The Consequences of Increasing Oregon's Income Tax Deduction for Federal Income Taxes Paid

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Oregonians will soon be considering whether to allow taxpayers to deduct more of their federal income taxes from the Oregon personal income tax. Under current law, Oregon taxpayers can deduct up to $3,000 of federal personal income tax on their Oregon tax returns. One proposed change pending before the Legislative Assembly would increase this limit from $3,000 to $10,000. A second proposal, currently circulating as an initiative, would eliminate the cap altogether, allowing Oregon taxpayers to deduct *all* of their federal personal income tax. The annual revenue loss from these proposals would exceed $200 million and $500 million, respectively.

This paper discusses the distributional consequences of these proposals for Oregon residents, the arguments being made in favor of the proposals, and the experiences of other states.

Distributional Effects of a Deduction for All Federal Personal Income Tax

The following table shows the distributional consequences of removing the existing limit on the federal personal income tax deduction, at 1999 levels. This change would reduce the Oregon personal income tax, particularly for high-income taxpayers. Specifically:

- The wealthiest five percent of Oregonians, those with annual incomes of over $116,000, would receive over two-thirds of the tax cut from this proposal.
- The very wealthiest one percent of Oregonians, whose average income is about $720,000 per-year, would receive an average tax cut of over $15,000. This represents an Oregon income tax cut of over 28

Effect of Eliminating the Cap on Deductibility of Federal Income Taxes

Oregon Residents by Income Group, 1999

Income Group	Tax Cut as % of Income	Average Tax Cut	Percent of Total Tax Cut	Tax Cut as % of Income Taxes
Lowest 20%	0.0%	$ —	0%	0.0%
Second 20%	0.0%	$ —	0%	0.0%
Middle 20%	0.1%	$ 20	1%	1.5%
Fourth 20%	0.3%	$ 130	8%	5.3%
Next 15%	0.7%	$ 525	24%	11.8%
Next 4%	1.2%	$ 2,054	25%	20.0%
Top 1%	2.1%	$ 15,080	43%	28.7%
ADDENDUM:				
Lowest 99%	0.5%	$ 191	57%	10%

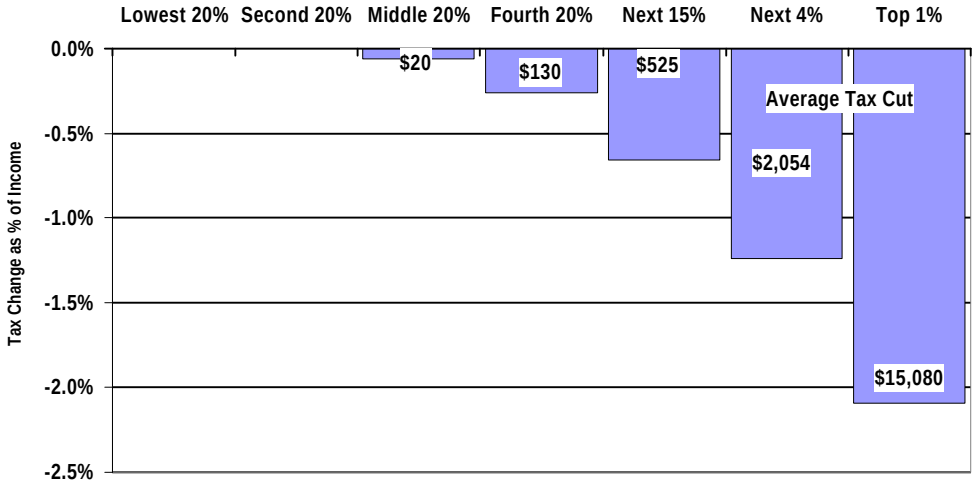
Source: ITEP Microsimulation Tax Model, May 1999

percent for this income group. The other 99 percent of Oregonians would receive an average tax cut of $191.

The twenty percent of Oregonians in the middle of the income distribution would receive only one percent of the total tax cut—an average reduction of $20. This represents less than a two percent reduction in Oregon personal income tax.

The poorest 40 percent of Oregonians, those earning less than $25,000 in 1999, would receive virtually no benefit from the proposal.

Effect of Eliminating the Cap on Deductibility of Federal Income Taxes - Tax Change as a % of 1999 Income



Distributional Effects of Increasing the Cap on the Federal Personal Income Tax Deduction To $10,000

The table at right shows the distributional effects of increasing the cap on the federal income tax deduction from the current $3,000 to $10,000. This tax cut also disproportionately benefits higher-income Oregonians.

The lowest-income 60 percent of Oregonians would receive only 3 percent of the tax cut from this proposal. The best-off 20 percent of Oregonians would receive

Effect of Increasing the Cap on Deductibility of Federal Income Taxes to $10,000

Oregon Residents by Income Group, 1999

Income Group	Tax Cut as % of Income	Average Tax Cut	Percent of Total Tax Cut
Lowest 20%	0.0%	$ —	0%
Second 20%	0.0%	$ —	0%
Middle 20%	0.1%	$ 20	3%
Fourth 20%	0.3%	$ 128	21%
Next 15%	0.5%	$ 416	51%
Next 4%	0.4%	$ 620	20%
Top 1%	0.1%	$ 643	5%

Source: ITEP Microsimulation Tax Model, May 1999

over three-quarters of the benefit. Moreover, the 5 percent of the population with incomes in excess of $116,000 would realize a full 25 percent of the tax break from this proposal.

Why Expanding The Federal Personal Income Tax Deduction Disproportionately Benefits the Well-Off

The skewed distribution of the tax cuts under these proposals is due to the fact that better-off people pay more in federal personal income taxes. Low- and middle-income taxpayers whose federal income tax is $3,000 or less would get no benefit from the proposal, because they are already deducting their entire federal personal income tax liability under current law. Upper-income taxpayers for whom the $3,000 they currently can deduct constitutes a substantial portion of their federal tax liability, would receive some benefit. But the wealthiest Oregonians, for whom the current $3,000 maximum deduction is a small share of their federal personal income tax liability, would realize enormous tax cuts if the full amount is deductible.

It is telling that the federal personal income tax is singled out for special treatment under these proposals. The federal personal income tax is the most progressive major tax on individuals—the tax that takes the most from the well-off relative to middle- and low-income taxpayers.

Most Americans actually pay less in federal personal income taxes than in other federal taxes such as the regressive excise and payroll taxes. For the 92 percent of Americans earning less than $100,000 in 1999, the federal personal income tax represents only 38 percent of total federal taxes paid. Only at higher incomes does the income tax begin to exceed half of taxpayers' total federal tax bill.

Components of the Federal Tax Burden

All U.S. Residents, 1999

Income $-000	% of Returns	Average Income	% of Federal Tax Bills		
			Inc. taxes	Other taxes	Total
<$10	15.5%	$ 4,400	none	all	100%
$10-20	19.0%	14,500	none	all	100%
$20-30	14.6%	24,500	25%	75%	100%
$30-40	11.4%	34,500	35%	65%	100%
$40-50	9.4%	44,500	40%	60%	100%
$50-75	14.3%	61,500	45%	55%	100%
$75-100	7.2%	82,500	49%	51%	100%
$100-200	6.1%	132,000	60%	40%	100%
$200+	1.8%	580,000	86%	14%	100%
ALL	**100.0%**	**$ 48,455**	**55%**	**45%**	**100%**
Addendum:					
<$100,000	92.1%	$ 32,400	38%	62%	100%
>$100,000	7.9%	235,000	75%	25%	100%

Sources: All figures are from the Joint Committee on Taxation, Feb. 1999, except for figures on average incomes, which were calculated based on JCT's published figures.

Thus, a plan to increase the deduction for the federal personal income tax, as opposed to taxes borne more heavily by the less well-off, targets its benefits to the most affluent Oregonians.

In addition, choosing to cut Oregon's personal income tax over other Oregon taxes also makes a bias towards better-off taxpayers likely. The Oregon income tax is somewhat progressive, taking more from the better-off than from low- and middle-income Oregonians. Thus, a cut in the income tax is likely to be of greater benefit to the better-off.

Federal Deductibility as a Solution to "Double Taxation"

Advocates of full deductibility of federal personal income taxes raise the specter of "double-taxation" as the evil which their proposal would remove. But, beyond the onerous-sounding phrase, is double taxation of income really a problem that needs remedying? And if double taxation is a problem, does a full (or increased) deduction for federal personal income taxes remedy it?

Double taxation is often referred to as paying "a tax on a tax." For example, take a family that has income of $50,000 and pays $2,400 in federal personal income tax. If there were no deduction for federal income tax payments, the Oregon tax would apply to the full $50,000 (less other deductions and exemptions), including the portion of their income used to pay federal income taxes (the $2,400). This is the so-called "tax on a tax."

Double Taxation of Whom?

If double taxation is a problem worth addressing, a full deduction for the federal income tax only comes close to solving it for the best-off Oregonians. The middle-income family in our example already deducts their full federal income tax because it amounts to less than the current $3,000 cap. Thus, they currently aren't paying any "tax on a tax" with respect to the federal personal income tax. With respect to the $3,800 they likely owe in federal payroll tax or the amounts they pay in other federal taxes, however, they remain subject to double taxation. Expanding the deduction for the federal personal income tax does nothing about this form of double taxation, and therefore provides no tax cut for this family.

For low- and middle-income families in general, the federal personal income tax represents less than half of federal taxes paid. A substantial portion, if not all, of their federal income tax is already deductible. Thus, if middle- and low-income Oregonians have a problem with double-taxation, these proposals don't do much to solve it.

For a wealthy family, however, the proposals do a great deal to reduce double-taxation. The personal income tax represents 86 percent of total federal tax liability for those with incomes over $200,000. Other federal taxes, such as the federal payroll tax, are relatively small for taxpayers in this income class. This reflects the fact that the wealthiest taxpayers are much more likely to rely on investment income to which the payroll tax doesn't apply. In addition, most of the payroll tax only applies to the first $72,600 of earned income—a small portion of a well-off taxpayer's income. So if well-off Oregonians have a problem with double taxation, it is overwhelmingly with the federal personal income tax. Thus, allowing an unlimited deduction for federal personal income tax payments largely eliminates any "tax on a tax" for Oregon's wealthiest residents.

Is Double Taxation of Income a Problem?

We have assumed here that double-taxation is a problem in Oregon's income tax structure to demonstrate that the proposals being considered would only constitute a solution for the wealthiest Oregonians. But in fact, when it comes to Oregon's income tax, double taxation is not really a problem as such.

Multiple taxation can be a legitimate tax policy concern. This is particularly true in states that, unlike Oregon, rely heavily on general sales taxes. Sales taxes in these states are typically structured to exempt a large portion of purchases made by businesses. This is because if goods are taxed at each point where they change hands —for example: at the purchase of raw materials, at the sale of goods to wholesalers, at the sale to retailer and at the sale to the final consumer—the ultimate tax burden on the good will depend more on how many transactions there are in the production and distribution stream than on the ultimate value of the product.

This can create significant problems. It favors vertically integrated industries and business over the less integrated. In our example, if the same company produces the raw materials, manufactures the product, distributes the product and sells it at retail, the tax is only paid once. If, on the other hand, separate businesses handle each of these steps, tax is paid several times.

Thus, multiple taxation under a sales tax gives an unfair advantage to vertically integrated businesses. This creates a bias toward vertical integration even though that might not be the most economically efficient manner to bring goods to market.

Oregon, of course, doesn't have to worry about multiple taxation in the sales tax because it doesn't have one. Nor is double taxation truly an issue in Oregon's income tax. The "double taxation" created under the Oregon income tax does not give

an advantage to one taxpayer over another. Each taxpayer is subject to the Oregon income tax once and the federal income tax once. Oregon taxpayers don't change their behavior to avoid "double taxation" because legally, they can't. Thus, "double taxation" under the income tax does not create the economic inefficiencies associated with multiple taxation under general sales taxes.

What Matters is Total Tax Burden, Not "Double Taxation"

From the income taxpayer's perspective, what matters is not the number of times income is taxed, but the overall tax burden on income. In other words, two taxes of five percent are exactly equivalent to one tax of ten percent (if neither tax is deductible from the other). And, as shown in the preceding analysis, the proposals analyzed here have virtually no effect on the tax burden facing low- and middle-income Oregonians. The claim that the Oregon personal income tax violates the tax policy principle that multiple taxation should be avoided is a misapplication of that principle.

As a justification for increasing the deduction for federal income tax payments, "double taxation" is simply a red herring. A deduction for federal income tax payments should be evaluated in the same manner as any other income tax proposal: on the grounds of its impact on government services, its fairness and its efficiency—not on whether it eliminates double taxation.

Experiences of Other States and Oregon's Proposed Marginal Tax Rates

In the few states that currently allow a deduction of the sort that has been proposed in Oregon, the deduction for federal personal income tax payments significantly decreases tax progressivity. Only Alabama, Louisiana and Iowa allow an unconditional full deduction of the federal personal income tax. In each of these states, nominally progressive income tax rate structures are offset by the regressive effect of the federal tax deduction, resulting in an effective income tax burden that is much less progressive than the nominal rates would suggest.

New Oregon Marginal Tax Rates on Families of Four*

Oregon Taxable Income	Marginal Tax Rate
$0- 4,700	5%
$4,700- $11,800	7%
$11,800- 21,900	9%
$21,900- 52,800	7.7%
$52,800- 96,000	6.5%
$96,000- 133,000	6.2%
$133,000- 213,000	5.8%
Above $213,000	5.4%

*Assumes standard deduction for federal and Oregon taxes.

The table at right shows what the effective Oregon marginal tax rate table would look like with a full deduction. In other words, the state of Oregon could achieve the same result as

adopting the full deduction by explicitly adopting this marginal tax rate table.[1]

The structure of this tax rate schedule is unusual in that the top marginal rate is applied only to income between $11,800 and $21,900 of Oregon taxable income, with marginal tax rates declining sharply for income above $21,900. In particular, the effective marginal tax rate on income above $213,000 is well below the effective rate on Oregon taxable income between $11,800 and $21,900.

Note that this table applies to married couples filing joint returns with two dependents who take the standard deduction, and it assumes income for federal and Oregon purposes is taxed in the same way (which is true of most forms of income). The exact income brackets vary for differing deduction amounts, filing statuses, family sizes and some types of income. The pattern and rates do not, however, change significantly.

Trade-offs for the Deduction

For a given amount of revenue and level of progressivity, states that have a deduction for federal income taxes must have higher nominal tax rates. Two states make this tradeoff explicit by giving the taxpayer a choice. In Oklahoma and North Dakota, the taxpayer can choose not to deduct the federal personal income tax and pay taxes at lower rates, or may take the deduction and pay at higher nominal tax rates. This, of course, makes for much more complicated tax filing without any real benefit. Taxpayers simply choose whichever method is best for them. A single rate

State Deductions for Federal Income Taxes Paid, 1998

Alabama	All federal personal income taxes paid are deductible.
Iowa	All federal personal income taxes paid are deductible.
Louisiana	All federal personal income taxes paid are deductible.
Missouri	Maximum federal income tax paid deduction is $5,000
Montana	Taxpayers choose between taking the standard deduction and itemizing deductions. If they itemize, the full amount of federal taxes can be deducted UNLESS the taxpayer makes over $124,500. Then, the deductible amount is limited as income increases.
North Dakota	Taxpayers can either take the deduction for federal income taxes paid and apply higher state tax rates, or multiply their federal tax by 14% to get their state liability. 5% choose the deduction option.
Oklahoma	Taxpayers have two options, only one of which allows a deduction for federal income taxes paid. 58% of taxpayers choose the federal tax paid deduction option (which entails higher nominal state tax rates), and the rest forgo the federal deduction in favor of lower nominal state rates.
Oregon	**Maximum federal income tax paid deduction is $3,000.**
Utah	50% of the federal income tax paid is deductible.

[1]The numbers in this table refer to *marginal* rates. This means, for example, that the first $4,700 of taxable income is taxed at 5 percent, and the $7,100 of taxable income between $4,700 and $11,800 is taxed at 7 percent, and the $10,100 of taxable income between $11,800 and $21,900 is taxed at 9 percent.

structure could be designed that accomplished approximately the same result for most taxpayers without the additional layer of complexity.

The lesson from these states is that allowing a deduction for federal taxes paid has consequences. Adopting (or increasing) a deduction for federal taxes paid is equivalent to cutting tax rates, with a bigger cut at high incomes than low. The main distinction between increasing the deduction and cutting rates explicitly is that the deduction approach makes the effect less apparent, and preserves the illusion of progressive rates. The consequences are, however, the same—lower revenue and a greater share of taxes paid by middle- and low-income taxpayers. These effects could be offset by raising tax rates, particularly on the well off. But, of course, if Oregonians don't want to lower taxes disproportionately for the well-off, foregoing the expansion of the federal personal income tax deduction in the first place would be a more sensible course of action.

Summary

A full deduction for federal taxes paid would reduce Oregon state government revenues by over $500 million per year. Raising the cap to $10,000 would reduce revenue by over $200 million per year. The bulk of this revenue loss would go to tax cuts for the best-off Oregonians. Notwithstanding the expressed goal of avoiding "double taxation," there is no principle of taxation that can be used to justify such a proposal. The question facing Oregon, clearly put, is whether the state wishes to cut taxes for its best-off citizens at the price of reduced government services.

Distributional Consequences of Increasing the Federal Deduction
Effects by Oregon Income Group in 1999

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	Top 1%
Average Income in Group	$8,500	$19,200	$30,900	$50,000	$80,200	$165,600	$719,900
Income Range	Less than $14,000	$14,000 – $25,000	$25,000 – $39,000	$39,000 – $63,000	$63,000 – $116,000	$116,000 – $271,000	$271,000 – or more
Deduction Limit at $10,000							
Tax Cut as % of Income	—	—	0.1%	0.3%	0.5%	0.4%	0.1%
Average Tax Cut	$ —	$ —	$ 20	$ 128	$ 416	$ 620	$ 643
Share of Total Tax Cut	—	—	3%	21%	51%	20%	5%
Unlimited Deduction							
Tax Cut as % of Income	—	—	0.1%	0.3%	0.7%	1.2%	2.1%
Average Tax Cut	$ —	$ —	$ 20	$ 130	$ 525	$ 2,054	$ 15,080
Share of Total Tax Cut	—	—	1%	8%	24%	25%	43%

Source: Institute on Taxation and Economic Policy Microsimulation Tax Model, May 1999.

ITEP METHODOLOGY

The Institute on Taxation & Economic Policy has engaged in research on tax issues since 1980, with a focus on the distributional consequences of both current law and proposed changes. ITEP's research has often been used by other private groups in their work, and ITEP is frequently consulted by government estimators in performing their official analyses. Over the past several years, ITEP has built a microsimulation model of the tax systems of the U.S. government and of all 50 states and the District of Columbia.

What the ITEP Model Does

The ITEP model is a tool for calculating revenue yield and incidence, by income group, of federal, state and local taxes. It calculates revenue yield for current tax law and proposed amendments to current law. Separate incidence analyses can be done for categories of taxpayers specified by marital status, the presence of children and age.

In computing its estimates, the ITEP model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to three quarters of a million records. To forecast revenues and incidence, the model relies on government or other widely respected economic projections.

The ITEP model's federal tax calculations are very similar to those produced by the congressional Joint Committee on Taxation, the U.S. Treasury Department and the Congressional Budget Office (although each of these four models differs in varying degrees as to how the results are presented). The ITEP model, however, adds state-by-state estimating capabilities not found in those government models.

Below is an outline of each area of the ITEP model and what its capabilities are:

The Personal Income Tax Model analyzes the revenue and incidence of current federal and state personal income taxes and amendment options including changes in:

- rates—including special rates on capital gains,
- inclusion or exclusion of various types of income,
- inclusion or exclusion of all federal and state adjustments,
- exemption amounts and a broad variety of exemption types and, if relevant, phase-out methods,
- standard deduction amounts and a broad variety of standard deduction types and phase-outs,
- itemized deductions and deduction phase-outs, and
- credits, such as earned-income and child-care credits.

The Consumption Tax Model analyzes the revenue yield and incidence of current sales and excise taxes. It also has the capacity to analyze the revenue and incidence implications of a broad range of base and rate changes in general sales taxes, special sales taxes, gasoline excise taxes and tobacco excise taxes. There are more than 250 base items available to amend in the model, reflecting, for example, sales tax base differences among states and most possible changes that might occur.

The Property Tax Model analyzes revenue yield and incidence of current state and local property taxes. It can also analyze the revenue and incidence impacts of statewide policy changes in property tax—including the effect of circuit breakers, homestead exemptions, and rate and assessment caps.

The Corporate Income Tax Model analyzes revenue yield and incidence of current corporate

income tax law, possible rate changes and certain base changes.

Local taxes: The model can analyze the statewide revenue and incidence of aggregate local taxes (not, however, broken down by individual localities).

Addendum: Data Sources

The ITEP model is a "microsimulation model." That is, it works on a very large stratified sample of tax returns and other data, aged to the year being analyzed. This is the same kind of tax model used by the U.S. Treasury Department, the congressional Joint Committee on Taxation and the Congressional Budget Office. The ITEP model uses the following micro-data sets and aggregate data:

Micro-Data Sets:
IRS Individual Public Use Tax File, Level III Sample; IRS Individual Public Use Tax File; Current Population Survey: Consumer Expenditure Survey; U.S. Census, 1990.

Partial List of Aggregated Data Sources:
Miscellaneous IRS data; Congressional Budget Office and Joint Committee on Taxation forecasts; other economic data (Commerce Department, WEFA, etc.); state tax department data; data on overall levels of consumption for specific goods (Commerce Department, Census of Services, etc.); state specific consumption and consumption tax data (Census data, Government Finances, etc.); state specific property tax data (Govt. Finances, etc.); American Housing Survey 1990; 1990 Census of Population Housing; etc.

A more detailed description of the ITEP Microsimulation Tax Model can be found on the ITEP Internet site at www.ctj.org/itep/model.htm.