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## REAGAN'S TAX REVOLUTION: ENDING THE FREE RIDE FOR STATE & LOCAL TAXES

### INTRODUCTION

Ronald 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.<sup>1</sup> This deduction has existed since the creation of the federal income tax in 1913. Yet there is a strong case for eliminating it as an integral part of an overall tax reform. Today's deduction for state and local taxes favors the rich over the poor and affluent states over low-income states, and it discourages more efficient methods of financing and delivering state and local services. As such, its elimination is one of the most important provisions in the Reagan tax plan and is central to the attempt to make the U.S. tax system fairer and simpler.

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This is the first of a series on the President's tax reform plan. Future studies will examine the plan's impact on families and the poor, international finance and trade, energy policy and industries, financial institutions, and savings investment and risk-taking. For a brief overview of the plan, see Bruce Bartlett, "Two Cheers for the Reagan Tax Revolution," Heritage Foundation Executive Memo No. 81, May 29, 1985. For an analysis of the President's earlier tax plan, Treasury I, see Grover Norquist, "One Cheer for the Treasury Tax Plan," Heritage Foundation Background No. 397, December 17, 1984.

<sup>1</sup> The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (Washington, D.C.: Government Printing Office, 1985), pp. 62-69; Milton Coleman, "Ending State, Local Deduction Controversial," The Washington Post, May 29, 1985, p. A15; Jacob Javits, "The Treasury's Trojan Horse," The New York Times, May 14, 1985; Editorial, "Guess Who Pays for Tax 'Reform,'" The New York Times, May 26, 1985.

## THE INEQUALITIES OF THE DEDUCTION

Under current law a taxpayer who itemizes is allowed to deduct from his adjusted gross income all income, sales, and property taxes paid to state and local governments. On the other hand, those who do not itemize--approximately two-thirds of all taxpayers--receive no advantage from this deduction.

### A Benefit for the Rich

The benefits of this tax break accrue largely to more wealthy taxpayers, partly because they tend to pay more state and local taxes and partly because each dollar of the deduction is worth more for those in the higher marginal tax brackets. As Table 1 illustrates, those with economic incomes above \$50,000 account for two-thirds of the deduction for state and local taxes.

TABLE 1

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

<u>Income Class</u>	<u>Percent</u>
\$ 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 breaks. In 1970, \$32 billion of these taxes were deducted at the federal level. By 1983 this figure had ballooned to over \$100 billion.<sup>2</sup> The Congressional Budget Office estimates that eliminating deductibility would raise federal revenues by \$176.2 billion between 1986 and 1990, in the absence of any other tax change, assuming there is no impact on economic growth.<sup>3</sup> The

<sup>2</sup> Internal Revenue Service, Statistics of Income Bulletin 4 (Spring 1985), p. 78.

<sup>3</sup> Congressional Budget Office, Reducing the Deficit: Spending and Revenue Options (Washington, D.C.: Government Printing Office, 1985), p. 291.

Treasury Department estimates that eliminating deductibility would raise revenues by \$148.9 billion<sup>4</sup> between 1986 and 1990 if it were part of an overall tax reform proposal that also lowers marginal tax rates. 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 it would be no higher than 35 percent.

### A Break for Rich States

The value of deductibility for taxpayers varies widely between states. It predictably is greatest in those states where taxes are the highest. The Advisory Commission on Intergovernmental Relations (ACIR) estimates the tax savings from deductibility at \$263 per capita for a New York resident, but only \$33 per capita for a Tennessee resident. Table II lists the figures for all states in descending order of the value of the deduction. The biggest benefits go mainly to the richer states in the north-east and the west.

Table II  
Tax Saving from Deductibility of State and Local Taxes  
and Per Capita Income, 1984

<u>State</u>	<u>Total Tax Saving</u> in Millions	<u>Tax Saving Per Capita</u>	<u>Per Capita Income</u> in 198.
New York	\$ 4,729	\$263	\$12,990
Maryland	916	211	12,994
Massachusetts	1,146	195	13,264
California	4,664	185	13,257
Minnesota	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
Connecticut	480	150	14,895
Oregon	389	144	10,740
Colorado	426	137	12,770
Virginia	712	127	12,116
Rhode Island	123	126	11,670
<u>United States</u>	<u>28,480</u>	<u>120</u>	<u>11,658</u>
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
Pennsylvania	1,199	99	11,448
Arizona	274	94	10,656

<sup>4</sup> President's Tax Proposals, op. cit., p. 453.

<u>State</u>	<u>Total Tax Saving in Millions</u>	<u>Tax Saving Per Capita</u>	<u>Per Capita Income in 1983</u>
Vermont	49	93	9,979
Kansas	218	89	12,247
North Carolina	537	88	9,787
Georgia	492	86	10,379
Idaho	82	84	9,555
Ohio	904	82	11,216
Montana	64	78	9,949
South Carolina	253	78	9,187
Missouri	384	76	10,969
Kentucky	280	75	9,397
Maine	87	75	9,847
New Hampshire	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
North Dakota	31	46	11,666
Florida	478	45	11,593
Mississippi	116	45	8,098
Texas	643	41	11,685
West Virginia	79	40	9,159
Wyoming	20	39	11,911
Louisiana	151	34	10,270
South Dakota	23	33	9,847
Tennessee	154	33	9,549

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Source: Advisory Commission on Intergovernmental Relations.

Because the benefits of deductibility vary so widely, the state and local tax deduction in effect forces lower-taxed states to subsidize 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.

#### For Itemizers Only

The deductibility of state and local taxes is also a subsidy from the poor to the rich within each state. This is because deductibility benefits only those who itemize--generally the more wealthy taxpayers. Those who use the standard deduction gain absolutely nothing from the deductibility of state and local taxes. Only 37 percent of all U.S. taxpayers itemize deductions

in their tax returns. The share of itemizers in each state, however, varies from Utah's high of 50 percent to West Virginia's low of 19 percent.<sup>2</sup> University of Michigan economist Edward Gramlich explains in a recent study that user fees and charges, which are generally more efficient methods of raising revenue, are not deductible while less efficient sales and income taxes are. Notes Gramlich: "the deduction...merely represents an unwarranted tax break for the high-income taxpayers who do itemize."<sup>3</sup>

### Homeowners vs. Renters

The deductibility of property taxes biases the tax code against renters and in favor of homeowners. A 1977 Treasury study notes that rents contain a share of property taxes paid by the landlord. Over time, rents will rise dollar-for-dollar with an increase in the property tax. Yet only homeowners and landlords will be relieved of part of this burden by being able to deduct such taxes from their taxable income. Renters will not.<sup>4</sup> And to the extent that homeowners are generally wealthier than renters, this again means that deductibility constitutes a subsidy from the poor to the rich.

This is also true of the deductibility of sales taxes, which must be paid regardless of one's income. Thus the inherent regressivity of sales tax is increased by allowing such taxes to be deducted from taxable income. A dollar's worth of sales tax will cost a dollar to taxpayers who do not itemize or whose income is so low that they pay no taxes. But it will cost someone in the top federal tax bracket only 50 cents under current law. The result: the rich enjoy government services at less cost than the poor. This deductibility, in effect, is income redistribution in reverse.

### THE IMPACT OF STATE AND LOCAL SPENDING

Deductibility of state and local taxes is estimated to increase overall state and local government spending by as much

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<sup>2</sup> Strengthening the Federal Revenue System: Implications for State and Local Taxing and Borrowing (Washington, D.C.: Advisory Commission on Intergovernmental Relations, 1984), pp. 44-45.

<sup>3</sup> 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, California: University of California Press, 1985), p. 50.

<sup>4</sup> Blueprints for Basic Tax Reform (Washington, D.C.: 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, D.C.: Government Printing Office, 1959), vol. 1, p. 414.

as 20.5 percent, according to the Congressional Research Service.<sup>8</sup> The ACIR puts it at only 7 percent--which would still be about \$30 billion in 1983.<sup>9</sup> Most other estimates put the figure at 13 to 14 percent.<sup>10</sup> This means that, without federal deductibility for state and local taxes, state and local spending would be about 14 percent less than it now is and would fall by this amount in the absence of deductibility. It is unlikely, of course, that it would fall immediately, but the relative pressure to raise spending would.

If the nation as a whole benefited from having state and local spending subsidized and encouraged by the federal tax code, there might be some case for keeping the deductibility. Yet, writes Harvard Professor Helen Ladd, 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."<sup>11</sup>

#### HOW THE DEDUCTION BOOSTS STATE AND LOCAL TAXES

Deductibility makes state and local taxes politically easier to impose. As such, it encourages state and local governments to establish progressive income taxes in contrast to flat-rate income taxes. The advantages, notes economist Edward Moscovitch, are:

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.

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<sup>8</sup> 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, D.C.: Government Printing Office, 1983), p. 11.

<sup>9</sup> Strengthening the Federal Revenue System, p. 48.

<sup>10</sup> 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, D.C.: Urban Institute, 1984); Roger H. Gordon and Joel Slemrod, "A General Equilibrium Simulation Study of Subsidies to Municipal Expenditures," Journal of Finance 38, May 1983, pp. 585-594.

<sup>11</sup> Ladd, op. cit., p. 196.

Moscovitch estimates that in 1973 Massachusetts could have saved over \$100 million simply by shifting from a flat-rate income tax schedule to a progressive rate schedule.<sup>12</sup>

Marginal tax rates vary a great deal between states and localities. Several states have no income taxes whatsoever, while rates rise to over 18 percent elsewhere. Deductibility of such taxes from federal taxable income, however, cushions the impact of such tax rates, making it easier for states to impose taxes on those who are politically active but itemize their tax returns. In short, deductibility reduces the progressivity of tax rates--but again, only for those who itemize.<sup>13</sup> Table III illustrates the impact of deductibility and how the President's proposal will affect taxpayers in the top tax bracket among the different states.

Table III  
Highest Marginal Tax Rate by State Under Current Law  
and Reagan Proposal

<u>State</u>	<u>Current Law</u> (Top rate of 50% plus deductibility)	<u>Reagan Proposal</u> (Top rate of 35% and no deductibility)
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
District of Columbia	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

<sup>12</sup> Edward Moscovitch, "State Graduated Taxes--State-Initiated Form of Federal Revenue Sharing," National Tax Journal 25, March 1972, pp. 53-64.

<sup>13</sup> 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.

<u>State</u>	<u>Current Law</u> (Top rate of 50% plus deductibility)	<u>Reagan Proposal</u> (Top rate of 35% and no deductibility)
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

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Source: Calculated from data of the Advisory Commission on Intergovernmental Relations.

Naturally, those states with tax rates substantially above the national average worry that loss of federal tax deductibility will sharpen the differences in tax rates among the states. They know full well from past experience that taxpayers "vote with their feet" and move to states with less tax bite. It thus would become more difficult for states to finance programs of doubtful benefit to their taxpayers by "hiding" the full cost within the federal tax system.

It should be no surprise that states protesting the proposed tax loss of tax deductibility most loudly are mainly those, such as New York, that are high taxers and big spenders. Many of these states have offset the recent decrease in federal subsidies with increased state spending, cushioned by the deductibility of



state taxes, which has meant that the increased taxes have been borne partially by Uncle Sam. Now they fear that they will have to cut back on the spending that is currently subsidized by the federal tax code. And well they may. Loss of deductibility of state and local taxes could trigger the most powerful tax revolt since 1978, the days of Proposition 13 in California. It threatens the political livelihood of spendthrift lawmakers across the nation.

### The Privatization Option

Despite the loud complaints of many state and local politicians, making it more difficult for them to raise taxes does not mean that government cannot carry out its obligations. The main activity of state and local governments, in contrast to the federal government, is to deliver goods and services--police and fire protection, trash collection, education, parks, and similar services. 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 with only 32.9 percent of federal spending. Numerous studies show, however, that it is far less expensive to provide most of these goods and services through the private sector.<sup>14</sup> Municipal and state governments therefore could cut costs dramatically by contracting with private firms to provide a broad array of services. Even now, condominium residents and other citizens' groups shop around for such services as garbage pickup and security and end up paying less for them than if they paid local taxes for the services. But since such private fees are not deductible from federal taxable income, while payments of local taxes are, after-tax cost of private services is often higher to the taxpayer than such services funded by taxes. With the loss of deductibility, therefore, privatization and contracting out of state and local government services are no longer at a disadvantage.

### CONCLUSION

Without the elimination of the deduction for state and local taxes, tax reform is essentially impossible. Without the \$149 billion revenue gain from this provision in the Reagan plan, there simply will not be enough revenue to offset more than a modest reduction in tax rates--perhaps too little to make the exercise worthwhile. Since the state and local deduction mainly benefits Americans with upper incomes, its elimination restores balance among the various income sectors. This balance disappears if state and local deductibility is kept in the tax code. Ironically, therefore, those who battle against eliminating deductibility are effectively against any tax reform--and they wish to retain a deduction that favors the rich.

<sup>14</sup> E. S. Savas, Privatizing the Public Sector (Chatham, New Jersey: Chatham House Publishers, 1982); James T. Bennett and Manuel H. Johnson, Better Government at Half the Price (Ottawa, Illinois: Caroline House Publishers, 1981); Robert Poole, Jr., Cutting Back City Hall (New York: Universe Books, 1980).

To be sure, means may be devised to make the end of the deduction less painful for state and local governments. It might be phased out over a few years to ease the fiscal impact. Or an additional tax bracket could be added between 25 and 35 percent; this would ease the loss of deductibility for the vast majority of itemizers.<sup>15</sup>

Whatever is done to buffer the transition, Congress must remember that deductibility benefits only a relatively small number of taxpayers in a small number of states. Congress must also recognize that the U.S. pays a heavy price in terms of economic efficiency for a tax system riddled with deductions like that for state and local taxes.<sup>16</sup> There is no question that the nation as a whole would be better off without it even if federal tax rates are not reduced.<sup>17</sup> When coupled with rate reductions, the nation gains a cleaner, fairer, more efficient tax system.

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<sup>15</sup> One option that definitely should not be considered is the elimination of deductibility for only selected state and local taxes. This would just cause state and local governments to alter their tax systems toward those taxes that retain deductibility. See Ladd, op. cit., p. 196.

<sup>16</sup> Jacqueline M. Browning, "Estimating the Welfare Cost of Tax Preferences," Public Finance Quarterly 7, April 1979, pp. 199-219.

<sup>17</sup> 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, op. cit., p. 585.