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THE EFFECT OF THE PRESIDENT'S TAX PLAN ON STATE AND LOCAL TAXPAYERS

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-NINTH CONGRESS

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THE EFFECT OF THE PRESIDENT'S TAX PLAN ON STATE AND LOCAL TAXPAYERS

WEDNESDAY, MAY 29, 1985

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room 2255, Rayburn House Office Building, Hon. David R. Obey (chairman of the committee) presiding.

Present: Representatives Obey and Stark.

Also present: Scott Lilly, executive director; and William R. Buechner, Dena Stoner, and Carl Van Horn, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

Representative OBEY. Good morning. Today, the Joint Economic Committee will begin 2 days of hearings on how the proposed elimination of the Federal tax deduction for taxes paid to State and local governments will affect the fairness of the current tax system, and how it will affect our Federal system of taxing and providing for the common good at the local, State, and national levels.

The President announced last night that he was including the proposed elimination of these deductions in the so-called tax simplification package which he is sending to the Congress. He claims that his plan is simple, equitable, fair, and revenue neutral.

I share the desire of most Americans for a Tax Code which is less complex and which treats all the taxpayers more fairly. But, based on those standards, in my judgment, the President's plan is very disappointing.

It is hard to overlook the fact that many reforms are not in this package, reforms that have been on almost every tax reform list for decades. Even reforms which were included in the original Treasury Department reform package have been eliminated in the President's proposal. They include the first-year expensing of oil drilling costs, the taxation of real capital gains as ordinary income, and more significant reform of accelerated cost recovery.

But most disturbing, at least to me, are the implications of the elimination of the deduction for State and local taxes. When the Federal income tax was first adopted, it was simple, it was straightforward, and most people felt it was fair. They didn't like the fact that they had it, but they thought it was probably pretty fair. It

was three pages in length. The staff has distributed a copy of the original tax form, and taxpayers had to fill in only a few spaces.

On the third page, which was then the last page of the Federal tax form, one of those deductions which existed since the beginning of the Federal income tax was for State and local taxes. In all of the years we have had the Federal income tax it has been felt that Americans should not pay taxes on money which they had already paid in taxes to another jurisdiction. It is hard for me to see how reversing that simple principle will add either simplicity or fairness to our tax system.

[The tax form referred to follows:]

TO BE FILLED IN BY COLLECTOR.

List No. ....

.... District of ....

Date received ....

Form 1040.

INCOME TAX.

THE PENALTY
FOR FAILURE TO HAVE THIS RETURN IN THE HANDS OF THE COLLECTOR OF INTERNAL REVENUE ON OR BEFORE MARCH 1 IS $20 TO $1,000.
(SEE INSTRUCTIONS ON PAGE 4.)

TO BE FILLED IN BY INTERNAL REVENUE BUREAU.

File No. ....

Assessment List ....

Page .... Line ....

UNITED STATES INTERNAL REVENUE.

RETURN OF ANNUAL NET INCOME OF INDIVIDUALS.

(As provided by Act of Congress, approved October 3, 1913.)

RETURN OF NET INCOME RECEIVED OR ACCRUED DURING THE YEAR ENDED DECEMBER 31, 191__

(FOR THE YEAR 1913, FROM MARCH 1, TO DECEMBER 31.)

Filed by (or for) .... of ....
(Full name of individual.) (Street and No.)

in the City, Town, or Post Office of .... State of ....
(Fill in pages 2 and 3 before making entries below.)

1. Gross Income (see page 2, line 12)		$
2. General Deductions (see page 3, line 7)		$
3. Net Income		$
Deductions and exemptions allowed in computing income subject to the normal tax of 1 per cent.		
4. Dividends and net earnings received or accrued, of corporations, etc., subject to like tax. (See page 2, line 11)	$	
5. Amount of income on which the normal tax has been deducted and withheld at the source. (See page 2, line 9, column A)		
6. Specific exemption of $3,000 or $4,000, as the case may be. (See Instructions 3 and 19)		
Total deductions and exemptions. (Items 4, 5, and 6)		$
7. Taxable Income on which the normal tax of 1 per cent is to be calculated. (See Instruction 3)		$

8. When the net income shown above on line 3 exceeds $20,000, the additional tax thereon must be calculated as per schedule below:

	INCOME.	TAX.
1 per cent on amount over $20,000 and not exceeding $50,000	$	$
2 " " 50,000 " " 75,000		
3 " " 75,000 " " 100,000		
4 " " 100,000 " " 250,000		
5 " " 250,000 " " 500,000		
6 " " 500,000		
Total additional or super tax		$
Total normal tax (1 per cent of amount entered on line 7)		$
Total tax liability		$

GROSS INCOME.

This statement must show in the proper spaces the entire amount of gains, profits, and income received by or accrued to the individual from all sources during the year specified on page 1.

DESCRIPTION OF INCOME.	A. Amount of income on which tax has been deducted and withheld at the source.	B. Amount of income on which tax has NOT been deducted and withheld at the source.
1. Total amount derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid	$	$
2. Total amount derived from professions, vocations, businesses, trade, commerce, or sales or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, including bonds, stocks, etc		
3. Total amount derived from rents and from interest on notes, mortgages, and securities (other than reported on lines 5 and 6)		
4. Total amount of gains and profits derived from partnership business, whether the same be divided and distributed or not		
5. Total amount of fixed and determinable annual gains, profits, and income derived from interest upon bonds and mortgages or deeds of trust, or other similar obligations of corporations, joint-stock companies or associations, and insurance companies, whether payable annually or at shorter or longer periods		
6. Total amount of income derived from coupons, checks, or bills of exchange for or in payment of interest upon bonds issued in *foreign countries* and upon *foreign mortgages* or like obligations (not payable in the United States), and also from coupons, checks, or bills of exchange for or in payment of any dividends upon the stock or interest upon the obligations of foreign corporations, associations, and insurance companies engaged in business in foreign countries		
7. Total amount of income received from fiduciaries		
8. Total amount of income derived from any source whatever, not specified or entered elsewhere on this page		
9. TOTALS	$	$
NOTE.—Enter total of Column A on line 5 of first page.		
10. AGGREGATE TOTALS OF COLUMNS A AND B		$
11. Total amount of income derived from dividends on the stock or from the net earnings of corporations, joint-stock companies, associations, or insurance companies subject to like tax (To be entered on line 4 of first page.)		$
12. TOTAL "Gross Income" (to be entered on line 1 of first page)		$

GENERAL DEDUCTIONS.

1. The amount of necessary expenses actually paid in carrying on business, but not including business expenses of partnerships, and not including personal, living, or family expenses	$			
2. All interest paid within the year on personal indebtedness of taxpayer				
3. All national, State, county, school, and municipal taxes paid within the year (not including those assessed against local benefits)				
4. Losses actually sustained during the year incurred in trade or arising from fires, storms, or shipwreck, and not compensated for by insurance or otherwise				
5. Debts due which have been actually ascertained to be worthless and which have been charged off within the year				
6. Amount representing a reasonable allowance for the exhaustion, wear, and tear of property arising out of its use or employment in the business, not to exceed, in the case of mines, 5 per cent of the gross value at the mine of the output for the year for which the computation is made, but no deduction shall be made for any amount of expense of restoring property or making good the exhaustion thereof, for which an allowance is or has been made				
7. Total "GENERAL DEDUCTIONS" (to be entered on line 2 of first page)				

AFFIDAVIT TO BE EXECUTED BY INDIVIDUAL MAKING HIS OWN RETURN.

I solemnly swear (or affirm) that the foregoing return, to the best of my knowledge and belief, contains a true and complete statement of all gains, profits, and income received by or accrued to me during the year for which the return is made, and that I am entitled to all the deductions and exemptions entered or claimed therein, under the Federal Income-tax Law of October 3, 1913.

Sworn to and subscribed before me this ....

day of ...., 191

....
(Signature of individual.)

SEAL OF OFFICER TAKING AFFIDAVIT.

....

....
(Official capacity.)

AFFIDAVIT TO BE EXECUTED BY DULY AUTHORIZED AGENT MAKING RETURN FOR INDIVIDUAL.

I solemnly swear (or affirm) that I have sufficient knowledge of the affairs and property of .... to enable me to make a full and complete return thereof, and that the foregoing return, to the best of my knowledge and belief, contains a true and complete statement of all gains, profits, and income received by or accrued to said individual during the year for which the return is made, and that the said individual is entitled, under the Federal Income-tax Law of October 3, 1913, to all the deductions and exemptions entered or claimed therein.

Sworn to and subscribed before me this ....

....
(Signature of agent.)

day of ...., 191

ADDRESS IN FULL.
....
....

SEAL OF OFFICER TAKING AFFIDAVIT.

....

....
(Official capacity.)

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[SEE INSTRUCTIONS ON BACK OF THIS PAGE.]

INSTRUCTIONS.

1. This return shall be made by every citizen of the United States, whether residing at home or abroad, and by every person residing in the United States, though not a citizen thereof, having a *net income* of $3,000 or over for the taxable year, and *also* by every *nonresident alien* deriving income from property owned and business, trade, or profession carried on *in the United States* by him.

2. When an individual by reason of minority, sickness or other disability, or absence from the United States, is unable to make his own return, it may be made for him by his *duly authorized* representative.

3. The *normal tax* of 1 per cent shall be assessed on the total net income less the specific exemption of $3,000 or $4,000 as the case may be. (For the year 1913, the specific exemption allowable is $2,500 or $3,333.33, as the case may be.) [If, however, the normal tax has been deducted and withheld on any part of the income at the source, or if any part of the income is received as dividends upon the stock or from the net earnings of any corporation, etc., which is taxable upon its net income, such income shall be deducted from the individual's total *net income* for the purpose of calculating the amount of income on which the individual is liable for the normal tax of 1 per cent by virtue of this return. (See page 1, line 7.)

4. The *additional or super tax* shall be calculated as stated on page 1.

5. This return shall be filed with the Collector of Internal Revenue for the district in which the individual resides if he has no other place of business, otherwise in the district in which he has his *principal place of business;* or in case the person resides in a foreign country, then with the collector for the district in which his principal business is carried on in the United States.

6. This return must be filed on or before the first day of March succeeding the close of the calendar year for which return is made.

7. The *penalty* for *failure to file the return within the time specified by law* is $20 to $1,000. In case of refusal or neglect to render the return within the required time (except in cases of sickness or absence), 50 per cent shall be added to amount of tax assessed. In case of *false or fraudulent return*, 100 per cent shall be added to such tax, and any person required by law to make, render, sign, or verify any return who makes any false or fraudulent return or statement with intent to defeat or evade the assessment required by this section to be made shall be guilty of a misdemeanor, and shall be fined not exceeding $2,000 or be imprisoned not exceeding one year, or both, at the discretion of the court, with the costs of prosecution.

8. When the return is not filed within the required time by reason of sickness or absence of the individual, an extension of time, not exceeding 30 days from March 1, within which to file such return, *may be* granted by the collector, *provided* an application therefor is made by the individual within the period for which such extension is desired.

9. This return properly filled out must be made under oath or affirmation. Affidavits may be made before any officer *authorized by law* to administer oaths. If before a justice of the peace or magistrate, not using a seal, *a certificate of the clerk of the court as to the authority* of such officer to administer oaths should be *attached to the return.*

10. Expense for medical attendance, store accounts, family supplies, wages of domestic servants, cost of board, room, or house rent for family or personal use, *are not expenses that can be deducted from gross income.* In case an individual owns his own residence he can not deduct the estimated value of his rent, neither shall he be required to include such estimated rental of his home as income.

11. The farmer, in computing the net income from his farm for his annual return, shall include all moneys received for produce and animals sold, and for the wool and hides of animals slaughtered, provided such wool and hides are sold, and he shall deduct therefrom the sums actually paid as purchase money for the animals sold or slaughtered during the year.

When animals were raised by the owner and are sold or slaughtered he shall not deduct their value as expenses or loss. He may deduct the amount of money actually paid as expense for producing any farm products, live stock, etc. In deducting expenses for repairs on farm property the amount deducted must not exceed the amount actually expended for such repairs during the year for which the return is made. (See page 3, item 6.) The cost of replacing tools or machinery is a deductible expense to the extent that the cost of the new articles does not exceed the value of the old.

12. In calculating losses, only such losses as shall have been actually sustained and the amount of which has been definitely ascertained during the year covered by the return can be deducted.

13. Persons receiving fees or emoluments for professional or other services, as in the case of physicians or lawyers, should include all actual receipts for services rendered in the year for which return is made, together with all unpaid accounts, charges for services, or contingent income due for that year, if good and collectible.

14. Debts which were contracted during the year for which return is made, but found in said year to be worthless, may be deducted from gross income for said year, but such debts can not be regarded as worthless until after legal proceedings to recover the same have proved fruitless, or it clearly appears that the debtor is insolvent. If debts contracted prior to the year for which return is made were included as income in return for year in which said debts were contracted, and such debts shall subsequently prove to be worthless, they may be deducted under the head of losses in the return for the year in which such debts were charged off as worthless.

15. Amounts due or accrued to the individual members of a partnership from the net earnings of the partnership, whether apportioned and distributed or not, shall be included in the annual return of the individual.

16. United States pensions shall be included as income.

17. Estimated advance in value of real estate is not required to be reported as income, unless the increased value is taken up on the books of the individual as an increase of assets.

18. Costs of suits and other legal proceedings arising from ordinary business may be treated as an expense of such business, and may be deducted from gross income for the year in which such costs were paid.

19. An unmarried individual or a married individual not living with wife or husband shall be allowed an exemption of $3,000. When husband and wife live together they shall be allowed jointly a total exemption of only $4,000 on their aggregate income. They may make a joint return, both subscribing thereto, or if they have separate incomes, they may make separate returns; but in no case shall they jointly claim more than $4,000 exemption on their aggregate income.

20. In computing net income there shall be excluded the compensation of all officers and employees of a State or any political subdivision thereof, except when such compensation is paid by the United States Government.

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Representative OBEY. The newspaper columnist, David Broder, wrote a column this morning on the issue of tax reform and in that article he listed four criteria by which we should judge tax reform. One of them was whether compromises which are made on the road to tax reform are compromises that relate to tactics or compromises that compromise away basic principles. And as he said, compromise becomes dangerous when those who are not party to the deals cannot see any principle that is employed to guide the choice. Then cynicism undermines the product.

Then with respect to the issue under discussion today, he asked the following question: "Are we going to repeal the deductibility of State and local property taxes? Then let's debate the principle of federalism that underlies that deductibility and see if it is a principle we are prepared to abandon or to compromise for the billions of revenue the Federal Government will gain. In each case, let's put the principle front and center and measure the Tax Code changes by that principle." I think that's good advice.

Thirty-three million Americans who itemize their returns—virtually every family that makes a mortgage payment on their house—will lose the right to deduct the money that they have already paid in property taxes, sales taxes, and State and local income taxes from their gross income.

We are not talking simply about rich Americans. IRS data show that one-half of all the households who make between $20,000 and $25,000 a year deduct their State and local taxes. Two-thirds of all households who make between $25,000 and $30,000 use this deduction.

It is interesting that the President's plan retains provisions of the current law which allows large corporations to continue to get not just a deduction but a full tax credit on the taxes they pay to Japan or Saudi Arabia, but treats the taxes that a family would pay to their own State as taxable income and subject to Federal taxation.

But there are three other aspects of this proposed change which I hope we can examine in some detail this morning. The first is that the tax burdens are not shared equally among States. Americans with the same level of income pay significantly different amounts in taxes, depending upon where they live. While some may argue that this can be accounted for by different levels of services provided, that is only one—and in many instances, not even the most significant—factor in determining the variation in tax rates from one locality to the next.

Alaska, for instance, has a per-pupil expenditure in elementary and secondary education of well over $6,000. That is more than twice the national average, but Alaska has an income tax system in the form of rebates rather than revenue collections. Further, the increased service levels provided in some States as opposed to others are frequently not provided to those who are paying the higher taxes.

This disparity in the total tax bill of taxpayers with similar incomes, but living in different political jurisdictions, worsens dramatically when the money paid in taxes to one level of government becomes subject to a second round of taxation as proposed in the President's plan. Nowhere, I would suggest, is that more vividly il-

lustrated than what would happen right here in the District of Columbia metropolitan area if you want to compare the marginal tax rates in a jurisdiction like the District of Columbia versus Virginia just across the river.

Second, States compete against one another for industry and economic development and, since they do, the total effect of tax imposed on businesses and individuals in one jurisdiction as opposed to another has a significant impact on patterns of development and economic change among the States. There is little question that the elimination of this deduction will further penalize those States which are already strapped with high tax burdens and exacerbate the competitive disadvantage under which they are already suffering in attracting and retaining industry. There is little question that this has significant implications for future patterns of development and economic growth.

Finally, if money paid to State and local governments in taxes is subjected to taxation again at the Federal level, there will obviously be increased pressure at the State and local levels to back away from responsibilities in areas such as education, health care, environmental protection, and law enforcement as a way of offsetting the increased tax burden. This will ironically come at a time when the administration is calling for reduced Federal effort in these areas because they are "State and local responsibilities."

There is one additional issue which I think needs to be addressed. Some supporters of the President's plan have charged that State and local governments are just another special interest when it comes to their treatment in the Federal Tax Code. It seems to me that whether you are talking about towns or cities or States or the Federal Government, you are talking about the Federal system of government and that system is charged with the public interest at every single level. Those governments are not responsible to one select group of stockholders or one segment of private enterprise; they are responsible for the well-being of all the people as part of that Federal system.

As Maryland's Budget Director, Lewis Stedler, said just last week, "There is a big difference between providing transportation to public schools and providing a business trip to the Super Bowl." I think frankly to suggest that the objection to the elimination of the deduction for State and local taxation is just another special interest is a lot of baloney. We are talking about levels of government which have a very significant responsibility, a very important role to play in meeting our joint responsibilities to all of the taxpayers in this society.

I hope we will be able to probe more deeply into each of these issues this morning.

We have a distinguished panel of economists who are among the tops in their profession in the field of public finance. They include Henry Raimondo, who is associate dean of the Business School of Rutgers, and specializes in public finance; William Oakland of Tulane University, who is widely published and who, among other things, served as a consultant to the Treasury Department in the preparation of Treasury I; and finally, Joe Minarik, who is a senior research associate of the Urban Institute and formerly a member

of the staff at the Congressional Budget Office, a very familiar operation around here.

Gentlemen, I welcome you here this morning and I would ask if you would take whatever time you feel you need. Mr. Raimondo, I notice your prepared statement is a little longer than the rest. If you would like to summarize your prepared statement, touching on the things you feel that are important, we will be happy to submit the full prepared statement for the record, and I would ask each of the other two witnesses to do the same.

STATEMENT OF HENRY J. RAIMONDO, ASSOCIATE DEAN, BUSINESS SCHOOL, RUTGERS, THE STATE UNIVERSITY OF NEW JERSEY, NEW BRUNSWICK, NJ

Mr. RAIMONDO. Thank you, Congressman Obey. I would be pleased to summarize my prepared statement.

Before we go into the specific reasons why I support the deduction of State and local taxes from the Federal personal income Tax Code, I would like to introduce a principle which I think is at work in many legislative initiatives that this administration has put forth and rears its head again when we're talking about tax reform. That is a principle with regards to public policy change that I have categorized as a "get-you-later" policy approach.

By this, I mean the administration is very often willing to recommend significant changes which leave most of the population unchanged in the short run so it is easy for the representatives of the administration to say that this plan is fiscally neutral in the short run. Everyone will enjoy a property or income tax relief of one kind or another, but in the long run, the changes that have been introduced by this proposal will have significant adverse effects on taxpayers throughout the country whether they come from high tax States or low tax States.

In looking at this proposal, I would ask you to keep in mind the phrase "get-you-later" because this proposal will certainly do that to the taxpayers of the United States.

I support the continued deduction of State and local taxes from the personal income tax because it serves four principles. I will just mention these principles in passing and I would be more than willing to answer any questions which you have about them at the end of my statement or at the end of the statements of the three of us.

The first principle is fiscal autonomy in the Federal system. The way we have organized the public sector is to decentralize or share decisionmaking among Federal, State, and local governments. In fact, we have asked State and local governments to play the role of innovators in policy at the subnational level—let them decide on different tax strategies, different levels of taxes; let them decide on different service delivery systems, different service levels, or a different mixture of services State by State. In fact, in every Fourth of July speech most of us would be proud to list that as an element of the Federal system that we find very attractive—this notion of local decisonmaking.

The removal of the deduction of State and local taxes from the Federal personal income tax represents a significant change in the decisionmaking process in fiscal federalism. It moves us away from

constructing a tax policy that views the United States as one, into constructing a tax policy which fragments the United States into 50 unequal parts. I do not think that makes for good Federal policy.

It puts the squeeze on State and local governments, as you say, at a time when they have already been squeezed by the Federal budget changes and by the recession that the economy has just gone through. It magnifies the fiscal capacity disparities which exist across the country so that people in poor States, if they want the services that they need, will have a difficult time getting those services unless they are willing to bear a higher tax burden than their neighbors from a richer State. This is consistent with the policy of breaking the country up in pieces rather than viewing it as one whole.

There is an adage that says that bad news comes in threes. In terms of fiscal autonomy for State and local governments, we can say that they have just heard the third of three. They have lived through the property tax revolt which has limited property tax collections. They have seen an acceleration in the decline of intergovernmental grants which started in 1978 but certainly has accelerated during this administration. And now the third of three, they are told that they must lose the deduction for State and local taxes from the personal income tax. I think that this damages fiscal federalism and moves us away from fiscal autonomy in a Federal system.

The second principle that I believe this deduction serves is fairness in the taxation of personal income. Our principle in taxing personal income has traditionally been one of ability to pay. We could argue whether the current tax law satisfies that principle, but by and large we have paid homage to this notion of ability to pay which simply says the more you earn, the more you should pay in percentage terms.

We could consider State and local taxes as a forced reduction in an individual's personal income. I say it is forced because, while people can vote on whether they want the State and local tax levels they are presented with, if they vote against it and the majority vote for it they certainly cannot veto the proposal. They must pay. So it is viewed as forced reduction.

If State and local taxes and benefits were tied in a one-to-one correspondence so that for every dollar a taxpayer put into the State or local treasury he or she received back a dollar's worth of services, you might be able to make an argument for eliminating the deduction. But redistribution at the State and local level is inevitable, which means that some people put a dollar in and it's only by coincidence that they get a dollar's worth of service back. More likely, they get more or less.

Because of this redistribution it seems unfair to eliminate the deduction of State and local taxes from the Federal Tax Code. This exaggerates the ability to pay of taxpayers by including a component in their income which has forcibly been taken away by State and local governments.

There is another element to fairness in the taxation of personal income. The deductions serve as an incentive for State and local

governments to structure relatively progressive or—perhaps I'm being overly optimistic—less regressive State and local taxes.

By eliminating the deduction, we are eliminating the opportunity for State and local governments to design taxes that are progressive in nature and forcing them more and more to turn to regressive taxation.

So because of the overstatement of income and the ability to pay concept and because of the loss of the incentive for progressivity at State and local levels, I feel that the elimination of this deduction does not serve fairness in the taxation of personal income.

The third principle I believe the maintenance of the deduction serves, is that it restrains interstate tax competition. As I said, in a fiscal Federal system, we encourage States to be innovators, try different tax systems, experiment, tax at different levels, be different. But because our Federal Tax Code is designed right now to look at us as a nation, we dampen some of the effects of these differences through the deduction. So be different, but too much competition could hurt us as a nation. So we minimize some of this competition.

The deduction's elimination would just magnify the importance of fiscal disparities and tax differentials between States. I call this the "fun house mirror" effect. All of us at one time or another have stood before a fun house mirror. Our small parts become large and our large parts become small and we laugh at the distorted image of ourselves. However, when States try to negotiate with businesses for location or expansion, State and local taxes, which are a very small part of business costs, suddenly are magnified, just the way the fun house mirror magnifies small parts of us. And businesses hold up these tax differentials to the States as a bargaining chip to decide whether they should locate or expand there.

This also holds in the case of homeowners when they negotiate for home prices across communities. I feel that this type of bargaining with State and local governments encourages inefficiency in business location, encourages inefficient social migration, and really does not serve the purpose of efficient operating businesses.

In fact, let's go one step further and say that, by magnifying tax differentials, we are pitting the service provision to people against tax relief and economic development. I think the game is stacked against service provision.

The last principle I think that the maintenance of the deduction serves is the assistance in public service provision to people. Is the deduction a subsidy for public service provision? I believe it is to some extent, by intention.

All State and local services are subsidized in one form or another by lowering the tax price that people must face. This is particularly true in the area of education which relies so heavily on the property tax. The elimination of this deduction will raise the tax price of services, particularly education, to State and local residents and, again as you have said, Congressman Obey, in your opening statement, this comes at a time when the States are being asked to do more with less. Certainly an unfair situation to place these service providers in.

It leaves the States with one of two alternatives—to cut services over the long haul or to raise taxes. If they raise taxes, they are

faced with interstate competition being magnified and with relying on unfair or unequal fiscal capacities with which to tax themselves.

Also, the incentive would be for them to rely on regressive taxes rather than progressive.

Now this is not going to happen in the short run and that's why I stressed to you this "get-you-later" approach, because this is something that we can expect to see happen to services and tax policy over the long haul among State and local governments.

Those are my four points. There is one last statement I would like to make. Some proponents of this elimination of the deduction would like to categorize its elimination as an American revolution. I think the statement is somewhat overblown, but there is some validity to it.

In the one and only American revolution, the States were created, but they were left in disarray, facing fiscal hardship. If this deduction of State and local taxes is eliminated from the Federal Tax Code, no new States will be created, but they will certainly be left in disarray, facing fiscal hardship. Thank you.

[The prepared statement of Mr. Raimondo follows:]

PREPARED STATEMENT OF HENRY J. RAIMONDO

INTRODUCTION

Whether the cancelled check to the Internal Revenue Service (IRS) is fresh in your mind or whether the check from the IRS is not yet in your hands, changing the personal income tax sounds appealing. There is no resisting an honest attempt to reform the personal income tax so that the tax claims a fair share from every taxpayer; encourages personal savings, business investment, and economic growth; is understood by all taxpayers; and can be easily administered. In their haste to accomplish these ends, it is no surprise that the designers of the Administration's tax reform plan made a mistake. The mistake is the modification of the deductibility of state and local taxes from the U.S. personal income tax.

The deduction of state and local taxes (e.g. personal income, general sales, and property) amounts to at least a $30 billion annual tax saving for all taxpayers. This deduction is especially important to the taxpayers in California, Illinois, Michigan, New Jersey, New York, and Pennsylvania. 1/

This portion of the tax plan follows a standard technique which the Administration has used in the past when it introduced proposals which have significant adverse effects. That technique is a "Get-Ya-

Later" or a delayed reaction approach to public policy changes. The immediate impact of the change may be neutral (or even beneficial), but the near and long-term future impact is adverse.

The legislative history of the Administration provides many examples, but the indexation of the federal personal income tax and the now forgotten "New Federalism" proposals are worth mentioning. Some proponents of modification of the deductibility of state and local taxes are counting on this approach being successful this time. While supporters of the Administration's tax reform proposal hope that opposition to this change will be swept away by talk of revenue neutrality, reduced marginal tax rates, and incentives to economic growth, my advice is: beware of the long-term implications of this particular proposal.

While every member of Congress is (or will be) weary of hearing why a particular provision of the present personal income tax code should remain unchanged, there are four major reasons why I believe that the deductibility of state and local taxes are in line with the goals of tax reformers and should, therefore, remain in effect. The deductibility of state and local taxes serves the principles of fiscal autonomy in the federal system, fairness in the taxation of personal income, restrained interstate tax competition, and assistance in the provision of state and local public services, particularly public elementary and secondary education.

FISCAL AUTONOMY IN THE FEDERAL SYSTEM

The Theory. The federal system is composed of a federal government, fifty state governments, and approximately 70,000 local

governments of one kind or another (i.e., county, municipality, township, school district, and special district). Each level of government has decision-making authority which should reflect the interests of the residents.

This shared decision-making means that people should be able to vote on public questions in federal, state, and local elections; public policy should differ across jurisdictions and levels of government, as much as the outlook of the people differs; and people at each level of government should have a voice in tax and expenditure decisions. In general, a federal system places the states and localities in the role of innovators of public policy. On fiscal issues, people in the states and localities can choose the level and type of taxes which they pay and the nature and the direction of public spending. 2/

The modification of the deduction of state and local taxes from the federal personal income tax is contrary to this notion of federalism. There has been little discussion about the fact that this modification represents a significant change in the nature of fiscal federalism. This unilateral action on the part of the federal government will squeeze the fiscal resources of the state and local governments. This fiscal squeeze will magnify the variations in state-local fiscal capacity and reduce the notion of local choice and local innovation in public policy to a Fourth of July slogan.

Fiscal Disparities. For state and local governments, bad news comes in threes. First, they were jolted by a tax revolt movement in thirty-five states (e.g., Proposition 13 in California, Proposition 2

1/2 in Massachusetts, and limit laws in Wisconsin and New Jersey to mention a few). Second, they experienced a decline in real per capita federal intergovernmental grants which began in 1978. 3/ Third, they face the possibility of a modification in the deductibility of state and local taxes from the federal income tax.

All these changes bring us back to the fiscal disparities which exist among subnational governments. For example, the Advisory Commission on Intergovernmental Relations (ACIR) notes that the fiscal capacity (relative ability to raise revenues) of the highest state, Alaska, is eighty percent higher than the fiscal capacity of the lowest state, Mississippi. Even if I omit the top 5 and lowest 5 states, the fiscal capacity of the sixth state, Illinois, is forty percent greater than the fiscal capacity of the forty-fifth state, Utah. Moreover, within geographic regions fiscal capacity varies. This disparity reduces local choice to local fretting about finances. 4/

An inadequate state-local fiscal capacity undermines the success of fiscal federalism. The modification of this deductibility provision contributes to the weakening of the federal system. Local choice without adequate resources is no choice. Under these circumstances, "voting with your feet" translates into wealthy individuals and profitable businesses "making tracks" to another jurisdiction where they can avoid state-local public problems, such as the costs of providing education, fighting crime, and servicing the needs of the poor. This consequence is certainly the case with metropolitan areas and their surrounding suburbs. Those people and

businesses who can avoid relatively higher taxes, do so by moving to a relatively lower tax jurisdiction; thereby evading the ends of a state-local public policy that is not to their liking. 5/

Consequences. Simply put, the "get-ya-later" or delayed reaction of this modification in current tax policy is that fiscal federalism is damaged. At the very time when the federal government is expecting state-local governments to take on more of the public service responsibilities which it is shedding, the modification of this deductibility provision will decrease the state-local governments' willingness and ability to respond with increased spending in the areas of health care, education, and social services for the poor. 6/

In terms of the way in which this country organizes its public sector, the modification of the deductibility of state-local taxes will reduce the ability of state-local governments to experiment within the public policy arena and diminish the significance of state-local choice in the development of public policy. In terms of the way in which state-local governments respond to the service needs of their people, the series of bad news capped by the possible modification of the deductibility provision highlights the fiscal disparities among state-local governments and makes state-local service pick-up of federal programs even more unlikely.

FAIRNESS IN THE TAXATION OF PERSONAL INCOME

Equity. In a federal system where more than one level of government can and does use the same tax base, tax equity requires the deductibility of state and local taxes. This issue of tax equity has two dimensions which I wish to mention. One dimension refers to the

marginal tax rates which a taxpayer faces. In a federal system, deductibility is one way of keeping the level of marginal tax rates (i.e., sum of federal, state, and local rates) from creating disincentives and economic inefficiencies. 7/

With each level of government acting without regard for the other levels, marginal tax rates, particularly at the upper end of the income distribution could become prohibitive. For example, in some relatively high state personal income tax states, the combined legislated federal and state marginal tax rates for certain income classes under certain circumstances could be the same or actually increase _after_ the modification of the deductibility provision compared to the current law with the deductibility provision. Recall that these marginal rates would be applied to a larger base so that the tax liability would increase.

A second dimension of taxpayer equity deals with the ability-to-pay principle. The ability-to-pay principle of taxation requires the deductibility of state and local taxes from the federal personal income tax. Under this principle, a taxpaying unit should pay more in taxes, the more _net_ income the unit receives. State and local taxes are a forced reduction in personal income, very often not tied to public service benefits. As such, taxpayers should not pay federal personal income taxes on state and local tax liabilities. 8/ A modification of the deduction would make taxpayers do just that. Taxpayers would be paying tax on income over which they have no control. This modification exaggerates the taxpayers' ability-to-pay.

This last point raises another issue. State and local taxes,

particularly income taxes, but also general sales and property taxes are generally not tied to public service benefits. Redistribution of income is an inevitable outcome of the state-local fiscal system. The deductibility provision re-affirms that redistribution of income is primarily a national interest, as it should be. 9/ Its repeal pushes the redistribution function away from the federal government towards the state and local governments, where it should not be. State and local governments may well reject this responsibility so that the end result will be that the nation steps away from its redistribution obligations.

Consequences. The "get-ya-later" or delayed reaction implications for fairness in the taxation of income are twofold. State and local governments will be encouraged to distort their tax structures to avoid the full impact of the modification of the deductibility provision. If the Congress eliminates the deductibility provision, then state and local governments might look to business income although I doubt that.

Rather state and local governments will turn to user charges where possible (the possibilities are limited) or to taxes which can be exported (e.g., severance taxes, hotel room taxes, etc.). All these contortions in the state and local tax structure serve the causes of tax regressivity and interstate tax competition, not tax equity. 10/ I will develop this last topic later in my statement.

The second implication is that the modification of the deduction will discourage states from implementing progressive state personal income taxes. With the deduction, state governments could tax income

at a progressive rate and the deduction would dampen some of the effects of the progessivity of the state income tax. 11/ This outcome seems more in line with the national interest than the alternative of encouraging regressive taxes at the state and local levels of government.

RESTRAINED INTERSTATE TAX COMPETITION

Free to Choose. In a federal system, state and local governments are encouraged to choose the type and the magnitude of the taxes which their residents support. To restrain interstate tax competition which could result from tax variations across states, federal deductibility of state and local taxes is necessary. It reduces the tax differences among states.

For example, state and local determination of tax policy has resulted in six states not using a state personal income tax to contribute to their general revenue while 10 states use it to collect at least 15 percent of their general revenue; four states not using a business income tax while eight states use it to collect at least four percent of their general revenue; and four states not using a general sales tax while 16 use it to collect at least 15 percent of their general revenue. 12/

Not only would the selection of a tax structure be jeopardized, but also the level of taxes -- relatively high or relatively low -- whichever state and local residents support. This reduction in tax-designing discretion means that the federal government has chipped away at the notion of fiscal federalism. Public service levels will also be affected at the same time when state and local governments are

being asked to pick-up the programs which the federal government has cast-off.

Consequences. The "get-ya-later" or delayed reaction of this aspect of the modification of the deductibility provision is that over time businesses can exploit the tax differences among states when they are planning a location or expansion move. People can also pit state against state when they are planning a home-buying decision. This exploitation manifests itself in the form of states being careful not to be "too different" from their neighbors (a loss of individual state choice) or businesses demanding taxes breaks. In this environment, tax policy experimentation would be chimerical.

Tax differentials among states are subject to the "funhouse mirror effect." We have all stood before a funhouse mirror and laughed at the distorted image of ourselves -- the large parts become small and the small parts become large. When a business negotiates with a state about the possible location of a new facility or the expansion of an existing facility, state tax differentials grow from a relatively small part to a relatively large part of the decision. The same effect holds for a potential home-buyer. When a home-buyer considers the price of a home in one jurisdiction versus another, the local property tax differential will now become magnified. Not only could the modification of the deduction of property taxes depress the home-building industry and discourage home buying, but the modification of the deduction will also intensify the tax competition between locality and locality, particularly city against suburb. I doubt that this outcome is worthwhile.

The tax diversity which we applaud as vital to the federal system becomes a liability to the states which dare to be different. For example, the interstate competition would intensify between Massachusetts and New Hampshire, Wisconsin and Ohio-Indiana, Minnesota and South Dakota, and Georgia and Alabama-South Carolina. What end does this intensified interstate tax competition serve? Certainly, not efficient business and residential location decisions. The price of the factors of production -- land, labor, interest rates, and energy costs to name a few -- will determine efficient business location and expansion decisions, not tax differentials.

Rather the intensified interstate tax competition which would result from the modification of the deductibility provision would discourage constructive innovation in tax policy and fuel inefficient migration from state-to-state and locality-to-locality. In addition, the competitive tax situation would pit public service provision against promises of tax relief and economic development. The outcome of the competition is stacked.

ASSISTANCE IN THE PROVISION OF STATE AND LOCAL PUBLIC SERVICES

Role in Service Provision. In each of the three previous points, I have alluded to the impact which the modification of the deductibility of state and local taxes from the federal personal income tax would have on state and local public service provision. The deductibility provision lowers the tax-price of state and local public services. In short, the U.S. Treasury is paying some of the tab for police and fire protection, sanitation, road maintenance, sewerage, and education. Much as it would if the federal government

were providing a grant for these services.

This relationship holds especially for the deductibility of property taxes and the provision of public elementary and secondary education. Public elementary and secondary education relies very heavily on property taxes. The federal deductibility makes the regressive local property tax more acceptable to the taxpayer. More importantly, the deduction of local property taxes stimulates spending on education. This increased spending is consistent with the emphasis which the federal and many state governments have recently placed on education. It also comes at a time when the hi-tech sector of the U.S. economy has been growing.

Consequences. The "get-ya-later" or delayed reaction to the modification of the deductibility provision in the state and local public service area is that the tax-price of state and local public services will increase. This tax-price increase means that state and local governments must either cut services or raise taxes, ceteris paribus. Let's examine each alternative.

In the case of general public services, state and local governments have already been trimming their budgets back to the basic services throughout the 1930s. Additional service cuts are unlikely and could prove harmful to each state's residents and businesses. In the case of public elementary and secondary education, public officials have not shown any inclination to cut spending. Yet the modification of the deductibility provision may mean just that.

This service reduction alternative is ironic for at least two reasons. First, state governments have been trying to respond to the

cutbacks in federal spending. Fiscal disparities have made their response uneven. Now the federal government would be raising the cost to state and local government pick-up of a federal program. Second, if there is one area where the state government has succeeded in increasing financial aid to local governments, it is education. Cutting educational spending would be contrary to the recommendations of educators and business people.

It is also difficult to urge that state governments reduce financial assistance to local governments, yet the modification of the deduction might mean just that. State governments have not been able to give much assistance to their local governments. The intergovernmental relations between state and local governments could be characterized as "the piker and the pauper." (My apologies to Mark Twain.)

By this I mean that state governments have increased financial assistance to local governments in a small way relative to local government fiscal needs. Meanwhile local governments in the role of the pauper have inadequate financial resources to meet the demands on their public services. Again the loss the deduction raises public service tax-prices at a time when state and local governments do not have adequate fiscal resources to meet current public service needs.

If state and local governments decide to raise taxes, then they find themselves confronted with the problems of fiscal disparities and interstate competition which I have already discussed. This alternative is not likely. Incidentally, if a state or local tax increase came to past, it would undo some of the principles behind the

federal tax reduction policy. The damage would be significant because state and local governments would turn to regressive taxes to replace the lost revenue from the progressive federal tax system.

SUMMARY

I support the deductibility of state and local taxes from the federal personal income tax. My reason is that the deduction serves the principles of fiscal autonomy in the federal system, fairness in the taxation of personal income, restrained interstate tax competition, and assistance in the provision of state and local public services. If the deduction is modified or eliminated, it would place state and local governments in much the same circumstances as Jonah in the whale's belly. That is, their financial circumstances would be worsened, but they would survive. But oh how nice it would be not to be in that predicament in the first place!

FOOTNOTES

1/ U.S. Treasury Department, Individual Income Tax Returns, Statistics of Income. (Government Printing Office, Washington, D.C.: annual).

2/ Charles M. Tiebout, "A Pure Theory of Local Expenditures," Journal of Political Economy, Vol. 64 (October, 1956): 416-424.

3/ Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism. (Government Printing Office, Washington, D.C.: annual).

4/ Advisory Commission on Intergovernmental Relations, Tax Capacity of the Fifty States. (Government Printing Office, Washington, D.C.: 1981).

5/ Henry J. Raimondo, "Central City Isolation and Intergovernmental Grants, 1961-1977," Growth and Change, Vol. 13, No. 1 (January, 1982): 26-36.

6/ "States Are Found More Responsive On Social Issues," New York Times, (May 19, 1985): 1 and 32.

7/ George F. Break, Financing Government in a Federal System. (The Brookings Institution: Washington, D.C.: 1980).

8/ Richard A. Musgrave and Peggy B. Musgrave, Public Finance in Theory and Practice. (McGraw-Hill: New York, 1984).

9/Wallace Oates, Fiscal Federalism. (Harcourt, Brace & Jovanovich: New York, 1972).

10/ Charles M. McClure, "Interstate Exporting of State and Local Taxes: Estimates for 1962," National Tax Journal, Vol. 20 (March 1967): 19-36 and T.D. Hogan and R.B. Shelton, "Interstate ax Exportation and States Fiscal Structure," National Tax Journal, Vol. 26 (December, 1973): 553-564.

11/ Henry J. Raimondo and H. Peter Gray, "Improving the Progressivity of State Personal Income Taxes At Federal Expense," (Rutgers University: mimeographed, 1985).

12/Advisory Commission on Intergovernmental Relations, Significant Features.

Representative OBEY. Thank you very much. Mr. Oakland, would you like to follow?

STATEMENT OF WILLIAM H. OAKLAND, PROFESSOR OF ECONOMICS, TULANE UNIVERSITY, NEW ORLEANS, LA

Mr. OAKLAND. Yes, sir. My name is William Oakland. I am a professor of economics at Tulane and my specialty is public finance, particularly as it relates to State and local governments. In this connection, I recently completed a study for the U.S. Treasury on the consequences of the repeal of State and local tax deductibility under the Federal personal income tax. I appreciate the opportunity this morning to be able to discuss my principal findings.

The consequences of tax deductibility are many, complex, and far reaching. It is unlikely that many of these effects were foreseen by framers of U.S. income tax law, nor have they all been considered by those who advocate reform. Let me begin with a brief summary of these consequences. The details supporting my arguments can be provided during the question period as well as in my Treasury paper which I submitted for the record.

First, and most important, the equity case for total repeal of tax deductibility is far from compelling. It is true that a comprehensive income tax would include, as income, benefits one receives from public services. The problem is how to measure the benefits of these services. I don't find it convincing that such benefits are accurately measured by tax payments as our reformers would have us believe. Taxes may vary among two individuals residing in different States not only because of differences in public services each receives but also because of differences in the costs of others' public services each absorbs.

For example, the costs of welfare and related services will be higher in States with more generous benefits or with a greater incidence of poverty. In neither case could it be said that the higher tax payment represents an increase in public services to the taxpayer. It is also true that areas with high concentrations of poor, such as central cities, must impose a heavier tax burden on their nonpoor for ordinary public services such as education, policy, and sanitation. Once again, the higher taxes cannot be said to constitute income to the taxpayer. For this reason, it is difficult to believe that repeal of deductibility will improve the fairness of our income tax.

The second major finding has to do with the use of tax deductibility as a means of aiding State and local governments. It has been alleged by some reformers that tax deductibility is an inefficient way of accomplishing this objective, that it could be done more effectively through outright grants, say through revenue sharing or through block grants. However, quite the opposite is the case. Because tax deductibility operates in a fashion similar to open-ended matching grants, tax deductibility may offer a more powerful stimulus to State and local government spending than the alternatives of revenue sharing or block grants.

As a matter of fact, in my study I estimated that to provide the same degree of tax deductibility, the block grants would have to be increased by an amount greater than the tax forgone under

present deductibility. Thus, if the Federal Government is interested in maintaining current State-local spending, it will have to increase its budget deficit.

Third, State and local governments may respond to the repeal of personal tax deductions by redirecting their tax systems toward business establishments whose taxes remain deductible. Sometimes these types of changes would be cosmetic, not fundamentally changing the nature nor the incidence of taxes. For example, a State could replace its personal income tax by a value-added tax or a tax upon payroll. In both cases, the legal liability of the tax would be shifted to the business enterprises. This would enable the States to continue to export its tax to the Federal Government without changing the incidence of the tax.

Now such cosmetic opportunities may be somewhat limited. Many States and localities will respond by making a substantive shift to business taxation. Because the incidence—that is, the burden—our knowledge of the burden of these business taxes is very incomplete, the consequences for equity are very, very uncertain. Furthermore, the increased reliance on business taxation could lead to heightened tax competition among States. As Mr. Raimondo pointed out, that kind of competition for business does tend to keep service levels down and the more that we rely on business taxation, the greater the effects of this competition.

Now these reactions will be difficult to avoid. It would be very hard to tailor a tax bill which said, all right, States if you try to make these changes we are not going to allow it; you're not going to have the deductibility; because it seems to me inconceivable that business taxes would be disallowed as deductions. I can't see that we would ever get to the state where we would say that business payments would not be deductible.

Now while these constitute the major consequences of repeal, there are a few other effects worth mentioning. Repeal will not uniformly favor the poor taxpayer relative to the rich, as is sometimes alleged. In high expenditure States, the poor will experience a reduction in redistributive services as these governments respond to the reduced subsidy from the Federal Government. Moreover, such people will also experience increases in housing costs as the effective rate of the property tax is increased. On the other hand, affluent residents of low tax States, such as my own, Louisiana, will experience lower housing costs, and capital flees from the high tax States to the low tax States in order to equalize its rate of return. That surely is not a movement in the direction that I think is intended.

I also would note that for reasons somewhat too technical to go into detail here, it's not even clear that the incentive and productive improvements that are supposed to accompany the lowering of the Federal marginal tax rates because of the elimination of these deductions will in fact materialize if deductibility is repealed.

Basically, the argument has to do with the productivity effects having to do with the rate of tax and the higher the rate, the more proportionately the waste that these higher tax rates cost, and what we are going to do essentially by eliminating deductibility is increase in a nonuniform fashion, as this chart [indicating] demon-

strates, the rates of State taxation, and that may actually create more disincentives than we are gaining by reducing the Federal rate.

Well, to sum up and restate my original point that the consequences of repeal of tax deductibility are many and complex, the case for their removal is not as compelling as advocates of tax reform would have us believe. Perhaps partial repeal, by placing some kind of a floor on deductible tax payments, should be considered as an alternative. This would maintain most of the incentives that are currently in the present arrangement in terms of local and State governments' incentives to provide services, while still providing significant revenue increase for the Federal Government. Moreover, it would be consistent with the reality that all taxpayers enjoy some level of State and local services and therefore could be expected to pay some taxes on these benefits. Thank you.

[The Treasury Department study attached to Mr. Oakland's statement follows:]

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CONSEQUENCES OF THE REPEAL OF STATE AND LOCAL TAX DEDUCTIBILITY UNDER THE U.S. PERSONAL INCOME TAX

By

William H. Oakland

Tulane University

January, 1985

I. INTRODUCTION

This paper addresses the consequences of totally or partially eliminating the deduction, by households, of State and Local (S&L) taxes from taxable income under the U.S. Personal Income Tax. This question arises naturally from the shortfall of revenues which is currently being experienced at the federal level. The tax deduction provision is estimated to cost the U.S. Treasury $28 billion in 1983 and is expected to grow further in the future.[1] The question has also arisen in connection with a larger overall effort to simplify the federal income tax which has come under the ruboric of "flat-rate" taxation. By the elimination of the myriad of exemptions and deductions that now exist, marginal tax rates could be sharply reduced, thereby increasing incentives to work and save.

Before proceding with the analysis, an important caveat is in order. The issue under consideration is extremely complex and is deserving of much more time and resources than were available to this study. These resource limitations meant that we could not pursue the empirical dimensions of our arguments. Rather we are restricted to painting a "qualitative" picture of the likely outcome of reform. Furthermore, we do not claim a great deal of originality for our arguments. Many of the salient points have already been addressed by others. Our objective was to review this work and to fill in gaps as was deemed necessary.

Our plan of attack is as follows. We begin with a discussion of the original justification for tax deductibility--that such tax payments do not constitute income--and of the arguments of its major critics, those who hold that deductibility is a form of tax expenditure. The discussion then

turns to the question of the relative effectiveness of the provision as a form of fiscal relief to S&L governments. The principal alternatives considered are revenue sharing or block grants. Whether such expenditure stimulus as occurs is socially justifiable is taken up next. Several factors which tend to make S&L expenditure sub-optimal are identified.

The analysis continues with a discussion of some somewhat neglected consequences of tax deductibility. These are its impact on interstate tax competition, on the revenue structures of S&L governments, and on the distribution of income.

The final section considers partial as opposed to total repeal of deductibility. Among the alternatives considered are the elimination of the deduction for sales taxes, putting a floor under deductions, or placing a ceiling on them. The paper concludes with a discussion of its principal findings.

II. TAX DEDUCTIBILITY: A REFINEMENT OF ABILITY-TO-PAY OR A TAX EXPENDITURE?

It has become commonplace to refer to S & L tax deductibility as a tax expenditure. This term is meant to imply that the deduction's cost to the Treasury is an implicit form of Federal expenditure. If the deduction were not permitted the Federal Government could use the proceeds to finance additional expenditures and/or decrease taxes. While this terminology has intuitive appeal, closer scrutiny reveals important conceptual problems. It clearly cannot be used to describe any activity the

government might not choose to tax. It would be inappropriate to conclude, for example, that because there is no federal excise tax on bread, there is a federal subsidy to bread consumption. In order to have substance, the concept of tax expenditure must be linked to a consensus of what activities should be taxed; that is, there must be broad agreement as to what constitutes an optimal tax base. Implicit in much of the literature on tax expenditure is the assumption that income is just such a tax base. Some hold that income is the best indicator of ability to pay taxes while others are attracted by the breadth of the income tax base for its efficiency advantages. Yet this support for an income base has its detractors. Some feel that consumption is a superior base while others point to the conceptual and practical difficulties in measuring income.

For the problem at hand, namely S & L tax deductions, it is not necessary to enter the debate as to whether income is the fairest or most efficient tax base. We will take this to be a working assumption. Instead, we will focus upon the question of whether S & L deductibility constitutes a form of tax expenditure.

The answer to this question rests with whether S & L tax payments constitute income. If so, their exclusion must be justified on other grounds; viz. the equity and efficiency consequences of the exclusion. If not, the concept of tax expenditures in this context is vacuous. If the S&L tax payments by individuals are matched dollar for dollar by S & L expenditure benefits, i.e. are benefit taxes, then they can be viewed properly as income. In effect, individuals would be purchasing S & L services on the same terms that they buy private goods and services.

To what extent does this quid pro quo between S & L taxpayers and governments obtain? Under the idealized conditions of the modified Tiebout model, local governments would use their zoning powers to stratify people into homogeneous housing and public service consuming communities. Differences in public expenditure benefits among communities would be fully reflected in differences in tax payments. Under the assumption of free mobility of taxpayers, each citizen could choose that combination of taxes and benefits which maximizes his/her utility. In effect, S&L taxes become perfect benefit taxes.

While the Tiebout model is suggestive of how decentralization can improve resource allocation, its stringent assumptions have little basis in reality. With the exception of certain bedroom suburban communities, localities are not perfectly or even partially stratified by income class. Even if they were, states are extremely heterogeneous, so that the Tiebout model would not apply to state expenditure.

In a heterogeneous community there will not necessarily be consensus about the level of taxation and public services. To illustrate this, suppose individuals differ only in terms of income; i.e., they have the same tastes. Suppose further that public expenditure decisions are made by referendum according to majority rule and that people are taxed in proportion to their income.[2] In this environment, the level of public services in equilibrium will be that preferred by the voter with the median income. Moreover, the tax price confronting an individual voter is proportional to his/her share of community income; hence, it rises monotonically with income. On the other hand, for a given tax price, those with higher incomes can be assumed to prefer a larger public sector. A

given voter's satisfaction with the equilibrium level of services will thus reflect these conflicting forces. It is easy to show that if the income elasticity of demand, E_I, exceeds the price elasticity of demand, E_p, those with below median income will desire a contraction of public services and those with above median incomes will desire an expansion.[3] If $E_I < E_p$, the situation is reversed.

In either circumstance, the relationship between the taxpayer and S&L governments differs materially from that between the individual and the private market. In the latter case, people pay a "tax" equal to their marginal benefit. In the former case this correspondence disappears for all but the median taxpayer. If $E_p < E_I$, the marginal benefit of the well-to-do exceeds his/her tax for additional services.[4] If $E_p > E_I$, it falls short. For those below the median income the situation is reversed.

For the issue at hand, however, we can limit our attention to the situation for the above-average income taxpayer. For it is this group which itemizes and hence enjoys the fruit of deductibility. If the marginal public service benefits of the well-to-do systematically exceed their tax prices, the case for deductibility is considerably weakened because such individuals would enjoy net fiscal benefits from the S&L sector.[5] Thus, inclusion of S&L taxes in taxable income would not <u>overstate</u> true income.[6]

Unfortunately, one cannot make generalizations about the marginal benefits to the above average income taxpayer.[7] S&L governments engage in a myriad of activities, many which are of different import to the

well-to-do taxpayer. There are clearly categories of expenditure where the benefit (excluding altruistic benefits) to the affluent taxpayer is zero--income redistribution activities. Moreover, many of the non-explicitly redistributive programs of S&L government have a significant redistributive component. For example, expenditures for public health, remedial education, police and fire protection, and mass transit are often predicated on the socio-economic composition of the population. Areas with a high incidence of poverty are often forced to make "defensive" outlays on such programs simply to put themselves on an equal footing with affluent suburbs or neighboring states.[8] Such outlays can hardly be regarded as "beneficial" to the affluent citizen of such jurisdictions.

Even the most important local service, education, is marked by considerable redistributive elements. Households without children subsidize the education of those with children. Moreover, even though E_I may be high for education, E_p may be high for the affluent because of private school alternatives. Hence, marginal benefits may decline with income. Thus, we currently have the spectre of many central city school systems populated primarily by underpriviledged minorities.

.The preceding discussion paints to a much different picture of the quid-pro-quo between a citizen and his/her state and local governments than does the Tiebout model. The existence of redistributive public expenditure programs and tax prices which increase with income substantially loosens the correspondence between S&L tax payments and public service benefits. Thus, a resident of a high tax, high social service

state (e.g., the Northeast) may enjoy no more, or even less, public service benefits than a similar individual in a low tax, low social service state (e.g., in the South).[9]

To conclude this section, it seems questionable to apply the concept of tax expenditure to the deductibility of S&L taxes. The concept of income as a measure of ability to pay requires that public service benefits be included in the tax base. There is, however, no consensus about how to measure such benefits. Those who would repeal tax deductibility are implictly measuring benefit flows by tax payments. But as we have argued above, the correspondence between tax payments and benefits is too imprecise to make such a connection. If the income tax were otherwise free of loopholes the elimination of deductibility could not be advocated on the grounds of equity. Otherwise, a case for repeal would have to be based upon some sort of second-best argument; e.g. those who benefit from deductibility also enjoy other unfair favorable treatment. While this is often alleged in a broad sense -- the well-to-do have all of the loopholes -- the problem could be best resolved by eliminating the loopholes or increasing the progressivity of the rate structure; the incidence of the benefits of deductibility, while correlated with income, is not sufficiently precise to serve as a basis for increasing taxes on the rich.

While S&L taxes may not be a good indicator of public service benefit flows, it remains true that, redistributive programs aside people do receive benefits from S&L expenditures. To exempt such benefits from income taxation will bias choices towards S&L services, away from private goods and services. To what extent is such a shift desirable? On the other hand, the elimination of the deductibility of personal taxes

would be bias S&L governments to choose taxes upon business, whose taxes would remain deductible. Such business taxes may well create greater inefficiencies and inequities than personal taxes. It is to these issues that we now turn.

III. TAX DEDUCTIBILITY AS A SUBSIDY TO S & L GOVERNMENTS

It is often alleged that tax deductibility constitutes a subsidy to S&L governments. An analogy is drawn to the exemption of the interest on S&L securities. Because of their tax free status, the interest cost of S&L securities is lower than otherwise, freeing budget resources for S&L governments. This analogy, however, is less than complete. In the case of tax deductibility, the subsidy is to citizen-voters and not to S&L governments themselves. Budget relief to S&L governments is afforded only insofar as voters are willing to support a larger level of S&L services; this will require the increase of nominal S&L tax rates.

The implementation of tax deductibility will have two effects on taxpayers. First, the income of itemizers will be increased and second, the "price" of S&L services to this group will diminish. We shall treat these in turn.

The income effects arising from tax deductibility are likely to be of minor importance. This is because the revenue losses caused by deductibility will have to be recouped.[10] It is impossible to say which federal taxes would be increased to recover the revenue loss, but let us suppose that the loss is made up by an accross-the-board increase in

marginal income tax rates. While many itemizers will still be better off, it is clear that non-itemizers will be worse off. With the higher after-tax incomes,
itemizers might be expected to support added public services.
Non-itemizers, however, would tend to favor a smaller public sector.
Consequently, the net effect on S&L services is uncertain. Whatever the net outcome, it is likely to be small. Thus, we can ignore the income effects of the deductibility provision.

Let us consider the "price" effects. After the adoption of deductibility, added S&L services will appear to be cheaper to itemizers because the federal government will share in the tax costs of the new services. In effect, the federal government becomes a partner in the finance of expanded S&L services. Thus, part of the S&L electorate, the itemizers, will be more responsive to an expansion of services. It is in this sense that deductibility constitutes a "subsidy" to S&L governments.

The quantitative significance of this subsidy is difficult to establish because of the paucity of consistent estimates of the price elasticity for total S&L expenditures. Indeed, the literature contains only a handful of estimates for total local expenditures and none whatever for state expenditure.[11] And the local estimates span the range of the credible, ranging from a high of -1.2 by Inman (1971) to a low of -.1 by Gramlich and Rubinfeld (1982). Making matters worse is the use of different "tax prices" by different investigators. Only Inman (1971) explicitly considers the effect of tax deductibility on tax price; the others use some variant of one's house value as a fraction of the total community tax base. Faced with this lack of data, Noto and Zimmerman (1983) use a rough average of

price elasticities (-.5) for individual services -- which are much more consistent and available. Such a procedure overlooks the substitutability effects among public services, which would be absent for total expenditures. Thus, the (-.5) figure is biased upwards.

Existing estimates are also biased upwards because they include the effects of tax competition among jurisdictions -- which would be absent from a general decrease in tax prices as results from tax deductibility. Furthermore, they include income effects. The appropriate compensated elasticity would be approximately .1 less in absolute value than the incompensated elasticity.[12]

In my judgement, the above reasons call for a considerable reduction in the published price elasticity figures -- say by one-half. Thus, the price elasticity which is relevant for tax deductibility ranges from a high of (-.6) (Inmnan) to (-.05) (Gramlich and Rubinfeld). Noto and Zimmerman estimate that the average price reduction to the itemizers due to deductibility is 41%. Applying this to the range of elasticities above gives us an expenditure estimulus of between 2% and 24%. If we choose the mid-range of this interval as our best guess, we get an expansion of 13% in S&L expenditurtes because of deductibility. Even though the basis for the calculation is extremely crude, this figure suggests that tax deductibility may have a significant impact on the size of the S&L sector.

II. Tax Deductibility as an Inefficient Subsidy

Noto and Zimmerman (1983), using a price elasticity of -.5, argue that

the increase in S&L expenditure caused by deductibility amounts to only 60¢ per dollar of loss to the federal treasury. Because the federal government has the option of giving the dollar to S&L government directly, say through Revenue Sharing, Noto and Zimmerman conclude that deductibility is an inefficient mechanism for stimulating S&L spending.

There are two flaws in this argument. If the price elasticity is indeed -.5, then S&L expenditure rises by 50¢ per dollar of foregone federal revenue. For the change in S&L expenditure is equal to $-E(\Delta p/p)e_p$, where e_p is price elasticity, $\Delta p/p$ is the price reduction to itemizers, and E is the original (prededuction) level of S&L expenditure. The cost to the federal government, on the other hand, is $E(\Delta p/p)$. The ratio of these two is clearly $-e_p$, and is independent of the size of the price reduction.

Using my own figures for e_p, we obtain an expenditure stimulus of 5¢ to 60¢ per dollar of federal expenditure. This appears to strengthen Noto and Zimmerman's inefficiency argument. Further inspection of the logic, however, raises some serious doubts about their hypothesis.

First, it should be noted that if we consider Revenue Sharing to be the alternative to tax deductibility, we no longer can decrease income tax rates in the face of the repeal of deductibility. To the average taxpayer, this means that his/her taxes will have risen by the average tax-saving from deductibility. Thus, repeal of deductibility will carry with it an income effect. This income effect will cause S&L taxpayers to reduce their demand for public services.

Second, the allocation of Revenue Sharing money to S&L governments

does not guarantee that all such funds will remain with them. These governments have the option of reducing their taxes, in effect sharing some of the Revenue Sharing with the taxpayer.

The net effect of substituting tax deductibility by Revenue Sharing will depend, in part, upon the relative size of these two effects. And there are good theoretical reasons to suppose that these effects will exactly cancel out. Suppose, instead of giving the Revenue Sharing monies to S&L officials the federal government gave the money directly to the taxpayer. These monies would, in the aggregate, exactly match the tax increase caused by the repeal of deductibility.[13] Thus, taxpayers as a whole would be no worse off nor better off with respect to the income that they must allocate between private goods and S&L services. If follows that the only effect of the change that remains operative is an increase in the tax price that voters confront for incremental S&L services. Using the argument of the preceding section, the, S&L expenditures could be expected to fall by 2% to 24%. Contrary to Noto and Zimmerman, then, our reasoning suggests that tax deductibility may be more stimulative than Revenue Sharing.

Central to our argument is the hypothesis that General Revenue Sharing would have the same stimulative effect whether the monies are given to S&L governments or to S&L citizens. If voters are perceptive, it is reasonable to assume that this is the case because the total resources available to the community would be the same in either event. But there is not support for this proposition in the empirical literature on the

determinants of S&L expenditures. Studies repeatedly find that general purpose grants, such as General Revenue Sharing, stimulate spending by a much greater amount than would a similar increase in community income. According to Gramlich and Galper, for instance, an unrestricted grant of $1 would increase spending by 43¢ while a $1 increase in income would raise spending by only 9¢. This disparity has come to be known as the "flypaper effect"--money sticks where it hits.

Various attempts have been made to reconcile the flypaper result with public choice models of budget determination. Some use "voter illusion" to explain the result, others bureaucratic control of the political agenda, and still others the deadweight losses of S&L taxes. None of these explanations, to date, have received widespread acceptance. The median voter paradigm to which the flypaper effect is inconsistent continues to dominate the public choice literature.

To some, including the author, the problem may involve the empirical estimates themselves. All of the estimates for General Revenue Sharing, for example, were based upon behavior during a period during which the growth rate of S&L taxation was undergoing a profound shift-- the decade of the seventies. It is not unreasonable to believe that many governments found themselves in a disequilibrium situation, trying to accomodate budgets to the changing demography and voter tastes. Revenue Sharing, in such a situation, could have helped to ease the period of transition to the lower growth track, allowing budgets to be larger than they would be in the new equilibrium setting. The widespread "taxpayer revolt" of the late seventies is ample evidence of the pressures put on S&L governments. For many governments, particularly central cities, the problem has continued

into the eighties with the cutback of many federal social programs. Thus, it may be that, over time, the predictions of the median voter model will prevail.

The upshot of this discussion is that it would be imprudent to base an important policy change upon an empirical finding that is at odds with a model which enjoys widespread acceptance. To use an example, twenty years ago the preponderance of empirical work supported the hypothesis that, in the short-run, the corporation income tax was passed on to consumers -- a result totally at odds with the hypothesis of profit maximization. Over time, however, using different methods, economists have come to find that the burden of the corporation income tax falls upon owners of capital. By analogy, it seems premature to accept the flypaper hypothesis. Considerably more evidence is required before we should base policy upon this result.[14]

To conclude this section, it is not necessarily the case that tax deductibility will stimulate S&L spending by less than a program of General Revenue Sharing. Indeed, theoretical consideration suggest that the opposite may be true. In any event, the evidence is not sufficiently clear cut to conclude that tax deductibility is an inefficient form of subsidy to S&L governments. This is not to say that there are not grant mechanisms that could more effectively stimulate particular forms of S&L expenditures. But with respect to stimulating S&L expenditures in general, tax deductibility is not inherently inefficient.

IV. CONSEQUENCES AND CHARACTERISTICS OF THE FISCAL STIMULUS PROVIDED BY DEDUCTIBILILITY

We now turn to the question of whether or not the stimulus provided to S&L spending by deductibility can be justified. In a world without spillovers among communites (externalities), without S&L redistributive activity, and in which all S&L services are financed through benefit taxation, the answer is an unequivocal no. Left to their own devices, S&L governments, in these circumstances, would provide an optimal level of public services. Tax deductibility would lead to over-consumption of S&L services.

As pointed out earlier, however, these circumstances do not correspond to reality. S&L governments provide a wide variety of services which are enjoyed by citizens who reside outside the boundaries of the providing jurisdiction. S&L government also engage in income redistribution activities and benefit taxation tends to be the exception rather than the rule. The consequence of each of these factors for the desirability of S&L taxes shall be discussed in turn.

First, consider externalities. For obvious reasons, S&L governments will underprovide services which generate externalities. Deductibility, by lowering the tax price of all services, will stimulate the provision of externality producing services. It has long been believed, however, that a more effective means of dealing with interjurisdictional externalities is through a set of conditional grants targeted towards those activities which produce externalities. While this position seems plausible in theory, it has fared less well in practice. The proliferation of conditional

grants programs during the sixties and seventies resulted in an unwieldy morass of regulations and paperwork, substantially reducing the effectiveness of the grants. It is also now suspected that the federal bureaucracy, bound by rules of uniformity, is not capable of fine tuning a categorical grants program to account for significant differences among local situations. The result has been a gradual deemphasis of categorical grants in favor of "block" grants which can be used by recipient governments over a broad range of programs. The effect of block grants is not dissimilar to that of an unconditional grant such as General Revenue Sharing, because of the fungibility of resources. Hence, much of the ability to target federal resources towards externalities has been lost through blocking. It is not clear, therefore, that deductibility is a less effective means of dealing with externalities than its principal alternatives -- unconditional or block grants. While block grants may have some edge with respect to targeting in a broad sense, deductibility has the advantage of providing a price effect for stimulating spending.

Second, many S&L expenditure programs are explicitly or defacto redistributive in character.[15] Deductibility fosters spending on such categories. However, the conventional wisdom has held that income redistribution should be left to the federal government. This is because citizen mobility can thwart attempts to redistribute and because there is a national interest in redistribution. Here again, conventional wisdom flies in the face of reality. S&L governments _do_ redistribute without lossing all of their population. Moreover, _all_ levels of government have consistently chosen to provide much of their redistribution through in-kind transfer programs such as food, shelter, medical assistance, and

subsidized public services. Among the last are below cost provision of police, fire, education, transportation, and a whole range of other services. These programs are precisely those provided by the S&L sector so that S&L governments must be part of the income redistribution process. But because the interest of those residing outside the jurisdiction providing the services are not taken into account, we tend to get too little S&L redistribution without federal intervention.

Just as in the case of externalities one can argue that such redistribution as is accomplished via deductibility could be more effectively achieved by a grant program targeted to the communities in which the poor reside. Here the argument is more telling because some of the benefits of deductibility accrue to communities where few poor live--e.g., affluent suburbs. Moreover, it should be relatively simple to define a grant formula which is targeted to the poor. Even so, at the state level, deductibility might come close to such a formula. For it is precisely those states who engage in vigorous redistribution to the poor, e.g., the Northeast, which obtain disproportionate benefits of deductibility. It may also be the case that the subsidy to wealthy suburban jurisdictions is not totally unwarranted for there are strong fiscal incentives for such communities to close their doors to the poor. The elimination of deductibility would serve to increase these forces. Even with these caveats, however, there are probably better ways of reditributing income to the poor than by the "trickling down" benefits provided through deductibility.

Third, let us consider the consequences of non-benefit taxation. The taxes used to finance S&L services will distort choices between work and

leisure, consumption and saving, between taxed and non-taxed commodities, and, most importantly, of where to live. These distortions and their associated efficiency costs may be taken into account when deciding upon the level of S&L services. Since they increase the costs of public services they can be expected to lead to a smaller public sector than otherwise. Deductibility, by reducing the effective marginal rates of S&L taxes, is an effective way of dealing with this problem. While one might argue that the higher federal tax rates needed to finance deductibility also produce distortions, this has no bearing on the argument at hand. For no S&L government will consider its impact on federal tax revenues when making its expenditure decisions. Finally, there may be a consequence of the fiscal stimulus provided by deductibility that we have overlooked in the discussion thus far. The stimulus applies to any expenditure financed by S&L taxes. There is the incentive, therefore, to have S&L governments provide goods and services that would have normally been provided by citizens themselves in the private sector. Instead of paying for private dancing lessons one could have the school district provide dancing as a part of its extra-curriculum activities. Or one could have a golf course provided by a municipality instead of through a private country club. In such situations, citizen-voters trade off some loss of control over the quality of services for the tax savings provided by deductibility.

The extent to which this is a serious problem cannot be resolved without considerable time and effort not available to us. However, the existence of public recreational facilities such as golf or tennis, is not primae facie evidence of abuse of deductibility. It may be social policy to

open up such activities to those with modest incomes. Indeed, the problem should arise only in connection with small, wealthy local jurisdictions where citizens can closely monitor the fiscal activities of their governments. It is difficult to imagine abuse in hard pressed central cities or in heterogeneous state jurisdictions.

To sum up this section, there are a number of legitimate reasons for promoting the expansion of S&L expenditures. In one case, the distortion caused by non-benefit S&L taxes, a general expansion is the objective.[16] In the other two cases, externalities and redistribution, expansion is necessary for only selected services. For redistribution could probably be done more effectively through a program of compensatory grants to jurisdictions with high incidences of poverty. For externalities, however, deductibility could be as effective as any alternative which is open to the federal government.

V. OTHER CONSEQUENCES OF THE REPEAL OF DEDUCTIBILITY

A. Reduced Productivity

The repeal of tax deductibility could be interpreted within the context of moving towards a flat income tax or modified flat income tax. That is, the additional revenues afforded by repeal could be used to lower marginal rates of the existing federal income tax. Since the efficiency or deadweight losses of a tax are an increasing function of its marginal tax rates, such a change would appear to promote productivity of resources.

This may not necessarily be the outcome, however. The repeal of deductibility would result in higher marginal rates of S&L taxes for itemizers and hence increase deadweight losses at the S&L level. Indeed, the net result may be to lower productivity. For one thing, the excess burden of a tax varies with the square of the marginal tax rate. Since the benefits of deductibility are concentrated on itemizers the increase in their marginal tax rates will be greater than the across the board decrease given to the population at large. Hence, net excess burden might rise. The result is uncertain because the mix of increased S&L taxes is different than a simple tax on income. For another, S&L taxes are not uniform across jurisdictions. Repeal of deductibility is tantamount to increasing marginal tax rates of S&L taxes in proportion to existing levels. This would lead to a reshuffling of population among jurisdictions and/or a general decrease in S&L expenditure, both leading to efficiency losses.[17]

For these reasons, the efficiency reasons given to justify flat-taxes in general do not apply in the case of the deductibility of S&L taxes.

B. Distort the Tax Structures of S&L Governments.

If the contemplated reform is to eliminate the deductibility of personal S&L taxes while continuing the deductibility of business taxes, one might expect S&L government to respond by increasing their emphasis on business taxes. Indeed, in the case of personal income taxes, the states could deny the federal government any revenue gain by shifting to factor taxes, such as a value-added tax or a payroll tax. Such taxes would be

similar to income taxes except that they would be less progressive than most state income taxes now on the books.[18]

Interestingly, emphasis in existing studies has been given to the fact that, in the absence of deductibility, S&L governments would make greater use of user charges. This overlooks the continued deductibility of business taxes and the greater attraction such taxes would provide. And the incidence of business taxes is much less certain than for personal taxes, and may also seriously distort the spatial allocation of resources.

This consideration is not simply a theoretical curiosem. Recent work by Hettich and Winer (1984) has provided evidence that states respond to tax exporting in choosing their tax structures. These effects can be avoided only by denying the deductibility of business taxes. But such a change is neither likely nor desirable.

C. Incidence Effects.

As pointed out above, the elimination of tax deductibility is equivalent to imposing new S&L property, sales, and income taxes upon itemizers. The increase will be proportional to existing tax rates. In the case of property taxes, this amounts to an increase in property taxes upon homeowners -- because the set of itemizers is almost identical to the set of homeowners. The increase in homeowner taxes will be largest in central cities and in the Northeast -- jurisdictions that are already fiscally beleaguered. In the short run the burden will be upon such homeowners. Nationally, this will tend to increase the progressivity of

the overall tax structure. Of course, the impact on a household of given income will depend upon where it is located. Thus, some higher income households will experience a smaller increase in property taxes than some lower income households. This detail is lost if one only considers national aggregates.

In the long-run, the burden of the higher tax on homeownership will be spread to those who own rental housing as well as other forms of capital. This reflects the tendency of the net returns to capital to be equalized. Since capital ownership is positively correlated with income, the result will remain a progressive incidence. However, there may be important excise effects to consider. Residents of high tax jurisdictions, renters as well as owners, will experience an increase in their housing costs, while the situation is reversed for low tax jurisdictions. This means that housing costs in the Northeast will rise relative to those of the South. Once again, the aggregate impact of the excise impacts--zero--masks important distributional effects. The poor in Northeastern cities will suffer higher housing costs while those in the South will enjoy lower housing costs.

A similar story can be told for income and sales taxes. In the short-run the incidence will bear disproportionately upon itemizers (homeowners) who live in high tax areas. In the long-run, such people will tend to migrate to lower tax areas. This will raise land costs and hence living costs in the recipient areas (opposite to property taxation) while lowering those in sending areas. Thus, the initial effects will be mitigated by migration.

In summary, the incidence effects of deductibility and its repeal are complex and involve effects such as changes in the costs of homeownership which are not obvious on the surface. In case of repeal, the burden, in the long run, of the higher S&L taxes will be felt by rich and poor alike, with the aggregate outcome exhibiting some increase in the progressivity of the tax structure. But the increase progressivity will not be uniform. Some well- to-do will benefit and some poor will lose. Some gain of vertical equity will be achieved by some loss of horizontal equity.

D. Effects on the Progessivity of S&L Tax Structures

The effects of tax deductibility is to reduce the effective progressivity of S&L taxes because of the rising marginal tax structure of the federal income tax. Thus, a sales tax, which might be otherwise proportional in incidence, is converted into a regressive tax in net terms by deductibility. This will not go unnoticed by S&L officials. It will encourage then to choose tax rates structures as well as tax base definitions which will be more progressive than otherwise. If deductibility is eliminated so will be this incentive. Thus, the apparent increase in progressivity discussed in the last section may be offset by S&L governments' moving towards a more regressive tax structure.

VI. PARTIAL ELIMINATION OF TAX DEDUCTIBILITY

An alternative to outright repeal is to eliminate some portion of deductibility. Several ideas have surfaced. One is to place a cap on deductibility, another to put a floor under it. Still another is to repeal the deductibility of the sales tax

Let us start with sales taxes. Our argument, though, would apply to the elimination of either the two other taxes. We can find no coherent basis for such a reform. There is, at best, a weak relationship between the payment of sales tax and the receipt of public service benefits. An this relationship presumes a monotonic relationship between income (and hence purchases), on one hand, and public service benefits on another, As we argued in section II, such a well behaved relationship may not exist. More importantly, it does not exist across space. Some states do not even use a sales tax and most local governments do not. Even among those units that use a sales tax, the extent of use is extremely variable. Elimination of sales deductibility would make the present Federal Income Tax more inequitable.

It is also not clear that repeal of sales tax deductibility will have any effect upon the level of Federal subisdy flowing to S&L governments. For these governments have several options open to them: (1) increase reliance on income, property, and business taxes; (2) convert the sales tax to a value-added tax which is deductible. In either event the stimulus to marginal S&L spending would not be materially reduced. Moreover, the revenue gain to the Federal Government would be significantly lessened.

The major effect of the proposal, then, would be to discourage the use of the sales tax as we now know it.

Next, consider a floor below the tax deduction. This could take the form of a flat dollar figure above which taxes are deductible or some percentage of income.

We consider the flat floor first. If set low enough, such a floor would not change the marginal incentives that currently exist to increase services. But it would still encourage S&L governments to shift to business taxes. With respect to tax equity a modest fixed dollar floor would constitute an improvement because all citizens enjoy some level of public service benefits. Thus, there is considerable merit to the idea of a floor if it is deemed desirable to maintain the spending and other incentives of present arrangements. In effect, a fixed dollar floor constitutes a lump-sum tax on itemizers. And such a tax would be progressive because the value of the floor is directly proportional to one's marginal tax rate. The floor could be computed as a percentage of average S&L financed expenditure upon non-redistributional programs.

A floor computed as a percentage of income would have many of the same attributes as a fixed dollar floor. Since S&L tax payments increase with income such an approach could yield greater revenue gains to the Federal Government and provide more progressivity. The difficulty, however, may be to find a percentage figure that does not remove a significant number of itemizers from those who enjoy marginal income tax reductions from the expansion of S&L expenditures. For this reason, it may be preferable to have a fixed dollar floor which grows over time with S&L spending.

A ceiling on tax deductibility, if chosen low enough, would remove virtually all incentive effects from the present system. All that would remain would be a redistribution of income from wealthy itemizers to less affluent itemizers and tax payers in general. While this would seem to be desirable on distribution grounds, i.e., it is more progressive than a floor, it creates similar horizontal inequities that full repeal would produce. In effect, it assumes that the only beneficiaries of S&L public services are those people that pay a good deal in taxes. Such an assumption seem untenable. If a ceiling is to be imposed, then, legislators would be best served by setting it at zero.

Thus, as a partial reform, a ceiling on deductibility has little to say for it. For it has the same incentive effects as total repeal but less fairness.

VII. CONCLUSIONS.

This brief survey of the consequences of S&L tax deductibility by households under the U.S. Personal Income Tax reveals them to be many, complex, and far reaching. It is unlikely that many of these effects were foreseen by the framers of U.S. Income Tax law, nor have some of them been considered by those who advocate reform.

Among our principal findings is that the equity case for total repeal is far from compelling. The connection between individual tax payments and service benefits is not a close one. This owes to the redistributive character of many S&L programs and the fact that poor are not uniformly

spread among S&L jurisdictions. At best, equity arguments can be used to put a floor on tax deductibility, reflecting the fact that all enjoy some level of S&L service benefits.

Another conclusion challenges the growing belief that S&L tax deductibility is a less efficient means of aiding S&L governments than a system of Revenue Sharing and/or Block Grants. Such arguments tend to confuse the income and price effects of the spending stimulus provided by the alternative mechanisms. Unlike the grants approach, tax deductibility offers a price stimulus to spending.[19] Grants can be more effective only if they have a more powerful income effect; but here, the evidence is far from complete.

A third conclusion is that S&L governments may respond to the partial or total repeal of personal tax deductions by redirecting and redefining their tax systems towards business taxes. Sometimes the change will be cosmetic, only changing the locus of the tax payment. Other times it will be substantive, leading to distortion in resource allocation as well as highly uncertain incidence effects. This "loophole" will be very difficult to close so that lawmakers should be fully appraised of its existence.

Finally, repeal will add far less progressivity than is suggested by looking at the aggregate distribution of tax deductions accross income classes. The increased effective rates of S&L taxes will be shifted towards rich and poor alike in other jurisdictions. Moreover, S&L governments may react by reducing the progessivity of their own tax structures.

Endnotes

[1]This estimate was taken from Noto and Zimmerman (1983).

[2]The very same argument can be made for property tax finance if the income elasticity of the demand for housing is unity. A qualitatively similar argument can be made for any degree of progression of the tax system; all that matters is that taxes and income are positively correlated.

[3]Let

$$q = D(p, I)$$
$$p = I/Y$$

where q = public service demand, p = tax price, I = income, and Y = community income, Then

$$dq/dI = q/I(E_I - E_p)$$

[4]This follows trivially from the fact that, at their prevailing tax price, the well-to-do have excess demand.

[5]This conclusion is based upon the assumption of declining marginal benefits from public services.

[6]Of course we might still have some problem of horizontal inequity; similarly situated individuals might enjoy widely different net fiscal benefits.

[7]Gramlich and Rubinfeld ((1982) allege to have found a "pro-rich" bias in the supply of local public services in Michigan. Such a bias, however, is measured <u>gross</u> of tax paid and cannot be used to refute our contention here.

[8]The characterization of defensive outlays was first made by Bradford, Malt, and Oates (1969). For a further elaboration, see Hamilton (1983).

[9]For a discussion of the quantitative significance of such redistribution in large urban areas, see Oakland (1979).

[10]The repeal of deductibility could be viewed as a revenue measure and thus have income effects. But such an action should be evaluated as an alternative to other revenue enhancing measures -- e.g. raising tax rates. Hence, it is appropriate to abstract from income effects.

[11]For a survey of the literature see the companion piece by F.T. Sparrow (1985).

[12]The compensated and uncompensated elasticities differ by the product of the share of S&L expenditure in total income and the income elasticity of demand for public services. Assuming the latter to be unity and the former to be ten percent, we arrive at the reduction factor of .1.

[13]This argument abstracts from the distributional differences between a Revenue Sharing Program and tax deductibility.

[14]This argument is more than conjecture. Gramlich and Rubinfeld (1982)'s estimates imply that the "flypaper" result does not hold for Michigan in the early 80's. The effect of income on public spending is greater than the effect of unconditional grants.

[15]For an estimate of the quantitative significance of such redistribution, see Oakland (1976).

[16]With the exception of course, of publicly provided private services.

[17]This outcome reflects our working hypothesis that S&L taxes are not benefit charges. If they are, the present system distorts the spatial allocation of resources and repeal would eliminate the distortion.

[18]One might think the states could also thwart repeal by shifting the legal liability of the retail sales tax from the consumer to the firm. This would not affect federal tax receipts, however, because the sales tax would become part of the firm's taxable receipts as well as a deductible expense.

[19]The present Revenue Sharing Program does have a price effect because of a tax effort component in the formula. Relative to tax deductibility, however, this incentive is small.

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Representative OBEY. Thank you very much. Mr. Minarik.

STATEMENT OF JOSEPH J. MINARIK, SENIOR RESEARCH ASSOCIATE, THE URBAN INSTITUTE, WASHINGTON, DC

Mr. MINARIK. Thank you, Mr. Chairman. One of the major provisions of the Reagan administration's proposed individual income tax reform plan is the repeal of the deductibility of State and local taxes. This step is estimated to increase revenues by roughly $35 billion per year by the end of the decade. Obviously, this is a course neither to be taken lightly nor to be casually deleted from the plan.

My brief prepared statement today from my own perspective of reform of the Federal income tax will be divided into two parts: First, is the repeal of the deductibility of State and local taxes economically wise? And second, would the repeal of State and local tax deductions help us to attain badly needed tax reform?

To betray my conclusions at the outset, it seems to me that the economic arguments for repealing all State and local tax deductions, though they have some appeal, do not obviously dominate the case for retaining the deductions. But beyond those considerations, I believe that a tax reform package without the State and local deductions is in for much rougher sledding than would be another plan that retained those deductions.

First of all, does it make economic sense? The main economic argument against the State and local tax deductions, as articulated by the Treasury, is that these taxes are voluntary costs incurred by residents of each locality to provide services to themselves. By making these costs deductible, the current Federal income tax law unfairly and inefficiently subsidizes those who voluntarily choose to provide themselves with more of these services. Furthermore, some of these services might be provided by private businesses, and the tax deduction inefficiently subsidizes public delivery.

Well, maybe. Some State and local government services might be seen as direct benefits to taxpayers, and some can be provided through either a public or a private mode. But a traditional argument of economists has been that governments are formed to provide services that the private market would not produce, or would produce in insufficient supply. And the reason for this undersupply is that these services provide general benefits to society, not the direct benefits to individuals claimed in the Treasury argument.

As both the previous witnesses have argued, one can look at the educational systems provided by State and local governments as an instance where relatively well-to-do Federal taxpayers provide the funds to supply education to the population at large. If the cost of those educational services is increased to those people who could afford to go outside of the public systems and into the private market, they may well lobby and vote to reduce the size of those public systems. A cutback in the public systems has an effect on the entire population, including those who are not affected by the Federal tax change whatsoever.

It's even more clear when one goes from the education function to the public income support function that upper income taxpayers, those who pay substantial tax liabilities under the Federal income tax, are providing support to people who are not taxpayers, and

that this is a function that is not a direct benefit to the taxpayers themselves. As I point out in my prepared statement, education costs are approximately 40 percent of the total expenditures of State and local governments and income support for low-income people is approximately another 16 percent. So we are talking about the majority of State and local expenditures in these two areas where we really shouldn't look at these expenditures of State and local governments as being direct services to individuals.

Nonetheless, I think the Treasury proposal does have some merit in the sense that the deductibility of State and local taxes can encourage the provision of gold-plated services in affluent localities. But keep in mind that reduced tax rates will curb such practices even if State and local tax deductions are retained. Under the current law, a public swimming pool, cabana and spa would cost a locality of top-bracket taxpayers 50 cents on the dollar after the Federal deduction; under the Treasury's tax rates it would cost 65 cents. Note that other tax plans, such as the Bradley-Gephardt proposal, would achieve even lower tax rates, and thus a higher private cost. This is a marginal but a significant increase in the private cost of gold-plated, tax-deductible projects. It is, further, a reflection of the general amelioration of all remaining distortions and inequities that tax reform and rate reduction can bring.

But in the area where I've spent most of my time, Mr. Chairman, I'd like to look at the question of whether repeal of these deductions would help to achieve tax reform.

The Treasury asserts that the very large revenue cost of the State and local tax deductions is a crucial roadblock to tax reform. To quote from the general explanation of the provisions of Treasury I, "Unless those revenues are recovered, the rates of tax on nonexcluded income will remain at their current unnecessarily high levels."

Well, perhaps. There is no denying that revenue gained in any one part of a tax reform package allows other parts to be more lenient toward particular interests. It may be that absent those revenues, the necessary heavier taxes on some other sector of the economy would capsize the package politically.

But the repeal of State and local tax deductions imposes pain of its own. That pain will be concentrated on middle- and upper-middle-income families, mostly homeowners, who live in high-tax areas. Those taxpayers now itemize their deductions, but they will lose much of that relief with the repeal of the State and local tax deductions. In some areas of the country, that loss will be sufficient to more than offset the higher personal exemptions and the modest rate reductions at middle-income levels. The taxpayers hardest hit will be those with the least flexibility in their family budgets, precisely because their State and local tax bills are large.

This causes two problems. First, these taxpayers could comprise another pressure group opposed to tax reform on grounds of pure self-interest. But second, and even more troubling, it could erode the image of fairness that tax reform must achieve. Remember that State and local tax deductions are not manipulative; they do not figure in tax shelter schemes, unlike some of the preferences that were treated more kindly in the administration plan. What is the answer to a middle-income homeowner who wonders why the

oil and gas lobby got away essentially scot-free, while his State and local tax deductions were declared an egregious loophole?

Any reduction of tax rates would narrow the tax differential between high-tax and low-tax regions, by reducing the value of any additional deductions. But retaining the State and local tax deductions would eliminate the potential political problem of the Treasury approach by providing a "cushion" for residents of high-tax areas. The tax differential among geographical areas would be reduced, but not eliminated.

Let me digress just for 1 minute if I might, Mr. Chairman, on a point that the President raised in his address last night.

The President said—and that sentiment has been echoed elsewhere—that nonitemizing taxpayers, those who claim the standard deduction, are in effect subsidizing itemizing taxpayers through the deductibility of State and local taxes. I think that's a very tricky question and I think we have to look at that conclusion somewhat critically.

Suppose that the President had suggested as a part of his tax reform plan that we repeal the zero-bracket amounts. So, in other words, every taxpayer, regardless of his income level and regardless of the deductions that he could claim, would have to itemize his deductions. In that case, low and lower middle-income taxpayers who are now claiming the standard deductions would have to fill out schedule A and enumerate all of their deductible expenses, including, let's say for the sake of argument, State and local taxes.

We can conclude by the fact that these people now choose to claim the zero-bracket amount, that if we repealed it they would have to pay higher taxes. But they would be claiming State and local tax deductions just the same as people who now itemize. Would that mean that those people were no longer subsidizing upper income taxpayers who itemize those deductions, even though the lower income taxpayers were paying more because they couldn't claim the zero-bracket amount?

I think we have to look at this question somewhat critically. The function of the zero-bracket amount is in large part to save many taxpayers, almost two-thirds under the current law, the obligation of recordkeeping and the complication of filling out their itemized deduction.

I don't think we should jump to the conclusion then that people who are saved the obligation of writing out all their State and local taxes and given a tax reduction besides by the generosity of the zero-bracket amount are necessarily subsidizing those who itemize the deductions that the zero-bracket taxpayers don't have to itemize.

For my conclusion, Mr. Chairman, I think the Treasury's arguments against the State and local tax deductions have some merit. In my judgment—and I have to be honest about this—from my concern about the state of the Federal Tax Code, if the only alternative to the current Federal income tax were a reformed system with no State and local tax deductions, we should take that reformed system.

Fortunately, however, we don't have to make that choice. The Bradley-Gephardt bill has demonstrated that we can attain a revenue-neutral tax reform—which on the individual side, I might add,

raises more revenue than the President's proposal—without eliminating the major State and local tax deductions.

But again, I think we have to be responsible and we must understand that if we do retain State and local tax deductions within the shell of the President's proposal, we have some ground to make up. We would have to raise more revenue. Such a tax reform would require a tougher and more even-handed approach than some might like. It would require real taxation of fringe benefits. It would require a more rigorous stand on industry benefits and, in all likelihood, it would also require some limit on the value of itemized deductions across the board, such as the Bradley-Gephardt restriction of deductions to a 14-percent basic tax. It could also require elimination of deductions for minor State and local taxes, including the sales tax.

I would ask you to note that the sales tax deduction has only a limited impact even under the current tax law. In 1982, only about 18 percent of all State and local general sales tax liabilities were deducted on Federal individual income tax returns, compared to almost 85 percent of income taxes and at least 32 percent of real property taxes. This is because the sales tax, being regressive, bears disproportionately on low-income households who tend not to itemize their deductions. So if it were necessary, Mr. Chairman, I would suggest that the sales tax deduction and the personal property tax and other minor deductions might be sacrificed to obtain the more important deductions of the more important taxes, which are the income and property taxes.

These would be tough choices, but the benefits of tax reform in terms of economic efficiency and public morale could be immense. It is entirely possible that these benefits would be better and more likely attained without elimination of the major State and local tax deductions.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Minarik follows:]

Prepared Statement of Joseph J. Minarik [1]

SHOULD WE REPEAL THE STATE AND LOCAL TAX DEDUCTIONS?

One of the major provisions of the Reagan administration's proposed individual income tax reform plan is the repeal of the deductibility of state and local taxes. This step is estimated to increase revenues by roughly $35 billion per year by the end of the decade. Obviously, this is a course neither to be taken lightly nor to be casually deleted from the plan.

My brief prepared statement today will be divided into two parts: First, is the repeal of the deductibility of state and local taxes economically wise? And second, would the repeal of state and local tax deductions help us to attain badly needed fundamental tax reform?

To betray my conclusions at the outset, it seems to me that the economic arguments for repealing all state and local tax deductions, though they have some appeal, do not obviously dominate the case for retaining the deductions. But beyond those considerations, I believe that a tax reform package without the state and local deductions is in for much rougher sledding than would be another plan that retained those deductions.

DOES IT MAKE ECONOMIC SENSE?

The main economic argument against the state and local tax deductions, as articulated by the Treasury, is that these taxes are voluntary costs incurred by residents of each locality to provide services to themselves. By making these costs deductible, the current federal income tax law unfairly and inefficiently subsidizes those who voluntarily choose to provide themselves with more of these services. (Furthermore, some of these services might be provided by private businesses, and the tax deduction inefficiently subsidizes public delivery.)

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[1] Opinions expressed herein are the author's alone and should not be attributed to The Urban Institute, its officers, trustees, or funders.

Well, maybe. Some state and local government services might be seen as direct benefits to taxpayers, and some can be provided through either a public or a private mode. But a traditional argument of economists has been that governments are formed to provide services that the private market would not produce, or would produce in insufficient supply. And the reason for this undersupply is that these services provide general benefits to society, not the direct benefits to individuals claimed in the Treasury argument.

A crucial area where this problem of undersupply may interact with deductibility is education. The Treasury asserts that taxpayers can choose how much of public services, like education, they want to buy; and that that choice is the most efficient one. Clearly, left to their own resources, the most affluent taxpayers could provide adequate education for their own children; and so if the cost of public education rose, as through repeal of state and local tax deductions, those taxpayers would likely wish to cut back on public systems. But the future of our country depends not on the education of the few, or even of the most affluent 50 percent plus one, but rather on that of the entire population. The state and local tax deductions encourage the expansion of public education, when a more market-oriented approach might lead to a deterioration. Thus, education can be seen as a general benefit to society, as well as a direct benefit to taxpayers. Note that education is the largest single expense of state and local governments, comprising 40 percent of total expenditures in 1982, according to the national income and product accounts.

Like the provision of public education, income support for the poor might be seen not as a direct benefit to taxpayers, but as a transfer to those whose incomes are low enough that they pay little or no federal income taxes. In parts of the country where the cost of living is high or where low-income

people historically have been concentrated, the cost of these transfer services is relatively greater. Many of these costs are borne through state and local taxes. Eliminating the deductibility of these taxes could lead to reductions in services for the low-income population, or in the extreme, to a "beggar thy neighbor" war in which urban areas race each other to cut welfare benefits and encourage outmigration of their low-income populations.

Nonetheless, the Treasury position has some merit; the deductibility of state and local taxes can encourage the provision of gold-plated services in affluent localities. But keep in mind that reduced tax rates will curb such practices even if state and local tax deductions are retained. Under the current law, a public swimming pool, cabana and spa would cost a locality of top-bracket taxpayers 50 cents on the dollar after the federal deduction; under the Treasury's tax rates it would cost 65 cents. (Note that other tax plans, such as the Bradley-Gephardt proposal, would achieve even lower tax rates, and thus a higher private cost.) This is a marginal but a significant increase in the private cost of a tax-deductible project. It is, further, a reflection of the general amelioration of all remaining distortions and inequities that tax reform brings.

WOULD IT HELP TO ACHIEVE TAX REFORM?

The Treasury asserts that the very large revenue cost of the state and local tax deductions is a crucial roadblock to tax reform. To quote from the general explanation of the provisions of "Treasury I", "Unless those revenues are recovered, the rates of tax on nonexcluded income _will_ remain at their current unnecessarily high levels." (Volume 2, page 63. Emphasis added.)

Well, perhaps. There is no denying that revenue gained in any one part of a tax reform package allows other parts to be more lenient toward

particular interests. It may be that absent those revenues, the necessary heavier taxes on some other sector of the economy would capsize the package politically.

But the repeal of state and local tax deductions imposes pain of its own. That pain will be concentrated on middle- and upper-middle income families, mostly homeowners, who live in high-tax areas. Those taxpayers now itemize their deductions, but they will lose much of that relief with the repeal of the state and local tax deductions. In some areas of the country, that loss will be sufficient to more than offset the higher personal exemptions and the modest rate reductions at middle-income levels. The taxpayers hardest hit will be those with the least flexibility in their family budgets, precisely because their state and local tax bills are large.

This causes two problems. First, these taxpayers could comprise another pressure group opposed to tax reform on grounds of pure self-interest. But second and even more troubling, it could erode the image of fairness that tax reform must achieve. Remember that state and local tax deductions are not manipulative; they do not figure in tax shelter schemes, unlike some of the preferences that were treated more kindly in the administration plan. What is the answer to a middle-income homeowner who wonders why the oil and gas lobby got away essentially scot-free, while his state and local tax deductions were declared an egregious loophole?

Any reduction of tax rates would narrow the tax differential between high-tax and low-tax regions, by reducing the value of any additional deductions. But retaining the state and local tax deductions would eliminate the potential political problem of the Treasury approach by providing a "cushion" for residents of these high-tax areas. The tax differential among geographical areas would be reduced, but not eliminated.

CONCLUSION

The Treasury's arguments against the state and local tax deductions have some merit. In my judgment, if the only alternative to the current federal income tax were a reformed system with no state and local tax deductions, we should take that reformed system.

Fortunately, however, we need not make that choice. The Bradley-Gephardt bill has demonstrated what we can attain a revenue-neutral tax reform without eliminating the major state and local tax deductions.

We must understand, however, that such a tax reform requires a tougher and more even-handed approach than some might like. It requires real taxation of fringe benefits, a more rigorous stand on industry benefits, and in all likelihood some limit on the value of itemized deductions across the board (such as the Bradley-Gephardt restriction of deductions to a 14 percent basic tax). It could also require elimination of deductions for minor state and local taxes, including the sales tax. (Note that the sales tax deduction has only a limited impact even under the current law. In 1982, only about 18 percent of all state and local general sales tax liabilities were deducted on federal individual income tax returns, compared to almost 85 percent of income taxes and at least 32 percent of real property taxes. This is because the sales tax, being regressive, bears disproportionately on low-income households who tend not to itemize their deductions.)

These would be tough choices, but the benefits of tax reform in terms of economic efficiency and public morale could be immense. It is entirely possible that these benefits would be better and more likely attained without elimination of the major state and local tax deductions.

Representative OBEY. Thank you all.

Let me ask Mr. Oakland—you obviously are not enthusiastic about the prospect of eliminating the deductibility of State and local taxes. You say that you prepared a study for the Treasury Department on that subject?

Mr. OAKLAND. Yes; I have it with me here.

Representative OBEY. Has the Treasury Department yet released that study?

Mr. OAKLAND. I'm not entirely sure. I checked with the Treasury Department and they said it would be no problem with submitting it to the committee.

Representative OBEY. Fine. We would certainly like to have it, but to my knowledge, the Treasury Department had not yet released this study and that's why I was especially anxious to get it in the record today if I could.

To start right here where we're all sitting today, we are in a city which has, I believe, a top tax rate of 11 percent in the District. My understanding is that the top rate in Virginia is 5.5 percent, just across the river.

Representative STARK. 6.3 and 10.7 here.

Representative OBEY. OK. What are the public policy implications in an area like this, for instance? Obviously, I care about my own area more, but this, I think, is a good example of an area which has large differentials between taxation levels at the local level. What are the public policy implications of the repeal of this provision of existing law in terms of the ability, say, of the core city to retain higher income taxpayers which I assume provide a significant share of revenue to the District of Columbia government?

Mr. OAKLAND. Well, Mr. Chairman, I think you've answered some of your own questions there. It seems to me pretty clear that the flight to the suburbs of the middle and upper income classes that have so plagued our central cities and seems to have been tapering off in recent years might well be resumed.

Certainly, we're going to increase the cost of having to reside in the District. People make these decisions at the margin and they may not be insubstantial. So, therefore, the ability of the District to provide services, including services to the low-income residents of the District, I think will be curtailed and if the District tried to respond by raising its tax rates, it's simply going to cause further flight.

Representative STARK. Would the gentleman yield at that point?

Representative OBEY. Sure.

Representative STARK. There's already a difference of 2-to-1 between the District and Virginia. So let's take in a microsense our well-to-do District resident. He or she has not opted to move across the river to cut their State tax rate in half at this time—correct?

Mr. OAKLAND. They are current District residents, by definition.

Representative STARK. I'm just saying, with almost double the rate, there's no option on the margin to move across the river at this point?

Mr. OAKLAND. But I would suggest that there are many would-be District residents who are out there already because of that 2-to-1 differential.

Representative STARK. All right, but I'm just talking about the present ones.

Now on the margin—I would never, obviously, had I ever tried to write a Ph.D. dissertation, could I pass this board if you were examining me, so I don't mean to question your credentials—but I just want to talk about on the margin, if the person paying, for the sake of simplicity, a 10-percent District tax and, in fact, at a 50-percent margin, he is paying 5 percent of his income to the District government if I calculate this all correctly. Under the proposed tax reform plan, if I calculate this properly, he will be saving much more than that. He will be saving 15 percent of his income, rather than 5 percent.

Now give me some marginal economics that make me want to go to Virginia because it will still be the same balance where I've already picked up a 10-percent increase in my income.

Mr. OAKLAND. Well, I think that——

Representative STARK. Just on the margin.

Mr. OAKLAND. Well, I think your reasoning is correct, other than the fact that the 15-percent saving will accrue whether or not you live in the District.

Representative STARK. OK. But I didn't move before, why am I going to move now?

Mr. OAKLAND. Well, currently the tax spread, the saving, if I've got your figures correctly—the District tax is 10 and the Virginia tax——

Representative STARK. 10.7 and 6.3.

Mr. OAKLAND. So, for the sake of argument, the effective differential is between 5 percent and 3 percent, a 2-percent differential. If you eliminate the deduction, it's a 4-percent differential.

Representative STARK. But my income goes up and that's going to make me move on the margin?

Mr. OAKLAND. Well, your income will go up wherever you live. The point is, you still can save 2 percent of your income by moving. You will have a greater incentive to move now than you did.

Representative STARK. And I can now save 5 percent.

Mr. OAKLAND. No. Right now you can only save 2 percent.

Representative STARK. 2.5 percent.

Mr. OAKLAND. Right. Some people are more sensitive to those differentials than others and I think you could increase the spread to 25 percent and still keep some residents in the District, but——

Representative STARK. By that token, we should all move to New Hampshire or Nevada, right?

Mr. OAKLAND. Or Louisiana.

Representative OBEY. Let me pursue the argument that has been made and I know you have touched on almost all of these questions in your statement but I'd still like to get your responses in the record in terms of the specific points that are usually raised in defense of the administration's position.

Mr. Regan, the Treasury Secretary, said a few weeks ago that after all, the existing deduction simply protects high-income people in high tax States and that you really don't want to be in the position of just defending their interests, so the deduction ought to go.

You have already referred to it in your testimony, but I wonder if any of you would like to again specifically respond to that specific allegation. What's wrong with that argument?

Mr. OAKLAND. If the intention or the goal is to put a higher tax on the rich, there are a lot fairer ways of doing it, such as raising the rate. Admittedly there is a poor-rich bias to the deduction provision, but it's so unfair to eliminate it—the differences among rich people and between different middle-income people are so great that it's much fairer, if you want to tax the rich, go ahead and tax them. Let's raise their marginal rates. Let's not do it by taking a provision that on average penalizes the rich but not in all cases. That would be my response.

Mr. RAIMONDO. Mr. Chairman, you have already mentioned this in some statistics which you read in your opening statement about who actually uses the deduction, and Mr. Minarik has talked about this in terms of whether the users of the standard deduction are benefiting or not relative to those who use the itemized deduction.

I would like to add a third element to this analysis. It would be to raise the point again that in most State and local tax systems, we have redistribution going on. It is inevitable. Economists like to talk about people grouping around the public services which they desire so that in effect for every dollar of taxes they pay, they are getting a dollar's worth of public services. Well, that works in theory but not very much in practice.

Empirical studies have shown that State and local tax systems indeed are redistributive, and redistributive is just a fancy way of saying that those of upper income are taking some of their money to pay for services—in many cases, education—for lower income people.

While it might be true that this deduction does benefit high-income people to some extent, let's focus on what it actually buys at the State and local level. It buys some subsidized State and local services like education, recreation, road maintenance, sanitation, sewage, police, fire protection, that people of lower income could not afford if they had to pay for all of this themselves.

So, in effect, by eliminating the deduction, you are penalizing States that are trying to provide adequate levels of services and doing it willingly by taxing in a progressive fashion.

Now that was the incentive—one of the incentives that the deduction introduces. Its elimination would take us away from that.

I feel that the elimination of the deduction puts the Federal Government in a position of backing away from its redistributive function. We have seen that over the last 4 or 5 years, that the Federal Government has constantly backed away from its redistributive obligations. This may be less dramatic than what has happened over the first 4 years of the Reagan administration, but it is yet another example where the Federal Government is backing out of redistribution and saying to the 50 States, "Hey, guys, go it alone. We're not a country. We are 50 unequal States. Everybody do it your own way." And I think that's unfair.

Mr. MINARIK. Mr. Chairman, if I could just add one thing, and I hope not to harp excessively on the issue of the sinkability of Federal income tax reform, but if you look at the pattern of changes in tax liabilities under the current version of the Reagan plan, there's

an overall tax cut on average of 7 percent for individual taxpayers. Within the $30,000 to $50,000 income range, that tax cut, however, is about 6 percent; and in the $50,000 to $100,000 income range, that tax cut is about 4 percent.

Now that's a figure that you achieve on average across the entire country. There is a dispersion around that average and one of the major ways in which you can determine who gets worse than that and who gets better than that is the State and local tax liabilities that are paid in particular areas.

It's very hard to determine exactly what the outcome is, but it seems to me a lot of these upper middle-income taxpayers who are relatively numerous and who are vocal in areas of the country where tax liabilities tend to be relatively high will figure out at some stage in this political process that they are not going to get the average tax cut for the population; rather, they are going to get something less than that and possibly might wind up paying more.

And it seems to me that that puts this proposal into political jeopardy that I think many people who are interested in achieving Federal income tax reform would like to avoid if it were possible, and as I said, I believe it is possible by following other courses of raising revenue than repealing these deductions.

Representative OBEY. Let me just ask one more question and then pass the witnesses to Congressman Stark.

The administration makes the argument, following up on the comments that you've been making, that if people really don't like the fact that some States are high tax States, they can vote with their feet and they can go to different States. There's been a disagreement here about whether that's likely to occur or not, but the administration says that if people don't like the sweat in the high tax State, they can go someplace else.

In your judgment, who is likely to do that, No. 1? And second, if there is any significant voting with feet in that manner, what are the results, in your judgment, going to be in the States which they left? Insignificant, moderately significant—how do you measure them?

Mr. OAKLAND. I don't believe that the evidence suggests that there's going to be a large interstate migration. There might be in certain areas such as in the New York City area between the city and New Jersey or in the Washington area. The major kind of migration that would occur would be I think between cities and suburbs where you have tax differentials existing—considerable tax differentials between central cities and suburban areas and the tax repeal or the deductibility repeal will widen those. I think generally that's the consensus, that tax differentials do not lead to major migrations among States, among regions.

To that extent, therefore, one cannot escape, using the administration's argument again—one cannot escape the high taxes for redistribution but, rather, one tends to put up with it and simply pays it. To that extent, the deductibility softens that.

Representative OBEY. So your argument is that there may be minor movement of people through time, especially from the central cities to suburbs but that the most likely impact in the high tax States, if that deduction is eliminated, is pressure from the segment of the population most affected to reduce the level of services

within that State which are causing the pressure on them for those tax payments.

Mr. OAKLAND. I think that's a fair assessment and we shouldn't underestimate the power of that group.

I also would point out that the business community will also—there will also be that heightened competition for business firms which will also put the same downward pressure on the level of services provided by State and local governments.

Mr. MINARIK. If I could add just a little bit there, Mr. Chairman, I think Bill was making a point earlier that when we talk about this kind of a change having an effect we don't necessarily believe that people now living in the District will get up and move to Virginia in great or even significant numbers.

I think the issue becomes when a person who lives in the District is offered a job somewhere else, another region of the country entirely, when he considers his spendable income here in the District considering the taxes that he has to pay, will he be likely to move somewhere else in the country? When he moves, then another question becomes, what can he get for his property?

If paying District income and property taxes is an unavoidable aspect of buying a house in the District and somebody else is moving to the area and is looking for a house either in the District or in Virginia, he doesn't have the cost of picking up and moving from the District to Virginia. He's moving anyway. The question is, Where does he want to buy?

And one would expect that if the marginal cost in terms of taxes of living in the District becomes greater relative to Virginia, that people moving into the area will look more favorably on homes in Virginia and therefore one would expect property values in the District to either decline or rise less rapidly than they otherwise would and property values in Virginia to rise perhaps more rapidly than they otherwise would.

So the changes may be marginal and they may be small, but they will be felt in the District because of that relative tax advantage and the shift in the terms of trade between District and Virginia properties that would occur.

Representative OBEY. Congressman Stark.

Representative STARK. Thank you, Mr. Chairman.

You said quite eloquently, Mr. Minarik, when you suggest in your testimony that the middle-income homeowner wonders why the oil and gas lobby got away essentially scot-free, and I'm not sure that's the issue. I don't think anybody in this room really thinks that anybody should have been let out of the box if we're truly going to do reform. So here's just one other problem we're faced with, a group saying let's let this deduction out and if we let many more out, then we might as well give up in the Ways and Means Committee in terms of doing anything.

I'd like to back up and see whether any of you gentlemen know how this State and local tax deduction got into the code in the first place, as oil depletion snuck in and we had trouble getting it out. Does anybody remember why we put the deduction of State and local income taxes in to begin with? None of you are old enough to remember.

Mr. MINARIK. Remember is not the word.

Mr. OAKLAND. I remember seeing some references to that and I believe it was in a study by the Congressional Research Service.

Representative STARK. Let me refresh your mind. It was when the marginal rates were 90 percent and if in fact we had not, we would have had some people paying in effect more than 100 percent of their marginal income over $100,000 and it was decided in the wisdom of the then Ways and Means Committee and the Senate Finance Committee that that was more than the public would stand for.

So in an effort to keep the marginal rate below 100 percent in the aggregate—and this happened to be in the early 1940's—we decided to allow the deductibility of State and local taxes as a sop to those poor folks in those days grossing out over $100,000 a year who were in the 90-percent bracket.

Now, like too many tax advantages to the rich that get into the code, they become like dog poop on your shoe and they are very hard to get rid of and the harder you stamp on them, the worse they become.

These deductions I think your statement indicates are regressive, probably elitist. We are leaving in one of the major tax advantages to the homeowner, which is the deductibility of home mortgage interest, which I would gladly trade if you want for this, which would bring us in much more revenue, but we continue to discriminate basically against the poor, the renter, and that hardly seems like something that reform ought to continue to do.

One of the things that you overlook in your testimony is that for those States that use the Federal code as a base, we will broaden their base in the State collection of income tax by the Federal broadened base and there will be some diminishing then of the effect on the States which may lose revenue because they can't raise their taxes. That ought to be cranked into your calculations. I hope, Mr. Oakland, you took cognizance of that in your report to the Treasury.

As to tax on the tax, assuming that you all represent the States, you are in the minority because States don't happen to think this is a tax on a tax. Only seven States allow the deductibility of corporate income tax and only 16 States allow the deductibility of Federal income tax for individuals from their own State tax calculations.

So that you've got to have the argument both ways. These arguments should really be in fact doubled-edged swords.

The President says that 80 percent of the people are going to pay the same or less tax. That I will reserve the right to review as we go through the hearings on this and see how that shakes down.

But the other point is, you keep bringing up education. One thing is that if you assume that only those third of the population who itemize are the people who control State governments—and that may very well be the case in many States—that's unfortunate and undemocratic, but it may, for instance, in Alabama, Mississippi, Virginia, Louisiana be the case, that the States are controlled and their local government by the very rich and the very powerful. You have all seen the battles we have had with education there, where the continuing public support of public education is reserved largely for minorities and it is continually decreased as the very rich who probably we assume itemize continue to create private

schools in an attempt to get them tax deductible through a series of Bob Jones type flim-flams on the code.

So I guess what I'm saying is that as a fairly regressive tax, there's very little that can defend leaving it in, particularly, as Mr. Minarik suggested, it was the last item on the agenda as compared with the deductibility of intangibles, 6,000 barrels a month on depletion hardly sounds like a very "Mom and Pop" operation to me—that's patently more unfair.

But I just think this is one of the many items that if we let it out of the box we may very well end up with no reform. There will be no argument that we could lower the marginal rate and at some point the marginal rate if it got low enough this would be an academic exercise, but I'm afraid that absent some—if we were to argue Treasury I, and this was basically one of the few things that was left in, I would ask you, would your feelings be different, Mr. Minarik?

Mr. MINARIK. Could I go back to the beginning, Congressman Stark, if I could?

Representative STARK. Sure.

Representative OBEY. Would you yield for one second?

Representative STARK. Sure.

Representative OBEY. I just wanted to bring to your attention, in light of your recitation of history, that the first Form 1040 in 1913 contained a deduction for State, county, school, and municipal taxes.

Please proceed.

Mr. MINARIK. I think the fine print on that, Mr. Chairman and Congressman Stark, has to do with the fact that State income taxes were a relatively recent invention. If my memory serves me correctly—and I don't think memory is exactly the right word—but I believe that Wisconsin was the first State to have a State income tax and it's probably the only one that predates the Federal income tax.

Representative OBEY. Two.

Mr. MINARIK. OK. And many State income taxes only came into being after the Federal income tax and I would suspect that the fine print of the law did not include the specific item of an income tax as being deductible against the Federal income tax.

Representative STARK. That was the change in the 1940's and Congress Obey is right.

Mr. MINARIK. So I think that one might make the argument that that change was perhaps a recognition not only of the reality of cascading tax rates, but also of bringing the code up to date with the State and local menu of taxes that were used.

I think you are correct, Congressman Stark, in saying that there is an important issue of whether the tax on the tax argument has any merit, and it is certainly true that once tax rates go below a certain point that the cascading issue becomes a lot less important.

I think it's probably true that States are less likely to allow a deduction for the Federal income tax simply because their marginal rates are low enough that that deduction will not have an awful lot of effect.

I think when you get to the question of overall progressivity of the tax system, we have to take into account that the overall progressivity really is the result of a lot of aspects of the tax law.

One thing we could do if we wanted to make the tax system more progressive would be to eliminate all itemized deductions which have the upsidedown subsidy aspect.

Another thing we could do would be to convert those itemized deductions to credits so they would have the same value for all taxpayers.

And I might suggest that if we feel that we have to leave some itemized deductions in the code, for whatever reason, that's one way to go in reforming the tax system to avoid the regressive aspects of the itemized deductions that we have now.

As I pointed out in my statement, that's one aspect of the Bradley-Gephardt plan that I think might merit some examination under these circumstances.

But I think you have to take into account that whether the overall progressivity of the system is desirable or not is not merely a function of the itemized deductions that we allow. If we think that the system is not sufficiently progressive as the President proposes it, we have many alternatives. One of them is to eliminate the itemized deductions, but the other is simply to change the rate structure or perhaps to put in greater low income relief. And one thing that I think the Congress should consider with the President's plan is a larger zero-bracket amount than the President proposes and that provides more low income relief and aids people who don't itemize.

Representative STARK. Rather than the credit?

Mr. MINARIK. That's another alternative. So there are all these aspects that go into the overall progressivity, and I think if one is to attempt to kill off deductibility of State and local taxes that one should consider not only repeal of those taxes as an option but other options that deal with the progressivity issue. There may be other solutions to overall progressivity that work better than eliminating the State and local deductions.

Representative STARK. No quarrel with that, but, unfortunately, that's the only item on the table today, but unfortunately you are following the same pattern that the oil companies are following and the life insurance companies—everybody wants out. And if we allow that, just from the standpoint of the procedural way to get to reform, we will have no reform because your statement again is you still have to answer to the guy next door who says, "Why my taxes when the oil companies are home free?" No quarrel there.

But if we assume that this were the only item that was left under Treasury I, we might think differently.

Mr. MINARIK. OK. I guess I would just refer again to the last page of the statement where I try to point out that there are tradeoffs here, and if we're going to give ground on State and local tax deductions we have to be tougher elsewhere. And I don't want to be disingenuous about that at all.

Representative STARK. Thank you very much. Thank you, Mr. Chairman.

Representative OBEY. At the risk of getting into a debate with my colleague, I would simply again like to suggest, as I did earlier

in my opening statement, that I think there is a whale of a difference between an oil company coming to the Congress and asking for a continuation of a special favor for a stockholder and a State government asking that their ability to continue to provide services to people who are voters rather than stockholders with a special financial interest, so that that State can continue to provide services to the population of that State. In many cases the States in question have no ability to tax oil, have no ability to tax gas, have no ability to tax coal, have no ability to export the cost of providing those public services to other taxpayers who are not taxpayers within the State in question. That is a major, major difference between the review of this item and the review of the more narrowly based items which provide more narrowly based benefits.

One other question. In your judgment, what would be the impact of eliminating the State income tax but continuing to provide the deductibility of the local property taxes? What impact do you see on that?

Mr. RAIMONDO. Mr. Chairman, I would think that's exactly the wrong direction to move in. If you were to eliminate the deduction for State and local income taxes, but keep the deduction for property taxes, I think you are setting up a situation—I'm not sure what the magnitude of it would be—but you are setting up a situation where State and local governments would have to turn potentially more and more to property taxes.

I don't know if they really would, but at least you're boxing them in so that their alternative for revenues is to look to regressive taxes, one of these being the regressive property tax.

One of the features that I think is attractive about the deduction is that it sets up an opportunity to encourage States to reform their taxes so that they become more progressive. Here you would be doing exactly the opposite and setting up an incentive for them to turn to regressive property taxes.

Now let's take it one more step. Given the property tax revolt and people's opposition and hostility to property taxes, it's not immediately clear to me that State and local governments would have much option in turning to the property tax. Of course, if they did, all of the comments that may colleagues have mentioned with respect to property values and home sale prices would take effect. Also, there would be an intensified interstate business competition.

But I think the other alternative that has to be explored is that if the alternative is to turn to the property tax, but local governments or State governments have already imposed limitations on how much property taxes or how fast property tax liabilities can grow, then you're cutting off yet another revenue source to State and local governements, particularly local governments, particularly in the area of education, and it raises the specter that over the long haul, service provision will be damaged.

Again, I bring back a point that I introduced in my statement. As the testimony and comments have unfolded here, again and again you have heard in comments from the witnesses and implied in your questions that there is a "get-you-later" approach to this policy. We are going to see some very adverse effects down the road. One of them may be that if you eliminate the deduction for the State income tax, but not for the property tax, States will view

the property tax as a way to go. But the property limit laws in most States will cut off the use of the property tax. Down the road we're going to see a slowdown, if not a complete deterioration, in service provisions in many local governments, particularly school districts which rely so heavily on the property tax.

Representative STARK. If the chairman would yield, as near as I can calculate, it's in round figures, $24 billion of the loss would come out of the State and local taxes other than owner-occupied homes. I presume that includes sales tax. And the property tax is about $10.7 billion. So roughly—and I can't break out the sales tax right here yet. So basically you would get only about a third of the savings if you left the property tax in.

Mr. OAKLAND. May I comment on this?

Representative OBEY. Sure.

Mr. OAKLAND. I think it's dangerous thing—this "get-you-later"—if you would allow some taxes to be deductible and others not. Now we do disallow certain taxes currently, like gasoline taxes and tobacco taxes, but those are relatively modest and the gasoline tax is a benefit tax.

As I pointed out in my statement, if you disallow a personal tax deduction, you're going to move toward business taxes, and if you have only one form of general tax deduction—say property tax—you're going to tilt the system in that direction as well as toward business taxes.

Finally, let me say that I think the disparity among States may be greater if you start singling out individual taxes. Some States have no sales taxes, for example, and its proposed to eliminate deductibility of sales tax. I think that would provide a very nonuniform set of taxes around the country.

So I would hesitate to single out particular taxes for deductions. Either we should have none of them or we should have all of them.

Representative OBEY. Mr. Minarik, you referred to Bradley-Gephardt and the way it handled this problem. Correct me if I'm wrong. My understanding is that the way that proposal handles this problem and picks up enough additional revenue is because it allows the deductibility of for instance, State income taxes, but only at the bottom rate level.

If you were to follow that track rather than the President's track, you would be talking about having to make up essentially—it is $12 billion from other sources?

Mr. MINARIK. That would be probably a reasonable rough estimate, Mr. Chairman. I can't tell you precisely how much revenue that particular provision would provide, but you would regain a substantial fraction of the revenue lost that the Treasury would face, which is of the total of $35 billion. I would imagine that you would be talking about something in the neighborhood of $10 to $15 billion of that $35 billion that you would still need to make up.

Representative OBEY. OK. Again, you have all referred to this in your statements but I'd like to have in the record your responses to this particular question.

The argument is often made that one reason for eliminating this deductibility of this item is that after all you simply have high income areas rewarding themselves with high levels of services and so, therefore, you encourage efficiency and you encourage resist-

ance to nonessential spending if you eliminate this deduction. I know that's the argument that the Senator from my own State makes, who is on the Kemp-Kasten bill.

I would like you now to lay out again for the committee what are some of the factors that go into determining levels of taxation in addition to a desire to have a "high" level of services? What are some of the other factors involved that require one locality versus another one and one State versus another State to have a higher tax rate?

Mr. RAIMONDO. Mr. Chairman, it would be very neat if we looked at these numbers across the country and those dollar amounts actually reflected differentials in public services. So we could easily say that Louisiana has roughly a third or 40 percent of the services available in California. Unfortunately, the dollar differentials do not tell the story of what the service levels are.

We may well discover that services in one State as compared to another State are affected by the cost of these services, the clustering or the demography of the people in those areas, what the service levels are in those areas, the income capacity of the State to pay for taxes, even the industrial mix within a State can have a big impact on its per capita spending levels. I come from a State which is trying to spend more and more money on environmental protection on its toxic waste cleanup. That's going to reflect itself in higher per capita spending.

Whether it's the demographic makeup of the people, the cost of the services that are provided, the different services that are provided, or the industrial mix that we find across the country, and last, the income capacity that we find across the country, that's what's buried in those numbers. Those numbers do not just show service quality. Some part of that number may be service quality, but another chunk of it is service cost.

It's very difficult to point to that map and look at the high tax States and say that here we have—to use a phrase—gold-plated services. Perhaps some of them are. We are discovering in reviews of the Federal, State, and local budgets that there are gold-plated services in every part of the budget. So I'm sure there may be some in domestic spending, as well as in military spending, but it's very difficult to know what those numbers represent. What I'm saying is it's not enough to just look at those differentials, look at the deductions, and say let's eliminate the deduction because then we can penalize the high tax States. It's a much more complicated problem than that and we have to look at the various elements that I have mentioned to know exactly what those numbers represent.

Again, I would just mention an issue which we have all made at one point or another. Within the State and local systems there's a whole lot of redistribution going on. Even if you want to take those numbers at face value, we have a situation where high tax people are paying for services that low income people enjoy. That's one of the benefits of the deduction. The Federal Government is stepping in and encouraging States to do that kind of tax and expenditure policy. Its elimination has the Federal Government turning its back on this State-level redistribution.

Representative OBEY. Congressman Stark.

Representative STARK. Mr. Chairman, I'd like to compliment you on having these hearings. I think this has taken some of the heat off the Ways and Means Committee. It's a major issue for six or seven high income tax States and I don't know whether the committee would rather have us take away the deductibility of homeowners' mortgages, which is probably more fair per capita, but we then get into the political considerations. Whether this will survive or not, I'm not sure. I share the panel's feeling that there are a lot worse and egregious loopholes that ought to be dealt with first. I hope we could do that and then perhaps we could get to what I think you asked, Mr. Minarik, is that if we could push the deductibility down against the lowest bracket only we would be more progressive and eliminate some of the regressive or elitist or whatever kinds of perjorative phrases I can think of for doing this, and that's very much a possibility I suspect in our deliberations, if I interpret what the chairman of the Ways and Means Committee indicated. What will be the effect on the Senate side is beyond my capacity to predict, but I thank you for holding these hearings. They have been most informative.

Representative OBEY. Thank you.

Mr. OAKLAND. Could I just make an appeal, if you use a minimum bracket rate consider as an alternative putting a floor on the credit on the deduction; I think that would be a good deal fairer.

Representative OBEY. I'm sorry, I didn't understand.

Mr. OAKLAND. Putting a floor on the deduction rather than using the low bracket rate.

Representative OBEY. Thank you. I'd just like to make just a short comment in closing.

I don't think that this is just a problem which affects a small number of States. If you take a look at the list of States that are affected significantly by this plan and negatively, you see Connecticut, Delaware, Maryland, Massachusetts, Michigan, Minnesota, New Jersey, New York, Rhode Island, Vermont, Wisconsin, and California to some degree. You have a lot of votes there very quickly in the House and I'm certainly sensitive to the need not to try to reward high income taxpayers. I think my record bears that out. But the fact is that I think the panel has made very clear today that we are not talking about an issue here which simply affects the convenience of high income taxpayers. We are talking about the ability of the Federal system to continue to experiment, the ability of the States within the Federal system to try to go their own way in supporting the values that each of those States has societally and culturally. You're talking about the ability of States which do not have the tax base that States with oil, gas, coal, and so forth, have, to continue to provide quality level services not just to high income people but to very low income people as well as the middle class.

And I cannot help but believe that one of the reasons—at least in the minds of some—for pushing this deduction totally out the door is the desire that some people have in this government to continue to pursue the goal of removing the ability of government to ameliorate social consequences or to affect social consequences and ameliorate social differences in this country. I cannot help but believe that at least one of the goals certainly as exemplified by the state-

ments of one of the authors of one of the plans under consideration is to create very heavy incentives for States to follow a single pattern, a pattern which would reduce their ability to provide education and welfare assistance to the population groups who really need it and to continue the process of getting the government out of using the income of well-off people in this society to improve the economic and social opportunities for people who are not as well off.

And while that may be an old-fashioned goal, I consider it to be a very valid goal, especially at the State level, and I think there's more than simply a tax plan in mind when you see something like this. I think it is an effort at social reengineering in a direction that I don't believe is healthy for the country.

But I thank you all for coming and I appreciate your time.

[Whereupon, at 11:35 a.m., the committee recessed, to reconvene at 10 a.m., Thursday, May 30, 1985.]

THE EFFECT OF THE PRESIDENT'S TAX PLAN ON STATE AND LOCAL TAXPAYERS

THURSDAY, MAY 30, 1985

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to recess, at 10:05 a.m., in room 2255, Rayburn House Office Building, Hon. David R. Obey (chairman of the committee) presiding.

Present: Representatives Obey and Scheuer.

Also present: Scott Lilly, executive director; and William R. Buechner and Carl Van Horn, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

Representative OBEY. This morning we will have the second day of hearings on the question of the elimination of the deductibility of State and local taxes on tax returns, which was recommended by the President in his speech to the country 1 day ago.

As the hearings yesterday indicated, the consequences of this change in tax policy go far beyond those argued by the proponents of such a change.

In my own personal judgment, they reflect far more than simply a tax change. I think they reflect the basic administration ideological goal to substantially weaken the ability of government to do much of anything in this society, and this is simply chapter 2, which is aimed at the ability of State and local units of government to provide services, as opposed to chapter 1, which was aimed at reducing that ability at the Federal level.

As the hearings indicated yesterday, these consequences include a reduction in resources available for American education and cutbacks in a variety of other State and local services. They also include an increased disparity between States and their ability to attract industry, a disparity which will benefit States and localities which are able to transfer tax burdens through methods such as severance taxes or isolate themselves from a variety of responsibilities which most taxpayers have to bear.

One issue which arose during the hearing yesterday which I would like to address for the record before I ask the witness to proceed this morning is the question of the genesis of the State and local deduction.

It was suggested yesterday that the deduction was added to the Revenue Code in the 1940's to offset increases in Federal tax rates adopted at that time.

As I pointed out then, that is not correct. The deduction was not added in the 1940's, but it was included in the original 1913 law and was one of the few items on the first IRS tax form used in 1913.

Further research by the staff of this committee indicates that the deduction predates even the 1913 law. In 1861, an income tax was adopted to fund the Civil War. State income taxes were exempted from double taxation in that law, as well. This deduction has historically been a matter of tax equity and an important principle in Federal-State relations.

This morning we will explore a second possible consequence of the elimination of this deduction, the impact which it will have on the bond market and the ability of States and communities to go into that market.

Before we get to the witness on that subject, I want to make one additional point. Treasury Secretary Baker yesterday in several interviews suggested that the elimination of this deductibility was simply the elimination of a subsidy which 35 States which don't need it provide to the taxpayers in the 15 States who have been getting good use out of it.

I want to point out that the Secretary simply has his facts wrong and his numbers wrong.

When you take Federal spending, when you take Federal taxes collected on a State-by-State basis, corrected for the deficit, the results show the following:

My own State provided the Federal Government with $2.3 billion more in taxes than they received back. Illinois lost $9.3 billion. Minnesota lost $1.7 billion. Michigan lost $5.3 billion. Connecticut $700 million. New Jersey $8.8 billion, and New York $4 billion.

These are not States who have been subsidized by other States. These are States who have been providing a much greater share of the national tax burden than they would like to provide, very frankly. These are States who, if anything, have been subsidizing other areas of the country, and I think that that fact ought to be clear.

I would like to make one other point. In light of the fact that the Secretary and other administration proponents yesterday also had been indicating that this deduction goes only for—or is of primary benefit, I should say, to high income taxpayers, the New York Times, in a very clear editorial, I think, pointed out just the opposite. They pointed out that while at first blush, this benefit might appear to accrue only to those who are high-income taxpayers, I would point out one additional fact which was made clear by the hearing yesterday. It is middle-income taxpayers and high-income taxpayers who are saddled with the essential burden in a civilized society of providing services that are needed for the education, transportation, and welfare of the poor. Nowhere do they do that more than in some of the States who are most threatened by the elimination of this deduction. And the only break that those middle- and high-income taxpayers get, who carry that very large burden of supporting the poor in our society, is the recognition of that fact by their ability to deduct from the Federal taxes what they pay in State and local taxes.

So this would be, at first glance, an attack on middle-income and high-income taxpayers, who at least would appear to benefit more, but the real people who would be under the gun by the elimination of this deduction would be the people who rely on the generosity of the middle class in order to support needs which they cannot afford to meet on their own.

I think it's essential in the interests of social stability to recognize that fact.

Having said that and gotten that off my mind, I would now like to ask our witness to proceed.

Our witness is Freda Stern Ackerman, executive vice president and director of the Municipal Department of Moody's Investors Service, who will describe what her view is, in terms of the impact of this recommendation on the financial creditworthiness of State and local governments.

Ms. Ackerman, would you please proceed.

STATEMENT OF FREDA STERN ACKERMAN, EXECUTIVE VICE PRESIDENT AND DIRECTOR, MUNICIPAL DEPARTMENT, MOODY'S INVESTORS SERVICE, NEW YORK, NY

Ms. ACKERMAN. Thank you, Mr. Chairman. As is the case whenever we are asked to comment broadly on implications to credit ratings of a new piece of proposed legislation, whether Federal, State, or local, we begin by reiterating that although credit ratings are assigned using a basic, industrywide, time-proven methodology, each rating is unique and the individual characteristics of the particular issue being analyzed are of paramount importance in the rating process. That being said, we can nevertheless comment on some of the possible effects that the administration's tax plan may have on municipal credit ratings.

My remarks today will cover the general thrust of the tax plan concerning municipal credits and what some of the possible implications to State and local governments may be.

The context in which the tax plan is being proposed is well known to all of us. There is a huge Federal deficit, unprecedented in size. The administration is seeking ways to reduce that deficit without contemplating any new or direct sources of Federal taxation. By stressing the sound financial condition of State and local government and citing large surplus accumulations by these units, the tax plan can be said to be an attempt to shift a portion of the Federal Government's deficit onto State and local governments.

The other major component of the tax plan has to do with the issue of where the ability of State and local governments to issue tax-exempt securities derives. Is it a gift of the Federal Government which can be taken away at its discretion, or is it rooted in the doctrine of reciprocal immunity and embedded in the U.S. Constitution?

My remarks today will focus on the first component, those portions of the tax plan relating to the financial condition of State and local governments.

There are three major components of the tax plan, three "assaults," if you will, that most severely affect State and local units. They are a general or direct assault on the overall attractiveness of

municipal bonds, with the proposed reduction of maximum individual tax rates to 35 percent; a repeated assault on State and local governments, with the proposed elimination of tax exemption for certain types of municipal bonds, depending on purpose and use of proceeds; and a direct assault on the financial condition of State and municipal units with the proposed elimination of deductibility of State and local income taxes from Federal tax returns which has direct implications to credit standing.

The general assault of the proposed reduction in tax rates is most open to debate as to its effects on the future attractiveness of municipal bonds to investors, when considered together with those portions of the tax plan to eliminate what have been characterized as "loopholes." On its face, looked at in isolation, a reduction of the maximum individual tax rate to 35 percent will, needless to say, substantially reduce attractiveness of municipal bonds.

This is of particular concern, as the vast majority of end buyers of tax exempt bonds in the last 2 to 4 years have been middle-income individuals. However, arguments have been made that if simultaneously with the reduction in tax rates, other types of tax-sheltered investments are eliminated, those municipal bonds remaining in the high market as tax exempt, will have less competition and will attract a solid following of investors.

Few people argue that a reduction in the size of the Federal deficit will be better for State and local units and will probably create more stability in the credit markets. However, the uncertainty as to what final adopted legislation will include, leads at this time to real concerns as to the future ability of State and local governments to obtain sufficient capital funds at affordable interest rates.

The repeated assault on the eligibility of certain bonds as tax exempt is a battle which has been fought many times before. The cutoffs of certain types of municipal bonds, namely, industrial development revenue bonds, pollution control revenue bonds, incorporated within these two, certain types of revenue bonds issued for what the administration considers "private purposes," such as airports, hospitals, housing, universities, and others, would, if adopted into law as now proposed, have two immediate effects. One would be to raise the cost of borrowing for State and local units of government and the other would be to put enormous pressure on general obligation debt ceilings and pressure on those revenues, namely, property taxes, which normally provide support for general obligation bonds. Whether pressure to provide investors with higher interest rates on a limited amount of future bonds either tax exempt or taxable, issues for municipal purposes, would continue for any long period of time is uncertain. It's possible that rates would eventually stabilize; but at what final level and at which point in the future, are two questions which remain unanswered.

There are enormous demands for capital funds at the State and local level. The conditions of the infrastructure nationwide is weak. These demands cannot be funded out of current revenues. They require a broad array of various types of debt instruments, now proposed to be eliminated. Most units of government are very interest-rate sensitive and their ability to play the market is not nearly as great as that of private corporations. Despite the advent of all sorts of new financing techniques, such as variable rate demand obliga-

tions, which are much more market and interest-rate sensitive than straight serial maturities or term bonds, the budgeting process of State and local governments are such that flexibility as to rate levels and timing of obtaining capital funds are limited.

Most States have interest-rate ceilings and most projects undertaken have specified timeframes. Even though bond buyers are becoming more sophisticated, as are government finance directors, nontraditional types of debt structures raise their own questions as to implications to basic credit quality. Variable rate demand obligations are attractive at the time of initial issuance, but the credit analyst must determine the interest rate exposure of the issuer over the life of the issue, which may look far less attractive, if overall interest rate levels rise from what they were at the time of sale.

With the proposal for fewer types of bonds being issued as tax exempt, cause issuers will obviously have to compete more directly, with the taxable market to attract investors to buy those bonds, no longer tax exempt. That, of course, means higher yields. However, many projects now financed by State and local governments may become economically unfeasible at higher interest costs. This may mean a reduction in the scope of governmental services and real financial pressures to raise revenues either to fund more projects directly out of current revenues or to raise revenues to support higher yields on municipal bonds.

In any case, the restrictions on the types of debt considered as tax exempt or public purpose by Treasury will have negative financial implications, at least in the short run.

As we have witnessed many times in the past, the debate and proposals over what types of bonds can be issued as tax exempt cause severe disruptions in the municipal market, and where restrictions are, in fact, adopted, they usually prove, over the longer term, to be ineffective. That is, when cutoffs have been legislated in the past, we experience a surge in volume just before a deadline, and then see subsequent issuances of debt in a slightly different form in the future, which circumvent the intent of legislation.

The net result is usually not that different from what things were like before the limits were imposed, but only after issuers have had to pay a price in real dollars.

The direct and most serious assault on the fiscal and economic integrity of State and local governments comes in the form of the third part of the tax plan. The deductibility issue for State and local taxes could have far-ranging effects on State and local units.

And I just wanted to also add that I have just come back from the Government Finance Officers Association's annual conference, this year in Chicago, and the deductibility issue was really a focus of the majority, I think, of the local finance officers that were in attendance at the conference, the GFOA, itself, coming out against the elimination of deductibility and a lot of finance officers that stopped by to talk to us, including the treasurer of the city of Milwaukee, the treasurer of the State of Michigan, really cited the elimination of deductibility as one of the most serious concerns that they had.

The adoption of this provision of the tax plan probably holds the most serious consequences for State and local credits, especially those with currently high tax burdens. A direct result could be

even higher tax burdens in a lot of States which has negative implications to future economic growth as well as to future funding of social service programs.

Without sounding too alarmist, taxpayers nationally have demonstrated in recent years their sensitivity to increasing tax burdens and these so-called tax revolts could increase in frequency as a direct result of the elimination of deductibility of State and local taxes. There will be a perceived, and in some cases a real, increase in the cost of funding local services caused by the elimination of deductibility. Although, Federal tax burdens are proposed to be lowered, certain State and local burdens will increase as a result of this tax plan. Although not strictly comparable in its provisions, it might be useful to review briefly proposition 13 adopted in July in 1978 in California to gain some perspective on the implications of the current tax plan.

The environment in which proposition 13 was adopted into law was one in which the State of California had accumulated a very large surplus. This is comparable to the current assertion that State and local governments nationally have accumulated large surpluses themselves.

One direct result of proposition 13 was the virtual elimination of general obligation debt issuance in the State. This has resulted in far less traditional types of debt issuance in California and has put pressure on local governments in the State to maintain their existing infrastructure.

Although numerous alternative means of obtaining capital funds have been used, particularly certificates of participation and short-term borrowing, both of these alternative means have had credit implications to ratings. Certificates are not viewed as strongly secured as general obligation bonds and basic governmental activities, particularly for urban areas, like street and road maintenance, are not well accomplished by the use of certificates. Increased use of short-term debt can have credit implications if debt structure becomes unbalanced. The reduction in property tax rates and local revenue raising abilities can be seen as parallel to the other two portions of the administration's tax plan.

What we've seen in California since proposition 13 is an expanded role of the State government in most local units, particularly school districts. This has created more pressure on the State's budget, has led a lot of local units to increase user fees and to cut back the scope of services previously financed from property taxes. It has also led to increased short-term borrowing in amounts greater than before and at earlier times in the fiscal year than before in order for local units to maximize arbitrage earnings from unspent note proceeds, not a very reliable or predictable revenue source.

Limits on types of municipal bonds and taxing and revenue-raising abilities have been around for many years. The usual effects of these kinds of measures are twofold: They act as an incentive to State and local governments to find ways to circumvent those limits, most of which usually result in weaker security arrangements, and they usually have the effect of diminishing financial flexibility, which can easily lead to deficit conditions.

The tax plan's intent, in addition to shifting a portion of the Federal deficit to the State and local level, also proposes to alter dra-

matically intergovernmental fiscal relationships and appears to have the implication of severely reducing whatever surplus accumulations there are or of creating deficits at the State and local level. These implications are even more severe when considered together with other Federal Government proposals which include the phaseout of Federal revenue sharing and the phaseout of Federal operating subsidies for mass transit.

Additionally, many State and local units already have debt limits of varying kinds. As credit analysts, debt limits can often be considered as a negative rather than as a positive factor because all too often they act as an incentive to units of government to find ways to circumvent those limits leading to a poor debt structure. Issuers have enormous demands for capital funds and if traditional means of raising those funds are curtailed, ways will probably be found to access the market but at a real cost to the issuer. Where debt limits have existed in the past, the most usual way around them has been to create nondebt debt; that is, some form of contingent liability which is legally not considered direct debt of the issuer.

Because these types of bonds, like lease rental bonds and certificates of participation, may not generally be as well secured as straight general obligation or revenue bonds, they usually result in lower credit ratings and cost the issuer more. Credit quality is also likely to be negatively affected if governments must directly finance a majority of those projects previously financed by revenue bonds.

The deductibility provision of the tax plan may have a direct effect of reducing surpluses at the State and local level although Treasury has been citing statistics of large surplus accumulations for State and municipal governments, we really have not seen the same level of financial strength in those issues we rate and we rate about 90 percent or so of all issues which come into the municipal market.

A number of units are coming out of the throes of the national recession and appear to be beginning to benefit from the recovery. But many are still depressed economically and many no longer enjoy previous levels of economic stability. For example, many credits with economies based in part on oil and gas-related revenues are experiencing financial strains once unimagined.

This portion of the tax plan puts the Federal Government in the position of forcing State and local units to make a tradeoff between surplus and taxes. If State and local units are faced with the elimination of the present deductibility some entities may face pressures to reduce their own taxing levels which could lead to reduced revenues and may result in the reduction of surpluses for those units that have them. This may have a negative effect on credit ratings.

State and local governments are innovative and resilient as I said at the beginning of my remarks. Credit ratings are assigned on a case-by-case analysis. Numerous units of government with restricted revenues and narrow economies can achieve favorable ratings if management strives to operate within its resources. Although this can sometimes be a painful process for taxpayers, when the resolve to maintain stability in the face of adversity can be demonstrated, credit ratings need not suffer. However, when

limits are imposed from above rather than from within, the ability to manage well becomes a most difficult task.

An analysis of rating changes in 1984 made at Moody's reveals that lowerings far outnumbered rating increases. In 1984, 212 ratings were downgraded exclusive of ancillary and dependent ratings while only 84 ratings were upgraded. These numbers are comparable to the number of rating changes made in 1983 both downgradings and upgradings. These actions speak to the fact that the size of a surplus for any one unit of government is not necessarily the most important factor in a credit rating. Many other factors are equally of importance. Some of these may now be jeopardized.

As now proposed, we feel the tax plan may have serious implications to credit ratings. Consequently, we will be carefully monitoring congressional actions concerning the tax plan and will be, as the year progresses, reviewing those ratings which in our opinion will be most affected. Thank you.

Representative OBEY. Thank you very much. I'd just like to walk you through a series of questions which might seem elementary but I'm trying to lead to a point. Can you tell the committee what are the most common activities or projects funded by public purpose bond?

Ms. ACKERMAN. Really, just about any purpose that anyone could think of. Highways, streets, higher education, primary and secondary education, airports, water and sewer service, electric power generation. The complete array of what most taxpayers expect a local unit of government to provide.

Representative OBEY. And why should the average taxpayer care whether or not credit ratings of the State or locality decline?

Ms. ACKERMAN. Well, although there is not an absolute correlation between the level of credit rating and the interest rate which the municipality may have to pay in order to borrow money, there certainly is an indirect correlation. Yields do vary by rating category and the amount of interest cost for a particular capital financing directly affects the taxpayer and the level of taxes that he or she has to pay.

Representative OBEY. I understand from your statement that States and cities in all parts of the country might find it more difficult, more costly, to raise money to complete the kinds of projects you just were listing for us if this proposal is accepted by the Congress; is that correct?

Ms. ACKERMAN. Yes.

Representative OBEY. Is it likely to be the States and cities with the highest current tax burden who would be the most negatively affected by that change?

Ms. ACKERMAN. Yes, I'd agree with that.

Representative OBEY. You have spoken of the need, the enormous need, for investing in public purposes such as infrastructure. This committee 1½ years ago commissioned a study on that very subject. Isn't it also true that the States and cities with the greatest needs for this kind of investments by and large, are going to be the ones who will have to pay higher costs for the capital investments?

Ms. ACKERMAN. In all likelihood, yes, I would agree with that. Because I think if you look at infrastructure needs it really again

is broad-based across the country. Obviously, those areas that are growing rapidly like the South and the Southwest have the needs to build the new facilities to serve their growing population but I think in order to retain their competitiveness economically, the older urbanized Northern and North-Central States need an equal amount if not, in fact, larger amounts of capital funds in order to repair and maintain existing infrastructure.

Representative OBEY. Is it possible to estimate here, or if you can't, can you provide us with how much we might anticipate the cost of capital for public purpose investment to increase, say, in the next 5 years if this proposal were to be adopted?

Ms. ACKERMAN. That would be something I would be happy to provide for you. I don't really have those statistics on hand right now.

Representative OBEY. Is it also likely, as you imply, that some of these States and communities which face the greatest need for public investment would not be able to afford to raise the additional capital that they would need to meet those needs?

Ms. ACKERMAN. I think that's a real likely scenario because they'd be facing more competition, tighter competition than the marketplace, and if there is a simultaneous elimination of deductibility as well as a real curtailment of the types of bonds that can be issued as tax exempt. One alternative, I suppose, although not a very viable one for some high tax States would be the issuance of taxable debt which obviously would be far more expensive than the issuance of tax exempt debt.

Representative OBEY. I can't help but observe—I notice in your statement a reference to the innovative nature of State and local governments finding other instruments to use in order to finance debt.

I can't help but recall that when I was in the Wisconsin Legislature, at that time we had a constitutional prohibition on State debt. And during the 6 years and 3 months that I served in the legislature, the State's debt doubled because they simply set up in those days what were known as dummy building corporations in order to get around the State limitations. And at that time I remember then State Senator Gaylord Nelson running for the governorship arguing that he was going to improve the creditworthiness of the State by eliminating the prohibition on State debt, so that you could incur directly the full faith and credit of the State behind it in order to improve the creditworthiness of the State which people find hard to follow, but they followed it closely enough to elect him.

Let me pass the witness to Congressman Scheuer.

Representative SCHEUER. I wish you would pass the witness to Congressman Scheuer. I enjoyed your statement, Ms. Ackerman.

Ms. ACKERMAN. Thank you.

Representative SCHEUER. I don't have very many questions about it. Don't you feel it a little ironic that an administration that is devoted to chucking as much responsibility off of the Federal Government and onto States and localities should be trying to penalize those very States and localities that historically have been doing the most and spending the most and taxing the most to provide for their own needs.

New York, Illinois, Wisconsin, California, Hawaii, and Pennsylvania, do you have any explanation for that? That's not a really, purely economic question.

Ms. ACKERMAN. I agree with your perception, with your characterization. It seems if the administration does have the goal of reducing Federal involvement in State and local affairs and finances, that there should be a multitude of options available at the State and local level to take on this increased burden rather than restrictions and curtailments in the options available at the State and local level which comes out of this particular tax proposal.

Representative SCHEUER. They should be rewarding and encouraging the various States that are showing the most sense of responsibility. Instead, they're penalizing the States that have tried to do it themselves and have had the fiscal integrity and the concern for the well-being of their own people to be willing to make extra expenditures for infrastructure for education, for health services, and to tax their people for it. Doesn't that seem somewhat bizarre to you?

Ms. ACKERMAN. Well, we weren't consulted in the process of Treasury's putting together these proposals but, yes, obviously, we're very concerned about the implications.

Representative SCHEUER. As a matter of equity, who is being hurt? According to IRS figures, over 50 percent of the people who deduct State and local taxes earn less than $30,000, $30,000 or less, and according to the IRS, 87 percent of people who deduct their State and local taxes, 87 percent of them have incomes of less than $50,000. So the vast bulk of these people—well, over half of them make less than $30,000 and the overwhelming proportion of them make less than $50,000. Doesn't this indicate to you that this hits hardest at the middle class, the very middle class, that seems to be penalized the most in the overall conception of the administration tax plan?

Ms. ACKERMAN. Certainly from the figures you cite but I'd really have to defer to someone with more expertise in that area since our focus is really State and local governments rather than the other side of the picture, the individual taxpayer.

Representative SCHEUER. You are saying, though, as I gather it, that just as these half dozen States that I mentioned, the ones that have been trying to make a go of it themselves, taxing their own citizens to provide for their own needs, they are the ones who are going to be hurt most by this provision, and they are the ones who are going to be crippled in their efforts to financial independence on a State level.

Ms. ACKERMAN. Yes, it would appear that way.

Representative SCHEUER. Thank you very much, Mr. Chairman. I appreciate your testimony very much, Ms. Ackerman.

Representative OBEY. Let me ask you about education. You indicated that that was one of the principal areas which required States and cities to go into the bond market.

We had a lot of discussion recently about the need, for instance, for large expenditures to modernize laboratories and research facilities at institutions of higher education. In fact, the House passed a bill this last year trying to provide incentives for the higher education community to do just that, to reequip their scien-

tific laboratories around the country, if any of them are left that aren't devoted to star wars research.

As I understand your testimony, it is likely that the cost of funding higher education projects would increase for State taxpayers, especially in some higher tax States which have traditionally supported strong public higher education systems. Would that be a fair statement?

Ms. ACKERMAN. Yes.

Representative OBEY. It is likely then that some of those States would simply either not be willing or able politically to make investments in those new laboratories, in dormitories, in research facilities in institutions of higher education because of reduced credit ratings and higher costs?

Ms. ACKERMAN. I would answer "yes" to that, primarily going by past experience. We in fact have seen that occur over the last 5 or 6 years in a number of States.

Representative OBEY. Can you give us examples?

Ms. ACKERMAN. Including, to the best of my recollection—three that come to mind are Wisconsin, Minnesota, and Michigan, each of which, when they were facing financial strain at the State level themselves, either cut back in the overall level of State moneys to higher education, and one or two of them also simultaneously delayed payments to both higher as well as primary and secondary education districts.

So, yes, we have seen that happen before, and I think it would be likely to be repeated.

Representative OBEY. Let me try to get specific to try to quantify what it is that we are talking about, and let's take a hypothetical situation.

Suppose there was a community with a AAA bond rating in a high tax State that decided it had to build or rebuild a major bridge. I just had that experience in my district. It cost us $20 million.

Let's say the city decides to go ahead and go to the bond market to raise funds for a project that will cost, say, $10 million. If we have reductions in that city's bond rating from AAA to AA, is that going to increase the cost of raising money for that bridge, and if it would, is there any way of estimating by what amount it would raise that cost?

Ms. ACKERMAN. I think it would definitely raise the cost of borrowing.

I have with me a booklet that we publish on yields by rating category for the last 25 years. Looking at last year's experience, 1984, which was a pretty moderate interest rate environment, between AAA- and AA-rated bonds we had about a 35 basis point spread. It cost AA-rated credits about 35 basis points more than AAA-rated credits to issue debt.

I think probably, since in the overall scheme of our ratings we have less than 1 percent of our ratings at the AAA, the highest level, perhaps an even better scenario would be a unit of government currently rated AA whose rating would fall to the A level, and in 1984 we had a spread in interest cost of almost 50 basic points between those two rating levels.

So I think, yes, it certainly would be more expensive.

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Representative OBEY. So that way, on a $10 million bridge, what would that increase the cost by if it were to increase by 50 basic points?

Ms. ACKERMAN. Half a million dollars.

Representative OBEY. If we were to try to translate that into a nationwide picture, a study on the needs of the Nation's infrastructure which was prepared by the staff of the Joint Economic Committee before I became chairman assumed—or indicated that we needed infrastructure investment in some 23 States of about $300 billion by the year 2000. In other words, that report estimated that cities, counties, and States would have to raise an additional $300 billion to build roads, bridges, sewer systems, water treatment plants, et cetera, et cetera.

Now, if we suppose the overall cost of borrowing money increased by the same amount you just estimated for that bridge and if you applied that nationally using the 50 basis points gap that you have just described, what would be the projected increased cost of raising that $300 billion for infrastructure investment over the next 30 years? Do you have any idea?

Ms. ACKERMAN. I would suggest that the cost would be even higher than the example earlier, just the 50 basis point spread, because if you look at the tax plan as it now exists you really have a compounding effect. There is a lessening of the attractiveness of municipal bonds, therefore some degree of higher interest rates because of the reduction in overall tax levels.

That is compounded by the potential elimination of deductibility, and then if the types of bonds which you can be issued as tax exempt are restricted in the future and municipalities start issuing taxable debt, I think you are talking about potentially very large incremental additional costs of borrowing.

I would like to take a little bit more time to work up some numbers, and I would be happy to submit them to you at a little later date.

Representative OBEY. Thank you. So to sum up, would you sketch for us the likely scenario for the public purpose bond market in the future if the Congress were to adopt the President's proposal to totally eliminate the deductibility of State and local taxes?

Ms. ACKERMAN. Well, I think the key there is that it certainly creates a climate of uncertainty, and whenever that exists in the bond markets, in particular, there is a higher perceived level of risk on the part of investors, and that inevitably leads to higher interest costs.

I guess a prime example of that was during the New York City fiscal crisis in 1975-76.

So we really see significant associated higher costs to State and local governments because of this tax plan, therefore, as I have said, the potential for lowered credit ratings.

Representative OBEY. We have seen a lot of stories in the media over the past week indicating who was able to get the ear of the Treasury and the administration between the time Treasury I was proposed and the time the administration's plan was actually produced.

I noticed on CBS News a long piece describing the different degree of access that representatives of the oil industry and oil and

gas States were able to obtain in order to plead their case on the depletion allowance and other oil and gas tax breaks. They indicated that they were able to see Treasury Secretary Baker and Mr. Darman, his chief assistant, as well as the President himself to discuss the question. They indicated somewhat more limited access had been provided for a number of other groups.

To your knowledge, were the leading firms in the public purpose bond industry consulted by the Treasury Department in preparation of this tax plan?

Ms. ACKERMAN. I can certainly speak for Moody's Investors Service, and we were not contacted. I really don't know about the other firms in the industry, so I really can't speak to that.

Representative OBEY. Do you know whether they discussed it with the Public Securities Association, which is the umbrella group of the public service bond industry?

Ms. ACKERMAN. I know the Public Securities Association has instigated correspondence to Secretary Baker and Mr. Darman. I really don't know if there were responses to those questions raised.

Representative OBEY. Congressman Scheuer, do you have any additional questions?

Representative SCHEUER. Just one last question. There are now about $400 billion worth of State and local tax-exempt bonds outstanding according to the Federal Reserve. A significant amount of these is owned by the Nation's banks.

Now, if the President's tax plan reduces credit ratings and increases interest rates, perhaps the 35 to 50 points that you are talking about, the value of these bonds will fall enormously, maybe in the order of magnitude of $14 or $15 or $16 billion.

How would that affect the financial condition of the Nation's banks that hold a high proportion of these bonds?

Ms. ACKERMAN. Again, I don't mean to sound evasive. That is really not my area of expertise.

All I could really add in the way of trying to answer the question is because banks are regulated both at the federal and the State level, there usually are requirements set for the level of rating, the level of creditworthiness of debt obligations, whether corporate or municipal, that the are allowed to hold.

So what I would say, at the very least, is that if credit ratings started to fall on municipal bonds you would see probably a number of banks which would have to sell a lot of their portfolio holdings. That obviously would cause some financial difficulty for some of them.

But again, I think there are people more expert in the financial condition of banks than I.

Representative SCHEUER. But if a large number of these bonds were dumped on the market as of a certain date, which might be required by the Fed, as you indicated, that certainly would produce insecurity and a certain amount of chaos in the industry.

I would think over a period of time the market values would accommodate themselves and over a period of time some ratings might even improve. I would think that over the short term it would produce a great deal of disequilibrium.

Ms. ACKERMAN. I am sure that is true.

Representative SCHEUER. So there are real costs of this short-term costs of insecurity, loss to investors, loss to banks, loss to the stability of the system itself.

The administration is taking the position that it is not fair to subsidize cities and States by ending what in effect was an arrangement that eliminated double taxation. Yet they do this for foreign governments. They allow Americans abroad to pay taxes to foreign governments, to take full credit on that in their income tax returns.

Why is it so much noble and righteous to give this unfair subsidy to foreign governments, to Saudi Arabia and all the other Persian Gulf states, than it is to give it to American cities and States and give this same consideration to American cities and States?

Ms. ACKERMAN. Again, that is an issue that has been having a lot of discussion over the last couple of years within the industry, both on the private side of the industry as well as at the State and local government level, and that is: From where does the ability of State and local government to in fact issue tax-exempt debt derive?

I think that question has yet to be fully resolved.

Representative SCHEUER. Thank you very much, Ms. Ackerman. Thank you, Mr. Chairman.

Representative OBEY. Just one more comment. In your statement you indicated that this recommendation can be said to be an attempt to shift a portion of the Federal Government's deficit onto State and local governments.

I think that really sums it up in a nutshell. In my judgment, what is really happening with this recommendation is a lot of people are being fooled by it, frankly, because it is a tough one to explain. Financial and tax relationships always are.

But I think Mr. Stockman gave us very early warning in his Atlantic Monthly article a number of years ago when he indicated that the entire administration approach on the budget was simply a Trojan Horse for the purpose of getting that top rate down, trickle-down economics in order to get the top rate down. That was their main goal, and everything else is window dressing.

They accomplished half of their goal in the 1981 tax bill. In doing that and in reducing tax rates generally, they created an enormous deficit, as you indicate, because simultaneously with cutting those tax rates we have seen a huge buildup on the military side of the budget.

What is happening is that an effort is being made again to lower that top rate and in order to do that they are trying to simply shift a good portion of the impact to State and local governments through the elimination of this deduction.

I don't know, I don't have the number exactly yet. Frankly, I have had three different numbers on it for the last day and a half. But certainly it is going to cost, I would guess, around $20 billion to lower that top rate, somewhere within $5 billion on either side of that. This item costs $33 billion or so.

So what is happening is that in order to finance the reduction of the top rate for the people who are the most well off in this society, in order to fulfill its promises to restore two-thirds of the tax breaks for the oil and gas industry and in order to meet a few of its other political requirements, the administration is asking the

States to face a significant rise in their own taxes again or to reduce services to adjust to the pressures that will result from this recommendation.

So I think, as I said at the beginning of the hearing, this is not just a tax plan; it is an ideological plan. It is part of an ideological plan that would crowd out the ability of anybody but the Federal Government to dictate basic tax policy and budget policy at the Federal and State level.

As the panel indicated yesterday it certainly shrinks the ability of States to follow their own stars in meeting their own social obligations and budget needs.

It certainly, as George Will pointed out this morning in the paper, makes the Federal Government the tax hog on the block. I find it ironic that while the administration is proposing budgets over a series of years which ask States to pick up the greater share of the burden of educating people, providing welfare, providing transportation services, providing mental health services—you name it—they are also squeezing their ability to do so by attacking this provision.

This provision is key in that ideological agenda, and I think that is one reason why it has nothing whatsoever to do with the issue of tax reform.

I thank you very much for coming here today.

Ms. ACKERMAN. And you are very welcome. Thank you.

Representative OBEY. The committee stands adjourned.

[Whereupon, at 11 a.m., the committee adjourned, subject to the call of the Chair.]

APPENDIX

The Case for Eliminating Deductibility of State and Local Taxes

by

Bruce Bartlett

President Reagan's proposal to eliminate the deductibility of state and local nonbusiness taxes from the federal tax base is among the most controversial provisions in his tax reform plan.1/ It is a deduction that has existed since the beginning of the federal income tax in 1913. Nevertheless, the case for eliminating this deduction as part of an overall tax reform is strong. Although there is likely to be strong pressure for retaining or limiting the scale-back of this deduction, its elimination should be strongly supported.

Under current law a taxpayer who itemizes is allowed to deduct from his adjusted gross income all state and local income, sales and property taxes paid. Obviously, therefore, taxpayers who do not itemize -- approximately two-thirds of all taxpayers -- get no benefit from this deduction. Moreover, benefits of the taxes paid deduction accrue largely to more wealthy taxpayers, partly because they tend to pay more state and local taxes and partly because each dollar of deduction is worth more the higher one's marginal tax bracket is. Thus, a $1 deduction is worth 25 cents to someone in the 25 percent bracket but 50 cents to someone in the 50 percent bracket in terms of tax savings. Table 1 illustrates the distribution of benefits from the deduction for state and local taxes.

Bruce Bartlett is a senior fellow at the Heritage Foundation.

Table 1

Percent of Total Deductions for State and Local Taxes by Income Class, 1983

Income Class	Percent
$ 0 - 9,999	0.3
10,000 - 14,999	0.5
15,000 - 19,999	1.2
20,000 - 29,999	6.1
30,000 - 49,999	25.4
50,000 - 99,999	42.0
100,000 - 199,999	14.0
200,000 or more	10.5

Source: Treasury Department.

The deduction for state and local taxes is among the fastest growing "tax expenditures." In 1970 $32 billion of state and local taxes were deducted. By 1983 this figure had risen to over $100 billion.2/ The Congressional Budget Office estimates that elimination of deductibility would raise federal revenues by $176.2 between 1986 and 1990 on a static basis, in the absence of any other tax change.3/ The Treasury Department estimates that elimination of deductibility as part of an overall tax reform proposal which also lowers marginal tax rates would raise revenues by $148.9 billion.4/ The difference between the two figures is largely due to the fact that under current law the top tax rate rises to 50 percent while under the President's proposal is would be no higher than 35 percent.

The value of deductibility is not the same for everyone, of course. Its benefits are greatest in those states where taxes are the highest. The Advisory Commission on Intergovernmental Relations

(ACIR) estimates the tax saving from deductibility at $263 per capita for a resident of New York, but only $33 per capita for a resident of Tennessee. Appendix I shows the figures for all states including the most recent per capita income. As one can see, the federal tax benefits from deductibility accrue mainly to the richer states.

Because the benefits of deductibility do vary so widely it in effect constitutes a subsidy from lower-taxed states to higher-taxed states. And because the states with heavier state and local taxes tend to be wealthier, in terms of per capita income, deductibility constitutes a subsidy from the poor to the rich. The 15 states with above average tax savings from deductibility, for example, have average per capita incomes over 17 percent higher than those states with less than average tax savings from deductibility.

Deductibility may also be seen as a subsidy from the poor to the rich within a state as well. This is because the advantages of deductibility accrue only to those who itemize -- generally more wealthy taxpayers -- and not to those who use the standard deduction. Throughout the U.S. as a whole only 37 percent of taxpayers itemize. In the states, however, the proportion of itemizers varies from a high of 50 percent in Utah to a low of 19 percent in West Virginia.5/ This point is emphasized by Professor Edward Gramlich of the University of Michigan in a recent study. He makes the point that fees and charges, which are generally more efficient methods of raising revenue, are not deductible while less efficient sales and income taxes are. Moreover, since far fewer than half of all taxpayers itemize, the vast majority of voters fail to benefit from deductibility. As Gramlich notes, "If the median, or decisive, voter

in a community does not itemize, then the deduction does not affect state and local spending but merely represents an unwarrented tax break for the high-income taxpayers who do itemize."6/

Perhaps more importantly, deductibility of property taxes represents a bias against renters in favor of homeowners. This is because, as a 1977 Treasury study reasons, rents embody a share of property taxes. Over time, in fact, rents will rise dollar-for-dollar with an increase in the property tax. Yet only homeowners will be relieved of this burden by deducting such taxes from their taxable income. Renters will not.7/ To the extent that homeowners are generally wealthier than renters, therefore, this again means that deductibility constitutes a subsidy from the poor to the rich.

This point is also true of sales taxes, which must be paid regardless of one's income. Thus not only are sales taxes inherently regressive, but this regressivity is increased by allowing such taxes to be deducted from taxable income. A dollar's worth of sales taxes will cost a dollar to someone who does not itemize, or even pay any income taxes at all because their income is too low, but will cost someone in the top federal tax bracket only 50 cents under current law. Again, the rich are able to enjoy government services at less cost than the poor -- income redistribution in reverse.

As bad as this situation is, it would be worse if, as some studies suggest, the rich were able to direct government spending toward their own interests. Helen Ladd of Harvard notes that a Massachusetts survey in 1980 found that 56 percent of household heads who voted lived in households that itemized. Of 58 cities and towns

surveyed, itemizers accounted for more than 50 percent of the voters in all but 16.8/ Gramlich cites a 1978 Michigan survey which found that 49 percent of Michigan voters itemized. This percentage, however, rose as high as 60 percent in some high-income areas.9/

This suggests that wealthier voters who itemize may be successful in raising local government spending for things they may favor, such tennis courts or golf courses, knowing full well that the cost to them of such services will be partially borne by the federal government and others in the community who do not itemize. Thus Gramlich argues that the tax code actually encourages rich people to live together so they can export their taxes to others. "It is hard," he says, "to imagine a consciously designed public-policy measure having worse impacts on both efficiency and equity, in the short and the long run, than the federal income-tax deduction for state and local taxes."10/

Overall, deductibility of state and local taxes has been estimated to increase total state and local government spending by as much as 20.5 percent, according to the Congressional Research Service.11/ The ACIR puts it at only 7 percent -- which would still be about $30 billion (total state and local government spending was $434 billion in 1983).12/ Most other estimates put the figure at 13-14 percent.13/ This means that in the absence of federal deductibility for state and local taxes state and local spending would be about 14 percent lower and thus would fall by this amount if deductibility were eliminated. This is not to say that it would fall by this amount immediately, but over time one would expect state and local spending to be 14 percent lower than it would otherwise be.

If one could show that there is some benefit to the nation as a whole of having state and local spending subsidized and encouraged to this extent, it should, of course, be taken into consideration. However, as Helen Ladd notes, to accept this argument "one would have to believe that such spillovers are positive in jurisdictions with large proportions of itemizing taxpayers and zero elsewhere. In fact, the reverse is more likely to be true; that is, positive spillovers from public sector spending are more likely in low-income or heterogeneous cities than in the higher-income communities where itemizing is more common."14/

Another effect of deductibility is to encourage state and local governments to establish progressive income taxes, as opposed to flat rate income taxes. The advantages are, as economist Edward Moscovitch notes, "the ability to shift a much greater share of the state income-tax burden onto the Federal Government, and the ability to increase state income-tax revenues...without increasing taxes on low and moderate-income families....By shifting state taxes onto those taxpayers in the highest Federal tax brackets, the adoption of graduated rates increases the total amount of Federal tax savings, and thereby reduces the total burden of a state income-tax. In effect, adoption of graduated rates offers an opportunity for the state to participate in a form of state-initiated revenue-sharing." He estimated that in 1973 the state of Massachusetts could have saved over $100 million simply by shifting from a flat-rate income tax schedule to a progressive rate schedule.15/

This is an important problem for two reasons: First, graduated tax rates tend to punish success -- i.e., the more

successful one is, the more one earns, the more taxes one must pay.16/ Second, to the extent that marginal tax rates affect incentives it is the total tax rate that matters: the federal plus state and local tax rates.

Marginal tax rates vary a great deal between states and localities. Several states have no income taxes whatsoever, while they rise to over 18 percent in other places. However, deductibility of such taxes from federal taxable income substantially mitigates the impact of such tax rates. In effect, low tax states don't benefit as much as they should while high-tax states don't suffer as much as they should. In short, deductibility reduces the progressivity of tax rates.17/ Appendix II illustrates the impact of deductibility and how the President's proposal will impact on taxpayers in the top tax bracket among the different states.

Naturally, those states which presently have tax rates substantially above average are concerned that loss of federal tax deductibility will sharpen the differences in tax rates among the states. They know full well that taxpayers may "vote with their feet" and move to other states where the tax bite is lower. This happens already even with the mitigating effects of federal tax deductibility.18/ Clearly, it would increase with the loss of deductibility.

It is worth noting that most of the states protesting most loudly the proposed loss of tax deductibility are states like New York which are largely controlled by the Democratic Party. In effect, Democrats in these states have offset the loss of federal spending under the Reagan Administration with increased state

spending -- cushioned by the fact that increased state taxes were partially borne by Uncle Sam. Now they fear that they will have to cut back on the spending they have used to buy votes with. And well they should. Loss of deductibility of state and local taxes may well create the most powerful tax revolt pressure seen since the days of Proposition 13 in California. It does indeed threaten the very existence of liberal administrations throughout the country.

The transition to a lower-tax environment need not be as painful as it might appear. Much more of what state and local governments do, in contrast to the federal government, is deliver goods and services to their people -- police and fire protection, trash collection, education, parks, etc. In 1983, for example, 95.8 percent of all state and local spending went to providing goods and services, according to the Department of Commerce, compared to only 32.9 percent of federal spending. It is much easier to shift the provision of goods and services to the private sector or establish user fees for their provision than such federal activities as social security or national defense. Hence, one would expect the loss of deductibility to produce a great deal of privatization and contracting out of state and local government services. Numerous studies have shown how easily this can be done.19/

Lastly one should note that without elimination of the deduction for state and local taxes tax reform is essentially impossible. Without the revenue from this provision there simply won't be enough revenue to reduce tax rates more than a very small amount -- too little to make the exercise worthwhile. Moreover, since most of the benefits of deductibility accrue to those with

upper incomes it will be impossible to maintain balance among income classes from tax reform. Therefore, those who pose themselves against elimination of deductibility have effectively positioned themselves against any tax reform.

This is not to say that compromise is not possible. It might be possible to phase in the loss of deductibility over a period of years, in order to ease its impact on state and local governments. It might also be possible to reform the President's proposal to provide for an additional tax bracket between the 25 and 35 percent brackets which would ease the loss of deductibility for the vast majority of itemizers.20/ However, we should not lose sight of the fact that the benefits of deductibility accrue only to a relatively small number of taxpayers in a few states. Nor should we forget the heavy price we pay in terms of economic efficiency for a tax system riddled with such provisions.21/ There is no question whatsoever that the nation as a whole would be better off without the deduction for state and local nonbusiness taxes even if tax rates are not reduced!22/ Since we would also get a cleaner, fairer, more efficient tax system in the bargain, there is little doubt that, in this regard, the President's tax proposal is exactly correct.

Appendix I

Tax Saving from Deductibility of State and Local Taxes

and Per Capita Income, 1984

State	Total Tax Saving*	Tax Saving Per Capita	Per Capita Income**
New York	$4,729	$263	$12,990
Maryland	916	211	12,994
Mass.	1,146	195	13,264
California	4,664	185	13,257
Minn.	761	181	11,913
Hawaii	179	177	12,114
Michigan	1,619	175	11,466
Delaware	107	174	12,665
New Jersey	1,277	169	14,122
Wisconsin	820	169	11,352
Conn.	480	150	14,895
Oregon	389	144	10,740
Colorado	426	137	12,770
Virginia	712	127	12,116
R.I.	123	126	11,670
U.S.	28,480	120	11,658
Illinois	1,390	119	12,405
Iowa	307	104	10,705
Alaska	45	101	17,194
Nebraska	162	101	11,212
Utah	160	101	8,993
Penn.	1,199	99	11,448
Arizona	274	94	10,656

Vermont	49	93	9,979
Kansas	218	89	12,247
N.C.	537	88	9,787
Georgia	492	86	10,379
Idaho	82	84	9,555
Ohio	904	82	11,216
Montana	64	78	9,949
S.C.	253	78	9,187
Missouri	384	76	10,969
Kentucky	280	75	9,397
Maine	87	75	9,847
N.H.	72	74	12,021
Oklahoma	240	74	10,963
Alabama	251	62	9,242
Washington	260	60	12,117
New Mexico	81	59	9,640
Indiana	320	57	10,476
Arkansas	123	53	8,967
Nevada	46	52	12,451
N.D.	31	46	11,666
Florida	478	45	11,593
Miss.	116	45	8,098
Texas	643	41	11,685
W.V.	79	40	9,159
Wyoming	20	39	11,911
Louisiana	151	34	10,270
S.D.	23	33	9,847
Tenn.	154	33	9,549

1. Millions

2. 1983

Source: ACIR.

Appendix II

Highest Marginal Tax Rate By State Under Current Law

and Reagan Proposal

State	Current Law*	Reagan Proposal**
Alabama	52.5	40
Alaska	50	35
Arizona	54	43
Arkansas	53.5	42
California	55.5	46
Colorado	54	43
Connecticut	56.5	48
Delaware	56.1	47.2
D.C.	55.5	46
Florida	50	35
Georgia	53	41
Hawaii	55.5	46
Idaho	53.75	42.5
Illinois	51.25	37.5
Indiana	51.5	38
Iowa	56.5	48
Kansas	54.5	44
Kentucky	53	41
Louisiana	53	41
Maine	55	45
Maryland	52.5	40
Massachusetts	58.75	52.5
Michigan	52.68	40.35

Minnesota	58	51
Mississippi	52.5	40
Missouri	53	41
Montana	55.5	46
Nebraska	54.75	44.5
Nevada	50	35
New Hampshire	52.5	40
New Jersey	51.75	38.5
New Mexico	53.9	42.8
New York	57	49
New York City	59.15	53.3
North Carolina	53.5	42
North Dakota	54.5	44
Ohio	54.75	44.5
Oklahoma	53	41
Oregon	55	45
Pennsylvania	51.18	37.35
Rhode Island	56.23	47.45
South Carolina	53.5	42
South Dakota	50	35
Tennessee	53	41
Texas	50	35
Utah	53.88	42.75
Vermont	56.5	48
Virginia	52.88	40.75
Washington	50	35
West Virginia	56.5	48

Wisconsin	55	45
Wyoming	50	35

*Top state tax rate plus 50 percent with deductibility.

**Top state tax rate plus 35 percent without deductibility.

Source: Calculated from ACIR data.

Notes

1. *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (Washington: GPO, 1985), pp. 62-69; Milton Coleman, "Ending State, Local Deduction Controversial," *Washington Post* (May 29, 1985), p. A15; Jacob Javits, "The Treasury's Trojan Horse," *New York Times* (May 14, 1985); Editorial, "Guess Who Pays for Tax 'Reform'" *New York Times* (May 26, 1985).
2. Internal Revenue Service, *Statistics of Income Bulletin* 4(Spring 1985), p. 78.
3. Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (Washington: GPO, 1985), p. 291.
4. *President's Tax Proposals*, p. 453.
5. *Strengthening the Federal Revenue System: Implications for State and Local Taxing and Borrowing* (Washington: Advisory Commission on Intergovernmental Relations, 1984), pp. 44-45.
6. Edward M. Gramlich, "Reforming U.S. Federal Fiscal Arrangements," in John M. Quigley and Daniel L. Rubinfeld, eds., *American Domestic Priorities: An Economic Appraisal* (Berkeley: University of California Press, 1985), p. 50.
7. *Blueprints for Basic Tax Reform* (Washington: Department of the Treasury, 1977), p. 87. See also Harvey E. Brazer, "The Deductibility of State and Local Taxes Under the Individual Income Tax," in *Tax Revision Compendium*, Committee Print, House Ways and Means Committee, 86th Congress, 1st session (Washington: GPO, 1959), vol. 1, p. 414.
8. Helen F. Ladd, "Federal Aid to State and Local Governments," in

Gregory B. Mills and John L. Palmer, eds., *Federal Budget Policy in the 1980s* (Washington: Urban Institute, 1984), p. 195. See also Helen F. Ladd and Julie B. Wilson, "Why Voters Support Tax Limitations: Evidence from Massachusetts' Proposition 2-1/2," *National Tax Journal* 35(June 1982), pp. 121-48.

9. Gramlich, "Reforming Fiscal Arrangements," pp. 50-1. See also Paul N. Courant, Edward M. Gramlich, and Daniel L. Rubinfeld, "Why Voters Support Tax Limitation Amendments: The Michigan Case," *National Tax Journal* 33(March 1980), pp. 1-20.

10. Gramlich, "Reforming Fiscal Arrangements," p. 52.

11. Nonna A. Noto and Dennis Zimmerman, *Limiting State and Local Tax Deductibility in Exchange for Increased General Revenue Sharing: An Analysis of the Economic Effects*, Committee Print, Senate Committee on Governmental Affairs, 98th Congress, 1st session, (Washington: GPO, 1983), p. 11.

12. *Strengthening the Federal Revenue System*, p. 48.

13. Ladd, "Federal Aid," p. 195; Roger H. Gordon and Joel Slemrod, "A General Equilibrium Simulation Study of Subsidies to Municipal Expenditures," *Journal of Finance* 38(May 1983), pp. 585-94.

14. Ladd, "Federal Aid," p. 196.

15. Edward Moscovitch, "State Graduated Taxes -- State-Initiated Form of Federal Revenue Sharing," *National Tax Journal* 25(March 1972), pp. 53-64.

16. For criticism of progressivity in general see Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962), pp. 161-76; Walter Blum and Harry Kalven, *The Uneasy Case*

for Progressive Taxation (Chicago: University of Chicago Press, 1953); Dan Throop Smith, "High Progressive Tax Rates: Inequality and Immorality?" University of Florida Law Review 20(Spring 1968), pp. 451-63; Harley L. Lutz, Guideposts to a Free Economy (New York: McGraw-Hill, 1945), pp. 66-82; F.A. Hayek, "Progressive Taxation Reconsidered," in Mary Sennholz, ed., On Freedom and Free Enterprise (Princeton: D. Van Nostrand, 1956), pp. 265-84; idem, The Constitution of Liberty (Chicago: University of Chicago Press, 1960), pp. 306-23; Edgar K. Browning, "How Much More Equality Can We Afford?" The Public Interest (Spring 1976), pp. 90-110.

17. Benjamin Bridges, Jr., "Deductibility of State and Local Nonbusiness Taxes Under the Federal Individual Income Tax," National Tax Journal 19(March 1966), pp. 1-17.

18. Ronald E. Grieson, "Theoretical Analysis and Empirical Measurements of the Effects of the Philadelphia Income Tax," Journal of Urban Economics 8(July 1980), pp. 123-37; Ronald E. Grieson, William Hamovitch, Albert M. Levenson, and Richard D. Morgenstern, "The Effect of Business Taxation on the Location of Industry," Journal of Urban Economics 4(April 1977), pp. 170-85.

19. E.S. Savas, Privatizing the Public Sector (Chatham, NJ: Chatham House Publishers, 1982); James T. Bennett and Manuel H. Johnson, Better Government at Half the Price (Ottawa, IL: Caroline House Publishers, 1981); Robert Poole, Jr., Cutting Back City Hall (New York: Universe Books, 1980).

20. One option that should definitely not be considered is the elimination of deductibility for only selected state and local

taxes. This will just cause state and local governments to alter their tax systems toward those taxes which retain deductibility. See Ladd, "Federal Aid," p. 196.

21. Jacquelene M. Browning, "Estimating the Welfare Cost of Tax Preferences," Public Finance Quarterly 7(April 1979), pp. 199-219.

22. Gordon and Slemrod find that even without reducing rates eliminating deductibility "raises the utility of all income groups, and of home owners as well as of renters." Gordon and Slemrod, "General Equilibrium Simulation," p. 585.

[From the New York Times, Tuesday, May 14, 1985]

The Treasury's Trojan Horse

By Jacob K. Javits

It would be ironic if the Administration's understandable and commendable zeal for income tax simplification resulted instead in a plan that sharply intensified inequities, undermined our Federal system of government and destabilized competitive economic relations between the states. There is such a Trojan Horse in the Treasury's "tax reform" plan — and, judging by the political climate at the Treasury and the White House, it is at our gates.

What has been rolled out is a provision to end the deductibility of state and local taxes on Federal income tax returns. It is a big item, and one reason the Treasury is backing it so strongly is that it would yield significant revenue. But the provision would also exact a significant price by destroying the Federalism on which our constitutional system is based.

As a practical matter, its imposition would be felt fiercely in high tax states — and little, if at all, in low tax states. It would trigger a tax migration by businesses and better-off families from the exposure of the one to the haven of the other. The Treasury blithely asserts that such a migratory process of "taxpayers voting with their feet" would achieve a kind of rough equity. But what about the millions of "disfranchised" citizens who could not participate in such an "election" because of poverty, age, race or ill-health? Shall we tell those left behind — with greater burdens and less resources — that the promise of "reform" is only for the affluent and mobile?

As damaging as the provision would be to the economies of significant parts of our country, it would wreak even more fundamental havoc on that delicately balanced document we call the Constitution.

Under its guidance, state capitals, city halls and county court houses are partners with Washington in sustaining government. State and local governments have long relied on an unambiguous Federal policy that income, once taxed by school districts, towns, cities, counties and states, would not be taxed again by Congress and the President. Even at the height of the Civil War, when an emergency Federal income tax was enacted, local taxes were deducted first before computing individual liability so as, in the words of the then chairman of the House Ways and Means Committee, "not to perplex and jostle, if we did not actually crush, some of the most loyal states of the Union."

Don't end deductions of local taxes

What states today might be so perplexed, jostled or crushed — New York, New Jersey, Massachusetts, California, Michigan, Oregon, Wisconsin, Minnesota? Is the principle of double taxation less abhorrent today for these jurisdictions than it was nearly 100 years ago for other loyal states of the Union?

This would seem a peculiarly contrary manifestation of the new Federalism that the Administration has so vigorously espoused. I share the belief that whenever state and local governments are willing and able to accept the responsibility, power should be returned to them by Washington. The freedom of our states to innovate, experiment and solve their problems is part of the genius of our Federal system. But with Washington aggravating tax disparities and competitive tensions between states, local initiative would be fatally compromised.

Every school district that must raise taxes to finance education — the most sacred of local functions — would be directly and adversely affected. The provision presents a far greater danger to the vitality and independence of local schools than any national education bill ever proposed. It would, in fact, hamstring the ability of local governments to carry out all their various responsibilities — at precisely the time Washington is dramatically increasing those burdens by budget cutbacks.

The deductibility of state and local taxes on Federal returns is not a "special interest" issue. Rather, it is an integral part of our system of government.

Simplification of the income tax code is the order of the day. But let us not damage the ability of our states to serve their constituencies, favor one region over the next, harm millions of Americans and undermine the Federal system in the process. □

Jacob K. Javits was Republican Senator from New York from 1957 to 1981.

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