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The State Tax Complexity Index:
A New Tool for Tax Reform and Simplification

BY PAUL WEINSTEIN JR. APRIL 2014

Across the political spectrum there is broad agreement that tax reform is long overdue. Yet reform remains an elusive goal—not just in Washington, but also at the state level. Ideological standoffs, the excessive influence of special interests, the impending midterm elections, and mistrust of government are just some of the road blocks to reform.

In Congress, House Ways and Means Committee Chairman Dave Camp has unveiled an ambitious blueprint for sweeping tax reform. President Obama's new budget calls for closing a raft of tax loopholes to pay for new investments in infrastructure. Despite all the political attention now being lavished on the federal tax code, however, almost no one is talking about tax reform at the state level. That's a problem, because state tax systems tend to mirror the flaws so evident in our federal tax code: They are regressive, economically distorting and absurdly complex. In state houses as in Washington, the inexorable growth of special tax preferences—or tax expenditures in budget parlance—is the prime culprit.

This policy report undertakes a unique examination and comparison of the complexity of all 50 state tax systems plus the District of Columbia – the State Tax Complexity Index ("Index"). The Index measures complexity in terms of the number of tax expenditures for each state revenue system. The top of the list (most complicated) includes several states that don't even bother reporting the number and type of tax expenditures they offer. These states include Alabama, Florida, Indiana, Nevada, New Hampshire, South Dakota, and Wyoming.[1] Among the states that do self-report Washington, Louisiana, and Oklahoma finish in the top three spots respectively.

In addition, the Index highlights several findings that are relevant to the national tax reform debate:

About the author

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1. All tax systems—whether income- or sales-based, single or multiple rates – suffer from too much complexity;

2. The *type* of tax system does not determine the level of complexity. Complex tax systems (as measured by the number of tax expenditures[2]), exist in states with progressive income taxes, states with a flat rate income tax, as well as states with no income tax (but with sales and other kinds of taxes);

3. Reducing complexity through the elimination of tax expenditures can finance lower tax rates and also increase fairness (progressivity) because their benefits mostly go to higher income individuals and businesses.

SHORT HISTORY OF STATE INCOME TAX SYSTEMS

As state governments and their programmatic responsibilities began to expand in the beginning of the 20th century, the need for greater revenues led many states to adopt income tax systems to supplement their existing revenue streams – then consisting mainly of fees and property taxes. In 1911, the State of Wisconsin became the first in the nation to levy a tax on individual and corporate income. Income taxes were quickly adopted in a number of other states soon after, including Mississippi (1912), Connecticut (1915), Virginia (1915), Massachusetts (1916), Delaware (1917), Missouri (1917), Montana (1917), North Carolina (1919), North Dakota (1919), and New York (1919).[3]

By 1940, 33 states had in place an income tax on individual and/or corporate income, with most of them utilizing withholding to ensure timely payments. Today, all but seven states collect individual income taxes and all but six collect taxes on corporate income.[4 5]

Initially, states modeled their income tax structures on the federal system. It was typical for states to use federal definitions for taxable income, personal exemptions, filing status, the treatment of capital gains and estate taxes, and common deductions. But over time, the federal and state income tax systems have diverged significantly. This is due to several factors.

First, unlike the federal government, most states have constitutional amendments requiring balanced operating budgets, necessitating that states cut spending and/or raise revenues during economic slowdowns. The federal government, on the other hand, can borrow without effective limit by selling Treasuries.

Similarly, starting in the 1980s and culminating with the Bush tax cuts in the last decade, the federal government dramatically cut (and reduced the number of) marginal rates, increased the number of tax incentives to an aggregate cost of over a $1 trillion per fiscal year, and provided more favorable treatment for capital gains and estate taxes. The main means of financing these policies was additional borrowing, leading to higher levels of national debt. Many states, for a variety of reasons including statutory requirements to balance their budgets, did not follow federal policy because to do so would have required deep spending cuts on important investments such as schools, roads, water infrastructure, and other public needs to keep their budgets in balance.

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Second, the political dynamics at the state level are different than in Washington. Beginning with the Reagan Administration, the debate over tax policy in Washington became increasingly partisan and rancorous, and has only gotten worse. That's why it's been more than 25 years since the last major overhaul of the federal tax code. While state tax politics are hardly immune from the partisan combat so common at the federal level, the more accessible and responsive nature of state governance has encouraged more cooperation between the two parties.

Third, the federal government has stuck with a "traditional" federalist approach when it comes to state revenue policy. Washington has regularly used carrots or sticks to get states to adopt uniform policies in a number of areas – such as education standards, health care for the poor, the legal drinking age or highway speed limits. But despite having at its disposal considerable leverage (think state and local tax deductions), state tax policy remains one area where the federal government has not intervened with a heavy hand.

Fourth, states often use the tax code to compete for business investment. This has led to a growing industry in special exemptions and privileges for businesses willing to relocate or open new operations in certain states. At the same time, many states and localities, particularly those with higher living costs, feel obliged to provide tax relief to certain long-established businesses that policymakers believe are critical to their job and revenue base.

KEY DIFFERENCES BETWEEN FEDERAL AND STATE INCOME TAX SYSTEMS

There are many differences between how states and the federal government tax income. Here are some of the most common:

Filing status. Federal law lets married couples file joint returns. If they choose, they can use a filing status called married filing separately. This status often prevents one or both spouses from claiming certain deductions or other tax breaks. For example, if one spouse itemizes, the other cannot choose the standard deduction. Certain states (Arkansas, Delaware, and Georgia) allow something called "combined filing" for married couples.[6] Combined returns allow each spouse that earns income to file separately and choose different tax breaks in some areas.

Capital gains. Twenty-five states that tax income have generally followed federal treatment, with the exception of various state-specific exclusions and deductions. Eleven states and the District of Columbia treat capital gains and losses the same as under federal law, taxing all capital gains and allowing the deduction of up to $3,000 in net capital losses. However, most charge the same rate as normal income, unlike the federal government, which has a preferential rate. Seven states with income taxes exempt or tax capital gains and losses very differently than the federal government.[7]

Tax credits. Some tax credits on the federal level are transformed into deductions at the state level. For example, North Carolina gives deductions for the Hope and Lifetime Learning Credits. Oklahoma and Rhode Island allow a deduction for adoption expenses. West Virginia offers a deduction for the elderly and permanently disabled.[8]

Deductions. Some states offer additional deductions to federal law while others governments exclude certain federal deductions. For example, Alabama, Maine, New Jersey, and Wisconsin do not provide deductions for contributions to health savings accounts even though the federal government does provide one.[9] On the other hand, Hawaii lets residents deduct contributions to individual housing accounts in order to save for a down payment on a house or condo.[10] The federal government does not offer anything similar. And Indiana gives residents a deduction for rent on their principal residence, something the IRS does not allow.

Retirement Income. Under federal law, distributions from retirement accounts, such as 401(k) plans and IRAs, are fully taxable. States, however, have a wide range of tax breaks for this income.

Free File. Free File is a public-private partnership between the IRS, state revenue departments, and a consortia of private software firms. Taxpayers who fall below a certain income threshold (currently

$58,000) are eligible to receive free tax software, including Turbo Tax and H&R Block. According to the IRS, some 70 percent of taxpayers qualify (although not that many actually take advantage). About half the states offer Free File for state income taxes. The rest have hired systems integrators to build their own unique consumer software systems, at taxpayer expense. In any event, such software has enabled many taxpayers (though not businesses) to mitigate the compliance burdens imposed by the growing complexity of state tax codes.

Such variations notwithstanding, the federal tax code is partly to blame for the large number of state tax expenditures. The majority of states link their income tax systems completely or partially to the federal tax system. This means many of the $1 trillion in federal tax expenditures are built into state tax systems.

MEASURING TAX SYSTEM COMPLEXITY AMONG STATES

No two state tax systems are alike. Among the 50 states and the District of Columbia, seven have no individual income tax, and of the 43 that do, seven apply only a single rate. In addition, two states, New Hampshire and Tennessee, only tax income earned on interest and dividends.

With so many different tax systems, anyone working or doing business across state lines faces a bewildering maze of complexity.

With so many different tax systems, anyone working or doing business across state lines faces a bewildering maze of complexity. But complexity is also a problem for those who live and work in a single state. Even though many states offer "EZ" tax returns that are two to three pages, the number of instructions and supporting forms continues to grow. Most states have multiple revenue streams (sales taxes, corporate income taxes, individual income taxes, user fees, etc.) with an ever-growing set of rules that create more paperwork, confusion, and inequities.
Common to all types of tax systems are tax expenditures. These are tax provisions that provide a targeted benefit to specific individuals and groups, and thereby reduce government revenue. Common tax expenditures include deductions, credits, exclusions, deferral, and rebates.
Some progressive analysts tend to look at tax expenditures as an indirect form of government spending that obviate the need for new programs and administrative bureaucracies. Conservatives see them as a way of cutting tax burdens on families and businesses. Either way, the growth of tax expenditures greatly increases tax complexity because they spawn a special set of regulations which multiply over time and often lead to growing inconsistencies and inequities.

How do we know tax expenditures add to complexity? According to the IRS, someone filling a 1040 form (which includes those taxpayers who chose to itemize their deductions) devote 16 hours, the equivalent of two full work days, to the task. The 1040EZ form (which limits the number of deductions, credits, and other tax expenditures), by contrast, takes just four hours out of a year.[11]

Based on self-reporting data from the individual states themselves, PPI has compiled an index of tax complexity based on the number of tax expenditures offered by each state. As noted above, several states do not provide complete reports on tax expenditure data. These non-transparent states received the highest ranking in our survey because producing a comprehensive list of tax expenditures is a key first step in reducing complexity.

A number of interesting conclusions can be drawn for the data in Table 1:

All types of tax systems contain tax expenditures. No revenue system type – sales tax, individual income tax, corporate income tax, user fee, etc. – is immune to political pressures to continually add new tax expenditures.

TABLE 1 – STATE TAX SYSTEM COMPLEXITY INDEX:[12] COMPLEXITY AS MEASURED BY # TAX EXPENDITURES

STATE	RANGE OF TAX EXPENDITURES	RANK	STATE	RANGE OF TAX EXPENDITURES	RANK
Alabama	N/A	1	Rhode Island	200 to 250	24
Florida	N/A	1	Texas	200 to 250	24
Indiana	N/A	1	Colorado	150 to 200	29
Nevada	N/A	1	Connecticut	150 to 200	29
New Hampshire	N/A	1	Michigan	150 to 200	29
South Dakota	N/A	1	Missouri	150 to 200	29
Wyoming	N/A	1	North Dakota	150 to 200	29
Washington	550 to 600	8	South Carolina	150 to 200	29
Louisiana	450 to 500	9	Vermont	150 to 200	29
Oklahoma	450 to 500	9	Virginia	150 to 200	29
Arizona	400 to 450	11	California	100 to 150	37
New York	400 to 450	11	Hawaii	100 to 150	37
Georgia	350 to 400	13	Idaho	100 to 150	37
Oregon	350 to 400	13	Kansas	100 to 150	37
Wisconsin	350 to 400	13	Mississippi	100 to 150	37
Maryland	300 to 350	16	Montana	100 to 150	37
Minnesota	300 to 350	16	New Mexico	100 to 150	37
Nebraska	300 to 350	16	Ohio	100 to 150	37
North Carolina	300 to 350	16	Tennessee	100 to 150	37
Iowa	250 to 300	20	Utah	100 to 150	37
Kentucky	250 to 300	20	DC	100 to 150	37
Maine	250 to 300	20	Arkansas	50 to 100	48
New Jersey	250 to 300	20	Delaware	50 to 100	48
Illinois	200 to 250	24	West Virginia	50 to 100	48
Massachusetts	200 to 250	24	Alaska	0 to 50	51
Pennsylvania	200 to 250	24			

KEY: State with No Income Tax | State with Progressive Income Tax | State with Flat Income Tax | Income Tax on Interest/Dividends

There is no link between the level of tax expenditures and tax system type. Many proponents of flat tax or sales tax systems tout simplicity as a benefit. But in measuring complexity in terms of tax expenditures, states that rely on flat or sales tax systems are just as likely to have high levels of complexity as those states that have progressive income tax systems. For example, Hawaii and California, states with some of the most progressive income tax systems (Hawaii has more marginal rates than the federal income tax), ranked among the least complex tax systems in terms of the number of tax expenditures. Meanwhile, states with no individual income tax ranged all over the spectrum. Washington ranked close to the top of our list, while Texas (also no income tax) finished in the middle, and

Alaska finished at the bottom. On the other hand states utilizing a flat tax clustered in the middle of our survey, with the exception of Utah, which tied for 37th.

While it is important to respect the American tradition of federalism, it is also in the national interest for the federal government and the states to find ways to collaborate on tax policy, and to endeavor to coordinate and streamline their revenue systems.

Most states had at least 100 tax expenditures but no more than 300. Forty-six states plus the District of Columbia had at least 100 tax expenditures, while a handful had over 300 tax breaks.

LINK FEDERAL AND STATE TAX REFORM

Given the differing revenue needs and policy goals of individual states, it is not surprising that their tax systems diverge increasingly from each other, as well as from the federal tax code. Yet there is a cost to the uniqueness of individual state tax systems. The necessity to file across state lines for businesses that operate in two or more jurisdictions is a cost that many of our international competitors do not face in their own countries. In addition, the confusion created by different rules at the state and federal level can often lead to filing errors and greater expense to individual taxpayers.

On the other hand, states often serve as laboratories of policy innovation, and both the left and the right could plausibly argue that the federal tax code is more complex, less progressive, and more inefficient than those of many states.

While it is important to respect the American tradition of federalism, it is also in the national interest for the federal government and the states to find ways to collaborate on tax policy, and to endeavor to coordinate and streamline their revenue systems. One possible first step would be the creation of a joint Congressional-Governors Commission focused on federal and state tax reform. The creation of such a commission would be particularly timely, since the growing debate on federal tax reform offers a rare opportunity for state and federal policymakers to collaborate on reducing complexity for all taxpayers, assuring greater progressivity across the board, and promoting economic innovation, growth, and competitiveness.

ENDNOTES

1. Seven states do not self report the type and total number of tax expenditures. Yet, these states, based on budget and revenue information, have tax codes that include tax expenditures that have a significant budgetary impact. For example, according to the "2010 Florida State Tax Handbook" the state's tax expenditures are approximately one-third of Florida's revenue collections. Because these states choose not to self report the number of tax expenditures, they are given the worst rating in our survey.
2. Tax expenditures as defined here include deductions, credits, exclusions, deferrals, rebates, expensing and other tax incentives for individuals, families, and entities.

3. Edward Howe & Donald Reeb, "The Historical Evolution of State and Local Tax Systems" http://www.lincolninst.edu/subcenters/property-valuation-and-taxation-library/dl/howe_reeb.pdf.
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About the Progressive Policy Institute

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