IMPACT OF FEDERAL TAX REFORM ON STATE-LOCAL FINANCES

Thomas R. Dye

State and local governments are vital components of the nation's revenue system. The state and local government sector constitutes a significant share of the GNP—10.5 percent in 1982—and about one-third of all government spending. While state and local governments have only modest responsibilities for the nation's major entitlement programs and national defense, they have the major responsibility for what many Americans consider the most vital functions of government—schools, roads, water and sewers, garbage collection, police, and fire protection. It is self-evident that any major reform of the federal tax system should consider the consequences for state and local government finance.

The specific reform proposals that impinge most directly on state and local government are the elimination of deductions for state and local taxes from the federal personal income tax base, and restrictions on tax exempt state and local government bonds.

The Elimination of Deductions for State and Local Taxes

About 35 percent of the nation's federal individual income taxpayers itemize deductions. Almost all of these "itemizers" claim deductions for state and local taxes (see Table 1). These deductions amounted to $88 billion in 1982, and were the largest of the personal deductions (aside from the personal exemption). In 1982, deductions for state and local taxes exceeded deductions for medical and dental expenses ($22 billion), home mortgage interest ($79 billion), other interest ($43 billion), charitable contributions ($34 billion), and miscellaneous deductions ($19 billion). If state-local tax deductibility were eliminated at present tax rates, the U.S. Treasury would collect an esti-

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TABLE 1

STATE-LOCAL TAX DEDUCTIONS FROM FEDERAL INDIVIDUAL INCOME TAX, 1982

Type of Tax	No. Claiming Deduction (thousands)	Percent of Total Returns	Amount of Deduction ($ billions)
Income	27,260	28.6	43,952
Real Estate	27,994	29.4	27,471
General Sales	31,968	33.6	11,428
Auto Sales	8,419	8.8	2,793
Personal Property	8,560	9.0	1,205
Other	6,823	7.2	1,187
Total	33,080	34.7	88,037

SOURCE: U.S. Department of Treasury (1984a).

mated $30 billion. Persons careless with the English language might refer to these hypothetical revenues as "tax expenditures," or even as "tax subsidies" to state and local government taxpayers.

The effect of the state-local tax deductibility is to lighten the burden of state and local government financing. The burden of these deducted taxes is reduced by the marginal value of the tax against which it is deducted. Consider, for example, a state income tax of 10 percent levied on an individual's income at the highest federal rate of 50 percent. The federal deduction reduces the marginal state tax rate to 5 percent (see Table 2).

The Regressivity of Deductibility: Marginal Rates

Federal deductibility converts a proportional state income tax into a regressive tax. For example, married taxpayers at the lowest federal marginal rate of 11 percent—taxpayers whose taxable income is $3,400 to $5,500—pay 1.78 percent of a proportional state tax of 2 percent. (Indeed, they pay the full 2 percent, if like most federal taxpayers at this lowest rate they do not itemize deductions.) In contrast, married taxpayers at the highest federal marginal rate of 50 percent—taxpayers whose taxable income is $162,400 and over—pay only 1 percent of a proportional state tax of 2 percent (see Table 2).

It is true, of course, that most states have progressive state income taxes. But there are exceptions. Indeed, state income taxes in Illinois, Indiana, Massachusetts, Michigan, and Pennsylvania are proportional. In these states, federal deductibility renders these proportional income taxes highly regressive. In other states, income taxes

TABLE 2

MARGINAL BURDEN OF STATE INCOME TAXES UNDER FEDERAL TAX DEDUCTIBILITY

Marginal Federal Tax Rate	Marginal State Tax Rate				
	2	3	5	7	10
11	1.78	2.67	4.45	6.23	8.90
20	1.60	2.40	4.00	5.60	8.00
30	1.40	2.10	3.50	4.90	7.00
40	1.20	1.80	3.00	4.20	6.00
50	1.00	1.50	2.50	3.50	5.00

are not steeply progressive, and the effect of federal deductibility is to reduce or eliminate the progressivity of these state income taxes.

The regressivity of deductibility is aggravated by the distribution of itemizers. Only 2.7 percent of taxpayers with less than $5,000 in adjusted gross income claim the state-local tax deduction (see Table 3). This percentage rises steadily with income. All of the nation's 8,000 taxpayers with $1 million or more in annual income claim their state-local tax deduction. The average deduction claimed by the small proportion of taxpayers under $5000 who use the deduction is $716. The average deduction claimed by taxpayers with $1 million or more is $155,500. Again the regressivity of the deduction is obvious. However, political support for the continuation of the deduction may extend from the highest brackets well down into the middle class. (Note that over half of all taxpayers with $25,000 or more in adjusted gross income currently use the deduction.)

Interstate Differences in State-Local Tax Burdens

Federal deductibility also narrows interstate differences in net tax burdens, particularly at higher income levels. By decreasing the net price of government goods and services, itemizing taxpayers in high-spending, high-taxing states and communities benefit more from deductibility than those in low-spending, low-taxing states. Deductibility may reduce the incentive for high-income persons to emigrate from high-tax states.

In 1982, the average tax saving per itemized return was $770. But tax savings were $1,292 in New York compared to $257 in Wyoming (Table 4). Elimination of deductibility would cost the average itemizing taxpayer in New York, New Jersey, Massachusetts, and Washington, D.C. over $1,000.

TABLE 3

FEDERAL INDIVIDUAL INCOME TAX RETURNS CLAIMING STATE-LOCAL TAX DEDUCTIONS, 1982

Adjusted Gross Income[a]	Total Number of Returns[b]	Percent Claiming Deduction	Amount of Deductions[c]	Average Deduction per Return Claiming Deduction[d]
Under 5	17,952	2.7	359	716
5–10	17,040	9.4	1,485	922
10–15	14,307	18.9	3,202	1,182
15–20	10,535	30.4	4,653	1,452
20–25	8,803	47.9	7,284	1,726
25–30	7,622	61.6	9,712	2,067
30–40	9,863	77.6	19,759	2,580
40–50	4,717	89.3	13,662	3,241
50–75	3,057	93.8	12,859	4,482
75–100	702	96.2	4,596	6,808
100–200	571	91.2	5,520	9,945
200–500	140	98.5	2,774	20,101
500–1,000	21	95.1	926	46,300
1,000+	8	100.0	1,244	155,500
Total	95,337	34.7	88,037	2,661

[a]In thousands of dollars.
[b]In thousands.
[c]In Millions of dollars.
[d]In dollars.
SOURCE: U.S. Department of Treasury (1984a).

However, in no state do a majority of taxpayers itemize their deductions. This means that taxpaying majorities in every state would not suffer at all from the elimination of deductibility. Nonetheless, the higher-paying citizens who do itemize probably exert disproportional political influence—voting more often, contacting their representatives more frequently, and contributing more money to political campaigns.

If deductibility is viewed as a federal tax subsidy to state and local governments, then it is distributed unevenly, with high-tax states receiving bigger subsidies than low-tax states. This implies that state-local tax burdens in high-tax states are being shifted, via deductibility, to all U.S. taxpayers. Thrifty Wyomians are helping to pay for public extravagance in New York.

TABLE 4

FEDERAL TAX SAVINGS FOR DEDUCTIBILITY PER ITEMIZED RETURN, BY STATE, 1982

	Tax Dollars Saved per Itemized Return	Rank by Savings per Return
Fifteen States with Largest Saving		
California	971	5
Connecticut	853	13
Delaware	912	9
Washington, DC	1,116	2
Hawaii	762	15
Maine	950	6
Maryland	933	7
Massachusetts	1,018	3
Michigan	908	10
Minnesota	872	11
New Jersey	1,012	4
New York	1,292	1
Rhode Island	856	12
Virginia	801	14
Wisconsin	914	8
Fifteen States with Smallest Saving		
Alabama	442	40
Alaska	296	49
Arizona	473	37
Florida	438	41
Indiana	452	39
Louisiana	334	47
Montana	461	38
Nevada	349	46
New Mexico	322	48
North Dakota	423	42
South Dakota	289	50
Tennessee	399	45
Texas	404	44
Washington	422	43
Wyoming	257	51
All States	770	

SOURCE: Advisory Commission on Intergovernmental Relations (ACIR 1984).

The elimination of deductibility should place downward pressure on state and local government taxing and spending, especially in the high-tax states. It is difficult to estimate exactly how much reduction in state and local taxes might be expected from this reform, because we do not know exactly how to estimate the political influence of minority itemizers versus majority nonitemizers. If the nonitemizers prevailed politically, there would be little or no reduction in state-local taxes or services. However, if we assume that itemizers, despite their minority status, prevail politically, then state-local taxing and spending might decline by as much as 14 percent (Ladd 1984; see also ACIR 1984).

The Flat Tax and Restrictions on State and Local Bonds

The tax exempt status of interest from state and local bonds is defended on several grounds: the American federal system requires independent state and local governments whose financial instruments cannot be infringed on by the national government; the tax exemption encourages investment in state and local government and reduces interest rates for these governments; the use of this form of federal "subsidy," while less efficient than direct subsidies, allows state and local governments to decide for themselves about capital investments.

Tax reform may dramatically transform state and local government capital financing and the tax-exempt municipal securities market. There are no proposals before the Congress to tax interest on outstanding municipal bonds, and retroactive taxation would doubtlessly engender constitutional litigation. However, two provisions of the three major tax reform proposals—Kemp-Kasten, Bradley-Gephardt, and Treasury I—deserve serious attention: (1) the reduction of individual income tax rates that may reduce incentives to invest in municipal bonds and force state and local government to pay higher interest rates; and (2) the prohibition of a wide range of "private purpose" tax exempt municipal bonds.

The Modified Flat Tax and Tax-Free Yields

A great deal of speculation has centered on the effect of a modified flat tax on the ratio of tax exempt to taxable yields. If top tax rates decline, taxpayers would have less incentive to buy tax exempt municipal bonds. The yields on new and outstanding municipals would have to increase if they were to retain their attractiveness. This would make it more difficult for states and communities to finance capital improvements.

If an investor's marginal tax rate drops from 50 percent to 35 percent, a 10 percent tax exempt municipal bond's equivalent taxable yield drops from 20 percent to 15.38 percent. Table 5 shows the effect of tax rate changes on equivalent yields.

While a decline in top tax rates theoretically should increase municipal bond yields, this effect may not be very great. First, comparing tax-exempt and taxable investments, bond buyers will still find tax-exempts producing higher real returns. Historically, changes in municipal bond yields resulting from tax rate changes have not been proportional. In 1981 when the top federal tax rate was reduced from 70 percent to 50 percent, municipal yields rose only from 81 percent of taxable Treasury returns to 91 percent.

Municipal yields today are already at historically high levels, leaving little room for major increases. Long-term municipal yields are currently at close to 90 percent of the yields on Treasuries, partly as a result of flat tax concerns, but largely because of heavy municipal supply. At present, an investor in the 15 percent federal tax bracket could do as well in municipals as with taxable Treasuries.

Restrictions on Private Purpose Bonds

Perhaps the most important tax reform proposal for state and local governments is the proposal to eliminate the tax exemption for so-called private purpose bonds, including industrial development revenue bonds, pollution control revenue bonds, owner-occupied and multi-family housing bonds, private hospital bonds, and student loan

TABLE 5

EFFECTS OF PROPOSED CHANGES IN TAX CODE ON TAX EXEMPT VS. TAXABLE GROSS YIELDS

Taxable Income[a]		Marginal Tax Rate	Taxable Equivalent for Municipal Yields of			
			8%	9%	10%	11%
50	Current	38	12.9	14.5	16.1	17.7
	Proposed	25	10.7	12.0	13.3	14.7
75	Current	42	13.8	15.5	17.2	19.0
	Proposed	35	12.3	13.9	15.4	16.9
100	Current	45	14.6	16.4	18.2	20.0
	Proposed	35	12.3	13.9	15.4	16.9
162	Current	50	16.0	18.0	20.0	22.0
	Proposed	35	12.3	13.9	15.4	16.9

[a]In thousands of dollars per joint return.

bonds. These bonds are viewed as an important tool of state and local governments to stimulate economic development, diversify industry, provide employment, help local industry meet federally mandated pollution control requirements, expand housing and medical care facilities, and mitigate the effects of high interest rates.

Municipal bond rates are directly affected by supply and demand conditions in the municipal bond market. Few Americans realize that these private purpose, tax exempt bonds now constitute over 62 percent of the new municipal bond market (see Figure 1). These bonds have mushroomed in the market from $0.8 billion or a minuscule 4 percent of total tax-exempt offerings in 1970 to their present dominant position. Public purpose municipal bonds—revenue bonds for traditional purposes such as sewer, water, and waste treatment, and general obligation bonds for schools, police, fire, etc.—constitute only about 38 percent of the municipal bond market. All three major tax reform proposals would eliminate the tax exempt privilege of future issues of private purpose bonds.

The rationale for their elimination extends beyond the $8–10 billion in new federal revenues that would be realized if the interest on current private purpose bonds were taxable. Critics argue that these bonds do not promote economic growth, divert capital from more efficient uses in the private sector, and contribute to interjurisdictional competition without creating any net gains in employment or productivity.

Removing 62 percent of the supply of new municipal bonds from the market would have a dramatic effect in lowering municipal bond yields. States and communities would be able to fund traditional services at much lower interest costs because of the vastly reduced supply of tax-free instruments in the market. This reduction in supply would more than offset any effects of lower income tax rates.

Tax Reform: A View from the States

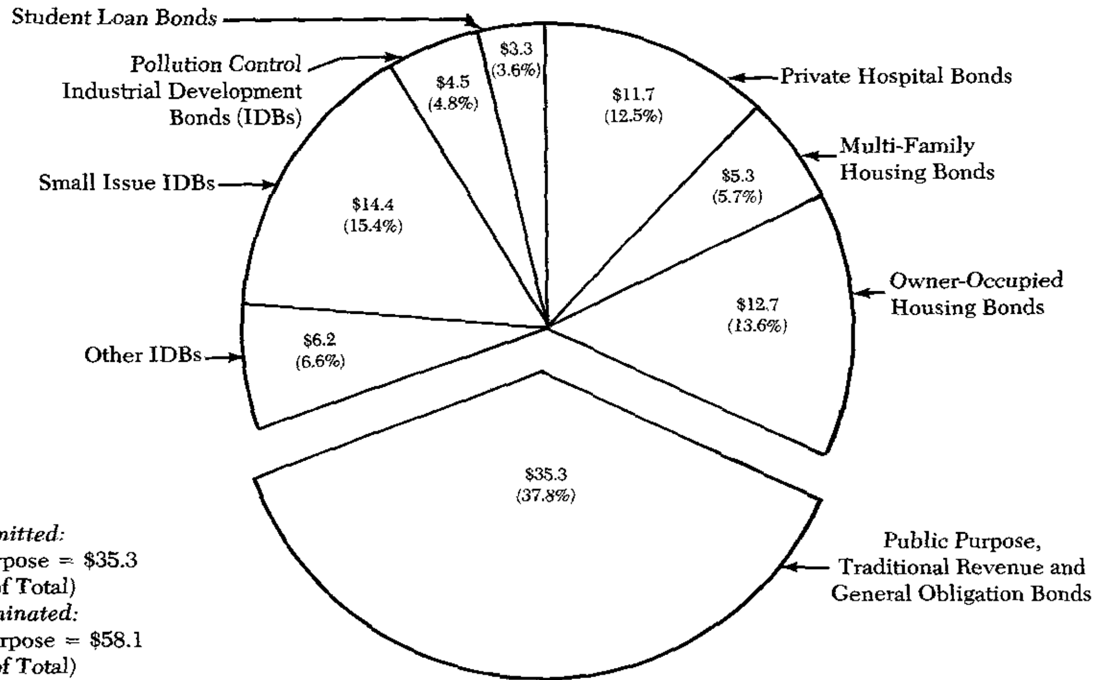
Tax reform is a politically popular idea, as long as it is expressed in generalities. Everyone wants a simple, fair, and efficient federal tax system; one that stimulates economic growth and does not distort market prices. The elimination of the deduction for state and local taxes, and the removal of the tax exemption for private purpose municipal bonds are desirable reforms whether or not general tax reform is achieved.

Eliminating State-Local Tax Deductibility

There are four major arguments for eliminating federal deductibility of state and local taxes:

FIGURE 1

HOW TREASURY PROPOSES TO SHARPLY REDUCE MUNICIPAL BOND SUPPLY
($ Billions)



To be Permitted:
Public Purpose = $35.3
(37.8% of Total)
To be Eliminated:
Private Purpose = $58.1
(62.2% of Total)

1. Federal deductibility reduces the progressivity of state and local tax systems and converts some state tax systems into regressive ones. A common criticism of state and local tax systems is that they are regressive; this simple step by the federal government would go a long way toward ending this criticism.
2. The burden of eliminating federal deductibility will be borne by higher income taxpayers—those who will benefit most from the reduction of the top marginal tax rate from 50 percent to 35 percent. In other words, the elimination of deductibility can be presented politically as closing a loophole which primarily benefits the rich. This may help offset criticism of the flat tax concept as a benefit for the rich.
3. The elimination of deductibility will contribute to the fiscal accountability of state and local governments to their own taxpayers. Doubtless, the elimination of deductibility increases the burdens of state and local taxation. These increased burdens may place downward pressure on state and local taxing and spending. But more important, state and local taxpayers will be able to make an accurate calculation of the costs of public services without indirect federal intervention. User charges and assessments will be encouraged by the elimination of deductibility.
4. The revenue gain to the federal government from the elimination of deductibility will be significant, approximately $30 billion per year. In an era of $200 billion annual federal deficits, it is difficult to argue that state and local government taxpayers really need such a "tax subsidy."

Opposition to the elimination of deductibility can be expected from high income taxpayers in high tax states. This opposition is likely to be informed, active, skilled, and well-positioned to influence policy discussion. The people who will lose most—the high income taxpayer in high tax states—have more reason to inform and activate themselves politically, and by so doing, skew the outcome of the collective choice process in their own favor.

They may be joined by state and local officials throughout the country who understand that federal deductibility reduces the direct costs of their own taxing decisions. It may be too much to ask elected officials to give up a federal tax provision that makes the net additional tax payments less than any proposed increases for many of their citizens. They may think they "deserve a break today," especially when the federal government itself is cutting back on many

direct grants to state and local governments, as well as general revenue sharing.

However, it is important to remember that 65 percent of the nation's taxpayers, and *a majority of taxpayers in every state*, do not itemize deductions. Most taxpayers will be unaffected by the elimination of deductibility.

Elimination of deductibility will certainly aggravate interstate differences in tax burdens, particularly for high income individuals. It might even contribute to migration of individuals and business from high tax states to low tax states. The incentive to migrate would be especially strong among high income taxpayers, unless the high tax states adjusted their tax schedules to discourage such migration. Still another effect might be to discourage the use of income taxes, or at least steeply progressive income taxes, by state governments. Since both federal and state rates would be additive at each income bracket, there would be pressure to reduce the progressivity of state income taxes.

Ending Tax Exemption for Private Purpose Municipal Bonds

Restrictions on tax exempt municipal bonds would also be desirable whether or not general tax reform is achieved. The social value of the municipal bond interest exemption is the incentive it provides for investment in public infrastructure—schools, hospitals, streets, sewers, airports, etc. Certainly the recent estimates of heavy infrastructure investment required in the United States over the next 20 years warn us not to tamper with this important incentive as it affects these basic public needs. We are aware, of course, of the liberal argument that the municipal bond interest exemption is "an ineffective type of subsidy" for public infrastructure, that "the saving in interest payments by state and local government is less than half the revenue loss to the federal government," and that there are "less costly . . . and more equitable ways to assist or subsidize state or local government" (Peckman 1984, p. 119). But those of us with "a bias toward federalism" and a preference for decentralized decision making in a large democracy, will continue to support a type of "subsidy" which minimizes federal involvement.

However, when state and local governments issue tax exempt securities to finance business enterprise, or apartment complexes, or single-family housing developments, they direct capital away from the private market and disadvantage business and developers who do not claim these public subsidies. Abusive examples of so-called industrial development bonds providing low interest capital funds for private firms are numerous. The explosive growth in the volume

of mortgage subsidy bonds and industrial development bonds to well over half of the municipal bond market should itself provide a warning of the potential for abuse in these issues. Elimination of private purpose bonds would have little effect on the nation's net industrial employment or productivity, but it would moderate some interjurisdictional competitive practices.

The removal of tax exemption from these private purpose municipal bonds would reduce significantly the cost of financing traditional public services. In recent years the municipal bond market has been affected more by supply changes than any other factor. Eliminating the tax exemption on new issues of private purpose municipal bonds would reduce the supply of new municipal issues by over half and dramatically reduce yields on the remaining public purpose municipal offerings. This would produce a substantial savings for state and local governments in financing public improvements and encourage the rebuilding of America's infrastructure.

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TAX REFORM: SOUND ECONOMICS OR POWER POLITICS?

Susan B. Hansen

The disciplinary bias of the economics profession is to analyze specific aspects of tax reform proposals. Political scientists, however, are less given to precisely defined models. Instead, many of us suspect that the elegance of a model is inversely proportional to the generality of its results. Further, in the real world of politicians and policymakers, it is frequently necessary to evaluate several competing values or outcomes without the luxury of "holding constant" other confounding factors.

Such is manifestly the case with respect to any reform in the federal income tax which affects the deductibility of state and local taxes. Flat tax reform proposals may suggest benefits such as greater simplicity, increased popular support for the tax code, lower business costs, incentives for human capital investment, or enhancement of the political fortunes of the president or members of Congress. But all such changes have consequences for fiscal federalism and are thus a matter of great concern for state and local governments and taxpayers.

The arguments for and against ending deductibility are summarized by Dye (1985). He also presents evidence as to which states will be the "winners" and "losers" under the proposed provisions. It is interesting to note that deductibility changes several state tax structures from progressive to regressive. Dye then turns to the impact of ending deductibility for interest from "private purpose" municipal bonds. He argues that bond yields would fall and that state and local governments would find it easier to raise capital funds at reduced costs. Dye's paper was written before President Reagan's version of tax reform, termed the "Second American Revolution," was actually introduced.

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Since then, several events have led me to conclude that Dye may have underestimated the political opposition to ending state/local tax deductibility. First, a *Newsweek* survey (10 June 1985) reported that many who do not itemize, and thus do not currently benefit from state/local tax deductibility, nevertheless oppose ending it; the margin was 54 percent to 37 percent. As is often the case, the economic rationale underlying such survey responses is somewhat obscure. Some people may not understand the issue, or they may favor federal aid to state and local governments as a matter of principle. Others may hope to itemize at some future date, or may feel that deductibility is part of the potential value of their property. Regardless of the reasoning (or lack thereof), popular support for ending deductibility appears weak.

Second, people who do itemize or who otherwise favor retaining deductibility, are in a position to exert more political influence than lower income taxpayers who would benefit from ending deductibility. A Massachusetts survey found that 56 percent of voters in the 1980 elections itemized, although only 37 percent of all taxpayers did so (ACIR 1984). Property owners are more likely to favor deductibility and are also more likely to be politically active.

Third, proponents of state/local deductibility are not without influence in Congress. Robert Packwood of Oregon, a state with fairly high and progressive taxes, is chairman of the Senate Finance Committee and has already voiced serious reservations on this point. The vocal protests of New York Democrats such as Governor Cuomo or Senator Moynihan may be written off as partisan politics. But many other senators and representatives from both parties are former mayors, governors, or state legislators, or have close contacts with state/local officials; their protests cannot so easily be dismissed. Also, a number of Republican senators facing reelection are from high-tax states.

Finally, state and local officials, and not just those from high-tax states, have raised strong objections to ending deductibility and to changes in the tax-free status of bonds. The U.S. Conference of Mayors, for example, recently announced its opposition because of concerns for economic development financed by industrial revenue bonds (IDBs). Dye and the flat tax proponents suggest a straightforward distinction between public purpose bonds and private purpose bonds, but in practice the distinction is hard to maintain. Local officials see strong public benefits to financing structures such as airports, hospitals, colleges, and pollution control via IDBs. The issue, of course, is the purpose of government, not just a minor change in the tax code.

Since so many other tax preferences are also politically controversial, I will hazard no guesses at this point as to the likelihood of ending deductibility. It might be fruitful, however, to speculate on possible consequences of *not* ending deductibility. At worst, it could jettison the whole tax reform effort because the revenue loss from this one deduction (estimated at $30 billion in FY 1985) is so large. If deductibility fails, overall tax rates must either increase or the personal exemption must be reduced to avoid a revenue loss. And if one such "tax expenditure" is retained, all the other loopholes are vulnerable. But this may be moot; the president already has backed down on the issue of intangible drilling costs. In short, the whole tax reform effort already has been moved from economics to power politics.

Also, if deductibility is retained, the federal government will remain involved with state/local finance, to the tune of $30 billion yearly in tax subsidies. To many this is a positive benefit, to say nothing of the constitutional issues involved in double taxation. Nevertheless reform efforts merit serious consideration, whether or not they are part of a comprehensive flat tax package. If one favors some form of federal financial assistance to states and localities, surely measures can be found that are less regressive and that do not favor wealthier states. Given the current federal deficit and state/local surplus (over $50 billion in FY 1985), however, it will be difficult to construct any coalition in favor of some new form of revenue sharing, even one targeted at the poorer states.

In conclusion, I must question Dye's expectation that states will be forced to reduce spending if the state/local tax deduction is ended. Similar forecasts were heard in the aftermath of Proposition 13. The experts and the voters, however, underestimated politicians' ingenuity in devising new sources of funds (Hansen 1983). One method was to increase user fees—a tax by any other name. Another was to "reform" state tax systems via what George Will has termed "loophole-closing compliance-inducing revenue enhancers." A third was to increase borrowing—per capita state debt has nearly doubled since Proposition 13 passed. As shown by Dye's thoughtful analysis of the 1981 changes in tax-exempt bond provisions, it should be easier for states and localities to raise funds to finance capital expenditures. In addition, tax revolt sentiment has already led state and local governments to cut costs and improve productivity. Further reductions must therefore come at the expense of service provision in popular areas such as education or recreation. Faced with such choices, voters in several states have rejected further tax cuts; state/local revenue as a percent of GNP has declined only a fraction of a percent since 1978. Even if his proposed flat tax passes, therefore, President Reagan may

have no more success in reducing state/local spending than he has had in cutting the federal budget.

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