REPORT

Proposals to Repeal the Federal Income Tax Deduction for State and Local Taxes

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I. Introduction

On January 7, 2005, President George W. Bush appointed an Advisory Panel on Tax Reform to develop "revenue neutral tax policy options for reforming the Federal Internal Revenue Code." [1] Initially, that panel was required to submit its recommendations to the Treasury Department by July 31, 2005. Recently, the President delayed its submission until September. In an April 4, 2005 speech, Treasury Secretary Snow said that the Treasury Department would develop before the end of 2005 a tax reform plan taking into account the recommendations of the Advisory Panel.

President Bush stated some broad goals in his Executive Order establishing the advisory panel. Those goals include simplification, fairness, and promotion of long-run economic growth and job creation. Press reports citing administration officials have added some details, such as further reduction in tax rates, repeal of the individual and corporate alternative minimum tax (AMT), and exempting all (or virtually all) investment income from tax.[2] Those are ambitious and costly goals which would require equally ambitious offsetting revenue increases if the President wants a tax reform plan that does not further increase Federal budget deficits.

When appointing his tax reform panel, the President indicated that he intends to preserve current law deductions for home mortgage interest and charitable contributions. However, he made no such commitment concerning the deduction for State and local taxes.

The deduction for State and local taxes is the second largest itemized deduction claimed on Federal tax returns; only the home mortgage interest deduction is larger. In 2004, the deduction for State and local taxes

[1] Executive Order Establishing Advisory Panel On Tax Reform, January 7, 2005, available at www.whitehouse.gov.

[2] See "Bush Plans Tax Code Overhaul," Jonathan Weisman and Jeffrey H. Birnbaum, Washington Post, November 18, 2004.

reduced Federal revenue collections by more than $60 billion.[3]

Many commentators expect that the President's Tax Reform Panel will propose repeal of the deduction for State and local taxes.[4] This report examines the history of the deduction, its policy rationale, and the consequences of its repeal.

II. History of the Deduction for State and Local Taxes

The deduction for State and local taxes has been part of the Federal income tax system since its very beginning. The deduction was one of only two deductions specifically provided for in the Income Tax Act of 1861. Every Federal income tax statute enacted since 1861 has continued that deduction, although there have been some restrictions on the types of taxes eligible for the deduction.[5]

Initially the deduction applied to all State and local taxes. The Revenue Act of 1964 limited the deduction to a specific list of taxes, income taxes, property taxes, and retail sales taxes. The major impact of the 1964 Act was to repeal the deduction for "sin taxes" such as taxes on tobacco products and alcoholic beverages. In 1978, motivated by then current energy problems, the Congress repealed the deduction for taxes on gasoline and other motor fuels.

The most significant change in the deduction was made by the Tax Reform Act of 1986. The 1986 Act eliminated the deduction for retail sales taxes. However, the deduction for retail sales taxes was partially restored by the American Jobs Creation Act of 2004 which contained a temporary provision that permits taxpayers to deduct the greater of State and local

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[3] Estimates of Federal Tax Expenditures for Fiscal Years 2005 - 2009, Joint Committee on Taxation, January 12, 2005, pages 42 and 43.

[4] Martin Sullivan, "Tax Reform Blues for the Blue States," Tax Notes, April 11, 2005.

[5] Harvey E. Brazer, "The Deductibility of State and Local Taxes Under the Individual Income Tax, " submitted to the House Committee on Ways and Means, 86th Congress, 1st Session.

income taxes or retail sales taxes. That temporary provision expires at the end of calendar year 2005.

III. Policy Rationale for the Deduction

The deduction for State and local taxes has been such a long-standing and accepted part of our Federal income tax that there was no official legislative history justifying its existence until 1964. The legislative history accompanying the Revenue Act of 1964, for the first time, set forth the Congressional rationale for the deduction.

A. Income Taxes

The legislative history of the Revenue Act of 1964 indicates that the policy rationale for the deduction of State and local income taxes is the most compelling: a combination of Federalism and preventing double taxation.

> "In the case of State and local income taxes, continued deductibility represents an important means of accommodation where both the State and local governments on one hand, and the Federal government on the other hand, tap this same revenue source, in some cases to an important degree. A failure to provide deductions in this case, could mean that the combined burden of State, local and Federal income taxes might be extremely heavy." [6]

The deduction for State and local income taxes is not the only feature of the Federal income tax designed to coordinate with income taxes imposed by other governmental entities. The Federal income tax system also includes the foreign tax credit which reduces the U.S. tax on foreign source income by the amount of income taxes paid on that income to other countries. The foreign tax credit is a dollar for dollar reduction in U.S. tax, a benefit much greater than a deduction. That credit has never been attacked as a subsidy for foreign governments. It is designed to avoid

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[6] Report of the Committee on Ways and Means accompanying the bill, H.R. 8363, September 13, 1963.

double taxation. Similarly, the deduction for State and local income taxes is an accommodation for taxes imposed by State and local governments, a far less generous accommodation than is accorded to income taxes imposed by foreign countries.

One of the principal reasons for adopting and maintaining an income tax is the concept that tax liability should be based on the individual's ability to pay. State and local income taxes are involuntary and are the unavoidable cost of earning the income. The case for their deductibility in an income tax is compelling, particularly since the amount of an individual's liability for State and local income taxes bears no direct relationship to the amount of government services received by the individual.

Repeal of the deduction for State and local income taxes would be equivalent to an increase in Federal marginal tax rates. For example, an individual in a State with a 10% income tax rate who earns an additional $100 would pay tax of $10 to the State. With the Federal deduction for the tax, an individual in the top Federal rate bracket would pay a tax of $31.50 (35% of the individual's net income of $90). Without the deduction, the individual would pay $35 in Federal tax (38.8% of the individual's net income).

President Bush often has argued that his marginal rate reductions would benefit small businesses since many small businesses are organized in a manner where their income is subject to the individual income tax. Those small businesses would face the marginal rate increase described above. However, it is unlikely that the Bush tax reform plan would repeal the deduction enjoyed by taxable corporations for their State and local income tax liabilities. If that is the case, small businesses, but not large corporations, effectively would face marginal rate increases.

B. Real Property Taxes

The Revenue Act of 1964 legislative history justified the continuation of the deduction for real property taxes on the grounds that it is an explicit incentive for home ownership. Denial of the deduction would result in a shift of the Federal tax burden between home owners and non-home owners, a shift that the Congress was unwilling to entertain in 1964.

Repeal of the deduction for State and local real property taxes could have unforseen consequences in the current housing market. It would be an increase in the after-tax cost of owning a home. Recently there have been press reports of increases in interest-only mortgage loans, adjustable rate mortgages, and mortgages with little or no down payments. Those mortgage loans are being used by individuals to meet the increasing cost of housing. The ability to meet those mortgage obligations depends in part on expectations that incomes will increase in the future. Repeal of the deduction for real property taxes could offset the impact of increasing income and could result in more individuals defaulting on their mortgage obligations.

C. *Retail Sales Taxes*

The legislative history behind the Revenue Act of 1964 states that the deduction for State and local retail sales taxes was continued so as to avoid discrimination among States.

There are three major revenue sources for State and local governments: income taxes, property taxes, and retail sales taxes. In 1964, Congress chose to continue the deduction for each of those major revenue sources, because "it is important for the Federal government to remain neutral as to the relative use made of these three forms of State or local revenue sources." [7]

In 1986, Congress rejected the rationale for deductibility of retail sales taxes, when it enacted the Tax Reform Act of 1986 which repealed the deduction for those taxes. The legislative history for the 1986 Reform Act justified repeal on the grounds that retail sales taxes were part of the cost of voluntary purchases of goods and services. Also, the legislative history argued that the amount of the deduction could vary significantly from the

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[7] Report of the Committee on Ways and Means accompanying the bill, H.R. 8363, September 13, 1963.

amount actually paid in taxes since the deduction was determined through tables.[8]

IV. Scope of the Deduction

The deduction for State and local taxes is the second largest itemized deduction claimed by individuals. The largest itemized deduction is the deduction for home mortgage interest. In 2004, the deduction for State and local taxes resulted in an overall Federal tax reduction of approximately $64 billion. In 2004, 46.7 million individuals itemized their deductions on their Federal income tax returns, approximately 50% of all individuals with positive Federal income tax liabilities. Virtually all individuals itemizing their deductions claim a deduction for State and local taxes.[9]

Although virtually all itemizers claim the deduction, there is significant variance in the average size of the deduction among the States (See attached Table 1). Table 1 is based on data for the 2002 taxable year (the most recent year for which data are available).[10] Since that time, Congress restored the deduction for State retail sales taxes. As a result, the differences between States for the 2005 taxable year will be far smaller than the amounts shown in the table.

Many have suggested that the differences between States as to the benefits from the State and local tax deduction are a reflection of differing tax burdens among the States. That is only part of the explanation.

State and local tax burdens (State and local taxes as a percentage of

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[8] General Explanation of the Tax Reform Act of 1986, Joint Committee on Taxation, May 4, 1987.

[9] Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009, Joint Committee on Taxation, January 12, 2005, pages 42 and 43.

[10] Martin Sullivan, "Tax Reform Blues for the Blue States," Tax Notes, April 11, 2005.

the State economy) do not vary as widely as many believe. State and local tax burdens average about 10 percent, and most States have tax burdens very close to the average. All but 13 States have tax burdens that fall between 9% and 11%.[11] There are States, like New York, with above average tax burdens. However, those above average tax burdens in part reflect the fact that the States have large urban areas where there is a greater need for government services. The urban nature of the State, not a conscious decision to have larger government services, may be the largest factor in the above average tax burden.

The difference among States is due to the combination of different tax burdens and different income levels. The combination of those two factors can create above average deductions for State and local taxes even in States with tax burdens not above the national average. Those States also typically pay more in Federal income taxes than their proportionate share of the population (See attached Table 2).

V. Effect of Repeal on Taxpayers

In the context of our current income tax structure, repeal of the deduction for State and local taxes would be a tax increase on 45 million individuals. On average, the size of the tax increase could be over $1,700 (See attached Table 1).

The size of the deduction for State and local taxes is roughly proportional to income. Therefore, you might expect that the tax increases resulting from repeal also would be roughly proportional to income. However, that would not be the case for two reasons.

First, individuals claiming the standard deduction (typically low-and-moderate-income individuals), would not be affected. Also, the individual alternative minimum tax (AMT) will dramatically change the distributional effect.

Under the AMT, the deduction for State and local taxes is not allowed.

[11] From Tax Foundation's *Facts & Figures on Government Finance*, 38th edition, 2004.

That does not mean that all individuals subject to the AMT would not be affected by repeal. Many of those individuals would face tax increases since repeal of the deduction could increase their regular tax liability above the minimum tax. However, individuals currently subject to the AMT would not face the full tax increase that would result from repeal.

In 2005, approximately 70% of families with incomes between $200,000 and $500,000 will be subject to the AMT.[12] If the current temporary increase in the AMT exemption is not extended, the AMT will become the de-facto tax system for most families with incomes over $100,000.[13] Therefore, the largest impact of repeal would be faced by families with incomes below $200,000 ($100,000 if you assume the exemption is not extended).

It is difficult to speculate on the impact of repeal of the deduction for State and local taxes in the context of a tax reform plan. However, if the tax reform plan repeals the AMT and reduces marginal rates, the burden of repealing the deduction for State and local taxes could largely fall on taxpayers with incomes below $100,000. The repeal of the AMT would offset the tax increase from repeal of the deduction for State and local taxes for families with incomes over $100,000. Very high income taxpayers typically are not affected by the AMT, but for them the benefit from the marginal rate decreases from a tax reform could offset the additional taxes resulting from the repeal.

However tax reform is constructed, repeal of the deduction for State and local taxes would be a shift of tax burden to homeowners and to residents of States where that deduction currently is more important. It is worth noting that residents of those States, even with the deduction for State and local taxes, already pay a disproportionate share of overall Federal income taxes.

VI. Effect on State and Local Governments

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[12] Treasury Submission to the President's Advisory Panel on Tax Reform, March 7, 2005.

[13] Present Law and Background Relating to the Individual Alternative Minimum Tax, Staff of the Joint Committee on Taxation, May 20, 2005, page 13.

There are two reasons why repeal of the deduction for State and local taxes is likely to be included in the Bush tax reform plans. The revenue from repeal will be necessary to offset the cost of other aspects of the plans. Also, conservatives argue that the deduction is economically inefficient, a subsidy for greater government services.

In the early1980's, the Reagan Administration originally argued for repeal of the deduction on ideological grounds. The 1984 Treasury Report explained "the current deduction for State and local taxes in effect provides a Federal subsidy for public services provided by State and local governments, such as public education, road construction and repair, and sanitary services." [14] Conservative columnist Bruce Bartlett stated the rationale more clearly, "The whole point of eliminating the deduction is to change government behavior by encouraging State tax cuts, contracting out and the privatization of government services, and the shrinkage of the public sector." [15]

Many may disagree with the goal of shrinking government at the State and local level, but it is clear that repeal of the deduction for State and local taxes would further that goal. Repeal effectively would increase the burden of those taxes. It would make it more difficult for States to finance government services, such as education, law enforcement and transportation. It would create pressure to reduce government spending at the State and local level, at the same time as the Federal government is imposing new mandates on State and local governments and reducing its spending in support of State and local governments.

The Reagan Administration, when it sent its tax reform plan to the Congress in 1984, justified its proposal on grounds of fairness. It changed its public rationale when it recognized that people want government services at the State and local level, and arguing for a proposal on the grounds that it would reduce a subsidy for public education was not viable. Instead, it argued that the deduction unfairly benefitted certain States, ignoring the fact that those States even if with the deduction, typically pay

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[14] Tax Reform for Fairness, Simplicity, and Economic Growth, 1984.

[15] Bruce Bartlett, "The State and Local Deduction," November 2, 2004, Townhall.com.

more than their proportionate share of overall Federal taxes.

VII. Conclusion

On July 17,1985, former New York State Governor, Mario Cuomo, testified before the Committee on Ways and Means in opposition to the Reagan proposal to repeal the deduction for State and local taxes. He began with the story of President Lincoln being presented with a book proposing reforms to the Constitution. Lincoln responded, what you have written is in part both original and good. Unfortunately, the parts that are good are not original and the parts that are original are no good.[16]

The reasons the Reagan proposal was rejected in 1986 remain valid today. The Federal deduction for State and local taxes is an important part of our Federal system of government. It is consistent with a tax system based on ability to pay. One thing has changed. Today, such a proposal is no longer original.

[16] Hearings before the Committee on Ways and Means, House of Representatives, 99th Congress, First Session.

Table 1
The Federal Income Tax Deduction for State and Local Taxes, by State, 2002

	Jurisdiction	Deduction for State and Local Taxes as % of AGI of All Taxpayers	Tax Benefit of Deduction, Per Deducting Taxpayer	Tax Benefit of Deduction, Per Capita	Total Deduction for State and Local Taxes (billions)
1	New York	8.2%	$2,774	$484	$37.1
2	New Jersey	7.5	2,501	530	18.2
3	Oregon	7.2	1,805	340	4.8
4	Maryland	7.2	1,986	461	10.0
5	Connecticut	7.0	2,606	547	7.6
6	Wisconsin	6.9	1,923	359	7.8
7	California	6.8	2,221	374	52.3
8	District of Columbia	6.7	2,309	457	1.0
9	Rhode Island	6.7	2,065	359	1.5
10	Massachusetts	6.2	2,164	420	10.8
11	Maine	6.0	1,825	278	1.4
12	Minnesota	5.9	1,701	341	6.9
13	Ohio	5.8	1,680	284	13.0
14	North Carolina	5.6	1,563	256	8.5
15	Vermont	5.5	1,731	274	0.7
16	Virginia	5.3	1,666	316	9.2
17	Georgia	5.2	1,490	250	8.5
18	Utah	5.1	1,272	219	2.0
	United States	**5.1**	**1,701**	**268**	**308.7**
19	Michigan	5.1	1525	262	10.5
20	Nebraska	5.1	1648	236	1.6
21	Kentucky	5.0	1507	205	3.4
22	Montana	5.0	1324	200	0.7
23	Idaho	5.0	1284	200	1.1
24	South Carolina	4.9	1407	205	3.4

25	Pennsylvania	4.8	1637	250	12.3
26	Iowa	4.7	1429	213	2.5
27	Illinois	4.7	1619	268	13.5
28	Kansas	4.7	1558	223	2.4
29	Missouri	4.5	1442	209	4.7
30	Colorado	4.5	1323	258	4.6
31	New Hampshire	4.4	1532	274	1.4
32	Hawaii	4.3	1325	211	1.0
33	Arizona	4.3	1204	192	4.2
34	Oklahoma	4.3	1283	168	2.3
35	Delaware	4.3	1373	246	0.8
36	Indiana	4.1	1298	194	4.8
37	New Mexico	3.9	1269	150	1.1
38	Arkansas	3.4	1221	126	1.4
39	Alabama	2.9	906	118	2.1
40	West Virginia	2.9	1331	104	0.8
41	Mississippi	2.8	992	94	1.1
42	North Dakota	2.4	1118	104	0.3
43	Florida	2.3	927	118	7.9
44	Washington	2.3	816	129	3.1
45	Texas	2.2	1072	100	8.7
46	Nevada	2.2	726	120	1.0
47	Louisiana	2.1	881	80	1.4
48	Alaska	1.6	716	92	0.2
49	Wyoming	1.3	690	67	0.1
50	South Dakota	1.3	695	53	0.2
51	Tennessee	1.2	540	53	1.2

Sources: Calculations by author assuming a marginal 25 percent federal tax rate and using federal tax return data from the IRS, "Individual Tax Statistics — State Income for 2002 through 2004," at http://www.irs.gov/taxstats; population data are from the U.S. Bureau of Census (http://www.census.gov); and data on the electoral college are from the Federal Election Commission (http://www.fec.gov).

News and Analysis, *Tax Notes*, April 11, 2005.

Table 2
STATES AFFECTED BY DEDUCTIBILITY OF STATE AND LOCAL TAXES

State	Tax Benefit of Deduction, Per Deducting Taxpayer	% of Federal Income Taxes Paid	% of Total Individual Taxpayers
New York	$2,774	8.7	6.58
Connecticut	2,606	2.3	1.27
New Jersey	2,501	4.6	3.11
California	2,221	13.2	11.53
Massachusetts	2,164	3.3	2.35
Rhode Island	2,065	0.4	0.38
Maryland	1,986	2.3	1.98
Wisconsin	1,923	1.7	1.98
Maine	1,825	0.3	0.47
Oregon	1,805	0.9	1.2
Minnesota	1,701	1.9	1.82
Ohio	1,680	3.4	4.19
Pennsylvannia	1,637	4.1	4.42
Illinois	1,619	5.1	4.38
Michigan	1,525	3.2	3.48
Total %		55.4	49.14

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