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Rising State and Local Tax Burden Crowds Federal Tax Policy

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Federal and total tax collections in the United States are at an all-time high in nominal terms and are rising steadily, and federal receipts as a share of gross domestic product (GDP) are again above the post-war average. At the same time, state and local tax receipts are also rising as a share of GDP toward their all-time high. Against this backdrop, many Members of Congress are looking to raise taxes even higher to fund a wide ranging expansion in federal spending, but they may be in for a surprise. The sustained rise in the state and local tax share is likely to stiffen public resistance to higher federal taxes.

The Threat to Raise Federal Taxes. Congressional Democrats have repeatedly signaled their desire to raise federal taxes. The Budget Resolution passed earlier this year is laced with tax increases, both explicit and potential. For example, the Budget Resolution makes no room for an extension of the AMT "patch," which expired at the end of 2006. If the patch is not extended, then Congress will have imposed a huge tax hike. Failure to act is no excuse.

Even if the AMT patch is extended, the omission from the Budget Resolution means that either the extension must garner a supermajority of votes in the Senate and House or it must be paid for by raising taxes on other taxpayers. Whether the patch is allowed to expire or is extended by raising taxes on other taxpayers, the result remains the same: a huge tax hike.

Similarly, the Budget Resolution makes no provision for an extension of the 2001 and 2003 tax cuts. Nor does it include an extension of other popular tax provisions that will expire, such as the research and development tax credit. In addition, the Budget Resolution includes "reserve funds" that permit new spending if the additional spending is matched by additional tax revenues. These reserve funds explicitly advertise Congress's intention to tax and spend.

Some Members are even eyeing additional opportunities to raises taxes beyond the tax hikes in the Budget Resolution. For example, proposals to extend and expand the State Child Health Insurance Program include large tax increases. The pending energy bill and farm bill are also likely candidates to carry tax hikes.

Taxes Are Already High. With the exceptional rise and fall and rise of tax receipts over the last decade, it is important to consider Congress's threats to raise taxes in context. The starting point is current receipts: Fiscal Year 2007 federal tax receipts are expected to reach an all-time high of about $2.6 trillion, up about $200 billion from 2006.

One way to put taxes in economic and historical context is to express receipts as a share of the economy as measured by GDP. As Chart 1 shows, in 2000 the federal tax-to-GDP ratio, or federal tax share, hit 20.9 percent, tying the previous record set

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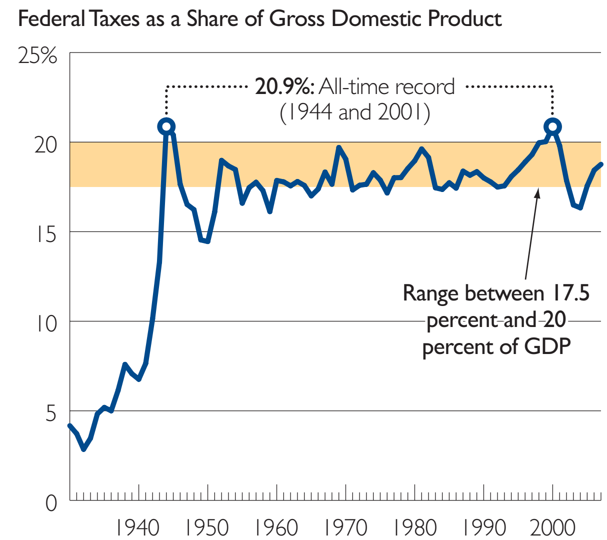
during the peak of World War II. The tax share dipped to 16.3 percent of GDP in 2004 following the recession at the start of this decade and the 2001 and 2003 tax cuts.

Since 2004, strong economic growth has propelled the tax share upward. In August, the Congressional Budget Office projected the 2007 tax share to hit 18.8 percent.[1] This is well above the 40-year average of 18.3 percent. Expressed another way, taxes would have to be cut by almost $70 billion in 2007 to move the tax share back to its historic level.

The fact that the tax share is above its post-war average does not indicate taxes are too high, too low, or just right. It does mean, though, that after all the economic and tax policy changes of recent years, the federal government in 2007 is receiving a somewhat greater tax share than usual. This leads to an important conclusion: The tax cuts enacted earlier in this decade did not drain the federal treasury to unusually low levels, as some have suggested, but, rather, had the effect of moving the level of taxation toward its modern norm.

Chart 1 WM1628

The Federal Tax Share Over Time



Source: U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts.

The ratio of taxes to GDP is a convenient and intuitive benchmark for assessing the level of federal taxes, but it provides only a partial measure of the total economic burden because it does not account for the costs of administering and complying with the tax system. The Internal Revenue Service's 2007 budget is just over $10 billion.[2] According to the President's Advisory Panel on Federal Tax Reform, compliance costs associated with the federal income tax alone "are conservatively estimated to be approximately $140 billion per year." [3] Compliance costs for the entire federal tax system approach 10 percent of revenues, or about $250 billion in 2007, according to a report by the President's Council of Economic Advisers.[4]

The ratio of taxes to GDP also does not account for the loss of economic output and income associated with taxation. The federal tax system distorts the level and allocation of resources employed in the economy. For example, the individual and corporate income taxes combine to reduce significantly the total amount of capital that can be profitably employed, thereby reducing the level of investment, but also productivity and wages. Further, by taxing some activities more than others, the tax system distorts the allocation of capital and labor, thereby reducing the total amount of output produced by these resources and reducing the benefits received from the output produced. In total, the distortions in the economy created by the federal tax system

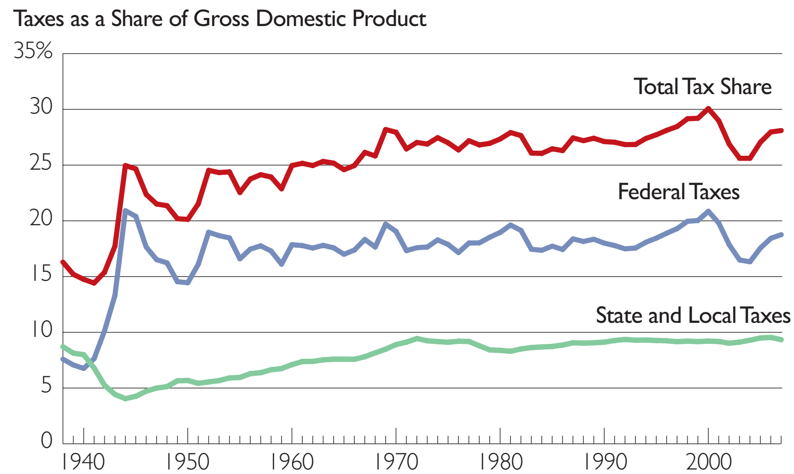
1. Congressional Budget Office, "The Budget and Economic Outlook: An Update," August 2007, at *www.cbo.gov/ftpdoc.cfm?index=8565&type=1*.
2. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2008* (Washington, D.C.: U.S. Government Printing Office, 2007).
3. President's Advisory Panel on Federal Tax Reform, *Final Report of the President's Advisory Panel on Federal Tax Reform* (Washington, D.C.: U.S. Government Printing Office, 2005), at *www.taxreformpanel.gov/final-report/*.
4. Council of Economic Advisers, *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, 2005), at *www.gpoaccess.gov/eop/2005/2005_erp.pdf*.

cost perhaps hundreds of billions of dollars in lost output and income annually.

Some Consequences of a Rising State and Local Tax Share. In contrast to the federal tax share, which has tended to remain in a remarkably narrow band between 17.5 percent and 20 percent in the post-war period, the state and local tax share has risen steadily. The state and local tax share grew rapidly in the 1960s, from 7.1 percent in 1960 to 8.9 percent in 1970. Over the next 30 years, it rose a modest 0.1 percentage point each decade. Over the last three years, however, the state and local tax share has risen at a much faster clip, gaining 0.3 percentage point. That is, the state and local tax share has risen as much in the past three years as it did in the prior three decades.

Chart 2 WM1628

The Rise of the State and Local Tax Burden



Source: U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts.

The total tax share—the combination of federal, state, and local taxes—hit an all-time high of 30.1 percent in 2000, driven primarily by soaring federal tax collections. This historically high share likely contributed significantly to the nation's appetite for tax relief in 2001 and 2003. After declining in the early part of the decade, the total tax share is now rising again. It hit 27.9 percent in 2006, 0.6 percentage points above the historical average and 0.1 percentage point above the average for the 1990s. The recent rise in the total tax share is due to the recovery of federal tax receipts following the recession and an acceleration in the rate of increase in state and local tax receipts.

The steady increase in the state and local tax share has important implications for the economy, for the taxpayer, and for the federal government. The remarkable stability of the total tax share over the past almost 40 years suggests an inherent limit in Americans' tolerance to taxes. There is no apparent economic or political explanation for this postwar limit, nor is there any certainty it will remain unchanged. But if it does remain steady or falls, the continued rise in the state and local tax share will put increasing pressure on the federal government not only to forego tax increases but also to provide increasing amounts of tax relief.

In short, state and local governments may be crowding out the federal government's tax share. If so, this trend will not be easy to halt or reverse at the federal level because it results from the individual policy decisions of the 50 state governments and thousands of local governments.

While this development would be good news for supporters of limited federal government, it is a mixed blessing because it suggests that whatever gains may be achieved in terms of reduced federal taxation will be offset by rising state and local taxation. Efforts to lower taxes and encourage economic growth through pro-growth policies will increasingly need to focus on state and local governments.

Conclusion. The federal tax share is again above the modern historic average where, absent additional tax relief, it will remain even with a permanent AMT patch and permanent extension of the 2001 and 2003 tax cuts. The historic average should be regarded as a ceiling, not a floor, and so Congress should devote its energies to effective, substantive, pro-growth tax relief and forego any of the net tax hikes under consideration.

The steady increase in state and local tax share is likely shifting the fiscal landscape in America. In particular, pressure on Congress to reduce federal taxes is likely to grow as American taxpayers react to the pinch of rising state and local tax burdens. In this way, state and local governments may be crowding out opportunities for federal-level tax hikes. Unless American taxpayers become markedly less resistant to higher taxes, the federal government may find itself under increasing and sustained pressure to reduce taxes.

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