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State and Local Tax Hikes Add to Federal Tax Relief Pressures

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Federal tax policy is not made in a vacuum. Small policy changes reflect current political winds. Congress enacts larger policy changes in reaction to broader budgetary or economic developments. More fundamental changes occur when theoretical perspectives and national views realign along key policy fault lines. And all the while, state and local tax policy developments provide often ignored context for the evolution of federal policy.

In the post-World War II era, the federal government has played the preeminent role in the evolution of tax policy. Yet in some respects, changes in tax policy at the state and local level have been every bit as dramatic as those at the federal, perhaps never more so than today with the growing appetites of state and local governments for tax revenue. Consequently, to the extent that the American people have a limited tolerance for taxation, federal policymakers will face new pressures to restrain and even reduce federal tax burdens.

Federal policymakers should also be cognizant of the fact that state governments receive significant amounts of federal funding through grant programs and other payments. Whether by intent or not, in important respects the federal government has become a major auxiliary revenue source in support of state and local spending. To pay for tax relief and higher-priority spending at the federal level, policymakers should acknowledge the rising state and local taxes by paring back federal grants to the states.

The Continuing Rise of State and Local Taxes. The national media and Washington-based analysts naturally focus most of their fiscal policy attention on the federal government's tax and spending habits due to its size and scope. Yet together, state and local governments collected $1.258 trillion in taxes in 2006,[1] more than half the amount collected by the federal government that year. With such a large fiscal footprint, state and local tax policies have a significant influence on the long-term strength of the American economy as well as on the pocketbooks of American taxpayers.

The federal government's tax share is expected to reach about 18.8 percent of gross domestic product (GDP) in 2007, somewhat above the 40-year historical average of 18.3 percent and well within the band of between 17.5 percent and 20 percent representing the post-war norm.[2] In contrast, state and local governments have steadily increased their collective tax share over this period. The state and local tax share rose from 5.7 percent of GDP in 1950 to 9.4 percent in 1972—an increase of almost two-thirds. The state and local tax share fell for some years and then resumed its steady rise to hit a

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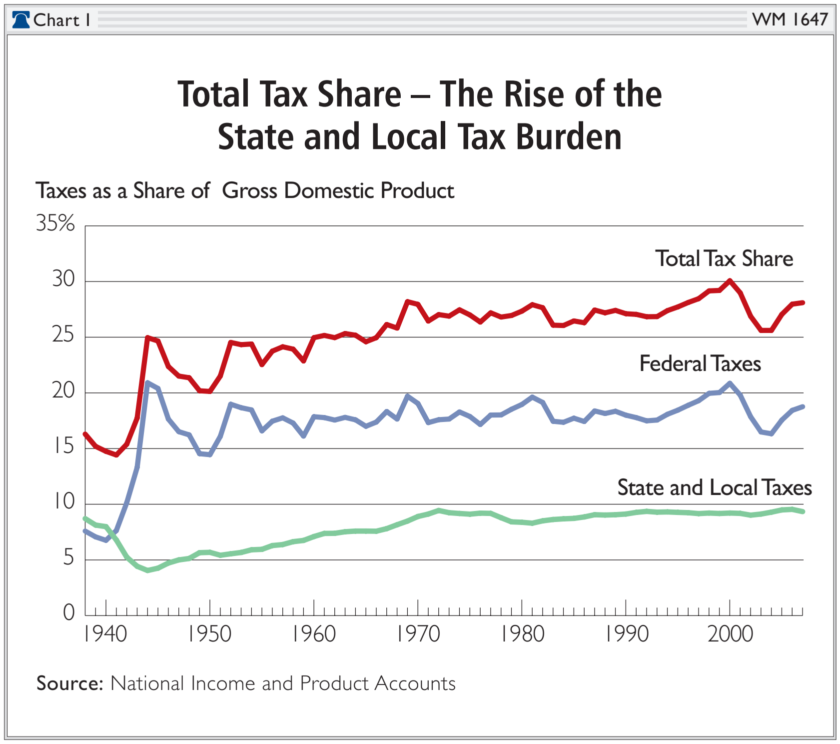
new all-time high of 9.5 percent in 2006. (It is important to note in making these comparisons that the figures are free of inflationary effects because inflation is captured in both the level of tax collections and the level of GDP.)

The tax share calculation is a useful means of presenting information on tax levels because it helps to relate tax levels to the level of income from which taxes are extracted. In important ways, however, the tax share calculation can give a misleading impression. The tax share does not measure the weight of the tax burden on the individual taxpayers who pay the taxes. An alternative measure called the American taxpayer burden shows the level and change in the tax burden on a per capita basis after adjusting for inflation.[3]



The per capita taxpayer burden of state and local taxes has been rising rapidly throughout the post-war period even after adjusting for inflation. In 1950, state and local governments collected $755 per taxpayer when measured in 2006 dollars. The taxpayer burden peaked temporarily in 1972, at which time it had risen to $2,243—a three-fold increase in just 22 years. The state and local taxpayer burden rose slowly through the end of the last century, but thereafter its rise accelerated. By 2006, the real per capita taxpayer burden reached $4,203—another 17 percent increase in just 7 years.

The combination of rising federal, state, and local tax burdens means the American taxpayer is facing an unprecedented level of taxation. In 2006, the total taxpayer burden hit a new high of $12,401, surpassing by $689 the previous record set in 2005. The combined real tax burden has been increasing at an average rate of 2.2 percent per year over the past 40 years.

Implications of Rising Total Tax Burdens for Federal Tax Policy. The steady increase in the federal, state, and local tax burden on a real per capita basis helps to answer one question while it raises others. It may explain why American taxpayers report being under increasing financial strain despite the significant tax relief enacted in 2001 and 2003 and despite a strong economy that is creating new jobs, raising real wages, and creating new wealth. The federal tax share suggests to some observers that taxes are not part of the problem. However, the per capita total tax share shows that taxes are rising rapidly. Rising taxes are almost certainly a major contributor to the financial strain being felt by many Americans.

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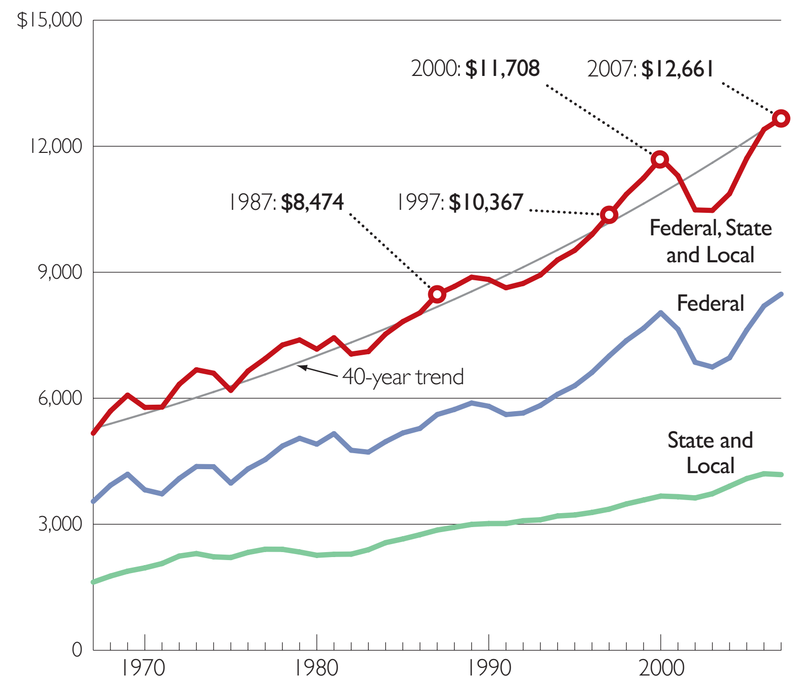
1. Figure reflects receipts collected by state and local entities and does not include federal transfers. National Income and Product Accounts, Table 3.1, Bureau of Economic Analysis, Department of Commerce.
2. For a discussion of the federal and total national tax share, see JD Foster, Ph.D., "Rising State and Local Tax Burden Crowds Federal Tax Policy," Heritage Foundation *WebMemo* No. 1628, September 21, 2007, at *www.heritage.org/Research/Taxes/wm1628.cfm.*
3. For a discussion of the rising per capita federal tax burden, see JD Foster, Ph.D., "Taxpayers, Beware: Record Tax Burden Is Rising," Heritage Foundation *WebMemo* No. 1639, September 26, 2007, at *www.heritage.org/Research/Taxes/wm1639.cfm.*

The increasing tax burden also raises important questions. One such question is the extent to which state and local tax policies are adding to the economic distortions arising from federal tax policy, thereby diminishing job growth, wage growth, and American international competitiveness. State and local governments levy their own individual income taxes, corporate income taxes, gross receipts taxes, property taxes, and taxes on productive capital—all of which diminish economic performance.

Another question is whether and when taxpayers will reach a point of deep resistance toward the taxes being collected and the governments levying those taxes. The recent surges in both federal taxes and state and local taxes have likely set the stage for a taxpayer backlash. One consequence is likely to be a heightened tension between the levels of government as they seek to preserve their own tax bases.

Chart 2 WM 1647

U.S. Real Per Capita Tax Burden



Source: National Income and Product Accounts, U.S. Census Bureau

In the intergovernmental contest for tax receipts, it may be easier to achieve significant tax relief at the federal level than through 50 state governments and thousands of local governments. On the other hand, individual state and local governments may prove more responsive to taxpayer demands for relief. In this regard, the steady upward trend in the state and local tax share as compared to the relatively flat trend in federal taxes may be telling. State and local governments are often considered to be more responsive to citizens' demands. For example, those jurisdictions that have experienced especially rapid tax receipts growth due to rapidly rising property taxes may be forced to lower property tax rates. In other jurisdictions, citizens may well decide the services they are receiving for their higher state and local taxes are more valuable than what they are receiving from the federal government.

The contest over revenues also means federal policymakers will need to reconsider their spending priorities in the years ahead. In particular, the federal government sends enormous sums to the states each year. The Office of Management and Budget projects that the federal government will send $372 billion to the states in 2008, of which the largest portion will be $207 billion for Medicaid.[4] The balance of these grants will help states pay for scores of programs in education, agriculture, homeland security, transportation, and other areas. In light of the states' own rapidly rising tax levels, these state grants should be on the table as federal policymakers seek offsets for either federal tax relief or increased spending in other areas.

Conclusion. Federal tax policy is the product of numerous competing forces. One factor often over-

4. See "Aid to State and Local Governments," Chapter 8, Analytical Perspectives, Budget of the United States Government, 2007.

looked is the steady increase in state and local taxes. Whether measured in nominal terms, as a share of the economy, or on a per capita basis, federal taxes are rising rapidly. Combined with steadily increasing state and local tax burdens, the resulting pressure on family finances increases the likelihood of a taxpayer backlash. It remains to be seen whether the backlash will be directed primarily at federal taxes, state and local tax levels, or all of the above. To make room for tax relief at the federal level, and given that the source of much of the pressure is the rise in state and local taxes, federal policymakers should look carefully at cutting back on grants to the states.

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