FEDERATION OF TAX ADMINISTRATORS

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December 23, 1993

Ms. Marina Weiss
U.S. Department of Treasury
3445 Main Treasury
1500 Pennsylvania Ave., NW
Washington, DC 20220

Dear Ms. Weiss:

In response to your request for information on the impact of the Administration's health care proposals on state revenue systems, I have enclosed an FTA Bulletin outlining those revenue proposals of greatest interest to the states and an FTA report on the "Impact of Federal Tax Changes on State Tax Systems" which should aid in understanding the relationships between state and federal income tax structures. Your inquiry also prompted us to perform a "quick and dirty" analysis of the question you posed. The key points of our review are presented below.

Cigarette Excise Taxes

Each of the 50 states and D.C. levies an excise tax on cigarettes and thus will be affected by the expected reduced consumption that will follow if the President's proposal to increase the federal excise tax by $.75 per pack is enacted. In FY 1992, states collected about $5.9 billion in cigarette excise taxes, and cigarette taxes comprised about 2.0 percent of all state tax revenues. The median state tax rate was 25.75 cents per pack.

In the attached table, we have estimated the impact of a $.75 per pack increase in the federal excise tax on cigarette tax revenues in each state and the District of Columbia. As shown, we project a decline in cigarette revenues of over $875 million in FY 1995, a figure which reaches a cumulative total of $4.2 billion for FY 1995-1999. This amounts to an average reduction of nearly 14 percent in state cigarette excise tax revenues.[1]

[1] You will note that the figures in the table for California are well below the $200 million per year figure I quoted you from the Legislative Analyst's Office. It appears they used an estimated elasticity of about -0.90, whereas we used an elasticity of -0.45. See next paragraph.

The assumptions and methodology for deriving the estimates is attached to the table. Essentially, we have tried to trend FY 1992 collections and consumption on a state-by-state basis to FY 1995 levels using the most recent data available and to account for state cigarette tax increases already enacted. We applied the $.75 per pack increase to the weighted average price by state in FY 1992 and used an estimated price elasticity of demand for cigarettes of -0.45, meaning that for every 1 percent increase in cigarette prices, consumption declines by 0.45 percent.

The standard revenue estimating methodology of the Treasury Department and Joint Committee on Taxation for excise taxes includes an "income tax offset" to reflect an estimating convention that the proposal does not cause economic aggregates (e.g., GDP or national income) to change. Thus, an increase in excise taxes will reduce income somewhere else in the economy and cause income tax receipts to decline by the amount of the excise tax increase multiplied by the average marginal tax rate. Applying this same methodology to state taxes produces a result that the $.75 per pack cigarette tax increase will reduce state income tax receipts by about $600 million in FY 1995 and by over $2.5 billion from FY 1995-1999.

As a final note, states are concerned that the magnitude of the proposed federal increase will have a substantial "crowding out" effect, i.e., it is so large relative to the price of cigarettes that it will make it difficult for states to increase their tax rates. As you know, a number of states have increased or proposed to increase cigarette excise taxes as a means of financing state-level health care reform proposals. Increasing them for health care or to offset any revenue loss becomes problematic when the federal government has just increased the price of the commodity by one-third by a tax increase.

Income Taxes

In addressing the impact of the President's proposed income tax changes on state income taxes, the key question is the degree to which and the manner in which a state income tax conforms to the federal Internal Revenue Code. The key data are as follows:

- Of the 42 states with a broad-based individual income tax (including D.C.), all but five -- Alabama, Arkansas, Mississippi, New Jersey and Pennsylvania -- conform to a "federal starting point," i.e., state law provides that the computation of state income tax begins at a specified point in the federal computation which has the effect of incorporating all federal tax law features prior to that point unless state law specifically provides otherwise.[1]

[1] States can and must make modifications to the federal starting point (e.g., to account for income which is taxed at the federal level but cannot be at the state level (federal interest) and *vice versa*. Other modifications to address particular state policy concerns are also used in a number of states, but the use of such modifications was reduced substantially after the Tax Reform Act of 1986.

- Twenty-six states use federal Adjusted Gross Income as the starting point, eight begin with federal taxable income, and three -- North Dakota, Rhode Island and Vermont -- define state tax liability as a specified percentage of federal liability.

- State conformity to the IRC is of two types. Twenty-one states conform prospectively or on a "current" basis to the IRC which means that the state automatically conforms to and adopts changes enacted in the federal code which affect its starting point and other items tied to the Code unless state legislative action to the contrary is taken. The remaining states conform to the IRC as of a particular date which means the state must enact legislation to update its reference to the Code and incorporate any changes in federal law. Most states rather routinely enact legislation to conform to federal changes because of the complexity that faces taxpayers and the state tax agency when state and federal tax rules are significantly different.[1] (The points and nature of state conformity on a state-by-state basis are presented in Table 1 of the "Impact of Federal Tax Changes... report.)

- States also conform substantially to federal itemized deductions. Twenty states use federal deductions as a starting point (and make modifications thereto, usually for state income tax payments), and nine others conform fully to federal itemized deductions. Eight states do not allow itemized deductions, and the remainder build independently to their own deduction amounts (but even here they are likely to track federal deductions to a degree.) (See Table 2 in Impact of Federal Tax Changes....)

- With respect to corporation income taxes, all but five of the 47 jurisdictions which levy such a tax begin the state calculations with federal taxable income. Twenty-four states conform to federal law on a prospective basis, and the remainder require legislation to incorporate any new federal rules. (See Table 7 in Impact of Federal Tax Changes....)

With this as background, the impact of the President's financing proposals on state income taxes can be summarized as follows:

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[1] This is not always the case. In 1981, a number of states declined to conform to the Accelerated Cost Recovery System because of the revenue loss involved. Over time, however, the complexity of differing depreciation schemes lead nearly all states to conform to ACRS and subsequent federal regimes. Similarly, only about one-half of the states currently conform to the federal system for taxing a portion of Social Security benefits (the other half exempts the benefits) and certain of the taxing states are considering not conforming the changes contained in the Omnibus Budget Reconciliation Act of 1993 although that is likely to present considerable complexity to the taxpayer.

- The three piggy-back states -- North Dakota, Rhode Island and Vermont -- will be affected by all the proposed income tax changes, including those that expand or reduce the base and the tax credit provisions.

- Presuming that states maintain their conformity, the increased deduction for health insurance premiums of the self-employed will flow through to most state income taxes and reduce the tax base. I know of only one state that has taken steps to non-conform to the current 25 percent deduction for self-employed persons.

- The exclusion of long term care benefits from income and the increased allowance for the expensing of certain medical equipment will reduce the base in most states.

- Allowing an itemized deduction for long term care premiums and long term care expenses will be automatically incorporated in only 8 states, but a number of others would likely conform by virtue of starting with federal itemized deductions. I know of few states that currently make any adjustment to the medical expense deduction. This will, of course, not affect the states which do not allow itemized deductions.

- The limits on the exclusion for employer-paid insurance premiums as well as the restrictions on cafeteria plans and flexible spending accounts will increase the tax base in most income tax states.

- State income taxes will not automatically be affected by the tax credit proposals (other than the piggy-back states) or the compliance provisions relating to self-employment taxes for Subchapter S shareholders and increased 1099 filing penalties. Likewise the corporate alliance assessment will not affect the states. I am not able to determine the impact, if any, of the provisions related to the treatment of retiree benefit reserves and the tax treatment of HMOs and other health care organizations.

- On balance, <u>for income taxes only</u>, it would seem that the President's proposals would increase the state tax base somewhat because of the impact of the limits on the exclusion for employer-paid insurance premiums and the restrictions on cafeteria plans and flexible spending accounts relative to the items that reduce the state tax base. Importantly, however, this expanded base does not come into play until FY 1997 under the proposal.

Insurance Premium Taxes

All states also levy an excise tax (usually ranging from 1.0-3.0 percent) on insurance premiums including health and accident premiums sold by for profit entities. Not being exceedingly familiar with these taxes or all facets of the Administration's proposal, I am unable to determine what, if any, impact it will have on premium tax receipts. To the extent the proposal increases the number of people covered by employer-paid or other insurance, it should serve to increase receipts, including any offsets for reduced insurance premiums resulting from the proposal's cost control mechanisms. On the other hand, if the proposal causes people to shift to exempt plans or plans not involving insurance premiums, receipts would decrease compared to current law.[1]

Summary

In short, by far the largest impact of the President's proposal is on expected receipts from state cigarette excise taxes where state collections can be expected to fall by nearly $4.2 billion from FY 1995-1999. This figure is increased by over 60 percent when the "income tax offset" effect of an excise tax increase is included. In addition, the magnitude of the proposed federal increase is likely to have a "crowding out" effect making it more difficult for states to increase tobacco taxes to either offset the tax reduction or to finance their own health care reforms as several have done or proposed to date. The impact of the Administration proposals on state income taxes are relatively marginal, but should have a slight positive impact on revenues over the five-year period, presuming states maintain their current degree of conformity.

I hope you find this information helpful. Please do not hesitate to contact me should you have any questions or comments or if I may be of assistance to you on this or any other matter.

Sincerely,

Harley T. Duncan
Executive Director

cc. Joe Huddleston, Commissioner
Tennessee Dept. of Revenue and
President, FTA

Ray Scheppach, Executive Director
National Governors' Association

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[1]Further information may be available from the National Association of Insurance Commissioners. The address is Ste. 309, 444 North Capitol St., Washington, DC 20001. Ph. 202/624-7790.

Impact of $0.75/Pack Federal Cigarette Tax Increase on State Revenues
($1,000)

STATE	Est. FY 1995 Cigarette Tax Collection	Revenue Loss	% Decrease Revenues	Total 5-year Revenue Loss*
ALABAMA	$58,053	$8,563	14.8%	39,342
ALASKA	[illegible]	1,842	12.4	8,873
ARIZONA	[illegible]	7,386	14.3	36,887
ARKANSAS	78,075	11,331	14.5	53,497
CALIFORNIA	612,723	80,176	13.1	363,836
COLORADO	50,459	7,715	15.3	35,902
CONNECTICUT	120,421	15,931	13.2	75,214
DELAWARE	19,310	2,709	14.0	13,611
DIST. OF COLUMBIA	26,137	3,329	12.7	15,717
FLORIDA	397,069	54,377	13.7	260,339
GEORGIA	78,051	11,988	15.4	57,764
HAWAII	37,254	4,503	12.1	25,774
IDAHO	16,039	2,419	15.1	12,889
ILLINOIS	414,538	58,245	14.1	274,984
INDIANA	98,950	15,907	16.1	75,976
IOWA	77,383	10,773	13.9	47,827
KANSAS	51,016	7,592	14.9	37,476
KENTUCKY	17,180	2,933	17.1	14,891
LOUISIANA	79,163	11,460	14.5	54,591
MAINE	50,120	6,895	13.8	32,551
MARYLAND	163,097	22,335	13.7	105,448
MASSACHUSETTS	238,130	34,456	14.5	162,673
MICHIGAN	227,545	32,365	14.2	152,648
MINNESOTA	158,661	19,944	12.6	94,159
MISSISSIPPI	46,792	6,854	14.6	35,156
MISSOURI	94,323	15,156	16.1	71,554
MONTANA	11,795	1,716	14.5	8,100
NEBRASKA	42,395	6,226	14.7	29,393
NEVADA	42,533	5,752	13.5	27,139
NEW HAMPSHIRE	40,535	5,853	14.4	29,228
NEW JERSEY	221,747	28,982	13.1	128,047
NEW MEXICO	20,135	3,023	15.0	14,273
NEW YORK	732,457	96,332	13.2	454,796
NORTH CAROLINA	41,722	6,839	16.4	36,828
NORTH DAKOTA	17,929	2,628	14.7	12,409
OHIO	255,053	40,039	15.7	189,031
OKLAHOMA	61,877	8,884	14.4	45,418
OREGON	98,568	13,599	13.8	64,200
PENNSYLVANIA	311,251	44,422	14.3	213,446
RHODE ISLAND	39,280	5,289	13.5	24,968
SOUTH CAROLINA	29,586	4,601	15.6	24,823
SOUTH DAKOTA	12,947	1,876	14.5	8,929
TENNESSEE	66,987	10,149	15.2	46,901
TEXAS	559,540	73,360	13.1	379,486
UTAH	28,960	4,199	14.5	23,696
VERMONT	12,457	1,857	14.9	8,768
VIRGINIA	13,430	2,077	15.5	9,599
WASHINGTON	188,843	24,984	13.2	117,950
WEST VIRGINIA	30,528	4,711	15.4	24,706
WISCONSIN	166,881	22,687	13.6	107,108
WYOMING	4,884	751	15.4	3,431
U. S.	$6,329,362	$878,022	13.9%	$4,192,253

Source: Federation of Tax Administrators
Note: An additional $619 million in FY 1995 and $2,761 million FY 1995-99 in State revenue losses will be incurred due to the State income tax offset.
* FY 1995 - FY 1999, assuming no changes in State policies.

See Assumptions and Methodology on Next Page.

Assumptions

Estimated FY 1995 Tax Collections were estimated by projecting FY 1992 collections (Tobacco Institute, *The Tax Burden on Tobacco*, March 1993) based on the changes in sales for the first three quarters of FY 1993 for each individual state as reported by the Tobacco Institute. Note: Adjustments were made for states that increased the cigarette excise tax rates. The overall sales trend was estimated using the national average for the first three quarters of FY 1993 (-2.87%) in lieu of the state trend. State revenues were increased in proportion to the tax rate changes, with sales losses estimated using a price elasticity of -0.45.

The Revenue Loss was estimated by multiplying the FY 1995 tax collections by the percentage decline in sales due to the Federal tax increase. First, the price increase was determined by adding the 75 cent Federal tax increase to each individual states' weighted average price for cigarettes, November 1992. (reported by the Tobacco Institute, *The Tax Burden on Tobacco*, March 1993) The percentage decline in sales was calculated for each state assuming a price elasticity of -.045. Note: No attempt was made to adjust the 1992 prices to inflation or include any wholesale/retail Mark-ups on the tax increase.

The 5-year Revenue Loss was calculated assuming the same trend for states sales as described above.

The State Income Tax Offset was calculated by multiplying the increase in Federal Tax payments (less state revenue losses) by the applicable State income tax rate. Note: For these calculations, we assume that the applicable marginal rate is the highest rate for each state. Note: An income tax Offset is consistent with Federal revenue estimating procedures used by the Joint Committee on Taxation and the U.S. Treasury. A detailed description of the income tax offset is given by Emil Sunley and Randall Weiss, in *The Revenue Estimating Process*, Tax Notes, June 10, 1991, p. 1299-1314.

Net Impact of $0.75/Pack Federal Cigarette Tax Increase on State Revenues

($1,000)

STATE	Income Tax Off-set*	Total Net Loss#	5-Year Total (1995-99) Income Tax Off-set*	5-Year Total (1995-99) Total Net Loss#
ALABAMA	10,348	18,911	44,339	83,682
ALASKA	0	1,842	0	8,873
ARIZONA	10,925	18,311	50,763	87,650
ARKANSAS	9,520	20,851	41,765	95,262
CALIFORNIA	98,875	179,051	417,167	781,003
COLORADO	6,899	14,614	29,901	65,803
CONNECTICUT	5,523	21,454	24,149	99,363
DELAWARE	3,263	5,972	15,236	28,847
DIST. OF COLUMBIA	1,932	5,262	8,430	24,147
FLORIDA	0	54,377	0	260,339
GEORGIA	21,905	33,893	98,384	156,148
HAWAII	3,363	7,866	17,748	43,522
IDAHO	4,087	6,506	20,233	33,123
ILLINOIS	14,269	72,514	62,427	337,411
INDIANA	11,992	27,899	53,352	129,329
IOWA	11,060	21,834	45,650	93,477
KANSAS	8,863	16,454	40,662	78,138
KENTUCKY	20,860	23,793	98,793	113,684
LOUISIANA	13,424	24,884	59,547	114,138
MAINE	5,588	12,482	24,475	57,026
MARYLAND	11,617	33,952	50,848	156,296
MASSACHUSETTS	13,539	47,995	59,111	221,784
MICHIGAN	21,921	54,286	96,179	248,827
MINNESOTA	14,108	34,052	61,734	155,893
MISSISSIPPI	7,365	14,219	35,135	70,291
MISSOURI	18,064	33,220	79,432	150,986
MONTANA	3,656	5,371	16,074	24,174
NEBRASKA	4,514	10,740	19,786	49,179
NEVADA	0	5,752	0	27,139
NEW HAMPSHIRE	0	5,853	0	29,228
NEW JERSEY	19,531	48,513	80,198	208,246
NEW MEXICO	4,404	7,428	19,356	33,629
NEW YORK	49,889	146,222	217,812	672,608
NORTH CAROLINA	40,787	47,626	204,553	241,381
NORTH DAKOTA	2,465	5,094	10,782	23,191
OHIO	39,329	79,368	172,698	361,729
OKLAHOMA	10,255	19,139	48,710	94,128
OREGON	11,774	25,373	51,579	115,780
PENNSYLVANIA	15,508	59,930	69,229	282,675
RHODE ISLAND	3,619	8,907	15,839	40,806
SOUTH CAROLINA	16,947	21,548	85,103	109,926
SOUTH DAKOTA	0	1,876	0	8,929
TENNESSEE	0	10,149	0	46,901
TEXAS	0	73,360	0	379,486
UTAH	4,255	8,454	22,243	45,940
VERMONT	2,940	4,797	12,923	21,690
VIRGINIA	19,039	21,116	82,241	91,839
WASHINGTON	0	24,984	0	117,950
WEST VIRGINIA	6,441	11,152	31,400	56,107
WISCONSIN	14,782	37,469	64,745	171,853
WYOMING	0	751	0	3,431
U. S.	619,445	1,497,467	2,760,735	6,952,988

Source: Federation of Tax Administrators

* Calculated using the highest marginal income tax rate in each state.

\# Losses from State Excise Taxes and Income Tax Offset.