

CRS Report for Congress

State and Local Sales Tax Deductibility: Legislation in the 108th Congress

Updated October 28, 2004

Pamela J. Jackson
Analyst in Public Sector Economics
Government and Finance Division

Steven Maguire
Analyst in Public Finance
Government and Finance Division



Prepared for
Committee on

TAB 115
TAB 156
AMERICAN JOBS
CREATION ACT. H.R. 4520,
PL 108-357



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Summary

Under current federal tax laws, federal income tax filers who itemize can deduct state and local income and property taxes when computing federal taxable income. Individuals, however, cannot deduct state and local sales taxes paid when computing federal taxable income. Thus, taxpayers in states without an income tax are able to deduct less state and local taxes. Taxpayers in non-income tax states argue that this differential tax treatment is inequitable.

In the 108th Congress, several proposals have been made to allow state and local sales taxes paid by individuals to be deducted from federal income tax (H.R. 261, H.R. 689, H.R. 720, H.R. 4520, S. 467, and S. 1436). Four of these bills, H.R. 4520, H.R. 720, S. 467, and S. 1436 would allow taxpayers to choose an itemized deduction for state and local general sales taxes in lieu of the itemized deduction for state and local income taxes. In October 2004, the conference report, H.Rept. 108-755, to H.R. 4520 was passed by Congress and signed into law, P.L. 108-357.

The deduction for state and local taxes was included in the initial income tax enacted in 1913 which allowed a deduction for "all national, State, county, school and municipal taxes paid within the year, not including those assessed against local benefits." The first state sales tax was enacted in Mississippi in 1932 and the deductibility of those taxes was explicitly stated in the Revenue Act of 1942 (P.L. 77-753). The provision was frequently changed, but significant revision to the provision did not occur until 1964 with the enactment of The Revenue Act of 1964 (P.L. 88-272). In the 1964 Act, only taxes explicitly mentioned were deductible: state and local taxes on real and personal property, income, war profits, excess profits, general sales, and the taxes imposed on the sale of gasoline, diesel fuel, and other motor fuels. The 1986 Tax Reform Act (TRA 1986) eliminated the deduction for sales and motor fuels taxes as part of a reform that broadened the tax base and cut individual tax rates.

Taxpayers in states without a state income tax would receive the greatest reduction in federal income taxes if a deduction for sales taxes were reinstated. Currently, nine states (Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming) do not have a broad based state income tax. Two of those nine, New Hampshire and Tennessee, tax only dividend and interest income. New Hampshire does not have a state sales tax. Thus, taxpayers in New Hampshire would not benefit from a choice between deducting income taxes or sales taxes. Under a proposal like that enacted in P.L. 108-357, CRS calculated that potentially deductible taxes in non-income tax states would increase from 14.7% to 35.9% of total state and local taxes. The percentage of potentially deductible state and local taxes for taxpayers in income-tax states would remain at 40.8%.

This report will be updated as legislative events warrant.

Contents

P.L. 108-357 and Other Legislative Proposals	1
Historical Background	2
Economic Analysis	5
Distributional Equity	5
Vertical Equity	5
Interstate Equity	6
Administrative Simplicity	9
Intergovernmental Fiscal Efficiency	9
Analysis of States Without a Broad-Based Income Tax	11

List of Tables

Table 1. Sources of Tax Revenue for all State and Local Governments, FY2003	7
Table 2. Type of Tax Revenue, Non-Income Tax States and Income Tax States, FY2000	8
Table 3. Percentage of Deductible Taxes under Three Scenarios by Type of State Tax Structure	9
Table 4. Estimated Reduction in Federal Taxes Under a Proposed Sales Tax Paid Federal Income Tax Deduction Option	13

State and Local Sales Tax Deductibility: Legislation in the 108th Congress

Several proposals have been made to enact a federal income tax deduction for sales taxes paid. This report begins by discussing P.L. 108-357, the American Jobs Creation Act of 2004 and other legislative proposals made in the 108th Congress. A history of the deductibility of state and local sales taxes paid follows with the next section providing an economic analysis of the equity, simplicity, and efficiency issues. The report concludes with an analysis of the impact of making state sales taxes deductible in specific states without a broad based-income tax.

The following states do not tax income: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. Alaska does allow local income taxes. New Hampshire and Tennessee tax only dividend and interest income.

P.L. 108-357 and Other Legislative Proposals

The American Jobs Creation Act of 2004, P.L. 108-357, contains a provision that allows taxpayers who itemize to deduct state and local general sales taxes in lieu of state and local income taxes. Taxpayers have the choice of either using tables generated by the Secretary of the Treasury to determine the amount of the deduction or collecting sales tax receipts to report actual sales taxes paid. The tables would take into account the taxpayer's (1) state of residence; (2) filing status; (3) number of dependents; (4) adjusted gross income; and (5) state and local sales tax rate. The conference report, which was agreed to in Congress in October 2004, allows taxpayers to add sales taxes paid on cars and boats to the table amount. The table amount will not include car and boat purchases. The new law, which is effective for tax years 2004 and 2005, expires after the 2005 tax year and is estimated to generate \$4.995 billion of lost federal tax revenue.¹

Other bills that would have allowed deductions for state sales taxes had been introduced in both the House and Senate. Representative Kevin Brady introduced H.R. 720, which would have allowed individuals to deduct state general sales taxes in lieu of a deduction for state and local income taxes. Unlike the provision in P.L. 108-357, H.R. 720 did not contain a sunset provision. In the Senate, Senator Kay Bailey Hutchison introduced S. 467, which also would have allowed taxpayers to choose to itemize state and local income taxes or state and local sales taxes. Unlike

¹ U.S. Congress, Joint Committee on Taxation (JCT), "Estimated Budget Effect of the Conference Agreement for H.R. 4520, the 'American Jobs Creation Act of 2004,' Fiscal Years 2005-2014," JCX-69-04, October 7, 2004. The estimates posted on the JCT website: [<http://www.house.gov/jct/x-69-04.pdf>].

the provisions in P.L. 108-357 and H.R. 720, S. 467 would have allowed a deduction for these taxes when computing taxable income for the alternative minimum tax (AMT). Senator Bill Nelson introduced S. 1436 which, like the other bills, proposed to allow taxpayers a choice between deducting income or sales taxes. It had no provisions concerning the AMT but did include several revenue raising provisions that would have offset the cost of the legislation.

Two other state and local sales tax deductibility bills were introduced in the House in the 108th Congress. These bills, H.R. 261 and H.R. 689 would have permitted only residents of states without an income tax to deduct state sales taxes when computing federal income tax liability.

All of the proposals, as introduced, would have required taxpayers to use tables provided by the Secretary of Treasury to determine the sales tax deduction amount rather than report actual sales taxes paid (i.e., collect receipts). When sales tax deductibility was allowed in the past, taxpayers could choose to collect receipts and claim actual sales taxes paid *or* use tables provided by the Secretary of Treasury. During the conference on H.R. 4520, Congress added a provision to allow taxpayers to collect receipts and claim actual sales taxes paid *or* use tables.

Historical Background

The deduction for state and local taxes first appeared with enactment of the Revenue Act of 1913.² A provision in that act allowed the deduction for “all national, State, county, school and municipal taxes paid within the year, not including those assessed against local benefits.” State sales taxes were not introduced until 1932 (Mississippi was the first) and a deduction for those taxes for individuals was not explicitly stated in the tax code until passage of the Revenue Act of 1942 (P.L. 77-753). The deductibility status of state sales taxes from 1932 to 1942 is unclear. The provision was frequently changed over the years, but significant revision to the provision did not occur until 1964 with enactment of The Revenue Act of 1964 (P.L. 88-272).

Before 1964, a deduction was allowed for all taxes paid or incurred within the taxable year except those taxes explicitly excluded. Exceptions included estate, inheritance, legacy and succession taxes, an employee’s Social Security contributions, federal war profits and excess profits taxes, as well as import duties and federal excise and stamp taxes. Under the 1964 change, only taxes explicitly mentioned were deductible. Included in the list of deductible taxes were state and local taxes on real and personal property, income, war profits, excess profits, general sales, and the taxes imposed on the sale of gasoline, diesel fuel, and other motor fuels. A new subsection spelled out the test for deductibility of general sales taxes.

² The 16th Amendment to the Constitution allowed for the taxation of income without regard to state population. With the newly granted constitutional authority, Congress passed The Revenue Act of 1913, initiating the current federal income tax. There was a civil war income tax and another income tax in the late 19th century. They may have been unconstitutional, but they existed.

First, the tax must be a sales tax (a tax on retail sales) and second, it must be general, that is, imposed at one rate on the sales of a wide range of classes of items. "Items" could refer either to commodities or services.

During the consideration of the 1964 act there was legislative discussion of the federal deductibility of sales taxes. The Senate report stated that "to deny the deductibility of general sales taxes while allowing deductions for other major revenue sources would encourage state and local governments to use these other resources in place of the sales tax."³ According to this theory, states with an income tax, for example, would either raise the income tax rate or expand the income tax base because that tax is deductible from federal income taxes. Relatively recent research, however, does not support this claim.⁴

In November 1984, the Treasury Department submitted to President Reagan a three-volume report entitled *Tax Reform for Fairness, Simplicity, and Economic Growth*. The Treasury report proposed to eliminate a long list of exclusions, exemptions, deductions, and credits in order to lower tax rates. Included among the far-reaching and controversial proposals was repeal of the deduction for all state and local taxes. President Reagan included the proposal when he submitted it to Congress in May 1985. The House Ways and Means Committee did not include repeal of the state or local taxes paid deduction when it reported out H.R. 3838. After passage in the House, the bill was referred to the Senate Finance Committee.

After hearings and extensive debate on the sales tax issue, the Senate sent legislation to conference that provided a partial deduction of state and local sales taxes only for cases where the sales taxes paid exceeded the income taxes paid. The conference agreement, however, repealed the itemized deduction for all state and local sales taxes.⁵

One of the primary issues discussed before repeal of deductibility for sales taxes under the Tax Reform Act of 1986 (TRA 1986) was that the services provided by some state and local governments had expanded beyond traditional public goods (e.g., police and transportation infrastructure). Popular examples at the time included recreational facilities such as swimming pools, golf courses, and tennis courts.⁶ Sales

³ U.S. Congress, Senate Committee on Finance. *Revenue Act of 1964, Report of the Committee on Finance, United States Senate to Accompany H.R. 8363*, 88th Cong., 2d sess, S.Rept. No. 830 (Washington: GPO, 1964), p. 54.

⁴ Gilbert E. Metcalf, "Deductibility and Optimal State and Local Fiscal Policy," *Economic Letters*, vol. 39, 1992, pp. 217-221.

⁵ The final act also provided that state, local, and foreign taxes which are incurred in a business or investment activity in connection with the acquisition or disposition of property, and for which an itemized deduction is not allowed, are to be treated as part of the cost of the acquired property or as a reduction in the amount realized on the disposition.

⁶ U.S. Congress, Senate Committee on Governmental Affairs, *Limiting State-Local Tax Deductibility in Exchange for Increased General Revenue Sharing: An Analysis of the Economic Effects Prepared for the Subcommittee on Intergovernmental Relations of the Committee on Governmental Affairs, United States Senate, by the Congressional Research*

taxes, it was argued, should not be deductible because they are used to finance private goods. At the time of repeal of the deduction, Congress provided a lengthy rationale for its position that "...it is appropriate to disallow the itemized deduction for State and local sales taxes." The following are some of the reasons for the disallowance of the sales tax deduction provided by the Joint Committee on Taxation's (JCT) explanation of the TRA 1986.⁷

The JCT suggested that extending nondeductibility to all state and local sales taxes would improve the consistency of federal tax policy, by not providing a federal income tax benefit for any type of consumption subject to sales taxes. Sales taxes are not applied to all of types of consumption, such as services and medicine in many states. Allowing a deduction for sales taxes confers a federal tax benefit to taxable goods, but not the non-taxable goods.

Another argument posited by the JCT, which is similar to the first, is that allowing the deduction was unfair because it favored taxpayers with particular consumption patterns, and was inconsistent with the general rule that costs of personal consumption by individuals should be nondeductible. This argument, however, does not seem consistent if the deduction for property taxes was allowed. Property taxes are calculated as a percentage of the value of a home and reflect a taxpayer's housing consumption choice.

A final comment from TRA 1986 explanation provides insight for the new legislation (P.L. 108-357) that includes the production of tables for the state and local sales tax deduction:

...use of the tables neither accurately measured the amount of disposable income an individual retained after paying general sales taxes, nor accurately provided an appropriate Federal tax benefit to residents of States that impose general sales taxes.

In other words, the tables used to determine the amount of sales taxes the taxpayer could deduct were considered so imprecise that the policy benefits derived from the deduction allowance were significantly reduced.⁸

Of course, the elimination of the sales tax deduction was an important part of tax base broadening measures necessary to permit lower rates in the revenue-neutral tax reform in 1986.

⁶ (...continued)

Service, Library of Congress, 98th Cong., 1st sess., S. Prt. 98-77, (Washington: GPO, 1983), p. 27.

⁷ U.S. Congress. Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Congress; P.L. 99-514)*, 100th Cong., 1st sess., JCS-10-87 (Washington: GPO, 1987), pp. 47-48.

⁸ At the time of the debate surrounding repeal of the deductibility, some observers suggested that the administrative cost to the IRS of sales tax deduction was reason enough to eliminate the deductibility.

Economic Analysis

An important part of the debate over sales tax deductibility is how the deduction is formulated. Some proposals would allow taxpayers to choose between deducting sales taxes or income taxes, while others would allow only taxpayers in states without a broad-based income tax to deduct sales taxes. Before sales tax deductibility was eliminated in TRA 1986, most state and local taxes were deductible. One of the arguments for allowing deductibility of most state and local taxes was based on the definition of a proper federal tax base. That argument suggests that income used to pay state and local taxes (e.g., income, property, or sales taxes) it is not available to pay federal taxes. To tax people on that income is seen by some as a “tax on a tax.” The choice of deductibility — either sales taxes or income taxes, not both — as provided in P.L. 108-357 and other current legislation, would negate the logic behind the “tax on a tax” argument, because it applies equally to all forms of tax. An alternative, albeit much more costly in terms of lost tax revenue, would be to allow the deduction of both state and local sales and income taxes. Given the budget concerns facing the Congress, this policy apparently is not considered an option.

The economic effects of the current proposals to allow sales taxes paid to be included in itemized deductions *in lieu of income taxes paid*, are analyzed in the following section. The section is structured by three criteria: distributional equity, administrative simplicity, and intergovernmental fiscal efficiency. The analysis would be considerably different if the proposal allowed an unconditional sales tax deduction, that is, not in lieu of income taxes.

Distributional Equity

There are many ways to examine the distributional impact of allowing taxpayers to deduct state sales taxes in lieu of state and local income taxes as provided for in P.L. 108-357. This report examines two types of distributional equity: vertical equity, as measured by income across all taxpayers, and interstate equity, such as how the proposal affects states with different tax structures.

Vertical Equity. The benefits of sales tax deductibility will most likely flow to higher income taxpayers who are more likely to itemize. Nationally, the percentage of taxpayers who itemize was 35% for 2002, up from 34% in 2001, and 33% in 2000.⁹ Lower income taxpayers generally do not itemize and use the standard deduction amount instead. In 2004, the standard deduction amounts are \$9,700 for a married couple filing jointly, \$7,150 for heads of household, and \$4,850 for single individuals. Taxpayers would need to have itemized deductions, including deductible taxes such as ad valorem property taxes, income taxes, or sales taxes, that exceed the amount of their standard deduction to make itemizing worthwhile. Itemizers can also deduct charitable contributions and mortgage interest paid, both of which trend toward higher-income taxpayers. Even though taxpayers who choose the standard deduction will be no worse off from a tax liability perspective, The

⁹ As reported in the Internal Revenue Service, *Statistics of Income Bulletin*, (Washington: Winter 2003-2004), pp. 105-107.

provision in P.L. 108-357 will shift the overall federal tax burden, albeit slightly, from itemizers (typically high-income taxpayers) to non-itemizers (typically low-income taxpayers). In other words, the *share* of federal taxes paid by itemizers will shrink and that paid by non-itemizers will rise.

Allowing the deduction for state and local sales taxes in lieu of income taxes will also diminish the progressivity of the federal income tax system because the value of itemized deductions increases with marginal tax rates (and income). That is to say, the tax liability of an individual in the 10% tax bracket (the lowest federal income tax rate) would be reduced \$10 for each \$100 of itemized deductions. In contrast, the tax liability of an individual in the 35% tax bracket (the highest federal tax bracket) would be reduced \$35 for each \$100 deduction.¹⁰ Hence, the proposed deduction for state and local sales taxes would be worth more to high-income taxpayers as are most other federal tax deductions. This effect is muted by the phase-out of itemized deductions for high-income taxpayers. Under current law, married filers with adjusted gross income (AGI is income less exemptions and exclusions) greater than \$142,700 (and single filers with AGI greater than \$71,350) are required to reduce itemized deductions by 3% on each dollar of AGI above the threshold.¹¹

Interstate Equity. Each state and local government relies on a different mix of taxes to finance public expenditures. In FY2003, state and local governments relied primarily on three taxes: the property tax, the general sales tax, and the individual income tax. These three combined generated 78.5% of total tax revenue for state and local governments (see **Table 1**).

In recent prior years, taxpayers who itemized could deduct both property taxes paid and income taxes paid but not sales taxes paid.¹² The data in **Tables 1** and **2** reflect total tax collections from both businesses and individuals. Businesses can deduct all state and local taxes as a cost of doing business; individuals can deduct less than the total tax paid. Combining Census Bureau data with estimates from published sources on taxes paid by businesses, CRS estimates that individuals in 2000 paid approximately 57.3% of the total sales taxes collected and approximately 43.7% of total property taxes collected.¹³ Using these percentages and the data in **Table 2**, it is estimated that roughly 14.7%¹⁴ of taxes collected in the non-income tax

¹⁰ The example assumes that the deduction does not drop the taxpayer into the next lower tax bracket.

¹¹ The total reduction in itemized deductions cannot exceed 80% of the actual amount. However, itemized deductions for medical expenses, investment interest paid, and casualty, theft or wagering losses, are not subject to reduction.

¹² Only property taxes measured as a percentage of the property's value are deductible.

¹³ Businesses paid approximately 42.7% of general sales and gross receipts taxes in FY2000 according to data in a report by Robert Cline, William Fox, Thomas Neubig, and Andrew Philips, "Total State and Local Business Taxes: A 50-State Study of the Taxes Paid by Business in Fiscal 2003," *State Tax Notes*, March 1, 2004, and from U.S. Census data on state and local tax receipts.

¹⁴ By multiplying the percentage of property taxes collected from individuals, 43.7%, by the
(continued...)

states were deductible for itemizers. In contrast, in states with an income tax, 40.8%¹⁵ of taxes collected are deductible for itemizers.

Table 1. Sources of Tax Revenue for all State and Local Governments, FY2003

Type of Tax	Amount (\$ billions)	Percentage of Total	Deductible from Federal Individual Income Tax	
			Before P.L. 108-357	After P.L. 108-357
Total	\$896.5	100.0%		
Property Tax	\$283.7	31.6%	Yes	Yes
General Sales	\$228.3	25.5%	No	Yes
Individual Income	\$191.8	21.4%	Yes	Yes
Motor Fuel	\$32.8	3.7%	No	No
Corporate Income	\$30.8	3.4%	No	No
Motor Veh. & Operator Lic.	\$18.2	2.0%	No	No
Tobacco	\$10.9	1.2%	No	No
Alcohol	\$4.8	0.5%	No	No
Other Taxes	\$95.2	10.6%	No	No

Source: CRS Calculations based on Census Bureau data. The Census data are available at the following site: [<http://www.census.gov/govs/www/qtax.html>]. The tax totals are the sum of quarters 3 and 4 of 2002 and quarters 1 and 2 of 2003, which roughly approximates most state fiscal years that begin on July 1 and end on June 30.

Taxpayers in states that do not impose an income tax will benefit most from P.L. 108-357. It is also true that states without an income tax also rely more on sales taxes and property taxes than do states with an income tax. The deduction for property taxes paid is not affected by P.L. 108-357. The implication is that itemizing taxpayers in non-income tax states will be able to deduct a larger portion of state and local taxes paid. Referring to **Table 2**, states without the income tax (and the localities within them) rely on sales and property taxes for 70.5% of total tax revenue. In contrast, states that levy an income tax rely on income and property taxes for 56.4% of total tax revenue.

¹⁴ (...continued)

portion of total taxes that are derived from property taxes, 33.4%, and then adding the portion of total taxes derived from income taxes, 0.1%, we arrive at 14.7%.

¹⁵ By multiplying the percentage of property taxes collected from individuals, 43.7%, by the portion of total taxes that are derived from property taxes, 27.7%, and then adding the portion of total taxes derived from income taxes, 28.7%, we arrive at 40.8%.

Table 2. Type of Tax Revenue, Non-Income Tax States and Income Tax States, FY2000

Type of Tax	Type of Tax Revenue as Percent of Total Tax Revenue		Deductible from Individual Income Tax	
	Non-Income Tax States	Income Tax States	Before P.L. 108-357	After P.L. 108-357
Total	100.0%	100.0%		
Property Tax	33.4%	27.7%	Yes	Yes
General Sales	37.1%	22.3%	No	Yes ^a
Individual Income ^b	0.1%	28.7%	Yes	Yes ^a
Motor Fuel	5.1%	3.3%	No	No
Corporate Income	1.7%	4.6%	No	No
Motor Veh. & Operator Lic.	2.3%	1.8%	No	No
Tobacco	1.1%	1.0%	No	No
Alcohol	1.1%	0.4%	No	No
Other Selective Sales ^c	9.0%	5.1%	No	No
Other Taxes	9.1%	5.1%	No	No

Source: CRS calculations based on Census Bureau data. FY2000 is the latest year for which data are available by individual states.

Notes:

^a Under P.L. 108-357, taxpayers can choose to deduct either income or sales taxes.

^b The income tax percentage is positive because New Hampshire and Tennessee levy an income tax on dividend and interest income.

^c This category includes selective sales taxes collected through public utilities.

Under P.L. 108-357, taxpayers in states without an income tax (who also itemize) could deduct relatively more in sales taxes than states with an income tax. Potentially deductible taxes in non-income tax states would increase from an estimated 14.7% to 35.9%.¹⁶ Deductible taxes in income-tax states would remain at 40.8%. Taxpayers in some income-tax states, however, may pay more in sales taxes than income taxes and would receive some tax benefit.

Table 3 below compares the percentage of potentially deductible taxes before P.L. 108-357 with a (1) sales tax in lieu of income tax deduction and (2) reinstating the sales tax deduction regardless of state income taxes.

¹⁶ By multiplying the portion of total taxes that are derived from general sales taxes, 37.1%, to by the percentage of total sales taxes paid by individuals, 57.3%, and adding to 14.7%, we arrive at 35.9%.

Table 3. Percentage of Deductible Taxes under Three Scenarios by Type of State Tax Structure

	Percentage of State Tax Revenue that Could be Deductible for Individuals under Three Scenarios		
Type of State Tax Structure	Before P.L. 108-357	After P.L. 108-357	Deduction for Sales Taxes Regardless of Income Taxes
No Broad-Based Income Tax	14.7%	35.9%	36.0%
Broad-Based Income Tax	40.8%	40.8%	53.6%

Source: CRS calculations based on Census Bureau data and data from Robert Cline, William Fox, Thomas Neubig, and Andrew Philips, "Total State and Local Business Taxes: A 50-State Study of the Taxes Paid by Business in Fiscal 2003," *State Tax Notes*, March 1, 2004.

Administrative Simplicity

Allowing individuals to choose between deducting income or sales taxes adds complexity to income tax return preparation in a variety of ways. Taxpayers who have not itemized deductions will need to determine if the state and local sales tax deduction would reduce taxes more than using the standard deduction. In addition, taxpayers who are already itemizing and live in states with both state and local income taxes and sales taxes, would need to decide which tax to deduct. This task is simplified for taxpayers with tables provided by Treasury for purposes of determining the sales tax deduction.

The proposal also will increase the administrative burden for the Internal Revenue Service (IRS). Taxpayers in states that do not levy an individual state income tax would clearly benefit from the availability of a new deduction and many would likely choose to itemize. The increase in the number of taxpayers who itemize, rather than use the standard deduction, will increase IRS administrative costs. As mentioned earlier in this report, when state sales tax deductibility was allowed in the past, taxpayers could either collect receipts and calculate their total actual sales taxes paid, or use tables provided by the Department of the Treasury. Not allowing taxpayers to calculate their actual sales tax and requiring them to use tables provided by the Department of the Treasury to determine the sales tax deduction amount would simplify compliance and administration relative to past practice.

Intergovernmental Fiscal Efficiency

Allowing the deductibility of state and local sales taxes would improve the revenue-raising ability of state and local governments. This enhancement can be justified economically when the benefits of state and local government programs spill over into neighboring jurisdictions. According to Robert Dilger, "This is especially the case for transportation, health, and environmental programs. Since the city or

state providing these services does not receive all the benefits, it may be reluctant to finance them if deductibility were eliminated or its value significantly reduced.”¹⁷

Others argue that some forms of taxes (such as graduated income taxes based on ability-to-pay) should be favored over other tax forms (such as sales taxes which extract a higher tax burden on low-income families). Sales taxes are generally said to be regressive since the proportional tax burden varies inversely with the incomes of the taxpayers. This is because the ratio of consumption expenditure to income declines as income increases. A lower income family is obliged to spend most of its income for items subject to a sales tax whereas a higher income family may have more savings or a greater proportion of its expenditures not subject to a sales tax, such as expenditures for housing and services.

An argument advanced for allowing state and local sales taxes to be deductible — in addition to income and property taxes — is that not doing so encourages state and local governments to raise rates of deductible taxes or to substitute deductible taxes for nondeductible taxes. In addition, state and local governments may finance expenditures with deductible taxes instead of specific user charges or fees that may be more economically efficient for public goods that provide primarily private benefits.

Allowing individuals to choose which state and local tax — sales or income — to deduct contains an incentive for states to alter their tax policy in response to federal tax policy changes. States currently have an incentive to concentrate revenues in the deductible income and property taxes. The deduction option will discourage states from concentrating on the income tax and could possibly broaden the use of sales tax in states with both taxes. However, as stated earlier, relatively recent research does not support this claim that states alter tax structure in response to deductibility.¹⁸ For states without an income tax, this proposal could be a disincentive to ever instituting an income tax, which would tend to maintain the relatively narrow the tax base in those states. Unlike allowing both taxes to be deductible, P.L. 108-357 is not neutral between sales and income taxes.

¹⁷ Robert Jay Dilger, “Eliminating the Deductibility of State and Local Taxes: Impacts on States and Cities,” *Public Budgeting & Finance*, Winter 1985, p. 77.

¹⁸ Gilbert E. Metcalf, “Deductibility and Optimal State and Local Fiscal Policy,” *Economic Letters*, vol. 39, 1992, pp. 217-221.

Analysis of States Without a Broad-Based Income Tax

As noted earlier, taxpayers in states without a broad-based income tax will receive the greatest reduction in federal income taxes from P.L. 108-357. Currently, nine states (Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming) do not have a broad based state income tax. Two of those nine, New Hampshire and Tennessee, tax only dividend and interest income. New Hampshire does not have a state sales tax. Thus, taxpayers in that state will not benefit from a choice between deducting income taxes or sales taxes.¹⁹ Many taxpayers in the remaining eight states would almost certainly pay less federal taxes under the proposal.

However, only itemizers in these states will clearly gain from the allowance of a state and local sales tax deduction in lieu of a state and local income tax deduction. Taxpayers who use the standard deduction would not benefit unless they switched to itemized deductions. Taxpayers who already itemize deductions should gain the most from the proposal because the deduction for sales taxes paid would be added in full to their present deduction. If taxpayers are using the standard deduction, \$7,350 for married taxpayers (\$4,400 for individuals) in 2000,²⁰ then the net benefit of switching to itemized deductions (e.g., including sales taxes paid), would be the total itemized deductions less the standard deduction previously claimed times their marginal tax rate. If a deduction for sales tax paid were allowed, the number of itemizers in states without an income tax would likely increase, since many would then have itemized deductions greater than the standard deduction amounts.

The calculations in **Table 4** focus only on the potential gain of current itemizers in states without a broad-based income tax (based on tax year 2000 data). An itemizer rate²¹ is used to estimate the total sales taxes paid by itemizers in a given state. The estimated sales taxes paid by itemizers is then multiplied by two marginal tax rates for itemizers: 28% and 31%.²² The potential aggregate tax savings for

¹⁹ Some New Hampshire taxpayers may receive a small tax benefit. The New Hampshire taxpayers that itemize and pay sales taxes to other states, while on vacation for example, could collect receipts and deduct those sales taxes.

²⁰ The year 2000 deduction amounts noted here are provided to accompany the year 2000 data calculated in **Table 4**. As noted earlier, in 2004 the standard deduction is \$9,700 for married taxpayers and \$4,850 for individuals.

²¹ The state itemizer rate is the percentage of all individual income tax returns in a state that claimed itemized deductions divided by total individual income tax returns filed in a state in the 2000 tax year. IRS, *Statistics of Income*, Spring 2002, vol. 21, no. 4, Table 2.

²² The 28% and 31% tax rates were chosen because itemizers could have been in any one of the five income tax brackets that existed in 2000, yet only one rate could be used for the calculation. Itemizers are generally wealthier, thus the two marginal income tax rates in the middle to high end of rate structure were chosen. Higher rates could have been used but would have to be adjusted for the phase-out of itemized deductions for high-income taxpayers. In 2004, the 31% tax rate no longer exists; its closest proxy would be the 33% tax
(continued...)

taxpayers in each of the eight states is provided in columns (e) and (f) under the two different tax rate assumptions.

The estimates reported in **Table 4** may understate or overstate the federal tax savings. The estimates assume that itemizers — typically high income taxpayers — pay an equal portion of sales taxes. Generally, high income taxpayers would pay a larger share of total state and local sales taxes than lower income taxpayers, thus the estimates could *understate* the potential gain. On the other hand, total taxes paid may overstate sales taxes paid by consumers because the itemized deduction phase-out (described earlier) limits the potential gain for high-income taxpayers. In addition, the estimates in **Table 4** assume that individuals paid approximately 58% of general sales and gross receipts taxes collected by state and local governments; businesses paid the remaining 42%.²³ If individuals paid more (less) than 58%, then the tax potential gain from deductibility is *understated* (*overstated*).

As mentioned earlier in this report, the sales tax deduction provision in P.L. 108-357 is projected by the Joint Committee on Taxation (JCT) to cost \$4.995 billion in lost tax revenue over the two-year life of the proposal. The CRS estimates in **Table 4** reflect \$2.2 to \$2.4 billion in revenue losses annually, which would total \$4.4 to \$4.8 billion over two years. The difference in the two estimates is relatively slight and could be due to many varying factors or assumptions including but not limited to the share of sales tax paid by businesses, the state itemizer rate, and the marginal tax rates applied. The estimates in **Table 4** do not reflect any gain for those taxpayers who switch from the standard deduction to itemized deductions.²⁴ Their gain would be limited, as noted above, to the margin by which the addition of sales tax deduction put them over the standard deduction. Overall, the allowance of a deduction for sales taxes in lieu of income taxes will reduce the federal income tax base resulting in a significant loss of federal revenues.

Tennessee is a special case. Tennessee currently taxes dividend and interest income. The taxes paid on this income would be included in the itemized deductions of those taxpayers who itemize. Thus, those taxpayers who chose to deduct sales tax in lieu of income taxes will not gain as much as those in states without any income tax. The marginal gain should be reduced by the amount of tax savings that the income tax deduction generated before switching to the sales tax deduction. To account for this, total income taxes paid in Tennessee are subtracted from sales taxes paid. The result of this adjustment for Tennessee is reported in column (b) of **Table 4**.

²² (...continued)
rate.

²³ Based on data in a report by Robert Cline, William Fox, Thomas Neubig, and Andrew Philips, "Total State and Local Business Taxes: A 50-State Study of the Taxes Paid by Business in Fiscal 2003," *State Tax Notes*, March 1, 2004, and U.S. Census data on state and local tax receipts, businesses paid approximately 42% of general sales and gross receipts taxes in FY2000.

²⁴ The estimate does not include the potential savings to taxpayers in all other states either.

There are likely some taxpayers in states with income taxes who would also experience a reduction in the federal tax burden if the proposal were to become law. Taxpayers who pay more state and local sales taxes than state and local income taxes (typically lower income taxpayers) would probably choose the option to deduct sales taxes if they do not take the standard deduction. For these states, the data necessary to estimate the number of taxpayers who would choose the sales tax deduction option and the amount of the tax savings are not readily available.

Table 4. Estimated Reduction in Federal Taxes Under a Proposed Sales Tax Paid Federal Income Tax Deduction Option

Average Net Tax Savings Calculated Under the Assumption that the Average Itemizing Taxpayer Is in the 28% or 31% Marginal Income Tax Bracket in the 2000 Tax Year (\$ in 000s)					
State	State and local sales taxes paid FY2000 (total)	State and local sales taxes paid FY2000 (by consumers)	State itemizer rate (tax year 2000)	Potential taxpayer savings (28% bracket)	Potential taxpayer savings (31% bracket)
(a)	(b)	(c)	(d)	(e)	(f)
Alaska	\$106,864	\$61,981	24.85%	\$4,313	\$4,775
Florida	\$15,556,791	\$9,022,939	27.36%	\$691,229	\$765,290
Nevada	\$2,061,496	\$1,195,668	34.30%	\$114,832	\$127,135
South Dakota	\$627,225	\$363,791	16.10%	\$16,400	\$18,157
Tennessee	\$7,135,956	\$4,138,854	22.05%	\$255,533	\$282,911
Texas	\$17,348,954	\$10,062,393	21.24%	\$598,431	\$662,548
Washington	\$8,918,781	\$5,172,893	33.76%	\$488,983	\$541,374
Wyoming	\$463,975	\$269,106	19.80%	\$14,919	\$16,518

Note: Data in column (b) are from the U.S. Department of Commerce, Bureau of the Census, *Government Finances: 1999-2000*, published January, 2003, [<http://www.census.gov/govs/www/estimate00.html>]. Data in column (c) is column (b) multiplied by 58%, the estimated share of general sales and gross receipts taxes paid by individuals. Data in column (d) are based on data reported in IRS, *Statistics of Income*, Spring 2002, vol. 21, no. 4, Table 2. The estimates in column (e) are column (c) multiplied by column (d) and multiplied by 28%. The estimates in column (f) are column (c) multiplied by column (d) and multiplied by 31%.