6%	—	1.6%	43
Oklahoma	0.8%	0.7%	1.4%	296
Massachusetts	1.4%	—	1.4%	350
Ohio	1.0%	0.4%	1.4%	733
Indiana	0.6%	0.6%	1.3%	389
Nevada	1.3%	—	1.3%	110
California	1.2%	—	1.2%	2,661
Illinois	1.2%	—	1.2%	714
North Carolina	0.6%	0.6%	1.2%	590
District of Columbia	1.1%	—	1.1%	90
Tennessee	0.9%	0.2%	1.1%	236
Missouri	1.1%	—	1.1%	297
Virginia	1.1%	—	1.1%	349
Iowa	0.8%	0.2%	1.0%	142
Kansas	1.0%	—	1.0%	111
Arizona	1.0%	—	1.0%	232
Maryland	0.9%	0.1%	1.0%	310
Louisiana	1.0%	—	1.0%	199
Maine	1.0%	—	1.0%	61

would (or could) be experienced by:

- New Hampshire: 4.5 percent of total state tax revenue, including 1.9 percent from the lost pickup tax and 2.6 percent in endangered supplemental inheritance tax. (New Hampshire Governor Jeanne Shaheen has recently proposed to repeal the state's supplemental inheritance tax.)
- Pennsylvania: 2.9 percent of total state tax revenue, including 0.8 percent from the lost pickup tax and 2.0 percent in endangered supplemental inheritance tax.
- Connecticut: 2.7 percent of total state tax revenue, including 1.2 percent from the lost pickup tax and 1.5 percent in endangered supplemental inheritance tax.
- New York: 2.7 percent of total state tax revenue (pickup only).
- Florida: 2.6 percent of total state tax revenue (pickup only).
- New Jersey: 2.2 percent of total state tax revenue, including 0.9 percent from the lost pickup tax and 1.2 percent in endangered supplemental inheritance tax.
- Vermont: 2.0 percent of total state tax revenue (pickup only).
- Delaware: 1.6 percent of total state tax revenue (pickup only).
- Oklahoma: 1.4 percent of total state tax revenue, including 0.8 percent from the lost pickup tax and 0.7 percent in endangered supplemental inheritance tax.
- Massachusetts: 1.4 percent of total state tax revenue (pickup only).
- Ohio: 1.4 percent of total state tax revenue, including 1.0 percent from the lost pickup tax and 0.4 percent in endangered supplemental inheritance tax.

A table showing the direct effects on all of the states of estate tax repeal is at the end of this paper as an appendix. As the next section of this paper details, however, these direct effects far understate the total impact of estate tax elimination on the states.

2. State *Income Tax* Losses from Estate Tax Repeal—Another $16.5 Billion a Year

A second effect of Bush's proposed repeal of the federal estate and gift tax is the major negative impact it would have on *income tax revenues*, both federal and state. When the gift tax was first attached to the estate tax back in 1932, its purpose was not only to curb estate tax avoidance, but also to protect the integrity of the income tax. Without the gift tax, many wealthy people could find ways to make temporary, untaxed transfers of their assets to low- or no-tax entities, and then, after interest, dividends, capital gains and so forth have been realized, recover the proceeds.[1]

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[1]Some of the potential income tax avoidance schemes are outlined in testimony before the House Ways and Means Committee on March 21, 2000 by Lauren Y. Detzel, an attorney with Dean Mead Egerton Bloodworth Capauano & Bozarth, P.A., of Orlando, Florida; in the *New York Times*, Jan. 21, 2001 (David Cay Johnston), citing numerous tax experts; by John Buckley of the House Ways and Means Committee staff in *Tax Notes*, Jan. 22, 2001, and by Jonathan Blattmachr and Mitchell Gans in "Wealth Transfer Tax Repeal: Some Thoughts on Policy & Planning," *Trusts & Estates*, Volume 140 #2, p. 49 (Feb. 2001).

Recently, the congressional Joint Committee on Taxation took note of this huge problem and sharply revised its previous estimates of the cost of estate tax elimination. Repeal of the estate and gift tax is now expected to cost the federal government 82 percent more than the tax currently raises! By fiscal 2011, for example, repeal would cost $96.9 billion a year, compared to anticipated federal estate and gift tax revenues without repeal of $53.4 billion that year. The $43.5 billion added annual cost would stem from widespread income tax avoidance.[2]

The Joint Tax figures imply that the best-off one percent of taxpayers would take advantage of estate and gift tax repeal to avoid about a fifth of the federal income taxes they now pay on their capital gains, interest and dividends—an estimate that may well be conservative once creative lawyers and accountants get to work. State income taxes would be endangered by estate tax repeal, too, perhaps to an even greater degree than federal taxes, because of the ease of moving investment assets from state to state.

As a result, the cost to the states from elimination of the estate tax could easily reach $35 billion a year in combined estate tax and income tax losses once repeal is fully effective.

Federal & State Revenue Losses from Repeal of the Federal Estate & Gift Tax

(Based on House-passed plan, not fully effective until fiscal 2012)

fiscal yrs, $-billions	2003	2004	2005	2006	2007	2008	2009	2010	2011	*2012*	Source
FEDERAL:											
Current federal estate & gift taxes	$ 34.9	$ 36.0	$ 36.4	$ 37.3	$ 39.8	$ 43.7	$ 46.4	$ 49.3	$ 53.4	$ 57.8	JCT except 2012
Immediate repeal	–54.5	–58.4	–61.1	–64.4	–69.7	–76.4	–82.8	–88.8	–96.9	–104.7	
House phased-in estate tax repeal	**–7.0**	**–9.1**	**–11.3**	**–13.1**	**–14.9**	**–19.8**	**–27.4**	**–33.7**	**–49.2**	**–104.7**	JCT 03-11
Loss of estate tax	–5.7	–7.2	–8.5	–9.7	–10.9	–13.3	–17.4	–20.9	–28.2	–57.8	CTJ, based on JCT
Income tax losses	–1.3	–1.9	–2.8	–3.4	–4.0	–6.5	–10.0	–12.8	–21.0	–46.9	
% of cost											
Estate & gift taxes	81%	79%	75%	74%	73%	67%	63%	62%	57%	55%	
Income taxes	19%	21%	25%	26%	27%	33%	37%	38%	43%	45%	
Income tax losses add to direct loss	+23%	+26%	+33%	+35%	+37%	+49%	+58%	+61%	+74%	+81%	
STATE											
State estate taxes now	$ 11.2	$ 11.5	$ 11.7	$ 12.0	$ 12.8	$ 14.0	$ 14.9	$ 15.8	$ 17.1	$ 18.5	IRS/CTJ
State losses											
Lost estate taxes	–1.8	–2.3	–2.7	–3.1	–3.5	–4.3	–5.6	–6.7	–9.0	–18.5	CTJ
Lost income taxes	–0.5	–0.7	–1.0	–1.2	–1.4	–2.3	–3.5	–4.5	–7.4	–16.5	CTJ
Total state losses	**$ –2.3**	**$ –3.0**	**$ –3.7**	**$ –4.3**	**$ –4.9**	**$ –6.6**	**$ –9.1**	**$ –11.2**	**$ –16.5**	**$ –35.1**	CTJ

Sources: Joint Committee on Taxation (JCT); Internal Revenue Service (IRS); Citizens for Tax Justice (CTJ) for 2012 and as noted.

[2]The Joint Committee figures assume a limited "carryover basis" to replace the current complete forgiveness of capital gains taxes on inherited assets. This provision is included in the version of estate tax repeal passed by the House in April, as is a vague exhortation to the Treasury Department to devise rules to curb income tax avoidance. Neither of these provisions is likely to do much.

3. Loss of Federal Tax Deductions for State and Local Taxes

In a third strike against state revenues, the Bush tax plan would indirectly make sharp reductions in federal itemized deductions for state and local taxes. Obviously, the lower marginal income tax rates proposed by President Bush would reduce the value of *all* federal income tax deductions somewhat. But the effects of the Bush plan on itemized deductions for state and local taxes are especially significant, potentially reducing the value of these deductions by more than 50 percent nationwide, and by even larger amounts in higher-income states.

Under the Bush tax plan, taxpayers in the top fifth of the income scale, except the top one percent, would see their apparent tax cuts sharply reduced because the President's tax cut plan would push millions of these taxpayers into the Alternative Minimum Tax. The "AMT," as the name implies, is an alternative income tax that taxpayers must pay if it exceeds their regular income tax. The AMT was originally intended to curb upper-income tax sheltering, but because its brackets have not been adjusted for inflation, it threatens to affect many taxpayers without shelters over the upcoming decade.[3]

According to the Joint Committee on Taxation, by 2006, Bush's tax cuts would double the number of taxpayers affected by the AMT, from fewer than 9 million to almost 19 million. That occurs because the Bush plan reduces the 28 percent and 31 percent regular income tax rates to 25 percent, but keeps the tax rates for the AMT at 26-28 percent.[4] (For the best-off one percent, the AMT effects are not very significant, because their top regular income tax rate will be 33 percent, down from 39.6 percent.)

Once in the AMT, taxpayers can no longer claim deductions for state and local taxes.

- Nationally, we calculate that for taxpayers in the top fifth of the income scale, excluding the best-off one percent, the Bush plan has the effect of denying them 78 percent of the state and local tax deductions they could otherwise take.

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[3]Under the AMT, taxpayers compute an "alternative taxable income." That equals regular taxable income, adjusted upwards for certain tax shelter items, and before personal exemptions, the standard deduction, and itemized deductions for state and local taxes. A special AMT standard exemption is deducted instead, which equals $45,000 for couples and $33,750 for unmarried taxpayers. Those AMT exemptions are not adjusted for inflation, so by 2008 their value in 2001 dollars will be only $37,600 for couples and $28,200 for singles. (The AMT exemptions are phased out between $150,000 and $330,000 for couples and between $112,500 and $247,500 for singles, also unindexed.) The AMT tax rate is 26 percent on the first $175,000 in alternative taxable income and 28 percent on amounts above that. (These amounts are also unindexed.)

[4]For example, take a family of four making $140,000, with $15,000 in itemized deduction and $11,200 in personal exemptions, leaving regular taxable income of $113,800. The family's regular income tax would be $26,400. Under the AMT, the family would add back to its taxable income its $11,200 in personal exemptions plus its, say, $10,000 in state and local taxes. Then it would subtract the AMT exemption ($37,600 in 2001 dollars in 2008), leaving $97,400 subject to the 26 percent AMT rate. The family's AMT would be $25,324. Since this is less than its regular income tax of $26,400, the AMT would not apply.

Under the Bush tax plan, however, the family's regular income tax would be only $23,565, considerably less than the AMT amount. So the AMT would apply to the family. As a result, the family's apparent tax cut under the Bush plan of $2,834 would end up being a tax cut of only $1,075—62 percent less.

- Because most itemizers are in the top fifth of the population, the Bush plan's AMT effect has the effect of cutting the total tax benefits from state and local tax deductions in half.

Such a large reduction in the federal tax benefits from state and local tax deductions could have a serious impact on the ability of states and localities to impose income and property taxes, since the effective burden of these taxes on the better-off would rise sharply under the Bush plan. The deductibility of state and local income and property taxes on federal itemizers' tax returns means that for every dollar in income or property taxes paid to a state or local government, federal taxpayers who itemize get a federal tax reduction of as much as 39.6 cents (depending on what federal tax bracket they are in). The reduced federal income tax rates under the Bush plan, and the resulting AMT hike, would reduce the percentage of state income and property taxes that would be "exported" to the federal government in the form of reduced federal income taxes.

Reducing the ability of states to export their income and property tax burdens to the federal government in this way would make these taxes a less attractive option for state policy makers—and could encourage states to rely more on regressive sales and excise taxes (which are *not* deductible for federal itemizers) as a source of funding. That would not be good news for the majority of state taxpayers.

Conclusion

Beyond its major effects on the federal budget, the Bush tax program threatens to reduce state revenues by upwards of $35 billion a year once it is fully in place—and to make state tax systems even more regressive than they already are. These serious impacts on the states have not received the attention they deserve, but they should worry anyone who cares about the adequacy of state and local public services and the fairness of how they are funded.

Appendix: Direct Effects on State Tax Revenues from Repeal of the Federal Estate Tax

State-by-State Estimates for the year 2012, $-millions

	State "Pickup" Tax Lost	Endangered Other Inheritance Tax	Total Lost or Endangered	Rank (total $$$)	As Shares of Total State Taxes: "Pickup" Tax	Other Inheritance Tax	Total	Rank (total share)
United States	**$ 15,198**	**$ 3,327**	**$ 18,525**		**1.1%**	**0.2%**	**1.4%**	
Alabama	136	—	136	29	0.7%	—	0.7%	35
Alaska	8	—	8	51	0.1%	—	0.1%	51
Arizona	232	—	232	21	1.0%	—	1.0%	23
Arkansas	104	—	104	33	0.8%	—	0.8%	34
California	2,661	—	2,661	**1**	1.2%	—	1.2%	14
Colorado	147	—	147	25	0.9%	—	0.9%	30
Connecticut	306	374	680	**9**	1.2%	1.5%	2.7%	**3**
Delaware	43	—	43	45	1.6%	—	1.6%	**8**
District of Columbia	90	—	90	35	1.1%	—	1.1%	17
Florida	1,860	—	1,860	**2**	2.6%	—	2.6%	**5**
Georgia	308	—	308	15	0.7%	—	0.7%	36
Hawaii	67	—	67	37	0.7%	—	0.7%	38
Idaho	28	—	28	46	0.4%	—	0.4%	49
Illinois	714	—	714	**8**	1.2%	—	1.2%	15
Indiana	198	191	389	11	0.6%	0.6%	1.3%	12
Iowa	111	31	142	27	0.8%	0.2%	1.0%	21
Kansas	111	—	111	31	1.0%	—	1.0%	22
Kentucky	135	—	135	30	0.8%	—	0.8%	32
Louisiana	199	—	199	22	1.0%	—	1.0%	25
Maine	61	—	61	39	1.0%	—	1.0%	26
Maryland	277	33	310	14	0.9%	0.1%	1.0%	24
Massachusetts	350	—	350	12	1.4%	—	1.4%	**10**
Michigan	293	—	293	18	0.5%	—	0.5%	44
Minnesota	196	—	196	24	0.4%	—	0.4%	46
Mississippi	51	—	51	41	0.4%	—	0.4%	47
Missouri	297	—	297	16	1.1%	—	1.1%	19
Montana	24	—	24	47	0.7%	—	0.7%	37
Nebraska	71	local tax	>71	na	0.6%	not available	>0.6%	na
Nevada	110	—	110	32	1.3%	—	1.3%	13
New Hampshire	61	85	146	26	1.9%	2.6%	4.5%	**1**
New Jersey	495	655	1,150	**5**	0.9%	1.2%	2.2%	**6**
New Mexico	51	—	51	42	0.4%	—	0.4%	48
New York	1,530	—	1,530	**4**	2.7%	—	2.7%	**4**
North Carolina	283	307	590	**10**	0.6%	0.6%	1.2%	16
North Dakota	15	—	15	49	0.5%	—	0.5%	45
Ohio	522	211	733	**7**	1.0%	0.4%	1.4%	11
Oklahoma	155	142	296	17	0.8%	0.7%	1.4%	**9**
Oregon	138	—	138	28	0.9%	—	0.9%	31
Pennsylvania	521	1,260	1,781	**3**	0.8%	2.0%	2.9%	**2**
Rhode Island	51	—	51	40	0.9%	—	0.9%	28
South Carolina	96	—	96	34	0.7%	—	0.7%	39
South Dakota	15	—	15	50	0.9%	—	0.9%	29
Tennessee	199	38	236	20	0.9%	0.2%	1.1%	18
Texas	832	—	832	**6**	0.9%	—	0.9%	27
Utah	44	—	44	44	0.3%	—	0.3%	50
Vermont	62	—	62	38	2.0%	—	2.0%	**7**
Virginia	349	—	349	13	1.1%	—	1.1%	20
Washington	272	—	272	19	0.6%	—	0.6%	40
West Virginia	47	—	47	43	0.5%	—	0.5%	43
Wisconsin	196	—	196	23	0.6%	—	0.6%	42
Wyoming	17	—	17	48	0.8%	—	0.8%	33

Notes: Pickup tax estimates for 2012 are based on estimated federal estate tax revenues in 2012 times the median of each state's pickup tax as a percentage of the federal tax in fiscal 1996-99. Other state inheritance taxes are assumed to bear the same relationship to the pickup tax as the median in fiscal 1996-99, except where state law has been changed. Totals include other areas.