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Oregon Should Follow the Feds in Not Taxing Some Unemployment Benefits

The American Recovery and Reinvestment Act (ARRA), commonly known as the federal recovery package, exempts from federal income taxes the first $2,400 a worker collects in unemployment benefits. The provision applies for tax year 2009 only, and benefits over $2,400 remain subject to tax. [1]

Absent legislative action, unemployed Oregonians will not be able to take advantage of this benefit on their state income taxes. With the enactment of HB 2157 earlier this year, the legislature must vote to connect to changes in the federal definition of taxable income if they are to be effective in Oregon.

ARRA's exemption of a portion of unemployment benefits is one change in federal law that Oregon should connect to. It will help many of those hardest hit by the recession. The legislature can reduce its fiscal impact by restricting the wealthiest households from receiving the exemption, limiting the provision to those who need help the most.

Taxing unemployment benefits undercuts the goals of the program

The ARRA provision exempts from taxation the first $2,400 a worker collects in unemployment insurance in 2009.[2] Unless Oregon connects to this provision, all unemployment benefits will remain subject to state income tax.

Taxing unemployment benefits undercuts the twin goals of the unemployment system: helping working families make ends meet during a spell of unemployment and stabilizing the economy. Unemployment benefits put money in the pockets of laid-off workers, not only helping them and their families as they search for work but also helping Oregon's economy because those dollars are likely to be spent quickly and locally. Taxing unemployment benefits works against the unemployment system's goals by effectively reducing the weekly benefit amount.

The tax exemption would offer a modest benefit to many Oregonians

With unemployment reaching historic highs, thousands of Oregonians would receive a modest tax benefit if the legislature connected to the federal provision. In 2006, the most recent year for which data are available, 109,000 Oregon tax returns listed income from unemployment benefits.[3] Because Oregon's unemployment levels are twice as high in 2009, far more Oregonians would benefit if Oregon connects to the provision.

The tax benefits would be fairly evenly distributed across income groups. According to an estimate prepared for OCPP by the Institute on Taxation and Economic Policy (ITEP), low-income Oregonians would get a slightly larger tax break as a share of their income than high-income Oregonians. This is because the amount that can be excluded is capped at $2,400.

Effect of Connecting to the Federal Exclusion of Unemployment Benefits						
2008 income group	Average income in group	2008 income range	Tax benefit as a share of income	Average tax break	Share of income group that would receive a tax benefit	Share of total tax change
Lowest 20%	$10,200	less than $17,000	0.09%	$142	14%	13%
Second 20%	$23,500	$17,100 - $31,000	0.09%	$147	32%	31%
Middle 20%	$40,100	$31,000 - $51,100	0.04%	$155	20%	21%
Fourth 20%	$64,300	$51,100 - $82,100	0.03%	$158	22%	23%
Next 15%	$110,900	$82,100 - $164,500	0.01%	$160	11%	12%
Next 4%	$237,300	$164,500 - $384,700	0.00%	$179	1%	1%
Top 1%	$1,046,100	more than $384,700	—	—	—	—

Note: Figures are based on 2008 income levels and assume that each return reporting unemployment benefits has only one benefits recipient. Average tax break is among those who receive the break.

Source: Institute on Taxation and Economic Policy.

The legislature can limit the exemption's cost and better target it

Connecting to the federal provision would cost Oregon at least $29 million in lost income tax revenue in 2009-11, according to a March 2009 Legislative Revenue Office estimate.[4] In view of the existing budget shortfall, the legislature could tweak the ARRA provision to reduce its cost.

Legislators can reduce the tax exemption's fiscal impact and still help those Oregonians who need it most by limiting the provision to all but the top quintile (top 20 percent) of taxpayers. If the state were to limit the tax break to the 80 percent of households with incomes below $82,100, it would save 13 percent of the cost of the provision.[5] That would be nearly $4 million.

Such a limitation would make the provision more targeted, providing a benefit to all but the wealthiest 20 percent of Oregon taxpayers, those whose incomes are between $82,100 and $384,700.[6] Without the limitation, those high-income taxpayers with an average income of $137,511 would receive 13 percent of the total tax break, the same share as the lowest-income 20 percent of taxpayers, those with income less than $17,100.[7] This means that Oregon would expend as much on the wealthiest Oregonians as it would on the poorest if it adopts the federal provision without an income limit.

Conclusion

The legislature should affirmatively adopt the exclusion of the first $2,400 of unemployment benefits as provided in the ARRA, a move that would further the goals of the unemployment insurance system. To reduce the fiscal impact, the legislature could limit the benefits of the provision to the 80 percent of Oregonians who have income below $82,100.

Endnotes

[1] Each recipient of unemployment benefits can take the exclusion, so joint filers who both had a spell of unemployment could exclude up to $4,800 in income. American Recovery and Reinvestment Act of 2009, H.R. 1, 111th Cong., title I, section 1007; Internal Revenue Service, "First $2,400 of Unemployment Benefits Tax Free for 2009," March 26, 2009, available at www.irs.gov/newsroom/article/0,,id=205633,00.html.

[2] While the ARRA provision is applicable only in 2009 and only to the first $2,400 of unemployment benefits, the legislature may wish to study whether it makes sense to exempt all unemployment benefits and whether the one-year period ought to be extended.

[3] Oregon Department of Revenue, *2006 Personal Income Tax Statistics,* full-year returns, table D-1.

[4] Legislative Revenue Office, *The American Recovery and Reinvestment Act of 2009: The Impact on Oregon,* March 2009, available at www.leg.state.or.us/comm/lro/2009_session/american_recovery_act.pdf. The measure will most likely cost more than the LRO's estimate, given the sharp increase in unemployment Oregon has experienced in 2009.

[5] Institute on Taxation and Economic Policy (ITEP), May 2009 estimate based on 2008 income levels.

[6] This is the income range for all taxpayers in the top quintile except the top 1 percent. The ITEP analysis concludes that the top 1 percent would not meaningfully gain from the provision.

[7] ITEP, May 2009 estimate based on 2008 income levels.

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