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Staff Information Report

PRELIMINARY ESTIMATES OF THE EFFECT OF THE 1986 FEDERAL TAX REFORM ACT ON STATE PERSONAL INCOME TAX LIABILITIES

December 8, 1986

Advisory
Commission on
Intergovernmental
Relations

Washington, D.C.

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ADVISORY
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WASHINGTON DC 20575

A PRELIMINARY REPORT

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John Shannon
Executive Director

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Introduction

As part of a larger study on the fiscal effects of federal tax reform on state and local governments, the Advisory Commission on Intergovernmental Relations (ACIR) is analyzing the impact of the Tax Reform Act of 1986 on state personal income tax liabilities. Since many state income tax codes conform or "couple" in some way to the federal income tax structure, reform of the federal system has the potential of directly affecting state income tax liabilities. Preliminary results are now available on how the 1986 Tax Reform Act would alter state personal income tax yields.[1]

State income tax codes generally couple to the federal income tax base, but do not conform to the federal rate structure. Since a broadening of the federal tax base was a major component of the new tax law, federal reform will result in tax base expansion for many states. The provisions in the new law that will have a major impact on the federal individual income tax base are: (a) the full taxation of capital gains, (b) the restriction of the use of net passive losses to offset income, (c) the repeal of the deduction for 2-earner families, (d) limitations on the eligibility of deductions for Individual Retirement Account (IRA) contributions, (e) increases in the standard deduction, personal exemption, and earned income credit, (f) repeal of the personal interest expense deduction, (g) elimination of the state and local sales tax deduction, (h) treatment of employee business expenses as itemized

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[1]Federal tax reform also has the potential of affecting state corporate and local government income taxes. Due to lack of data, however, it was not possible to analyze the impact of tax reform on these sectors of the economy.

deductions subject to a floor, and (i) repeal of the investment tax credit. Whether or not a state conforms to these provisions will in large part determine how its income tax base and, thus, income tax yields would be altered by federal reforms. State income tax bases may also be affected by federal tax revision if, for example, a state allows a deduction for federal tax liability, or disallows itemization of deductions on state tax returns if individuals do not itemize on their federal return. If state tax rate structures are not adjusted (or other measures are not taken) to compensate for base broadening at the state level, income tax yields will rise in many states.[2]

The Data Base and Model

The potential impact of tax reform on state individual income taxes was estimated by employing microsimulation modelling techniques of federal and state income tax codes.[3] The data base employed in the simulations is conceptually the same data file that the U.S. Department of the Treasury and the Joint Committee on Taxation use as their primary data source for analysis and revenue estimates of federal individual income tax changes. The number of records, however, is substantially larger and

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[2]Four states base their tax on a percentage of federal tax liability. Since federal income taxes will decline on average under the new law, state income taxes would fall for these states.

[3]The data necessary for this study was provided to ACIR under contract with Policy Economics Group, a Washington, D.C. based research group, and was funded in part by the Ford Foundation. The construction of the data base and modelling of federal and state tax codes was performed by Policy Economics.

therefore permits the calculation of meaningful results on a state-by-state basis.[4]

The state income tax liability estimates are based on projected levels of 1986 income and are designed to represent the fully phased-in effects of all provisions in the new law. Four major provisions in the Tax Reform Act are phased in over several years: a) the passive loss provision and the personal interest expense deduction are phased in over a 5-year period, b) the capital gains provision is phased in over a 2-year period, and c) the personal exemption is phased in over a 3-year period and adjusted for inflation beginning in 1990. Estimates of income tax liabilities during the transitional period, therefore, would differ from those based on a fully phased-in concept.

Two different assumptions concerning revisions to state income tax laws were made to estimate the changes in state personal income taxes because state conformity to the federal code takes two basic forms. Some states reference current and prospective tax law, while others reference federal law as of a specific date. States with tax codes that reference current and prospective tax law would be automatically affected by federal

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[4]The data base was constructed by merging tax return data from the 1981 Statistics of Income (SOI) file generated by the Internal Revenue Service with the 1981 Current Population Survey (CPS). Information on who did not file a tax return and data on non-taxable sources of income was imputed from the CPS file. The data base was updated using information from the most recent SOI file (1984) and extrapolated to 1986 levels based on the Administration's February 1985 forecasts of the national economy. The Administration projected a 4% growth rate in real GNP for 1986. Recent Congressional Budget Office (August, 1986) projections of growth in the national economy are 2.8% and 3.4%, respectively, for 1986 and 1987. The different forecasts, however, are only likely to cause at most a 4-5 billion dollar difference in national revenue estimates. State income tax liability estimates may be under or overstated depending on how a state's growth rate varies from the national forecast.

tax reform unless legislative action is taken to revise state tax laws. States that reference federal law as of a fixed date, on the other hand, would not be directly affected by many of the modifications to federal law, unless these states update their references to the federal code. One set of tax liability estimates is based on the assumption that state tax laws are not altered in any way in response to federal tax reform. Under this assumption, states that tie to federal tax law as of a fixed date would not be affected by many of the federal reforms.[5] Since states that link to the federal code as of a fixed date frequently update their references to federal law, a second set of estimates was made based on the assumption that these states revise their tax code by adopting the same conformity structure to the new federal provisions. Neither of the assumptions are realistic, but were made to perform a comparative analysis of the potential impact of the new tax law on state income taxes. In reality, many states are likely to alter their income tax structures in response to federal tax reform.

Behavioral Assumptions

Behavioral responses to several provisions in the new tax law were incorporated in the model because certain provisions are likely to evoke significant behavioral reactions among taxpayers. If this was not done,

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[5]Certain state tax provisions would be automatically affected by federal tax reform regardless of whether a state automatically couples to the federal code or ties as of a specified date. One such state provision is an allowance for a federal income tax deduction.

the base-broadening impact of most of these provisions would be overstated.[6] The provisions for which behavioral assumptions have been simulated are: a) the taxation of capital gains as ordinary income, b) the restriction of the use of passive losses to offset income, and c) the repeal of the personal interest expense deduction. In addition, reduced marginal tax rates and a decline in federal income tax liability are expected to influence charitable contributions. The price and income effects associated with charitable donations have also been simulated. The behavioral assumptions employed in this study are generally comparable to those used by the U.S. Treasury and the Joint Committee on Taxation. Although there will be other behavioral responses associated with federal tax revision, such as changes in decisions to work and incentives to save, these second order effects have not been modelled because they are likely to take some time to evolve and are difficult to estimate.

In eliminating the 60% exclusion for long-term capital gains, the new law raises the maximum marginal tax rate on capital gains from 20% to 28% and, in some cases, to 33%.[7] The maximum tax rate on capital gains is restricted to 28% in 1987. There are likely to be two behavioral responses to the capital gains provision. Some individuals will avoid the higher tax rates in 1987 and 1988 by increasing realizations of capital gains in 1986. Once the new law is effective, taxpayers are expected to respond to the higher capital gains rate by increasing the

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[6]The behavioral response associated with charitable contributions would increase the base.

[7]The phasing out of the 15% tax bracket and personal exemptions for certain upper income taxpayers, results in a 33% marginal tax rate. The marginal tax rate for taxpayers at the highest income levels is 28%.

length of time they hold these assets. As a consequence, individuals will realize fewer gains in any given year. Since the fully phased-in effect of the tax reform act is being examined in this study, it is the long-term behavioral response that is included in the model. Although all studies conclude that the long-term effect of a higher tax rate on capital gains will be a fall in capital gains realizations, there is disagreement as to the likely magnitude of this decline. The behavioral assumptions simulated in this study are consistent with the historical evidence presented in the "Report to Congress on the Capital Gains Tax Reduction of 1978," Office of the Secretary, U.S. treasury, Office of Tax Analysis, September 1985. Under these assumptions, the higher tax rate on capital gains is expected to result in a modest increase in federal revenues in the long-term.

The new tax legislation, with minor exceptions, will no longer allow the use of losses from passive investments, such as a limited partnership interest in an activity, to offset income from salaries, interest, and dividends. Passive losses are the basis for most tax shelters. It is expected, however, that individuals will be able to mitigate the impact of this provision by combining passive income-producing investments with passive-loss investments, since passive losses will be allowed to offset passive income. Thus, once individuals have fully adjusted to this provision, the revenue gains are expected to be fairly modest.

A third area where behavioral responses will play an important role is the tax treatment of personal interest expense. The 1986 Tax Act repeals the deduction for personal interest payments, such as those on automobile loans, but retains the deduction for mortgage interest payable

on a principal or second residence. Homeowners will be allowed to deduct interest on home equity loans if incurred for educational or medical expenses. In addition, interest on mortgage debt for purposes other than educational and medical expenses will be deductible to the extent that the principal does not exceed the purchase price of the residence plus the cost of improvements. Homeowners, therefore, will be given an incentive to shift personal debt to mortgage equity loans. This analysis assumes that homeowners will convert 25% of their personal interest to mortgage interest. A second likely behavioral response to the personal interest expense provision is that individuals will begin to payoff their consumer loans, since interest income will continue to be taxable but personal interest expense will no longer be deductible. It is assumed that taxpayers will forego 15% of their interest income in order to payoff personal debt. Both of these behavioral responses will have the effect of reducing the base-broadening impact of this provision.

Lower federal marginal tax rates will raise the minimum effective "price" of charitable contributions from 50 cents under current law to 67 cents under the new legislation. A higher price will have the effect of reducing donations. Although this reduction will be offset to some extent by an increase in disposable income under the new law, the net effect of the new legislation is expected to be a moderate decline in charitable contributions for itemizing taxpayers.

Deductions for IRA contributions will be restricted under the new law to lower and middle income individuals and those without employer-provided pension plans. Two behavioral responses to the IRA provision are anticipated: a) some individuals may continue to make IRA

contributions since the interest earnings on these accounts will be tax-exempt, and b) those no longer eligible for IRA deductions may switch to existing 401 (k) accounts. Since these responses are not expected to have a sizeable impact on revenues, the analysis assumes that taxpayers will contribute to IRAs only to the extent that they receive deductions for IRA contributions. Potential shifting to 401 (k) accounts is not factored into the model. Based on the most recent Statistics of Income data (1984), it is estimated that close to two-thirds of those making IRA contributions will no longer be eligible for this deduction.

Estimates of the Potential Changes in State Personal Income Taxes

Estimates of percent changes in state individual income tax liabilities under the 1986 Tax Reform Act from what they would be under pre-reform federal law are presented in Tables 1, 2 and 3. To obtain these figures, state individual income tax liabilities were computed for each state based on both pre-reform federal income tax law and the 1986 Tax Reform Act for calendar year 1986. As described above, two different assumptions concerning changes in state tax laws were made in calculating these figures. The first set of estimates is based on the assumption that state tax laws are not altered in any way in response to federal tax reform. The second set of estimates is based on the assumption that states linked to federal law as of a specified date update their references to federal law by maintaining the same conformity structure to the new federal provisions. A comparison of the potential impact of tax reform on state income taxes under both assumptions is presented in Table 1. The results are presented according to the magnitude of the effect on

state income taxes in Tables 2 and 3. Results under the first assumption are presented in Table 2, while estimates under the second assumption are shown in Table 3.

It should be kept in mind that the data presented here are based on total state personal income taxes paid by all residents of a state and, thus, indicate the average change in liabilities for all taxpayers of a particular state. The tax liability of any one taxpayer, however, will depend on many factors unique to that individual and is likely to differ from the average change in income taxes for all residents of a state. It might also be noted that certain provisions of the tax reform law cannot be captured by microsimulation modelling techniques. This results in an overstatement of the average decline in federal income taxes for the nation by 0.8 of a percentage point. In terms of the federal income tax base, this means that expansion of the base is slightly understated. How the understatement of the federal tax base translates into state tax base estimates is difficult to determine since it depends on how each state's tax code conforms to the federal tax structure. It would not, however, alter the estimates significantly.

The results of this analysis suggest that the potential impact of the new tax legislation on state personal income tax liabilities would vary substantially among the states. The preliminary estimates of changes in state income taxes range from an increase of 28% in Louisiana to a decline of 12% in North Dakota. In more than half the states, income taxes would rise. Although the analysis is not complete, the results suggest that under the assumption that no legislative action is taken to change state tax laws (Table 2), taxpayers in 14 states would experience

TABLE 1

A COMPARISON OF THE POTENTIAL EFFECT OF THE TAX REFORM ACT OF 1986
ON STATE PERSONAL INCOME TAX LIABILITIES
UNDER TWO DIFFERENT ASSUMPTIONS:
PRELIMINARY ESTIMATES OF THE PERCENT CHANGES IN 1986 TOTAL STATE
PERSONAL INCOME TAXES DUE TO CONFORMITY TO FEDERAL TAX LAW*

	ASSUMPTION ONE*	ASSUMPTION TWO*
	PERCENT CHANGE FROM PRE-REFORM LAW:	PERCENT CHANGE FROM PRE-REFORM LAW:
New England		
Connecticut	11%	11%
Maine	2%	12%
Massachusetts	-2%	1%
New Hampshire	-1%	-1%
Rhode Island	-11%	-11%
Vermont	-11%	-11%
Mideast		
Delaware	10%	10%
District of Columbia	less than 1%	10%
Maryland	8%	8%
New Jersey	-1%	-1%
New York	9%	9%
Pennsylvania	-1%	-1%
Great Lakes		
Illinois	7%	7%
Indiana	1%	4%
Michigan	1%	6%
Ohio	7%	7%
Wisconsin	-2%	4%
Plains		
Iowa	**	18%
Kansas	16%	18%
Minnesota	1%	15%
Missouri	18%	18%
Nebraska	-9%	-9%
North Dakota	-12%	-10%
South Dakota	no effect	no effect
Southeast		
Alabama	1%	1%
Arkansas	-2%	less than -1%
Florida	no effect	no effect
Georgia	1%	10%
Kentucky	3%	14%
Louisiana	28%	28%
Mississippi	4%	4%
North Carolina	-1%	-1%
South Carolina	less than -1%	**
Tennessee	-1%	-1%
Virginia	9%	9%
West Virginia	1%	11%

(Continued on next page)

TABLE 1

A COMPARISON OF THE POTENTIAL EFFECT OF THE TAX REFORM ACT OF 1986
ON STATE PERSONAL INCOME TAX LIABILITIES
UNDER TWO DIFFERENT ASSUMPTIONS:
PRELIMINARY ESTIMATES OF THE PERCENT CHANGES IN 1986 TOTAL STATE
PERSONAL INCOME TAXES DUE TO CONFORMITY TO FEDERAL TAX LAW*
(continued)

	ASSUMPTION ONE* PERCENT CHANGE FROM PRE-REFORM LAW:	ASSUMPTION TWO* PERCENT CHANGE FROM PRE-REFORM LAW:
Southwest		
Arizona	**	**
New Mexico	**	**
Oklahoma	18%	18%
Texas	no effect	no effect
Rocky Mountain		
Colorado	22%	22%
Idaho	-1%	**
Montana	19%	19%
Utah	19%	19%
Wyoming	no effect	no effect
Far West		
California	2%	9%
Nevada	no effect	no effect
Oregon	less than 1%	19%
Washington	no effect	no effect
Alaska	no effect	no effect
Hawaii	-1%	15%

* Estimates of the potential impact of the 1986 Tax Act on state personal income tax liabilities were made based on two different assumptions concerning changes to state tax laws. The first set of estimates (Column 1) is based on the assumption that state legislatures do not alter state tax laws in any way in response to federal tax reform. States that conform to federal law as of a specified date are assumed to maintain those references to federal law. The second set of estimates (Column 2) is based on the assumption that states coupled to federal law as of a point in time choose to update their references to the federal code and adopt the same conformity structure to provisions in the new tax law. States that automatically conform to federal law are assumed to retain all features of current state law. (Since the District of Columbia and Utah couple to the personal exemption as of 7/75 and 1/74, respectively, it was assumed that these jurisdictions do not update their reference to this provision.) In reality, however, state legislatures are likely to respond to either increases or decreases in state personal income taxes by adjusting their income tax structures. The percent changes are based on estimates of 1986 state personal income tax liabilities that would be generated under pre-reform federal law and under the 1986 Tax Reform Act.

** Data are not yet available for these states.

These numbers are preliminary and subject to change.

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TABLE 1

A COMPARISON OF THE POTENTIAL EFFECT OF THE TAX REFORM ACT OF 1986 ON STATE PERSONAL INCOME TAX LIABILITIES UNDER TWO DIFFERENT ASSUMPTIONS: PRELIMINARY ESTIMATES OF THE PERCENT CHANGES IN 1986 TOTAL STATE PERSONAL INCOME TAXES DUE TO CONFORMITY TO FEDERAL TAX LAW*
(continued)

SOURCE: ACIR staff compilation based on Policy Economics Group (PEG), "A Description of the Linkages Between the Federal and State Personal Income Tax Codes," August 5, 1985 and data supplied by Policy Economics Group. This research was funded in part by the Ford Foundation. These estimates are based on microsimulation modelling of federal and state income tax codes. The data base is conceptually the same as that used by the U.S. Department of the Treasury and the Joint Committee on Taxation for analysis and revenue estimates of federal individual income tax changes. The number of records in the PEG data base, however, is substantially larger and, therefore, permits the calculation of meaningful results at the state level. The data file was extrapolated based on the Administration's February, 1985 economic forecasts of the national economy. All estimates are based on 1986 projected levels of income and are designed to represent the fully phased-in effects of all provisions in the tax reform plan. All features of current federal and state tax law for 1986, as of June 15, 1985, were simulated by the model.

TABLE 2

THE POTENTIAL AUTOMATIC EFFECT OF THE TAX REFORM ACT OF 1986 ON STATE PERSONAL INCOME TAX LIABILITIES: PRELIMINARY ESTIMATES OF THE PERCENT CHANGES IN 1986 TOTAL STATE INDIVIDUAL INCOME TAXES DUE TO CONFORMITY TO FEDERAL TAX LAW UNDER ASSUMPTION ONE*

LARGE		MODERATE TO SMALL		NEGATIVE		NO EFFECT
Louisiana	28%	Mississippi	4%	North Dakota	-12%	Alaska
Colorado	22%	New Mexico	**	Vermont	-11%	Florida
Montana	19%			Rhode Island	-11%	Nevada
Utah	19%	Iowa	**	Nebraska	-9%	South Dakota
Missouri	18%	Kentucky	3%			Texas
Oklahoma	18%	Arizona	**	Wisconsin	-2%	Washington
		Minnesota	1%			Wyoming
Kansas	16%	Oregon	less than 1%	Massachusetts	-2%	
Connecticut	11%	Maine	2%	Arkansas	-2%	
		Georgia	1%			
Delaware	10%	West Virginia	1%	New Hampshire	-1%	
New York	9%			New Jersey	-1%	
Virginia	9%	California	2%	North Carolina	-1%	
Maryland	8%	Indiana	1%	Pennsylvania	-1%	
		Dist. of Col.	less than 1%	Tennessee	-1%	
Ohio	7%					
Illinois	7%	Alabama	1%	Hawaii	-1%	
				Idaho	-1%	
		Michigan	1%	South Carolina	less than -1%	

*This analysis assumes that state legislatures do not alter state tax laws in response to federal tax reform. States that conform to federal law as of a specified date are assumed to maintain those references to federal law. In reality, however, state legislatures are likely to respond to either increases or decreases in state taxes by adjusting their income tax structures. The percent changes are based on estimates of 1986 state personal income tax liabilities that would be generated under pre-reform federal law and under the 1986 Tax Reform Act.

**Data are not yet available for these states.

These numbers are preliminary and subject to change.

SOURCE: ACIR staff compilation based on Policy Economics Group (PEG), "A Description of the Linkages Between the Federal and State Personal Income Tax Codes," August 5, 1985 and data supplied by Policy Economics Group. This research was funded in part by the Ford Foundation. These estimates are based on microsimulation modelling of federal and state income tax codes. The data base is conceptually the same as that used by the U.S. Department of the Treasury and the Joint Committee on Taxation for analysis and revenue estimates of federal individual income tax changes. The number of records in the PEG data base, however, is substantially larger and, therefore, permits the calculation of meaningful results at the state level. The data file was extrapolated based on the Administration's February, 1985 economic forecasts of the national economy. All estimates are based on 1986 projected levels of income and are designed to represent the fully phased-in effects of all provisions in the tax reform plan. All features of current federal and state tax law for 1986, as of June 15, 1985, were simulated by the model.

ACT OF 1986 ON STATE PERSONAL INCOME TAX LIABILITIES:
PRELIMINARY ESTIMATES OF THE PERCENT CHANGES IN 1986 TOTAL STATE
INDIVIDUAL INCOME TAXES DUE TO CONFORMITY TO FEDERAL TAX LAW
UNDER ASSUMPTION TWO*

LARGE		MODERATE TO SMALL		NEGATIVE		NO EFFECT
Louisiana	28%	Michigan	6%	Rhode Island	-11%	Alaska
		Indiana	4%	Vermont	-11%	Florida
Colorado	22%	Wisconsin	4%	Nebraska	- 9%	Nevada
Montana	19%					South Dakota
Oregon	19%	Arizona	**	North Dakota	-10%	Texas
Utah	19%					Washington
Iowa	18%	Mississippi	4%	New Jersey	-1%	Wyoming
Kansas	18%			New Hampshire	-1%	
Missouri	18%	Idaho	**	North Carolina	-1%	
Oklahoma	18%	New Mexico	**	Pennsylvania	-1%	
Hawaii	15%	S. Carolina	**	Tennessee	-1%	
Minnesota	15%					
Kentucky	14%	Alabama	1%	Arkansas	less than -1%	
Maine	12%					
		Massachusetts	1%			
Connecticut	11%					
W. Virgina	11%					
Delaware	10%					
Dis. of Col.	10%					
Georgia	10%					
California	9%					
New York	9%					
Virginia	9%					
Maryland	8%					
Ohio	7%					
Illinois	7%					

*This analysis is based on the assumption that states coupled to federal law at a point in time choose to update their references to the federal code and adopt the same conformity structure to provisions in the new tax law. (Since the District of Columbia and Utah couple to the personal exemption as of 7/75 and 1/74, respectively, it was assumed that these jurisdictions do not update their reference to this provision.) States that automatically conform to federal law are assumed to retain all features of current state law. In reality, however, state legislatures are likely to respond to either increases or decreases in state personal income taxes by adjusting their income tax structures. The percent changes are based on estimates of 1986 state personal income tax liabilities that would be generated under pre-reform federal law and under the 1986 Tax Reform Act.

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a fairly large increase in state income taxes -- ranging from 7% to 28%. Individuals in 15 states would realize somewhat more moderate increases in income taxes of less than 1% to 4%. State income tax liabilities would decline in 15 states. Taxpayers in four of these states would experience fairly substantial decreases in taxes of 9% to 12%, whereas liabilities would decline by less than 1% to 2% in the remaining 9 states. Taxpayers in 7 states would not be directly affected by tax reform because these states do not tax personal income.

As indicated in Table 3, the results would be somewhat different if states that tie to the federal code as of a point in time update their references to federal law by adopting the same conformity structure to the new federal provisions. Under this second assumption, individuals in 24 states would experience fairly large increases in income taxes, taxpayers in 10 states would face a moderate rise, and income taxes would decline in 10 states. As under the first assumption, 7 states would not be directly affected by federal reform.

Interpreting the Results

Certain factors should be kept in mind when interpreting these results. Assumptions concerning behavioral responses to several provisions in the new law have been simulated so as to avoid the overstatement of the base-broadening effects of most of these provisions. Use of a static model, therefore, would produce higher tax liability estimates. Since the magnitude of the long-term behavioral response to the higher capital gains rate is a controversial issue, other studies may incorporate different assumptions concerning the behavioral reactions to

this provision. The response simulated in this model may be viewed as a "middle-of-the-road" estimate between that of a static model and a response that would result in a decline in federal revenues.

This study presents the fully phased-in effects of all provisions of the 1986 Tax Act, including behavioral responses to these provisions. Since some provisions are not fully phased-in until 1990 and short-term behavioral responses to these provisions are likely to differ from long-term reactions, the figures shown here would differ from any year-to-year estimates of the impact of the tax reform plan. Behavioral responses to the capital gains provision would result in less base broadening in the near-term than in the long-term. In contrast, the behavioral response to the passive loss rule is likely to cause greater base expansion in the short-term. The personal interest expense provision is likely to result in somewhat more base-broadening when it is fully phased-in, although this will be offset to a certain extent by behavioral responses to this provision.

Conclusion

Federal tax reform has the potential of affecting state income tax liabilities since many state income tax codes conform to the federal tax structure. Preliminary results indicate that the impact of the 1986 Tax Reform Act on state personal income taxes will be quite diverse among the states. Since many of the federal base-broadening reforms affect individuals in the middle and upper income levels, the distributional impact of tax reform on state income taxes will be quite different as well. Many states, therefore, are likely to respond to federal tax reform by revising their own income tax codes.

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