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Federal Deductibility of State and Local Taxes

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Federal Deductibility of State and Local Taxes

Summary

Under current law, taxpayers who itemize deductions can deduct state and local real and personal property taxes, and either income or sales taxes from federal income when calculating taxable income. The temporary deduction for sales taxes in lieu of income taxes expires after 2005. The federal deduction for state and local taxes results in the federal government paying part of these taxes through lower federal tax collections. Theory would suggest that taxpayers are willing to accept higher state and local tax rates and greater state and local public spending because of lower federal income taxes arising from the deduction. In addition, there is some evidence that state and local governments rely more on these deductible taxes than on non-deductible taxes and fees for services.

Repealing the deductibility of state and local taxes would affect state and local government fiscal decisions, albeit indirectly. Generally, state and local public spending would decline, although the magnitude of the decline is uncertain. And, repealing the deduction for state and local taxes would shift the federal tax burden away from low-tax states to high-tax states. Maintaining the current deductibility would continue the indirect federal subsidy for state/local spending. One Senate proposal (S. 27) and one House proposal (H.R. 519) have been introduced in the 109th Congress that would make the expiring optional sales tax deduction permanent. The Tax Reform Act of 2005 was scheduled for markup in the Senate Finance Committee on November 10, 2005, but was postponed. The legislation contains a one-year extension of the sales tax deduction *in lieu of* income taxes. In the House, H.R. 4297, introduced November 10, 2005 and tentatively scheduled for markup during the week of November 18, includes a one-year extension of the deduction for sales taxes *in lieu of* income taxes. The President's Advisory Panel on Federal Tax Reform has proposed eliminating the deduction for state and local taxes paid as part of a more comprehensive tax reform plan.

This report will be updated as legislative events warrant.

Contents

Introduction	1
Brief History	1
Deductible State and Local Taxes	3
Deduction for Property Taxes	5
Analysis	5
Deduction for Income Taxes	6
Analysis	8
Deduction for Sales and Use Taxes	8
Explanation	8
Analysis	9
Policy Alternatives and Current Legislation	10
Federal Tax Base Broadening: Eliminate Deductibility of State and Local Taxes	10
Making the Sales Tax Deduction Permanent	11
Other Policy Considerations	11
Significant Congressional Developments	12
President's Advisory Panel on Federal Tax Reform	13

List of Tables

Table 1. Number and Percentage of State and Local Taxes Paid Itemizers, 1986 and 1995 to 2003	4
Table 2. Federal Tax Expenditure on the Real Estate Property Tax Deduction ..	6
Table 3. Federal Tax Expenditure on the State and Local Income, Sales and Personal Property Tax Deductions	8
Table 4. Type of Tax Revenue, Non-Income Tax States and Income Tax States, FY2002	9

Federal Deductibility of State and Local Taxes

Introduction

The interplay between the federal and state and local tax systems through the federal deductibility of state and local taxes is the focus of this report. Generally, individual taxpayers who itemize deductions are allowed to deduct real and personal property taxes, and general sales taxes or state and local income taxes from federal taxable income. Taxpayers must choose between sales taxes or income taxes; they cannot deduct both. In 2004, Congress modified the deductibility of state and local taxes — adding the sales tax deduction option — and the 109th Congress will likely revisit the issue because the 2004 changes expire after 2005. In addition, the President’s Advisory Panel on Federal Tax Reform (the tax reform panel) recommends repealing the deduction for state and local taxes as part of a more comprehensive base broadening plan. In the Senate, the Tax Reform Act of 2005 contains a provision to extend the sales tax deduction for one year. In the House, H.R. 4297 would extend the sales tax deduction option one year. This report addresses the potential impact of changing the status of federal deductibility on state and local government tax systems, individual taxpayers, and the federal budget.

Brief History

The deduction from federal income for state and local taxes paid dates from the inception of the current income tax under the Revenue Act of 1913.¹ 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, however, 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 provision was frequently modified over the years, including the introduction of the standard deduction in lieu of itemizing deductions in 1944, but significant revision did not occur until 1964 with enactment of the Revenue Act of 1964 (P.L. 88-272).

Before the 1964 Act, a deduction was allowed for all state and local taxes paid or incurred within the taxable year except those taxes explicitly excluded. After the 1964 Act, only taxes explicitly mentioned were deductible. Included in the list of

¹ The 16th Amendment to the Constitution allowed for the taxation of income without regard to apportionment among the states. With the newly granted constitutional authority, Congress passed The Revenue Act of 1913, which initiated the current federal income tax. There was a civil war income tax and another income tax in the late 19th century.

deductible taxes were state and local taxes on: real and personal property, income, general sales, and the sale of gasoline, diesel fuel, and other motor fuels. A new subsection in the 1964 Act spelled out the test for deductibility of general sales taxes. 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.

The deductibility provision remained largely unchanged until the sales tax deduction was repealed by the Tax Reform Act of 1986 (TRA 1986, P.L. 95-514). One of the primary goals of TRA 1986 was to broaden the base of the federal income tax. Eliminating the deduction for all state and local taxes paid was one of the policy options considered to broaden the tax base. The final version of TRA 1986 repealed the deduction for general sales taxes but preserved the deduction for ad valorem property taxes and income taxes. The Joint Committee on Taxation (JCT) summary of TRA 1986 suggested that Congress chose to repeal the sales tax deduction and not income or property taxes, because:

- only general sales taxes were deductible and not selective sales taxes (e.g. tobacco and alcohol taxes) which created economic inefficiencies arising from individuals changing consumption patterns in response to differential taxation;
- the deduction was not allowed for taxes paid at the wholesale level (and passed forward to the consumer), thus creating additional inequities and inefficiencies;
- the sales tax deduction was administratively burdensome for taxpayers who chose to collect receipts to justify sales tax deduction claims; and
- the alternative sales tax deduction tables generated by the Internal Revenue Service (IRS) did not accurately reflect individual consumption patterns, thereby diminishing the equitability of the tax policy.²

The American Jobs Creation Act of 2004, (AJCA 2004, P.L. 108-357), reinstated deductible sales tax *in lieu of* income taxes.³ The *in lieu of* treatment in AJCA 2004 is in contrast to the “in addition to” treatment in pre- TRA 1986 tax law. The concerns noted above would still hold. A secondary concern — presented during the debate before repeal in 1986 — that states would alter their tax structures in response to the elimination of sales tax deductibility, would not arise. The AJCA 2004 sales tax deductibility provision expires after the 2005 tax year.

² For more on the 1986 Act, see 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.

³ IRS Publication 600, *Optional Sales Tax Tables*, provides an explanation of the new sales tax deduction.

In the 109th Congress, two proposals, S. 27 and H.R. 519, would make permanent the AJCA sales tax deduction option. In addition, the tax reform panel would eliminate the deduction for state and local taxes as part of broader tax reform proposal. The Senate legislation, the Tax Reform Act of 2005, extends the sales tax deduction for one year. In the House, H.R. 4297 would extend the sales tax deduction option one year.

The remainder of this report will describe and analyze the deduction for the following state and local taxes: (1) real estate property taxes; (2) personal property taxes; (3) income taxes; and (4) sales and use taxes. As Congress considers possible extension of the AJCA 2004 sales tax deductibility provision and proposals for fundamental tax reform, a better understanding of the existing deductible state and local taxes is important.

Deductible State and Local Taxes

Generally, taxpayers may deduct state and local taxes from federal taxable income. Individual taxpayers, however, must itemize deductions (rather than use the standard deduction) on their income tax return to claim the deduction for taxes paid. Business taxpayers, in contrast, may deduct state and local taxes as a cost of doing business. The federal tax savings from the deduction is equal to the taxpayer's marginal tax rate multiplied by the size of the deduction. Because the federal income tax rate regime is progressive,⁴ a deduction for itemizers, in contrast to a tax credit for all taxpayers, favors taxpayers in higher income tax brackets. **Table 1** reports the number and percentage of returns with itemized deductions for the four state and local taxes described and analyzed in this report.

The 1986 tax year is included in **Table 1** to exhibit the utilization of the deduction for sales taxes paid, which was repealed by TRA 1986. In 1986, the sales tax deduction was the most common itemized deduction for taxes paid. More taxpayers would claim a sales tax deduction because all but five states imposed a sales tax and, in contrast to property taxes, paying the tax is not conditioned on owning property, real or personal. When the sales tax deduction is renewed for the 2004 and 2005 tax years, however, the sales tax deduction will not be as common because its *in lieu of* income taxes.

The gradual growth in the percentage of itemizers through 2002 may reflect income growth that has outpaced inflation. Income growth that exceeds the inflation-adjusted expansion of income tax brackets (bracket creep) implies a higher marginal tax bracket, which ultimately increases the tax saving from itemizing. The decline in 2003 may reflect the impact of lower marginal tax rates.

Economists have theorized that if a particular state and local tax is favored by deductibility in the federal tax code, then state and local governments may rely more

⁴ A progressive tax is one in which the rate of tax increases with income.

upon that tax source.⁵ In effect, local governments and taxpayers recognize that residents are only paying part of the tax, and that the federal government, through federal deductibility, is paying the remainder.

For example, economists Douglas Holtz-Eakin and Harvey Rosen (1990) found that "... if deductibility were eliminated, the mean property tax rate in our sample would fall by 0.00715 (\$7.15 per \$1,000 of assessed value), or 21.1% of the mean tax rate."⁶ Following **Table 1** is an analysis of property taxes and the other deductible state and local taxes.

Table 1. Number and Percentage of State and Local Taxes Paid Itemizers, 1986 and 1995 to 2003
(Return numbers in millions)

	1986	1995	1996	1997	1998	1999	2000	2001	2002	2003
Number of returns										
All Returns:	103.0	118.2	120.4	122.4	124.8	127.1	129.4	130.3	130.1	130.4
Itemized Deductions	40.7	34.0	35.4	36.6	38.2	40.2	42.5	44.6	45.6	43.9
— Income Taxes	33.2	28.6	29.7	30.8	31.9	33.6	35.4	37.0	37.6	35.9
— Sales Taxes	39.0	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
— Real Estate Taxes	32.9	30.1	31.3	32.3	33.6	35.4	37.1	38.7	39.7	38.3
— Personal Property Taxes	11.5	15.6	16.7	17.4	18.2	19.0	19.6	20.0	20.6	20.0
— Other Taxes	9.1	3.9	3.6	3.5	3.4	3.4	3.3	3.7	3.4	3.2
Percentage of returns										
All Returns	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Itemized Deductions	39.5	28.8	29.4	29.9	30.6	31.7	32.9	34.2	35.1	33.7
— Income Taxes	32.2	24.2	24.7	25.2	25.6	26.4	27.4	28.4	28.9	27.5
— Sales Taxes	37.8	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
— Real Estate Taxes	32.0	25.5	26.0	26.3	27.0	27.9	28.7	29.7	30.5	29.4
— Personal Property Taxes	11.1	13.2	13.8	14.2	14.6	15.0	15.2	15.3	15.8	15.3
— Other Taxes	8.8	3.3	3.0	2.9	2.7	2.6	2.6	2.8	2.6	2.5

Source: U.S. Department of Treasury, Internal Revenue Service, Statistics of Income Division, *Individual Income Tax Returns, various years*, Publication 1304.

⁵ Lawrence B. Lindsey, "Federal Deductibility of State and Local Taxes: A Test of Public Choice by Representative Government," in *Fiscal Federalism: Quantitative Studies*, edited by Harvey Rosen, (Chicago: University of Chicago Press), pp. 137-176.

⁶ Douglas Holtz-Eakin and Harvey Rosen, "Federal Deductibility and Local Property Tax Rates," *Journal of Urban Economics*, vol. 27, 1990, pp. 269-284.

Deduction for Property Taxes

Under the federal income tax, taxpayers can deduct ad valorem property taxes (taxes levied as a percentage of assessed value) from taxable income.⁷ For example, an itemizing individual owning a home with an assessed value of \$100,000, and who pays a 1% property tax, can deduct the \$1,000 tax from his or her adjusted gross income. If this taxpayer is in the 28% marginal tax bracket, taking \$1,000 out of taxable income reduces taxes by \$280 (\$1,000 multiplied by 28%).⁸ In most cases, both the taxpayer's tax bracket and home value increase with income. Thus, higher-income taxpayers in higher tax brackets receive a greater tax savings than low-income taxpayers because of the typically progressive state income tax. The effect is even greater because the assumed positive relationship between home value (and property tax bill) and income.

Analysis. The property tax deduction is claimed on approximately 29% of all tax returns. However, almost two times that many homeowners pay property taxes on owner-occupied housing.⁹ Not all homeowners itemize, and only those who itemize can take the deduction. **Table 1** above provides data for the years 1986, and 1995 through 2003 on the number of returns that claimed a property tax deduction, the most common itemized deduction claimed.

Property taxes are a major source of local government revenue, and thus the federal transfer through deductibility is also quite large. State governments, in contrast, are less dependent upon property tax revenue and instead rely more upon income and sales taxes. Nationally, property taxes comprised 45.9% (\$286.2 billion in FY2003) of all local government general own-source revenue and 1.4% (\$10.5 billion in FY2003) of all state government tax revenue.¹⁰

Less than half of the combined \$296.7 billion in property taxes collected by state and local governments in FY2003 was deducted by individual taxpayers who itemized on their federal income tax returns or by businesses as a business expense. In 2003, \$118.0 billion of real estate property taxes were claimed as itemized deductions on individual federal income tax returns. Personal property taxes, such as annual car taxes (based on the value of the car), generated \$8.1 billion in

⁷ There are two types of property taxes, real estate (e.g., owner-occupied housing) and personal (e.g., cars and boats). The focus of this report is the real estate property tax. For ease of exposition, the modifier "real estate" is not used for the remainder of the report.

⁸ Marginal tax rates are sometimes referred to as tax brackets. There are currently six individual income tax brackets: 10%, 15%, 25%, 28%, 33%, and 35%.

⁹ According to the U.S. Census Bureau, Current Housing Reports, Series H15/01, *American Housing Survey for the United States: 2001*, (Washington: GPO, Oct., 2002), there were 72.3 million owner occupied households in 2001. In 2001, 38.7 million taxpayers claimed an itemized deduction for real estate property taxes.

¹⁰ U.S. Census Bureau, *State and Local Government Finance Estimates, by State: 2001-2002*, the data are available at [<http://www.census.gov/govs/www/estimate02.html>]. The property tax in the census data includes both real estate property taxes and personal property taxes.

deductions in 2003. The amount collected and the amount deducted are different because only one-third of taxpayers itemize on individual returns and businesses (including landlords) pay a large share of property taxes that would not appear as itemized deductions on individual income tax returns.

The federal tax expenditure estimated by the Joint Committee on Taxation (JCT) approximates the amount of federal revenue lost (or approximately the amount taxpayers benefit) as a result of the deductibility. **Table 2** presents the tax expenditure over the FY2005-FY2009 estimating window for taxpayers who claim a deduction for state and local real estate property taxes. The five-year total expenditure is estimated by the JCT to be approximately \$74.1 billion. The annual expenditure drops from \$19.6 billion in 2005 to just over \$13.0 billion in FY2007-FY2009. The drop likely reflects lower federal marginal tax rates.

In theory, if the property tax paid deduction were eliminated, taxpayers would gradually reduce their level of housing consumption, and thus the size of their property tax bill. This shift would be gradual as housing consumption choices are not as responsive as other expenditures to changes in after-tax price given the relatively illiquid nature of housing assets. In addition, as noted earlier, state and local governments may lower tax rates and shift to other revenue sources if the relative tax price of raising revenue through property taxes increases. Local governments would have more at stake than state governments, because the real property tax is primarily a local source of revenue. Across taxpayers, high-income property owners in states with relatively high local property values (and taxes) would likely see the greatest increase in total tax burden if property tax deductibility were repealed.

Table 2. Federal Tax Expenditure on the Real Estate Property Tax Deduction
(in \$ billions)

	2005	2006	2007	2008	2009	Total
Deduction for Property Taxes on Owner Occupied Housing	19.6	15.0	13.4	13.0	13.2	74.1

Source: U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009*, joint committee print, JCS-01-05, 109th Congress (Washington: GPO, 2005).

Deduction for Income Taxes

Beginning in 2004, taxpayers who itemize may choose between deducting either state and local income taxes or sales taxes, but not both.¹¹ As with local property

¹¹ For more, see CRS Report RL32455, *State and Local Sales Tax Deductibility: Legislation in the 108th Congress*, by Pamela Jackson and Steven Maguire.

taxes, the federal deduction is equal to the taxpayer's individual tax rate multiplied by the amount of state and local income tax paid.¹²

The income tax is a source of revenue primarily for states, not local jurisdictions. In FY2003, state governments collected \$181.9 billion in individual income taxes and local governments collected \$17.5 billion (\$199.4 billion combined). Federal deductions claimed on federal income tax forms for both state and local income taxes in the 2003 tax year totaled \$183.1 billion. The difference between what was collected and what was claimed on federal returns stems from taxpayers who did not itemize or individuals who were not required to file federal returns. Both groups are significantly more likely to be relatively low-income.

Two estimates of the tax expenditure for the deduction of income, personal property, and sales taxes are included in **Table 3**. One estimate was calculated before the American Job Creation Act (AJCA) of 2004 was enacted and the second after AJCA had been enacted. The pre-AJCA estimate does *not* include the sales tax deduction, whereas the post-AJCA includes the sales tax deduction. The pre-AJCA estimate for the revenue loss from the deductions in FY2005 is \$40.9 billion and the post-AJCA tax loss estimate is \$46.2 billion.¹³ In FY2006, the sales tax deduction provision expires, which reduces the tax expenditure estimate considerably from \$46.2 billion in FY2005 to \$33.9 billion in FY2007. A rough approximation of the cost of the sales tax deduction would be the difference between the two estimates (the pre- and post- AJCA Act estimates) for FY2005, or \$5.3 billion. Thus, one could surmise that the extension of the sales tax deduction would likely increase the tax expenditure for FY2006 and beyond by approximately \$5 billion annually. The sales tax deduction is discussed in more detail later.

Note that both of the annual tax expenditure estimates below include the personal property tax deduction. The tax expenditure generated by the personal property tax, however, is a small fraction of the federal tax expenditure reported below.

¹² In some states, taxpayers may also deduct federal income taxes from income when calculating state taxable income. The reciprocal deduction, however, for federal income taxes is practiced only in six states. Partial or limited deductibility is available in an additional three states. Because few states offer the reciprocal deduction for federal income taxes paid, the focus here is limited to the deductibility of state income taxes when calculating federal taxable income.

¹³ Recall that a rough approximation of the tax expenditure would be the amount of the deduction multiplied by the taxpayer's tax rate.

Table 3. Federal Tax Expenditure on the State and Local Income, Sales and Personal Property Tax Deductions

	2004	2005	2006	2007	2008	2009	Total
<i>Pre-AJCA Estimate</i>							
Deduction for State and local Income & Personal Property Taxes (in \$ billions)*	44.3	40.9	37.9	36.7	35.4	n/a	195.2
<i>Post-AJCA Estimate</i>							
Deduction for State and local Income, Sales & Personal Property Taxes (in \$ billions)**	n/a	46.2	36.8	33.9	33.7	35.2	185.8

* U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2004-2008*, joint committee print, JCS-08-03, 108th Congress (Washington: GPO, 2003).

** U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009*, joint committee print, JCS-01-05, 109th Congress (Washington: GPO, 2005).

Analysis. The deduction for state and local income taxes affects the distributional burden of both state and federal taxes. First, the deduction could increase the progressivity of *state taxes* if it causes states to rely more on progressive taxes such as the income tax. The cost of the deduction for high rate taxpayers is effectively “exported” to all federal taxpayers. A state that collects a relatively larger share of income taxes from taxpayers in high federal income tax brackets, is most effective at exporting a portion of its state tax burden to all federal taxpayers.

The federal tax burden, however, could be shifted to the majority of taxpayers who do not itemize deductions. Before the alternative sales tax deduction was enacted by AJCA, taxpayers in states without an income tax were more likely to be non-itemizers; thus taxpayers in these states bore a relatively higher tax burden than taxpayers in states with an income tax. The AJCA 2004 partially muted that shift in burden with the two-year sales tax deductibility provision.

Deduction for Sales and Use¹⁴ Taxes

Explanation. The deduction for state and local sales taxes was temporarily reinstated in 2004 with enactment of the AJCA. Unlike the pre-TRA 1986 deduction, AJCA allows for a deduction for sales taxes *in lieu of* income taxes. Taxpayers may choose between reporting actual sales tax paid, verified with saved receipts indicating sales taxes paid, or an estimated amount found in tables provided by the IRS.¹⁵ The table amounts do not include the sales taxes paid for cars, motorcycles, boats, aircraft, or a home. Taxpayers may add taxes paid for these items

¹⁴ A use tax is a tax on the use of a product. In the early years of the sales tax, states began with general sales then added the use tax. The intent of the use tax is to capture the sales tax due on purchases made out-of-state yet used in-state. Eventually, states adopting a sales tax included the use tax in the enacting legislation.

¹⁵ See IRS publication 600, noted earlier.

to the table amount. The table amounts do not include local sales taxes paid either. Taxpayers are asked to calculate the ratio of the local sales tax rate to the state sales tax rate, then multiply the result by the table amount to arrive at an estimate of local sales taxes paid. The estimated local sales taxes paid are then added to the state sales taxes paid table amount. The provision expires after 2005 and consequently is likely to be the subject of considerable debate in the 109th Congress.

Analysis. Allowing the deduction for state and local sales taxes in lieu of income taxes will likely diminish the progressivity of the federal income tax system because the new deduction from income is available only to taxpayers who itemize. Itemizers in states that do not impose an income tax will benefit most from the optional sales tax deduction (see **Table 4**, footnote “a” for these states). The gradual reduction in allowable itemized deductions for wealthy taxpayers does limit the benefit at the highest end of the income distribution.

It is also true that states without an income tax rely more on sales and property taxes than do states with an income tax. As a result, itemizers in states without an income tax will be able to deduct proportionately more of their state and local taxes than taxpayers in states with both an income and sales tax. As shown in **Table 4**, in states without an income tax, state and local governments rely on sales and property taxes for 70.7% of total tax revenue. In contrast, in states that levy an income tax, state and local governments rely on income and property taxes for 56.6% of total tax revenue.

Table 4. Type of Tax Revenue, Non-Income Tax States and Income Tax States, FY2002

Type of tax	Type of tax revenue as percent of total state and local tax revenue		
	All states and DC	Non-income tax states ^a	Income tax states and DC
<i>Total</i>	100.0%	100.0%	100.0%
Property tax	30.8%	36.5%	29.7%
General sales	24.6%	34.2%	22.7%
Individual income	22.4%	0.1% ^b	26.9%
Other taxes	22.2%	29.2%	20.7%
Maximum deductible	55.4%	70.7%	56.6%

Source: CRS calculations based on Census Bureau data. FY2002 is the latest year for which data are available by individual states.

a. Includes AK, FL, NH, NV, SD, TN, TX, WA, and WY.

b. The income tax percentage is positive for states without an income tax because New Hampshire and Tennessee levy an income tax on dividend and interest income (or capital income).

The differential treatment of states based on the reliance on the income tax was likely unintended. Nevertheless, states without an income tax are considerably better off than before after the enactment of AJCA relative to income tax states.

Policy Alternatives and Current Legislation

The Bush Administration and the 109th Congress have both indicated that tax reform would be high on the legislative agenda. Eliminating the deductibility of state and local taxes has been considered in the past as part of comprehensive tax reform and is proposed in the tax reform panel's recommendations. Eliminating deductibility of state and local taxes would affect the distributional burden of federal, state, and local taxes. Other provisions in the tax reform panel's recommendations would interact with the elimination of the deduction for state and local taxes paid. The magnitude of the impact would depend significantly on the response of state and local governments to the federal changes.

Federal Tax Base Broadening: Eliminate Deductibility of State and Local Taxes. If deductibility were eliminated and state and local governments are policy neutral (i.e., do nothing in response to the federal changes), then the impact on the distributional burden of state and local taxes will remain essentially unchanged. The federal tax burden, however, will shift from low tax state taxes toward high tax states. Under current tax rules, taxpayers in high tax states can deduct more from federal income than can those in low tax states.¹⁶

For example, state and local taxes in Maine comprise approximately 12.1% of total personal income whereas state and local taxes in neighboring New Hampshire account for approximately 6.6% of total personal income.¹⁷ Thus, taxpayers in Maine can deduct almost twice as much from income as can taxpayers in New Hampshire.

Assuming that other federal taxes were maintained after the elimination of the federal deduction for state and local taxes, the tax burden would shift toward high-tax states from low-tax states. If the federal government reduces tax rates to maintain revenue neutrality — the base is larger with the elimination of the deductibility allowing for lower rates to yield the same revenue — then the effect is even more pronounced. The higher the state and local tax burden (as percentage of total income), the lower the new federal tax rate would be under revenue neutrality.

More generally, if state and local tax deductibility were eliminated, the federal tax burden would shift from all federal taxpayers toward itemizers. As noted earlier, itemizers tend to be higher income, thus, federal income taxes may become more progressive if the state and local taxes paid deduction were eliminated.

¹⁶ The tax reform panel reform package would counter, or at least offset, the distributional effect of the state and local taxes paid deduction through elimination of the AMT and the highest tax bracket.

¹⁷ These data are from: The Tax Foundation, *Facts and Figures on Government Finance*, 37th edition, (Tax Foundation, Washington, DC), Dec. 18, 2003.

Some secondary effects, however, are anticipated at the state and local level. If deductibility were eliminated, state and local governments might be less willing to finance projects that generate benefits that extend beyond the taxing jurisdiction. The tax price to a community of these projects would increase as the federal “contribution” through deductibility is lost. Projects and initiatives whose benefits extend beyond the local jurisdiction would likely be the most sensitive to changes in the tax price as the benefits are more widely dispersed.¹⁸ A reduction in state and local public good provision may adversely affect low-income individuals relative to high-income individuals.

Quantifying the magnitude of the state and local spending response is difficult because many other factors influence state and local spending decisions such as state and local political considerations and overall economic conditions. Nevertheless, most research has found that state spending declines or would decline, but by how much? Before sales tax deductibility was eliminated in 1987, one researcher estimated that “... the overall responses are on the order of zero to ten percent, much less than estimates used in the political debate.”¹⁹ In contrast, another economist found that the “... level of state and local spending is significantly affected by deductibility.”²⁰

Making the Sales Tax Deduction Permanent. Under the AJCA, the sales tax deduction expires after 2005. For this reason, some in Congress may wish to extend the provision or make it permanent. Making the provision permanent would benefit itemizing taxpayers in states without an income tax the most. The cost of making the sales tax deduction permanent (and continuing with the *in lieu of income taxes* language) would likely mirror the estimated loss for the current two-year lifetime of the provision, approximately \$3 billion to \$5 billion annually.

Other Policy Considerations. Two concepts or issues were not directly addressed in this report yet will likely arise during the debate surrounding the federal income tax treatment of state and local taxes. One, are the tax expenditures for state and local taxes paid truly federal tax “expenditures?” Or, do these “expenditures” represent a return of taxpayer income that was never the federal government’s to begin with? Two, would the absence of a federal deduction for state and local taxes paid amount to “taxing a tax?” The foundation of these arguments can be traced to the difference between a theoretically ideal income tax and the federal income tax as it currently exists.

The ideal federal income tax would include wage income plus all accretions to wealth (including imputed income) over a designated time period, one calendar year,

¹⁸ Robert Jay Dilger, “Eliminating the Deductibility of State and Local Taxes: Impacts on States and Cities,” *Public Budgeting & Finance*, winter 1985, p. 77.

¹⁹ Edward M. Gramlich, “The Deductibility of State and Local Taxes,” *National Tax Journal*, vol. 38, no. 4, Dec. 1985, p. 462.

²⁰ Lawrence B. Lindsey, “Federal Deductibility of State and Local Taxes,” in Harvey Rosen, editor, *Fiscal Federalism: Quantitative Studies*, (Chicago, IL: University of Chicago Press, 1988), p. 173.

for example.²¹ This definition of income should, theoretically, accurately measure an individual's ability to pay income taxes. Any exclusions or deductions from this definition of income would represent a departure from the rule and thus generate a tax "expenditure" or federal subsidy for that expenditure.

There are two ways to view taxes paid for state and local government services under an ideal income tax.²² If one views state and local taxes paid as payment for government provided services which could be privately provided, then the federal deduction for state and local taxes is not appropriate for the federal income tax. In contrast, if one views state and local taxes as lost income resulting in a reduced ability to pay federal income taxes (a loss), then a deduction for those taxes seems reasonable. The more tangible, less theoretical, tax-on-a-tax issue arises from this last observation.²³

There is not a clear consensus on which view is "correct." For some state and local taxes and taxpayers, the fee-for-specific-services view is more accurate. Taxpayers with government-provided trash collection who pay property taxes for government spending on trash collection, for example, are receiving a tangible quasi-private benefit. Similar federal taxpayers in two otherwise equivalent jurisdictions — except that one provides garbage collection and one does not — would face different federal tax burdens. Generally, this would contradict the concept of horizontal equity across federal taxpayers.

The reduction-in-ability-to-pay view seems more reasonable for those paying general sales taxes for general government provision of public goods such as fire and police protection. Note that a federal deduction for sales taxes and not property taxes would theoretically seem more desirable.

Significant Congressional Developments. Early in the 109th Congress, S. 27 (Senator Hutchinson) was introduced. The proposal would make permanent the sales tax deduction *in lieu of* income taxes. As of November 2, 2005, the legislation had secured bi-partisan support with 11 co-sponsors including Senate Minority Leader Reid. The Senate Finance Committee was scheduled to consider the Tax Reform Act of 2005 on November 10, 2005, but the mark-up was postponed.

In the House, H.R. 4297, scheduled for mark-up in the House Ways and Means Committee on November 15, 2005, would extend the sales tax deduction through 2006. H.R. 519 (Representative Brady) would make the sales tax deduction permanent and it also has bi-partisan support with 72 co-sponsors. The

²¹ This definition of an ideal income tax is credited to Haig and Simons, who did much of their research in the 1930s. For more, see Simons, Henry Calvert, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (Chicago, IL: University of Chicago Press, 1938).

²² Note that the benefits received by taxpayers are not included in federal taxable income.

²³ When top federal income tax rates were much higher in the 1970s and 1980s (the top rate was 70% in 1981), it is true that combined with state and local rates of 10% to 15% would create almost confiscatory cumulative income tax rates. The current federal rate structure with much lower rates minimize this effect.

Administration's FY2006 budget proposal does not contain an extension of the sales tax deductibility provision.

President's Advisory Panel on Federal Tax Reform. The tax reform panel has recommended elimination of the deduction for state and local taxes as part of a broader effort to simplify the tax code. The repeal of the deduction would be accompanied by repeal of the alternative minimum tax (AMT), a switch from personal exemptions and a standard deduction to a family credit, and a lower top marginal tax rate. Each of the additional proposals affect the overall impact of state and local deductibility repeal. As outlined earlier in this report, under current law, the deductibility benefits itemizers in high-tax jurisdictions more than non-itemizers in low-tax jurisdictions. Thus, elimination of the deduction would shift the burden from low-income taxpayers to high-income taxpayers, all else held constant.

Elimination of the AMT and a lower top regular income tax rate, however, will benefit primarily high-income taxpayers. The elimination of the 10% bracket amount and the narrower 28% income tax bracket will increase taxes for all taxpayers. Low-income taxpayers will likely encounter a greater increase in relative tax burden (based on taxes as a percentage of income) under the tax reform plan. Thus, on balance, the tax reform panel package of tax code changes, taken together, may not significantly shift the federal tax burden.

The proposed tax reform plan(s) will also have an indirect effect on state and local government finances if implemented. Federal income taxes will not vary based on the residence of the itemizing taxpayer as is currently the case. Some may argue that the "neutral" treatment of all taxpayers, regardless of state and local tax burden, may be inequitable because taxpayers in high-tax jurisdictions have a reduced ability to pay federal income taxes. Alternatively, others argue that the federal income tax should be neutral with regard to state and local taxes. Nevertheless, the use of uniform credits will increase the relative price of state and local government services. High-tax/high-government-service jurisdictions would fare less well than low-tax/low-government-service jurisdictions.