Sensible Tax Change to State Income Taxes Would Raise $450 Million

Georgia is one of a few states that has not repealed the deduction for state income taxes

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Summary

Georgia is one of a shrinking handful of states that allow income tax filers who itemize to deduct their state income taxes. Repealing the deduction for state income taxes brings in badly needed revenue — an estimated $450 million.[1] In K-12 education alone, $450 million could have prevented the six furlough days and the additional cuts to the education funding formula in the Amended Fiscal Year 2010 budget.

Additionally, repealing the deduction prevents the current inequitable decrease in the effective tax rate for Georgia taxpayers who itemize compared to those who do not. Georgia lawmakers should take action to correct this circular tax break by repealing the deduction. Several other options within the income tax system would also raise funds; lawmakers should consider them in combination with the proposed increase in the cigarette tax.

A menu of revenue options to assist in balancing the deficit is available on GBPI's fact sheet, "Georgia Has Many Revenue Options," released March 3, 2010.

Federal Tax Deduction Not Wise for States

Many states allow taxpayers to claim the same itemized deductions at the state level as they do at the federal level. However, most states require taxpayers to adjust their federal itemized deductions by adding state income taxes deducted at the federal level back into their taxable income. Most states sensibly disallow the federal deduction for state income taxes in order to prevent the bizarre outcome of state taxpayers using their own state income tax bills to reduce their state income taxes.

The few other states besides Georgia that allow the federal deduction for state income taxes are Arizona, Hawaii, Louisiana, Oklahoma, New Mexico, Rhode Island, and Vermont.[2] Georgia is one step closer to disallowing the deduction than the other states, as it already requires taxpayers to add state income taxes paid that year to another state back into taxable income. In light of its state deficit, New Mexico lawmakers recently passed legislation to end the deduction, while Vermont

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lawmakers have capped the deduction at $5,000. The New Mexico legislature's fiscal analysis of the bill notes the weak rationale for allowing the deduction at the state level:

> "Deductible taxes include income taxes, property taxes and, under certain circumstances, sales taxes. The federal deduction can be justified as a way of cost-sharing for the cost of state and local government services. The justification for allowing the same deduction for state income tax purposes is less clear … <u>Allowing the [state income tax] deduction merely reduces the effective rate of state income tax for taxpayers who itemize</u>. This policy provides ease of compliance for taxpayers, but one consequence is a reduction in the effective income tax rate for households that itemize deductions relative to households that do not itemize."[3]

Deduction Costs Georgia $450 Million

Repealing the deduction in Georgia would raise an estimated $450 million, according to tax modeling by the Institute on Taxation and Economic Policy. Two-thirds of Georgia individuals and families would not be affected by this change, since the deduction currently only benefits those taxpayers who itemize.[4] For those Georgians affected, a portion of the increased tax obligation would be offset in their federal income taxes because the increased state taxes are deducted.

In recent budget hearings, legislators have suggested a sliding scale of pay cuts for state employees, with those earning less than $50,000 exempted from the proposed pay cut since they have the least ability to afford the lost income. <u>Legislators should take the same approach to revenue measures</u>, avoiding placing the heaviest burden on those at the lower end of the income spectrum. Repealing the deduction for state income taxes follows this principle, as shown in Tables 1 and 2, by focusing on those taxpayers who itemize and removing a deduction that they would not enjoy in the vast majority of states.

Among those Georgians earning less than $50,000 in tax year 2007, 15 percent included a deduction for state income taxes paid that year on their federal returns.[5] That compares to 95 percent of federal returns containing the deduction for those with incomes of $200,000 and above.

Table 1 **State Income Tax Deductions on Georgians' Federal Returns**

	Federal Adjusted Gross Income					
	All Georgia Returns	**Under $50,000**	**$50,000 to $75,000**	**$75,000 to $100,000**	**$100,000 to $200,000**	**$200,000 or more**
Total number of federal returns	4,560,422	3,232,767	528,701	311,892	363,036	124,026
Number of federal returns with state income tax deduction	1,493,100	482,716	326,026	240,954	324,978	118,426
Share of returns with deduction	33%	15%	62%	77%	90%	95%
Total dollar amount deducted (thousands) from federal taxes	$8,161,399	$794,231	$933,212	$982,542	$2,124,188	$3,327,226

Source: IRS Statistics of Income, Tax Year 2007

The deduction reduces state taxes by $21, on average, for middle-income taxpayers and almost $2,900, on average, for Georgians with the top one percent of incomes.[6] Those figures average the tax change across all taxpayers in the income group. Examining just those taxpayers affected by the change (those that itemize) shows that middle-income taxpayers affected (less than 15 percent of this income group) would pay an average of $89 more and Georgians in the top one percent of income, most of whom would be affected, would pay an average of $3,133 more.

Table 2 **Distributional Effect of Repealing Deduction in Georgia**

	Income Groups						
	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
	Less Than $15,000	$15,000 to $28,000	$28,000 to $46,000	$46,000 to $77,000	$77,000 to $161,000	$161,000 to $400,000	$400,000 or more
Tax Change as % of Income	—	0%	0.1%	0.1%	0.2%	0.2%	0.3%
Avg. Tax Change Across All Filers	$0	$1	$21	$74	$238	$511	$2,894
Avg. Change for Those Affected	$0	$38	$89	$163	$316	$565	$3,133

Source: Institute on Taxation and Economic Policy, March 2010

Additional Options in the Income Tax

Many states enacted income tax changes in 2009 to produce needed revenue during this historic recession. North Carolina, for example, placed a three percent surcharge on income above $250,000 for married couples filing jointly ($150,000 for individuals). New York restricted the number of itemized deductions allowed. The following list provides alternatives to repealing the deduction, as well as other income tax change options that raise revenues. Revenue estimates are produced by the Institute on Taxation and Economic Policy.

1. ***Repeal Deduction for State Income and Property Taxes***
   Raises $700 million; Affects 34 percent of Georgia individuals and families

   There is a greater rationale for deducting property taxes compared to deducting state income taxes, as there is a different level of government applying the property tax. Although removing the property tax deduction would place Georgia in the minority of states, the option remains to remove both the property tax and state income tax deductions.

2. ***Cap Deduction for State Income and Property Taxes at $5,000***
   Raises $200 million; Affects 11 percent of Georgia individuals and families

   New Jersey and Vermont enacted similar measures in 2009.[7] New Jersey placed a cap of $5,000 on the property tax deduction for taxpayers earning less than $250,000, while removing the deduction entirely for one year for those earning more than $250,000. Vermont enacted a $5,000 cap on the deduction for state income taxes. Georgia could also place a cap of $5,000 on the deduction of state income taxes and a separate $5,000 cap on the property tax deduction to raise $200 million and affect 11 percent of filers.

3. ***Enact Surcharge on Top Earners***
Raises $200 million; Affects 1 percent of Georgia individuals and families

Wisconsin, along with several other states, enacted surcharges on higher earners in 2009. Wisconsin placed a 1 percent surcharge on income above $300,000 for married couples ($225,000 for individuals) for a new top tax rate of 7.75 percent. Georgia could place a 1 percent surcharge on income above $400,000 for married couples ($200,000 for singles), taking the rate to 7 percent, to raise $200 million and affect less than 1 percent of filers.

4. ***Implement Tier-System in the Personal Exemption***
Raises $168 million; Affects 30 percent of Georgia individuals and families

Georgia could implement a tiered structure in the personal exemption similar to Alabama's structure. For example, Georgia could raise an estimated $168 million by adjusting the $3,000 personal exemption as follows:
- $2,000 for adjusted gross income between $20,000 and $100,000
- $1,000 for adjusted gross income of $100,000 or more
- (Maintain $3,000 for those with adjusted gross income of $20,000 or less)

Conclusion

This historic recession gives lawmakers the opportunity to examine the personal income tax and enact smart reforms most states have already undertaken. Repealing the deduction for state income taxes not only brings in badly needed revenue, but it also prevents the inequitable reduction in the effective tax rate for Georgia taxpayers who itemize. Repealing the deduction this legislative session will allow lawmakers to avoid some of the additional painful cuts to services they are debating.

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Endnotes

[1] Institute on Taxation and Economic Policy, March 2010.
[2] Wisconsin Legislative Fiscal Bureau, "Individual Income Tax Provisions in the States," January 2009, retrieved March 2010, www.legis.state.wi.us/lfb/Informationalpapers/4_individual%20income%20tax%20provisions%20in%20the%20states.pdf.
[3] New Mexico Legislative Finance Committee, "Fiscal Impact Report: House Bill 270," Updated February 7, 2010, retrieved March 2, 2010, http://legis.state.nm.us/Sessions/10%20Regular/firs/HB0270.pdf.
[4] Institute on Taxation and Economic Policy, March 2010. (Note: This change affects 30 percent of Georgia tax units for individual income tax purposes. An individual counts as one unit, while a family filing a joint return also counts as one unit.)
[5] Internal Revenue Service, "Tax Year 2007: Historical Table 2 (SOI Bulletin)," retrieved March 2010, www.irs.gov/taxstats/article/0,,id=171535,00.html.
[6] Institute on Taxation and Economic Policy, March 2010.
[7] National Conference of State Legislatures, "State Measures to Balance FY 2010 & FY 2011 Budgets," Updated January 7, 2010, retrieved March 2010, www.ncsl.org/?tabid=17255.

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