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How Would Expiration of Bush-Era Tax Cuts Affect State and Local Budgets?

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Introduction

While the U.S. economy continues its slow crawl towards recovery, many states are currently in budget limbo. Last year's stimulus bill saved state lawmakers from some politically painful fiscal adjustments, but another federal windfall is unlikely. States are wondering where to go for more revenue and what can be cut from outlays. Here we discuss how the major federal tax policy question of the day, the expiring Bush tax cuts, could affect states at this already tight time.

We highlight four main areas of interaction between state finances and the expiring tax cuts. First we discuss how potential changes in federal tax law would change state and local income tax revenue, both directly and in more

Key Findings

- *Many state income tax systems piggy-back off the federal income tax. Due to potential changes in federal taxable income, adjusted gross income, child tax credits and earned income tax credits, states that are linked closely to the federal tax code will see an automatic uptick in revenue if the Bush tax cuts expire.*
- *The handful of states that allow a deduction for federal income taxes paid are likely to see a revenue loss if federal income taxes increase, even after accounting for other revenue-increasing effects.*
- *"Interactive" effects from the expiration of the Bush tax cuts, either in January 2011 or some later date after a temporary extension, include a decrease in the value of the federal deduction for state and local taxes; a reduction in state revenues due to shrinking income and sales tax bases; and changes in tax planning by filers.*
- *If the federal estate tax returns there would be an automatic return of the estate tax in many states that are linked to the federal estate tax.*
- *Congress's actions on the Bush tax cuts could affect the federal and state budget conditions in the long term. We briefly discuss the consequences for states of a possible federal value added tax, the possibility that declining federal credits could hurt the states' ability to borrow, and the potential macroeconomic impacts of Congress' handling of the Bush tax cuts.*

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subtle, interactive ways. Secondly, we discuss the impact on state estate taxes if the federal estate tax is revived after its one-year repeal in 2010. Third, because higher taxes mean less money in peoples' wallets, we discuss the impact of various federal tax policy options on state and local sales tax collections. Finally, we discuss how the Bush tax cuts could affect the financial condition of the federal government as well as the macroeconomy, and the likely consequences for state and local finances.

Overview of Bush Tax Cuts

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) are generally referred to as the Bush tax cuts. Along with subsequent modifications, these bills significantly lowered federal individual income tax liabilities for virtually all tax filers and significantly cut the federal estate tax. In summary, the key provisions:

- Reduced marginal income tax rates for all earners and introduced a new 10-percent bracket below the previous lowest rate of 15 percent;
- Provided "marriage penalty" relief by increasing the standard deduction and raising the ceiling of the 15-percent bracket for married couples to an amount exactly double the amount in law for single filers;
- Gradually eliminated the limitations on personal exemptions and itemized deductions (respectively dubbed the PEP and Pease provisions) for high-income taxpayers;
- Doubled the child tax credit from $500 to $1,000 and made more taxpayers eligible for the refundable portion of the child credit;
- Expanded the earned income tax credit (EITC), the adoption credit, and the dependent care credit;
- Reduced tax rates on long-term capital gains and qualified dividends; and
- Gradually reduced the federal estate tax rate and increased the exemption, eventually eliminating the estate tax for 2010.

These tax cuts are scheduled in law to sunset 10 years after enactment. Republicans would have liked to make them permanent, but during the debate in the spring of 2001, Senate Republicans were unable to obtain the 60 votes they needed. They settled instead for a 10-year, temporary enactment, and since one of the provisions was effective retroactive to January 1, 2001, the sunset date is December 31, 2010.[1]

The tax cuts have reduced federal revenue considerably. If they were extended for another 10 years (fiscal years 2011-2020), the Office of Management and Budget estimates that federal revenues would be approximately $3 trillion lower than they would be if the tax cuts expired on schedule.[2] Instead of full extension as Republicans favor, if Democrats have their way, all the tax cuts would be extended except provisions affecting high-income taxpayers, and as a result, the 10-year impact on the deficit would drop from $3 trillion to $2.4 trillion. The Obama administration's specific tax proposals in the 2011 budget are apparently no longer under consideration, though both the Democratic and Republican proposals contain many of the same provisions.

Direct and Interactive Effects of Expiring Tax Cuts on State and Local Income Taxes

The area where the expiring federal income tax provisions are likely to have the most obvious and direct impact is on state and local income

1 Sixty votes are necessary in the Senate to override a point-of-order which can be raised whenever the Senate is voting on a measure that would add to the federal deficit beyond the 10-year budget window.

2 Office of Management and Budget, *Mid-Session Review, Budget of the U.S. Government, Fiscal Year 2011,* July 2010, http://www.whitehouse.gov/sites/default/files/omb/budget/fy2011/assets/11msr.pdf.

taxes, which are often statutorily based on the federal income tax. Virtually all of the 43 states that levy an individual income tax direct their taxpayers to enter some information directly from their federal form 1040.

For example, most state income tax filers must begin their calculations by entering federal adjusted gross income (AGI). As a result, any federal change to the definition of AGI changes state tax revenues. Some states link their systems more tightly with federal policy by having their taxpayers begin the calculation with federal taxable income, the definition of which is changed with regularity. All of these state-level "piggy back" provisions mean that when the federal government changes one of its tax laws, often states have to re-estimate what they can expect to collect in state income tax revenue.

As the expiration date of the Bush-era tax cuts approaches, these are the key provisions and interactions that may affect state income tax collections in 2011:

- State deductions for federal taxes paid would increase in the few states that allow this deduction;
- Scaled-back or eliminated deductions result in more income included in federal AGI;
- More income will be taxable at the federal level, not only because of higher AGI but also because of the suddenly lower dollar amounts set for the standard deduction and personal exemptions, and the return of limitations on personal exemptions and itemized deductions (PEP and Pease); and
- Changes to the federal earned income tax credit (EITC).

Table 1 summarizes which states' individual income tax systems would be affected by each of these interactions.

In addition to direct effects on state taxes resulting from statutory changes to the federal income tax, there are other interactive effects that the Bush income tax cuts have on state income taxes, such as:

- Impact of the Bush tax cuts (and AMT) on the value of state and local tax deductions and what that means strategically for state and local tax policy;
- Tax planning effects of the Bush tax cuts' expiration, perhaps causing some taxpayers to shift the timing of income and deductions to minimize their overall federal tax bill over multiple years, which would reverberate in state income tax revenues; and
- Supply-side effects of higher marginal tax rates, resulting in a smaller income tax base for states to tax.

Direct Effect: State Deduction for Federal Income Taxes Paid

Some states allow taxpayers to deduct federal income taxes from their taxable income for state income tax purposes. For these states, federal tax changes can directly affect state income tax collections. This provision has been dropped by several states over the past 20 years, but six states — Alabama, Iowa, Louisiana, Missouri, Montana and Oregon — still allow the deduction to some degree.

If the Bush tax cuts expire for everyone, or even just for high-income filers, revenue will fall in these states as state taxpayers deduct higher payments to Washington. This is likely to be true, even after accounting for revenue increasing effects, especially for states whose tax systems are not closely linked to the federal income tax code. The Alabama Department of Revenue has estimated that if the Bush tax cuts expire completely, the increased deductions for federal taxes paid could cost the state up to $106 million ($25 million in the case of the Democratic proposal).[3]

3 Ely, Bruce P., and Thistle, William T, "Letting Bush Tax Cuts Lapse Could Cost Alabama $154 Million, DOR Says," Tax Analysts, Doc 2010-22903, Oct. 25, 2010.

Direct Effect: Small Changes to What Is Included in Federal Adjusted Gross Income

Most states use federal adjusted gross income (AGI) as the starting point for calculating state income taxes. The Bush tax cuts made some changes to the definition of AGI, shrinking the total and thereby shrinking state income tax revenue in some states, albeit slightly. Some states take countermeasures, requiring tax filers to modify AGI for state tax purposes by adding back in these various "above-the-line" federal deductions. However, some states have maintained the linkages, and for them there are three significant provisions that will, if extended, continue to suppress state income tax collections. If they expire, the reverse will happen: federal AGI will grow, and state income tax collections will rise slightly:

- Congress created a new above-the-line deduction for higher education tuition and fees, with a maximum deduction of $4,000, $2,000, or zero, depending on the income of the taxpayer. This initially temporary provision has been renewed annually in the so-called extenders bill but is set to expire if no action is taken.
- The Bush tax cuts also modified the existing student loan interest deduction by raising the threshold where the deduction begins to phase out and doubling the phase-out threshold for married taxpayers.
- In 2002 an above-the-line deduction of up to $250 was enacted for teachers who purchase classroom education materials. This provision expired at the end of 2009 and has not yet been extended.

Direct Effect: Changes to Federal Taxable Income

In addition to shrinking AGI slightly, the Bush-era tax cuts expanded personal exemptions and itemized deductions, especially for high-income taxpayers. This was accomplished by eliminating the personal exemption phase-out (PEP) and the phase-out of itemized deductions (Pease) for high-income taxpayers, thereby shrinking federal taxable income. State income tax systems that start their calculations with AGI and do not allow subtractions of federal itemized deductions or personal exemptions are not sensitive to these federal changes. But those states that start with federal taxable income without modification experienced revenue losses when the Bush tax cuts were enacted, and they will see revenue shift upward if any of the Bush-era policies relating to itemized deductions and personal exemptions expire.

Changes to Itemized Deductions

Some state income taxes make it administratively easy for their tax filers by beginning their calculations with federal taxable income or amending it slightly. But in this case, what is easy arithmetically is hard on state revenue estimators. The federal government frequently makes changes to the calculation of federal taxable income, and in recent years that has meant a shrinking taxable income base driven by expanding tax deductions.

Other states create their own state taxable income figure, a process that has the potential to insulate the state from federal changes, but often those calculations incorporate a taxpayer's federal itemized deductions, resulting in the same vulnerability to federal tax changes. In either case, if itemized deductions are kept as they are in 2010, state tax revenue will be stable. If itemized deductions shrink substantially, as they will under expiration, state revenue will grow.

Until recently, one major component in defining taxable income was the so-called Pease provision. Pease, which was a feature of federal tax law throughout the 1990s, reduced the total value of itemized deductions by phasing them out for upper-income people. The Bush tax cuts gradually eliminated the Pease provision over the past decade. The result was that many upper-income taxpayers saved on their taxes by receiving the full value of their itemized deductions. That reduced federal taxable income, and for many states it reduced state taxable income and hence state income tax revenue.

In 2011, two scenarios will reinstate the Pease limitation: either full expiration on December 31 as scheduled in current law, or the Democratic plan that may be enacted during a lame duck session after the mid-term elections. If the Democratic plan is enacted, Pease would return for taxpayers with incomes above $200,000 (single) or $250,000 (married). If full expiration occurs, deductions would be curtailed even further because the income thresholds would be lower.

States that are still linked to the federal code could see an uptick in state income tax collections in either of these two scenarios. Some states will not be affected by this potential change in the Pease provision. They apply their own rules as to which itemized deductions may be taken and the extent to which they are limited for high-income taxpayers. These are the states that are not "coupled" to federal policy.[4]

Direct Effect: Bush Tax Cuts, EITC, and Interaction of Federal and State EITCs

The earned income tax credit (EITC) is a refundable federal tax credit for low-income working individuals and families. Twenty-three states offered a state-level EITC in 2009, and all of them piggy-back off the federal EITC in some way. Most state EITCs are refundable, as is the federal version, and most state EITCs are calculated as a percentage of a taxpayer's federal EITC. For example, the state EITC available to tax filers in New Jersey is simply 25 percent of their federal EITC.

The Bush tax cuts increased the federal EITC phase-out thresholds for married taxpayers. Previously, the EITC had begun to phase out at the same income level regardless of marital status, but the Bush tax cuts added $3,000 to the phase-out threshold for married taxpayers as part of its "marriage penalty relief." This change had the effect of increasing the credit amount for many married couples whose income had previously either completely disqualified them or caused their EITC to be reduced.

As part of the American Recovery and Reinvestment Act of 2009 (ARRA, often referred to as the stimulus bill), the Obama administration made two temporary changes to the EITC, similar to what the Bush administration had done. First, ARRA raised the phase-out threshold for married filers from $3,000 to $5000 above the threshold for single taxpayers. In addition, for filers with three or more children, ARRA increased the EITC credit rate from 40 percent to 45 percent of earned income, raising the maximum credit from $5,028 to $5,657 in 2010.

Because state EITCs equal a percentage of the amount claimed at the federal level, the expiration of any of these federal EITC expansions would decrease state EITC claims and increase state tax revenue from EITC filers.

The Obama administration has proposed keeping all of these EITC expansions: the one from the Bush years and both of the provisions enacted as part of ARRA, but this proposal has not gained broad support in Congress. Congressional Democrats have signaled that they would favor keeping only the Bush-era and ARRA phase-out threshold expansions for married filers, but not the new 3-child credit rate expansion. Congressional Republicans wish to retain only the Bush-era expansion.

In every likely scenario, then, state EITC claims will fall somewhat from 2010, leaving states with more revenue. State revenue will be slightly higher if the congressional Democrats' plan becomes law, yet a bit higher than that if the Republican plan becomes law, and

4 Fleenor, Patrick W., "PEP and Pease: Repealed for 2010 But Preparing a Comeback," *Tax Foundation Special Report,* No. 178, Tax Foundation, April 2010.

Table 1

How State Income Taxes Are Directly Affected by Expiring Bush Tax Cuts

State	Federal Deductibility	Changes to Federal AGI	Changes to Pease	Changes to Federal EITC
Alabama	Yes	No	Yes	No
Alaska	–	–	–	–
Arizona	No	Yes	Yes	No
Arkansas	No	No	Yes	No
California	No	No	No	No
Colorado	No	Yes	Yes	No
Connecticut	No	Yes	No	No
Delaware	No	Yes	Yes	Yes
Florida	–	–	–	–
Georgia	No	Yes	Yes	No
Hawaii	No	Yes	Yes	No
Idaho	No	Yes	Yes	No
Illinois	No	Yes	No	Yes
Indiana	No	Yes	No	Yes
Iowa	Yes	Yes	Yes	Yes
Kansas	No	Yes	Yes	Yes
Kentucky	No	Yes	Yes	No
Louisiana	Yes	Yes	Yes	Yes
Maine	No	Yes	Yes	Yes
Maryland	No	Yes	Yes	Yes
Massachusetts	No	No	No	Yes
Michigan	No	Yes	No	Yes
Minnesota	No	Yes	Yes	Yes
Mississippi	No	No	Yes	No
Missouri	Yes (a)	Yes	Yes	No
Montana	Yes (a)	Yes	Yes	No
Nebraska	No	Yes	Yes	Yes
Nevada	–	–	–	–
New Hampshire (b)	No	No	No	No
New Jersey	No	No	No	Yes
New Mexico	No	Yes	Yes	Yes
New York	No	Yes	Yes (c)	Yes
North Carolina	No	Yes	Yes	Yes
North Dakota	No	Yes	Yes	No
Ohio	No	Yes	No	No
Oklahoma	No	Yes	Yes	Yes
Oregon	Yes	Yes	Yes	Yes
Pennsylvania	No	No	No	No
Rhode Island	No	Yes	No	Yes
South Carolina	No	Yes	Yes	No
South Dakota	–	–	–	–
Tennessee (b)	No	No	No	No
Texas	–	–	–	–
Utah	No	Yes	Yes (d)	No
Vermont	No	Yes	Yes	Yes
Virginia	No	Yes	Yes	Yes
Washington	–	–	–	–
West Virginia	No	Yes	No	No
Wisconsin	No	Yes	No	Yes
Wyoming	–	–	–	–
Dist. of Columbia	No	No	Yes	Yes

(a) Deduction for federal taxes paid is limited to $5,000 (single filer) or $10,000 (married filers).
(b) New Hampshire and Tennessee tax only interest and dividend income.
(c) New York piggy-backs off the federal Pease, and it also applies an additional four-tiered phase-out of itemized deductions on top of Pease.
(d) Utah offers a non-refundable tax credit worth 6% of federal itemized deductions. The credit phases out at a rate of 1.3% of income over a phase-out threshold.
Sources: Tax Policy Center, Institute on Taxation and Economic Policy, CCH, and Tax Foundation research of state tax rates, forms and instructions.

even higher if the Bush tax cuts and ARRA fully expire.[5]

Interactive Effect: Federal Deduction for State and Local Taxes Becomes Less Valuable

Prior to the Bush tax cuts the Pease provision was in full effect, limiting itemized deduction for high-income taxpayers. Itemized deductions were phased out by an amount equal to 3 percent of AGI but never below 20 percent of their original amount. Under full expiration the income threshold at which the restored Pease phase-out would take effect in 2011 is $170,150. President Obama proposes a higher income threshold to fulfill his campaign promise to prevent tax increases on those earning less than $200,000 (single) or $250,000 (married). The Democratic proposal adopts these levels as well.

Even though taxpayers can lose up to 80 percent of the value of their deductions under Pease, even high-income taxpayers will rarely see their deductions reduced so drastically. As their income increases, taxpayers subject to a marginal state income tax rate greater than 3 percent, the Pease phase-out rate, would find that the value of their federal deduction for state-local taxes would grow rapidly enough to prevent Pease from ever reducing their itemized deductions all the way to the 20-percent floor. The majority of itemizers will fall into this category.

The Bush tax cuts eliminated Pease entirely. Their expiration, whether for everyone or just for high-income people, would reinstate Pease and directly affect two major itemized deductions that interact with state and local tax policy: the deduction for state and local income or general sales taxes and the itemized deduction for real estate taxes (as well as the new standard deduction for real estate taxes paid).

5 Kasprak, Nicholas A., "The Potential Impact of Expiring Tax Cuts on Low-Income Taxpayers," *Tax Foundation Fiscal Fact,* No. 250, Tax Foundation, October 2010.

The federal deductions for state and local taxes paid are an implicit subsidy to state and local governments. States can raise taxes on their residents by some amount, and then those residents will deduct that amount on their federal income taxes, thereby having some fraction of the state tax increase "paid" by the federal government with other federal taxpayers' money. The Joint Committee on Taxation estimates that in 2010, a year in which Pease is not in effect, the deductions for state and local income taxes, general sales taxes, and personal property taxes will reduce federal revenues by an estimated $34 billion, while the deductions for real property taxes will cost the government roughly $17 billion.[6]

Overall, as states look with increasing frequency to high-income taxpayers for additional revenue, Congress's actions regarding Pease and income tax rates could hit home in the states. If Pease returns in full effect, the federal subsidy for state income and sales taxes will be reduced and state tax increases would hurt a bit more, which could have mid- and long-term political and budgetary implications in those states.

Technically, the very existence of the itemized deduction for general sales taxes and the new standard deduction for real estate taxes is also up in the air. While not part of the expiring "Bush" tax cuts, these provisions have been extended every year for the past decade as part of the annual "extenders" bill. They have yet to be extended for tax year 2010 or 2011. The same holds true for the alternative minimum tax (AMT), which Congress has yet to "patch" for 2010. The AMT interacts with state and local tax policy because it disallows all deductions for state and local taxes (income, sales, and property). In its current form, it tends to hit taxpayers that live in high-tax, high-income areas. But if it were not patched, it would affect more and more taxpayers.

Interactive Effect: Federal Income Tax Planning and Likely Effects on the States

Some taxpayers have a considerable amount of control over the timing of their income and deductions. The pending expiration of the Bush tax cuts will lead some of these taxpayers to shift the timing of income and deductions to minimize their tax liability over multiple years.

Although almost every taxpayer has some discretion over the timing of some taxable income, such as when to make an IRA contribution, high-income taxpayers have a great deal more to gain from such tax planning strategies. Also, they receive a larger fraction of their income from flexible sources, and faced with the likelihood of higher tax rates in 2011, they are expected to move significant amounts of income from 2011 to 2010. In fact, federal and state revenue estimators are already banking on a surge of revenue in December.

One way taxpayers may implement this tax strategy is through "advanced" wages or bonuses paid in 2010 for labor that will be done in 2011. For example, the Los Angeles Lakers could pay Kobe Bryant his entire 2010-2011 salary in December and save him quite a bit of money, assuming that the Bush tax cuts expire or that the Democratic plan is enacted. If the Republican plan were enacted, extending all current rates, then the advance payment would have been for mostly for naught.

Another way taxpayers may move income from 2011 to 2010 is by realizing capital gains in 2010 as opposed to 2011. As the Congressional Budget Office (CBO) projections of capital gains realizations show, a significant jump in capital gains realizations is expected for 2010, followed by a sudden drop in 2011.[7] This is almost entirely the result of CBO's assumption that investors will anticipate higher tax rates and respond by realizing capital

6 Joint Committee on Taxation, "Estimates for Federal Tax Expenditures for Fiscal Years 2009-2013," Jan. 11, 2010, available at http://www.jct.gov/publications.html?func=startdown&id=3642

7 Congressional Budget Office. "The Budget and Economic Outlook: Fiscal Years 2010 to 2020" Jan. 2010. http://www.cbo.gov/ftpdocs/108xx/doc10871/01-26-Outlook.pdf

gains before those rates take effect. Even if the Obama administration or Democratic proposal to extend the tax cuts for everyone earning less than $200,000 (single) or $250,000 (married) is enacted, revenue estimators should expect high-end taxpayers to shift a significant amount of income.

Another tax planning strategy is for taxpayers to shift the timing of some itemized deductions. For example, taxpayers who were planning to give large sums to charity in 2011 may move that donation up to 2010 to avoid the return in 2011 of the Pease limitation on itemized deductions.

However, there is a counteracting effect that could prompt some taxpayers to shift itemized deductions in the opposite direction. Remember that the same expiration that would bring back Pease would also raise statutory tax rates for those same taxpayers. The tax benefit one receives from itemized deductions is directly related to one's marginal income tax rate: the higher the tax rate, the greater the tax savings from each dollar in itemized deductions. For some high-income taxpayers the effect of higher tax rates would outweigh the effect of Pease, meaning savvy taxpayers would minimize their multi-year tax liability by pushing deductions into 2011, even after accounting for Pease. For the majority of taxpayers, though, Pease would outweigh this effect and the net result will probably be a shifting of itemized deductions into 2010. Both of these effects on itemized deductions are important for high-income people because they give the largest amounts to charity and the timing of donations is generally flexible.

Despite the net movement of charitable deductions into 2010, which will diminish 2010's tax collections somewhat, on whole the net effect of all the tax planning strategies discussed above will be greater revenues for federal and state governments in 2010. This effect is likely to be most pronounced in high-income states like Connecticut, New Jersey and California. States should be mindful that the expected jump in revenue at the end of 2010 is not a windfall, and that if it is as large as some expect, it will come at the expense of the next year's budget.

Finally, because 2010 is the first year in which all taxpayers may contribute to Roth IRA plans (including conversions from traditional IRA plans) as a result of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), and because tax rates are set to be higher in 2011, many financial advisors are encouraging their clients to pay taxes in 2010 on a portion of their retirement plans. From the federal government's perspective, this has the effect of pushing tax collections up to 2010 at the expense of future tax years. To the extent that states have the same treatment of Roth IRAs as the federal government, states would face the same effect: more revenue now at the expense of lower revenues tomorrow.

Interactive Effect: Supply-side Effects of Bush Tax Cuts and Impact on State Income Tax Bases

Because workers value both consumption and leisure, and because there is only a limited amount of time available to them, they face a trade-off between work (which provides the income used for consumption) and leisure. A worker must choose how much time to devote to working and how much to devote to leisure, and this decision is affected by their wage rate and the value they place on leisure. If additional work doesn't generate enough additional income (that is, potential consumption) the worker will choose to spend her time in leisure.

Of course, income tax rates affect this labor-leisure tradeoff because they reduce a worker's after-tax wage. The higher the marginal tax rate, the more likely it is that a worker will choose an extra hour of leisure over an extra hour of work. As economists put this problem, higher marginal tax rates expand

Table 2

Top Marginal Effective Tax Rates (METR) on Labor Income by State (a) Calendar Year 2011

State	Top METR (Congressional Democrats' Plan)	Rank (b)	Top METR (Congressional Republicans' Plan)	Rank (b)
Alabama	44.90%	40	39.41%	40
Alaska (c)	42.94	42	37.21	42
Arizona	45.72	36	40.12	37
Arkansas	47.60	11	42.08	14
California	49.37	2	44.14	2
Colorado	45.78%	35	40.18%	35
Connecticut	46.81	20	41.38	19
Delaware	47.30	15	41.77	15
Florida (c)	42.94	42	37.21	42
Georgia	46.62	23	41.06	24
Hawaii	49.69%	1	44.26%	1
Idaho	47.73	9	42.21	9
Illinois	44.72	41	39.13	41
Indiana	45.65	37	40.13	36
Iowa	46.51	25	41.21	22
Kansas	46.90%	19	41.35%	21
Kentucky	47.09	18	41.54	18
Louisiana	45.22	39	39.76	39
Maine	48.16	7	42.66	7
Maryland	48.60	4	43.13	4
Massachusetts	46.09%	29	40.61%	29
Michigan	45.79	34	40.28	34
Minnesota	47.76	8	42.24	8
Mississippi	46.01	30	40.42	30
Missouri	46.69	22	41.13	23
Montana	46.62%	23	41.06%	24
Nebraska	47.14	17	41.60	17
Nevada (b)	42.94	42	37.21	42
New Hampshire (c, d)	42.94	42	37.21	42
New Jersey	48.33	6	43.02	5
New Mexico	45.94%	31	40.35%	32
New York (non-NYC)	48.44	5	42.96	6
New York City	50.68	(1)	45.30	(1)
North Carolina	47.69	10	42.18	11
North Dakota	45.92	32	40.33	33
Ohio	47.57	12	42.19	10
Oklahoma	46.31%	27	40.74%	27
Oregon	47.35	14	42.14	13
Pennsylvania	45.51	38	39.98	38
Rhode Island	46.21	28	40.74	27
South Carolina	47.23	16	41.70	16
South Dakota (c)	42.94%	42	37.21%	42
Tennessee (c, d)	42.94	42	37.21	42
Texas (c)	42.94	42	37.21	42
Utah	45.92	33	40.42	30
Vermont	48.77	3	43.30	3
Virginia	46.47%	26	40.90%	26
Washington (c)	42.94	42	37.21	42
West Virginia	46.81	20	41.38	19
Wisconsin	47.55	13	42.18	11
Wyoming (c)	42.94	42	37.21	42
District of Columbia	48.16%	(8)	42.66%	(8)

(a) Technically, the METRs presented here are for self-employed workers. Under standard incidence assumptions for income and payroll taxes, the differences between the maximum METRs for self-employment and labor income are minimal.
(b) State ranks only include the 50 states. Ranks in parentheses next to the District of Columbia and New York City are what they would have ranked if included.
(c) These states have no wage income tax. For very high-income taxpayers in these states the implicit surtax resulting from the limitation on itemized deductions would cease, thereby reducing the state's marginal effective tax rate by about 1 percentage point.
(d) New Hampshire and Tennessee tax investment income at 5 and 6 percent respectively, but neither taxes labor income, so their state income tax rates for the purposes of this table are zero.
Source: Tax Foundation calculations.

the wedge between labor and leisure. While real-world conditions complicate this picture, the basic tradeoff still holds. It should also be noted that most economists agree that as after-tax wages rise, individuals will engage in more work and less leisure, but only up to a point. Eventually, wages rise to a level that persuades individuals to spend less time working.

The effect of higher tax rates on capital income is similar, except that instead of resulting in a preference for leisure over labor, it results in a postponement of income realization and spending. Therefore, higher income tax rates typically lead to less investment and less labor supply, and thereby less income to tax.

The extent of this depressing effect on labor and income for the typical middle-income taxpayer is relatively small. From evidence of past tax rate cuts and increases, high-income taxpayers and second earners are the most sensitive to higher marginal tax rates.[8] Therefore, higher tax rates on those at the top of the income spectrum have the greatest adverse impact on the size of the income base. This effect of taxes on work is the subject of some of the most intense partisan disagreement in Washington, not over the existence of the labor-leisure trade-off but over its magnitude. Also, to some people the distributional benefit of taxing higher-income people at higher levels outweighs the deleterious effects on the tax base.

This depressing effect of high tax rates on taxable income — often called the supply-side effect — could compound problems for states like California and New York with high concentrations of high-income people. Those states already tend to have the most progressive

8 Carroll, Robert and Warren Hrung, "What Does the Taxable Income Elasticity Say About Dynamic Responses to Tax Changes?" *American Economic Review*, p. 426-431, May 2005, http://ideas.repec.org/a/aea/aecrev/v95y2005i2p426-431.html. See also Saez, Emmanuel, Joel Slemrod and Seth H. Giertz, "The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review," May 20, 2009, http://elsa.berkeley.edu/~saez/saez-slemrod-giertzJEL09elasticity.pdf.

state income taxes with the highest top rates, and many have raised them recently. As Table 2 shows, should the Bush tax cuts for high-income people expire, taxpayers in some states would face a top combined federal and state marginal effective tax rate on labor income, essentially the tax rate on the last dollar of income earned, approaching 50 percent in 2011.[9] In 2013, each of these tax rates will be nearly one percentage point higher when the new health care reform's Medicare tax on high-income tax returns' labor income takes effect.

Impact of Expiring Tax Cuts on State and Local Sales Taxes

When consumers purchase items that are subject to a sales tax at the state or local level, they are spending after-tax income. Therefore, any reduction in net income, whether it comes from lower gross earnings or higher taxes imposed on those earnings, will reduce the amount that people spend on goods and services or the amount that they save.

Many states exempt certain "basic needs" consumption, such as groceries and clothing, from the sales tax and instead focus their sales tax on "nonessential" consumption such as entertainment, restaurant meals, and household goods. State and local sales tax revenue would obviously be hit hardest in the short term if a reduction in disposable income led consumers to spend less on taxable items, as opposed to nontaxable goods or savings.

But the nonessential goods are the very items that consumers are most likely to cut back on when their incomes are reduced, precisely because they are nonessentials. That is, purchases of these products tend to be sensitive to changes in income, more so than "basic needs" purchases. In a sense, the nonessentials are the "last" thing that consumers buy, while they use their "first" dollars earned to buy the necessities. It follows then that if their income is reduced consumers will cut purchases of nonessential goods and resist cutting "basic needs" purchases.

As noted above, the nonessential goods tend to be the very goods that states tax, opting to exempt those essential goods that consumers will buy even if their income is reduced. States that exempt the essentials and thus are more reliant on sales taxes collected on the nonessentials will be more vulnerable to reductions in consumer spending resulting from expiration of the Bush tax cuts. Meanwhile, states that have maintained a broad sales tax base can expect steadier revenue. It should be noted that some consumer services may present a special case because many states do not tax services but at the same time consumers might treat some services like they treat "nonessential" goods. That is, these nonessential services may be part of the consumption that people cut back on first when their income is reduced. If this is the case it could have a mitigating effect for states that do not tax services.

States that rely more heavily on sales taxes in general over other tax sources would be hit harder by expiration. These states would also be affected if the deduction for sales taxes is not renewed as part of the extenders package, an

Table 3

Which States Rely Most on Sales Taxes? Fiscal Year 2008

State	Percent of State and Local Tax Revenue Derived from General and Selective Sales Taxes
Washington	62.6%
Tennessee	57.9
Nevada	55.7
South Dakota	54.3
Louisiana	52.9
Hawaii	51.5
Arkansas	51.4%
Arizona	48.3
Mississippi	47.0
Florida	46.9
Alabama	46.8

Note: Tax Foundation calculations based on Census Bureau's government finance data for state and local governments during fiscal year 2008. The major selective sales taxes are levied on motor fuel, tobacco, insurance premiums, public utilities (power, telephone service, etc.), amusements and alcoholic beverages.

9 For more information on marginal effective tax rates, see Prante, Gerald, "Top Marginal Effective Tax Rates by State under Rival Tax Plans from Congressional Democrats and Republicans," *Tax Foundation Fiscal Fact,* No. 246, Sept. 22, 2010, at http://taxfoundation.org/publications/show/26729.html.

action Congress customarily takes at the end of the year. Table 3 shows which states are most reliant on sales tax revenue to fund their state and local governments, and hence which states will be most vulnerable to a reduction in consumer spending. Among them are several states that do not tax wages: Washington, Tennessee, Nevada, South Dakota and Florida.

If the tax cuts are extended for virtually all low- and middle-income tax returns, which would happen under either the Democratic or Republican plan, the overall impact on sales tax revenue would be greatly reduced because the vase majority of people would not see a federal tax increase. Also, high-income households are more likely than low- or middle-income households to cut back on savings rather than on spending if their income is reduced. Still, under the Democratic plan, there would be some reduction of spending as high-income people find themselves with less after-tax income.

A special case worth considering is how expiration could affect states and localities for which tourism is both an economic driver and an important source of tax revenue. When households suddenly find themselves with less after-tax income, travel may be one of the first household budget items curtailed. Therefore, the expiration of the Bush tax cuts could disproportionately hurt sales tax revenue in states heavily reliant on tourism. Florida, Hawaii and Nevada could logically worry the most about that impact.

Reduced tax revenues, due to a combination of a reduced sales tax base and a reduced income tax base, as discussed above, could be the dominant effect of the expiring Bush tax cuts in some states. This is most likely to be true in states whose income tax systems are not closely linked to the federal tax code, since in these states tax base reductions will not be offset by increases in state income tax revenue when federal income taxes increase.

Impact of Expiring Tax Cuts on State and Local Estate Taxes

Also included in the original Bush tax cut bill, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), was a reduction in the federal estate tax.[10] While a reduction in the federal estate tax was set to go into effect in 2003 anyway (raising the exemption to $1 million from $675,000 with a rate of 55 percent), the 2001 tax cut put in place a timetable for the estate tax to be gradually reduced each year and then abruptly eliminated in 2010.

Few prognosticators in Washington tax policy circles thought Congress would allow January 1, 2010, to arrive without enacting a law to avert the scheduled one-year elimination of the estate tax, but a busy Congress focused on health care reform never touched it. So as the law stands now, the federal estate tax in 2010 is zero, but it is set to return to its 2001 level of 55 percent with a $1 million exemption in January. President Obama and most congressional Democrats favor a return to 2009 estate tax law, which calls for a 45 percent rate with a $3.5 million exemption. Some Republicans favor permanent repeal, and some favor a plan similar to the Democratic plan but with a lower rate and higher exemption level, possibly 35 percent and $5 million. Whether action on the Bush tax cuts over the next few months would (or legally could) impose the estate tax retroactively for 2010 is yet to be determined.

So how does all this turmoil in federal estate tax law affect state-level estate or inheritance taxes? It depends on the state. Prior to EGTRRA, one's federal estate tax could be reduced dollar for dollar by the amount paid in state estate taxes, equal to a maximum of 20 percent of the estate's federal estate tax liability. States reacted by imposing state estate taxes that were at least equal to the maximum amount that could be used as a credit in the federal estate tax. In most states, the state estate tax was

10 The estate tax is sometimes referred to as the "death tax," but that phrase is also often used in state-level statutes to refer to a state-level estate tax, or to refer in general to the various transfer taxes imposed at death, including inheritance taxes, gift taxes and estate taxes.

exactly equal to that maximum credit. For heirs in those states, then, state-level estate taxes did not change total estate tax liability but merely shifted revenue from the federal government's coffers to the state governments' coffers, a feat achieved by an enormous amount of expensive paperwork filled out by executors or estate tax specialists. Some states imposed additional taxes at death, either estate and gift taxes or inheritance taxes, beyond the amount allowed as a credit under the federal estate tax, but the revenue effects were relatively small.

As a result of EGTRRA, the state estate tax credit was eliminated over three years and replaced with a deduction. Because most states had written into their law that their state estate tax was tied explicitly to the maximum credit allowed under the federal credit for state estate taxes paid, their state estate taxes essentially went away unless they "decoupled" and imposed their own state estate tax. States that had stand-alone estate taxes did not face such an automatic elimination of their state estate tax. On the other hand, some states even went further than EGTRRA and enacted permanent repeals of their estate tax, meaning that if EGTRRA were to expire, they would still have no estate tax even though "free money" would be on the table. Since states rarely leave behind federal money that is there for the asking, many would presumably reinstate their old laws, linking them to the federal credit.

In summary, if EGTRRA were to completely expire, most states would see a revival of state estate tax laws, either automatically or by legislative action, to pick up the subsidy available via the state estate tax credit. Under the proposal of Democrats and President Obama, the state estate tax credit would not return, however, thereby still leaving most states with no state estate tax. Table 4 summarizes federal-state estate tax interactions under two likely scenarios.

Other Impacts of Expiring Tax Cuts on State and Local Finances

Because congressional action on the expiring Bush tax cuts affects federal revenues, it could also affect the financial relationship between federal and state and local governments beyond merely tax policy. For example, if Congress takes no action to reduce federal deficits, it increases the possibility of a federal debt crisis. In such a situation, Congress may reduce aid to states or Medicaid payments, and this would obviously affect state budgets in an adverse way. On the other hand, if the federal government pursues tax hikes in the future in order to finance projected spending, they might include a new value added tax (VAT), which could radically change state and local tax systems. States would be likely to piggy-back off a new federal VAT, either as a new tax or as a replacement for an existing sales tax.

Even worse is a scenario where Congress doesn't address the federal government's fiscal imbalance quickly enough through either spending reductions or tax increases, thereby precipitating a decline in the federal government's credit rating. In such a scenario interest rates that state and local governments would be forced to pay would rise, not only because interest rates throughout the economy would rise but also because a federal fiscal crisis would likely affect states' credit ratings which may be implicitly propped up by the federal government's credit. That is, to some extent there may be a presumption on the part of the world's investors that the federal government would "bail out" any state on the verge of bankruptcy, even if government officials deny that possibility presently.[11] But if the federal government's fiscal position were truly perilous, it would have less

11 See, for example, the public discussion over the likelihood or necessity of a federal "bailout" for the state of California: George Will, "The Coming California Bailout," Real Clear Politics, May 21, 2009, http://www.realclearpolitics.com/articles/2009/05/21/californias_dependency_culture_96597.html. "California Bailout, Impossible or Inevitable?" *The New York Times,* June 21, 2009. http://roomfordebate.blogs.nytimes.com/2009/06/21/california-bailout-reckless-or-inevitable/ Lin, Judy. "California budget perpetuates deficit spending," Associated Press, Oct. 8, 2010. http://www.google.com/hostednews/ap/article/ALeqM5jJ7uUDlO1sEo7K7bEfHpj4G7wuLQD9INS5Q00?docId=D9INS5Q00.

Table 4

Relationship between State Estate Taxes and Federal Estate Tax Policy

	State-Level Estate Tax in 2010 and Under Extension of Bush Tax Cuts (a)	If Current Federal Estate Tax Policy Expires	Notable State Estate Tax Policy Change Enacted Following EGTRRA
Alabama	No tax; tied to federal state estate tax credit	Estate tax returns	
Alaska	No tax; tied to federal state estate tax credit	Estate tax returns	
Arizona	No tax; was tied to federal state estate tax credit; was permanently repealed in 2006.	No tax	SB 1170, May 8, 2006, permanently repealed the estate tax
Arkansas	No tax; tied to federal state estate tax credit	Estate tax returns	
California	No tax; tied to federal state estate tax credit	Estate tax returns	
Colorado	No tax; tied to federal state estate tax credit	Estate tax returns	
Connecticut	Tax levied separately from federal estate tax. $3.5M exemption, rate between 7.2% and 12%.	No change	
Delaware	Tax levied based on federal state estate tax credit in effect on Jan. 1, 2001. $3.5M exemption.	No change	
District of Columbia	Tax levied based on federal state estate tax credit in effect on Jan. 1, 2001. $1M exemption.	No change	
Florida	No tax; tied to federal state estate tax credit	Estate tax returns	
Georgia	No tax; tied to federal state estate tax credit	Estate tax returns	
Hawaii	Tax levied separately from federal estate tax. $3.5M exemption.	No change	HB 2866, April 30, 2010, imposed the estate tax.
Idaho	No tax; tied to federal state estate tax credit	Estate tax returns	
Illinois	No tax as of Jan. 1, 2010; tied to federal state estate tax credit	Estate tax returns	SB 3694, introduced Feb. 11, 2010 would reinstate the estate tax in 2011 as it existed in 2009 with a $2M exemption.
Indiana	No estate tax; tied to federal state estate tax credit. Currently has a separate inheritance tax.	Estate tax returns	
Iowa	No estate tax; tied to federal state estate tax credit. Currently has a separate inheritance tax.	Estate tax returns	
Kansas	No tax	No tax	
Kentucky	No estate tax; tied to federal state estate tax credit. Currently has a separate inheritance tax.	Estate tax returns	
Louisiana	No tax; tied to federal state estate tax credit	Estate tax returns	

	State-Level Estate Tax in 2010 and Under Extension of Bush Tax Cuts (a)	If Current Federal Estate Tax Policy Expires	Notable State Estate Tax Policy Change Enacted Following EGTRRA
Maine	Tax levied based on federal state estate tax credit in effect before passage of EGTRRA. Exemption is based on law in effect on Dec. 31, 2000, including scheduled increases under pre-EGTRRA law.	No change	
Maryland	Tax levied based on pre-EGTRRA federal state estate tax credit. $1M exemption.	No Change	
Massachusetts	Tax levied based on federal state estate tax credit in effect on Dec. 31, 2000. $1M exemption.	No Change	
Michigan	No tax; tied to federal state estate tax credit	Estate tax returns	
Minnesota	Tax levied based on federal state estate tax credit in effect on Dec. 31, 2000. Exemption is based on law in effect on Dec. 31, 2000, including scheduled increases under pre-EGTRRA law.	No Change	
Mississippi	No tax; tied to federal state estate tax credit	Estate tax returns	
Missouri	No tax; tied to federal state estate tax credit	Estate tax returns	
Montana	No tax; tied to federal state estate tax credit	Estate tax returns	
Nebraska	No statewide estate tax; counties impose a separate inheritance tax.	No change	
Nevada	No tax; tied to federal state estate tax credit	Estate tax returns	
New Hampshire	No tax; tied to federal state estate tax credit	Estate tax returns	
New Jersey	Tax levied based on federal state estate tax credit in effect on Dec. 31, 2001. $675,000 exemption.	No Change	S. 1279, introduced on Feb. 8, 2010, would repeal the New Jersey Estate Tax effective January 1, 2010.
New Mexico	No tax; tied to federal state estate tax credit	Estate tax returns	
New York	Tax levied based on federal state estate tax credit in effect on July 22, 1998. $1M exemption.	No Change	
North Carolina	No tax; tied to federal state estate tax credit	Estate tax returns	
North Dakota	No tax; tied to federal state estate tax credit	Estate tax returns	
Ohio	Tax levied separately from federal estate tax. $338,333 exemption.	No Change	

	State-Level Estate Tax in 2010 and Under Extension of Bush Tax Cuts (a)	If Current Federal Estate Tax Policy Expires	Notable State Estate Tax Policy Change Enacted Following EGTRRA
Oklahoma	No tax; Oklahoma's own estate tax was phased out as of Jan. 1, 2010.	No tax	
Oregon	Tax levied based on federal state estate tax credit in effect on Dec. 31, 2001. Exemption is based on law in effect on Dec. 31, 2000, including scheduled increases under pre-EGTRRA law. $1M exemption for 2010.	No Change	
Pennsylvania	No tax; tied to federal state estate tax credit; separate state inheritance tax is levied.	Estate tax returns	PA had "decoupled" its estate tax from federal law in 2002, tying its estate tax to pre-EGTRRA federal law, but has since recoupled with federal law.
Rhode Island	Tax levied based on federal state estate tax credit in effect on Jan. 1, 2001. $850,000 exemption.	No Change	Rhode Island's Governor signed into law on June 30, 2009, effective for deaths occurring on or after January 1, 2010, an increase in the amount exempt from Rhode Island estate tax from $675,000 to $850,000, with annual adjustments beginning for deaths occurring on or after January 1, 2011, based on "the percentage of increase in the Consumer Price Index for all Urban Consumers (CPI-U). . . rounded up to the nearest five dollar ($5.00) increment." HB 5983.
South Carolina	No tax; tied to federal state estate tax credit	Estate tax returns	
South Dakota	No tax; tied to federal state estate tax credit	Estate tax returns	
Tennessee	No tax; tied to federal state estate tax credit; separate state inheritance tax is levied.	Estate tax returns	
Texas	No tax; tied to federal state estate tax credit	Estate tax returns	
Utah	No tax; tied to federal state estate tax credit	Estate tax returns	
Vermont	Tax levied based on federal state estate tax credit in effect on Jan. 1, 2001. $2M exemption.	No Change	Threshold was reduced from $3.5M to $2M in 2009 when the legislature overrode the Governor's veto of H. 442.
Virginia	No tax	No tax	The Virginia estate tax (which was based on federal state estate tax credit in effect on Jan. 1, 1978) is repealed effective July 1, 2007
Washington	Tax levied separately from federal estate tax. $2M exemption.	No change	On February 3, 2005, the Washington State Supreme Court ruled Washington's state estate tax was unconstitutional. The tax was tied to the federal state estate tax credit. Soon after, the Washington state legislature passed and the governor signed a standalone state estate tax with rates ranging from 10% to 19%, a $1.5M exemption in 2005 and $2M thereafter.
West Virginia	No tax; tied to federal state estate tax credit	Estate tax returns	
Wisconsin	No tax; as of Jan. 1, 2008, tax is tied to federal state estate tax credit.	Estate tax returns	For deaths occurring after September 30, 2002, and before January 1, 2008, tax was tied to federal state estate tax credit in effect on December 31, 2000 and was imposed on estates exceeding federal applicable exclusion amount in effect on December 31, 2000 ($675,000), not including scheduled increases under pre-EGTRRA law.
Wyoming	No tax; tied to federal state estate tax credit	Estate tax returns	

(a) For the purposes of this table, the EGTRRA-extended scenario is the same as the position of President Obama, which calls for restoration of 2009 estate tax law, that is, an estate tax with a $3.5 million exemption and 45 percent rate but with no state estate tax credit.
Source: McGuireWoods LLP and Tax Foundation research of state estate taxes

ability to offer a helping hand to insolvent states, making them a riskier investment in general. Furthermore, the consequences of a federal fiscal crisis could have a compounding effect on state budgets because such a crisis would likely take place during an economic downturn when states would already be fiscally strained.[12]

Finally, what happens to the Bush tax cuts could immediately affect the short-run macroeconomy and thereby affect the size of the entire tax base, regardless of the type of tax. Such effects on the state of the U.S. economy would have an impact on state expenditures on anti-poverty and other "automatic stabilizer" programs like unemployment insurance, Medicaid, Temporary Assistance to Needy Families, etc. Supporters of extending the Bush tax cuts in full, as opposed to merely for those whose incomes are below $200,000 (single) and $250,000 (married), point out that a large fraction of business income would face tax increases, and thereby possibly hurt short-term hiring and the overall economy. Collections of most types of state and local taxes could fall in that case.

Most Democrats who support extending the tax cuts for everyone except those above this income threshold claim that the tax cuts for high-income people are not worth their impact on the long-term fiscal imbalance. Additionally, they believe that extending the tax cuts for low- and middle-income taxpayers should, if combined with more deficit spending, be a sufficient fiscal stimulus for the economy in the near-term because low- and middle-income consumers are most likely to use their additional disposable income on consumption, which can give the economy a short-term boost. Former Federal Reserve chairman Alan Greenspan is even advocating full expiration, arguing that any short-term benefit from extending the lower rates is not worth the long-term fiscal costs.

Conclusion

We have discussed many nuanced implications for state budgets of the possible expiration of the Bush tax cuts. The net effect on any given state will depend on how their income taxes are structured and to what extent they piggyback off the federal income tax. It will also depend on how their sales taxes are structured, state demographics, economic conditions, and the level of reliance on income and sales taxes. In economics nothing happens in a vacuum, and state lawmakers need to be aware that the debate about federal tax policy could have a significant impact on their state's revenue.

12 Congressional Budget Office, "Federal Debt and the Risk of a Fiscal Crisis," July 27, 2010, available at http://www.cbo.gov/doc.cfm?index=11659

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