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TAX REFORM'S NEXT STEP: END STATE AND LOCAL TAX DEDUCTIONS AND BOOST THE PERSONAL EXEMPTION

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INTRODUCTION

As Ronald Reagan said in his message to Congress last week, tax reform took a giant stride in 1986, but the need for reform is far from over. He called for a cut in the capital gains tax rate to spur investment, as indeed it would. As important a reform would be to increase the personal exemption for the federal income tax from today's $2,000 to $3,000. To pay for this, the tax deduction for state and local taxes should be eliminated. This combination of changes would benefit millions of low-income Americans, help bolster the American family, and lead to lower state and local taxes.

Although the 1986 tax reform legislation increased the personal exemption to $2000 from $1,080, it is still well below its real value four decades ago; the $600 personal exemption of the 1940s would have to be $6,000 today to exempt the same proportion of income. Making matters worse, the huge hike in Social Security payroll taxes over the years has shifted more of the federal tax burden toward families and lower-income workers.

Favoring Big Spenders. The 1986 tax reform legislation also abolished the deduction for state sales taxes. But it retained deductions for state and local income and property taxes, which primarily benefit upper-income taxpayers. These deductions also favor high tax, big spending states at the expense of residents of such states as Mississippi, Alabama, and Idaho, which have kept taxes and spending under control. In particular, these deductions hurt residents of states such as Florida, Texas, and New Hampshire, which have little or no income tax and rely heavily on sales taxes. Moreover, by allowing deductions for one form of state tax rather than another, federal tax law now arbitrarily interferes with state tax strategies, favoring some revenue sources over others.

The deductions also encourage higher state and local taxes and spending since the cost of the taxes is offset in part by the federal write-off. At the same time, the deductions discourage state and local privatization, since taxes paid for services to state and local governments are deductible, while payments to private providers of the same services are not. Thus the federal tax code artificially lowers the relative cost of publicly provided services.

Dividends from a $3,000 Exemption. Raising the personal exemption for taxpayers and their dependents to $3,000 per person and eliminating federal income tax deductions for state and local income and property taxes thus would eliminate benefits primarily for upper-income Americans and add benefits primarily for lower-income workers and families with children. The federal tax code's bias against frugal states would be ended, as would the bias against states that rely more heavily on sales tax than on income tax. The federal tax system would become neutral as to the choice of revenue sources by state and local governments.

If the deductions were eliminated, moreover, voters could press state and local governments to reduce taxes and unnecessary spending, as the federal deductions would no longer offset part of the cost of the state and local taxes. And privatization might become even more widespread, helping to cut wasteful spending. Equitable and efficient user fees also would be more widespread.

HOW THE EROSION OF THE PERSONAL EXEMPTION HURTS AMERICANS

The 1986 tax reform legislation increased the personal exemption from $1,080 in 1986, to $1,950 in 1988, and $2,000 in 1989. This will be especially beneficial to families that receive an exemption for each child. It also will benefit lower-income taxpayers, who will be able to keep a larger proportion of their family income after taxes.

Not only has inflation reduced the real value of the personal exemption enormously, the Social Security payroll tax, which has no personal exemption to protect families, has soared since the 1940s. The maximum annual payroll tax for a worker, including the employee and employer shares (both of which ultimately are borne by the worker), has climbed from $60 in 1949 to $6,759 today. The payroll tax has climbed from just 4.4 percent of total federal taxes in 1949 to 33 percent today. As this payroll tax, without personal exemptions, has grown to a larger proportion of total federal revenues, the relative proportion of total federal taxes borne by families with children has increased.

Hitting Lower-Income Workers. The same tax trends have increased the relative federal tax burden on lower and moderate-income workers. If the personal exemption had maintained its value since the 1940s, millions of these workers would be completely exempt from federal income tax, and those paying taxes would have a much higher proportion of their income available after taxes.

The soaring Social Security payroll tax, with no personal exemption to protect lower-income workers, similarly has increased the relative tax burden on these workers. The total payroll tax rate has increased from 2 percent in the 1940s to 15.02 percent today. Thanks to these skyrocketing rates, total effective federal tax rates on lower-income workers are higher today than they were in 1977, despite the 1981 tax cuts and the 1986 tax reform.[1]

THE UNFAIR DEDUCTIONS FOR STATE AND LOCAL TAXES

The 1986 tax reform abolished the deduction for state and local sales taxes, but retained the much larger deductions for state and local income taxes and property taxes.

These remaining deductions benefit primarily upper-income taxpayers for two reasons. First, about two-thirds of taxpayers under the new tax law will not itemize deductions, since their accumulated deductions will not exceed the applicable standard deductions ($5,000 for married couples in 1988). These taxpayers consequently cannot take the deductions for state and local taxes. The vast majority of these non-itemizers are average and lower-income earners. Second, upper-income American taxpayers are in higher federal income tax brackets. Thus the same deduction reduces their federal tax burden more than it does that of a moderate income in a lower federal tax bracket.

Subsidizing High-Tax States. The benefits to Americans of these deductions also vary widely among the states. High tax, big spending states benefit the most, since their residents have more state and local taxes to deduct on their federal tax returns. But residents of states that have kept taxes and spending under control receive much less benefit from the federal deductions, since they have lower state and local taxes to deduct. Even more galling to residents of low tax states is that they have to pay higher federal taxes to help the Treasury offset the heavy revenue loss from the deductions of state and local taxes in the high tax states. In Fiscal Year 1988, the loss to the federal government of this deduction will be an estimated $22.8 billion.[2] Residents of low tax states thus are forced to subsidize residents of high tax states, especially the upper-income taxpayers of those states.

Rather than reducing this inequity, the 1986 tax law increased it by eliminating the deduction for state sales taxes while retaining the deductions for state income and property taxes. Hence, federal tax law now discriminates even more harshly against states that have little or no income taxes and rely heavily on sales taxes for their revenues. Among these are Florida, Texas, and New Hampshire, where

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1. Congressional Budget Office, *The Changing Distribution of Federal Taxes: 1975-1990*, Washington, D.C., October 1987.

2. Office of Management and Budget, *Special Analyses, Budget of the United States Government*, Washington, D.C., January 1987, Table G-2.

residents receive relatively little benefit from the retention of deductions for state and local taxes, yet now cannot deduct sales taxes. By allowing deductions for some major state and local taxes but not others, the federal government arbitrarily interferes in state and local tax structures. Over time, states will tend to shift more toward the deductible taxes and away from the nondeductible taxes, even when that is less efficient.

BOOSTING OVERSPENDING WHILE HAMPERING PRIVATIZATION

The deductions spur overspending by state and local government. The reason: state and local governments can get away with increased taxes since the cost is offset in part by the federal deduction. Because part of the true costs are hidden by these deductions, state and local governments find it easier to increase taxes and spending, even when the costs actually exceed the benefits. Numerous studies indicate that the federal deductions have increased state and local taxes and spending by 10 to 20 percent.[3]

In contrast, the federal deductions discourage privatization at the state and local level. Taxes paid to finance services provided by state and local governments are deductible, while payments made by individuals to private sector firms for the same services are not. Example: a federal taxpayer can deduct the full amount of property taxes paid to a city or county government to finance garbage collection services provided by a city. But if those garbage services were paid for directly by the householder to the private sector providers, the taxpayer could not deduct the fees paid directly to the companies. Numerous studies establish that privatization regularly reduces the costs of state and local services by as much as 50 percent.[4]

Equitable User Fees. The deductions for state and local taxes similarly discourage user fees, which are charges to the users of a government service. Fees might be charged for travel on a bridge, for example. Such user fees often are the most equitable means of financing a government service because the cost of the service is borne by those who benefit from it. Such fees also promote efficiency, since the user bearing the cost directly tends to explore less expensive alternatives and refrains from overusing the service. But state and local governments are discouraged from adopting such fees in place of general taxes, since federal law allows deductions for general taxes but not for user fees.

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3. Nonna A. Noto and Dennis Zimmerman, *Limiting State-Local Tax Deductibility for Increased General Revenue-Sharing: An Analysis of the Economic Effects*, Committee on Government Affairs, 98th Cong., 1st Sess., Washington, D.C., 1983; Dennis Zimmerman, "Resource Misallocation for Interstate Tax Exportation: Estimates of Excess Spending and Welfare Loss in a Median Voter Framework," *National Tax Journal*, June 1983, pp. 183-201; Roger H. Gordon and Joel Slemrod, "A General Equilibrium Simulation Study of Subsidies to Municipal Expenditures," *Journal of Finance*, May 1983, pp. 585-594; Allen F. Ladd, "Federal Aid to State and Local Governments," Gregory B. Miller and John L. Palmer, eds., *Federal Budget Policy in the 1980s*, Urban Institute, Washington, D.C., 1984; Edward M. Gramlich, "The Deductibility of State and Local Taxes," *National Tax Journal*, December 1975, pp. 447-465.

4. For a review of these studies, see E.S. Savas, *Privatization: The Key to Better Government* (Chatham, New Jersey: Chatham House Publishing, Inc., 1987).

A PROPOSAL FOR REFORM

The federal income tax deductions for state and local taxes are bad policy. To eliminate the deductions without an offsetting tax reduction would raise total federal taxes and thus slow economic growth. To avoid this, Congress should combine the elimination of the current unfairness--the state and local tax deduction--with an increase in the personal deduction, which would eliminate unfairness in the taxation of American families.

Congress should increase the personal exemption by $1,000, to a total of $3,000 per person, and eliminate remaining federal income tax deductions for state and local income and property taxes. Abolishing these deductions would have raised $22.3 billion in revenue in fiscal 1988; raising the personal exemption by $1,000 would have "lost" about $22 billion. The package therefore would be revenue neutral.

This twin-track reform would abolish tax deductions that primarily benefit upper-income workers and replace them with an increase in the personal exemption that would benefit especially lower-income workers and families with children. A $3,000 personal exemption, together with the applicable standard deduction, this year, for example, would relieve a married couple with two children, earning $17,000, from all federal income tax.

Incentives to Accept Jobs. The reform would help alleviate the rising federal tax burden on lower and moderate-income workers resulting from the declining value of the personal exemption and the sharp rise in payroll taxes. It would help the working poor. By reducing the taxes levied on lower paid workers it would increase the incentive for Americans on welfare to accept jobs and thus work themselves out of poverty and welfare dependency. These Americans would not be hit with a discouraging federal income tax burden just as they began to climb out of poverty.

An increased personal exemption also would help to offset the tax code's bias against families with children, caused by the depreciating personal exemption and sharp payroll tax increases. A higher personal exemption would help offset the extra costs of child care and provide the same degree of assistance to families in which the spouse provides the care as to those who choose professional care.

By repealing the federal deductions for state and local taxes, the reform would eliminate the disparity between different states. Low tax states no longer would be forced to subsidize high tax states through the federal income tax system. The arbitrary discrimination against states with little or no income tax and greater reliance on sales taxes would be ended. The federal tax system would become neutral as to the choice of revenue sources by state and local governments.

Abolishing Bias. Without these deductions, state and local governments would be inclined to curb taxes and unnecessary spending because the taxes would no longer be shielded by federal deductions. The arbitrary tax bias against cost-saving privatization policies would disappear, encouraging privatization and thereby helping reduce wasteful and unnecessary spending. The reform similarly would abolish an arbitrary tax bias against equitable and efficient user fees.

Some might prefer to use the new revenue derived from eliminating the deductions to reduce federal income tax rates or the deficit, rather than to increase the personal exemption. While these may seem attractive alternatives, restoring equity to the tax system is more important.

It also makes good political sense. The proposal should have a strong appeal to liberals, who otherwise would oppose repealing the deductions, because it would provide tax relief to lower-income Americans. At the same time, the reform should appeal to conservatives because of its benefits to families. Both liberals and conservatives from states relying heavily on non-deductible sales taxes for their revenues could take the lead in pushing the reform, since residents of these states are penalized most by the current system and thus have the most to gain from the proposal.

CONCLUSION

The federal income tax deductions for state and local income and property taxes are unfair and lead to bad state and local policies. They provide $22 billion per year in tax benefits primarily to upper-income taxpayers. They favor high tax states at the expense of the residents of low tax states. They interfere in state and local revenue structures, arbitrarily favoring some revenue sources over others. They encourage higher state and local taxes and unnecessary spending, while discouraging sound state and local privatization policies that can reduce costs and wasteful spending. Eliminating these deductions is well justified in its own right.

Using the resulting revenues to increase the personal exemption by $1,000 would rectify another unfair feature of the tax code. This especially would benefit lower income workers and families with children, offsetting the increase in their relative tax burden over the years caused by depreciation of the value of the personal exemption and sharp payroll tax increases. Such tax relief would help many Americans find their way out of poverty and welfare dependency by encouraging them to take jobs. It also would help offset more of the extra costs for those who are raising children and prevent excessive taxation from undermining the economic viability of families.

Many lawmakers recognize, as does Ronald Reagan, that the process of tax reform is incomplete. There is no better way for Congress to continue this process than by considering a reform that would remove many of the inequities remaining in the tax code.