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Federalism Through Tax Interdependence: An Overview

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Federalism Through Tax Interdependence: An Overview

Summary

Beyond direct federal government grants-in-aid, there are indirect federal revenue transfers to state and local governments through a variety of tax instruments. This report analyzes four such instruments and provides rough estimates of the relative magnitude of each. Specifically, the report focuses on: 1) the federal income tax exclusion for bonds issued by sub-federal governments (tax-exempt bonds); 2) the federal estate tax credit for state death taxes; 3) the itemized deduction for sub-federal property taxes; and 4) the itemized deduction for sub-federal income taxes under the federal income tax.

Economic analysis suggests that the exclusion from federal income taxes of interest income from state and local government tax-exempt bonds is an inefficient method of subsidizing public capital formation. Possible income tax reforms, such as lower marginal rates or a shift to a consumption-based flat tax, would reduce the attractiveness of tax-exempt bonds and could increase the borrowing costs of sub-federal governments. As a consequence, these tax reforms would also reduce the loss in economic efficiency arising from tax-exempt bonds.

The federal estate tax offers a state death tax credit which reduces the effective marginal state death tax rate to zero in most states. The federal credit serves as almost a direct federal transfer to the states through their estate taxes. Eliminating or reducing the federal estate tax would significantly reduce and perhaps eliminate the tax transfer to the states.

Under current law, taxpayers can deduct sub-federal property and income taxes as an itemized deduction on their federal income tax. The federal deduction results in the federal government paying part of these state and local taxes through lower federal tax collections. In addition, there is some evidence that state and local governments rely more on these deductible taxes rather the non-deductible taxes such as sales and use taxes. The deduction for income taxes may also increase the progressiveness of state income taxes.

This report will not be updated.

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Federalism Through Tax Interdependence: An Overview

Introduction

The vertical structure of government in the United States is typically identified as an example of fiscal federalism. The modifier "fiscal" evokes thoughts of annual budgets and the mechanisms through which governments balance them. Federalism is the term used to describe the relationship between a central government and its subdivisions; in the United States, the Constitution assigns certain powers and authorities to the central government while all other governmental powers remain with the states. The concept "fiscal federalism" has a logical interpretation which may expand beyond the sum of its parts. In the words of economist Wallace E. Oates, fiscal federalism:

> explores, both in normative and positive terms, the roles of the different levels of government and the ways in which they relate to one another through such instruments as intergovernmental grants.[1]

In this report the "instrument" of fiscal federalism examined is taxation rather than intergovernmental grants. Thus, instead of examining explicit transfers from the federal government to state and local governments, this report will focus on an indirect tool of fiscal federalism: federal tax deductions and credits that affect the budgets of state and local governments. The report will examine federalism through federal tax exclusions, deductions and credits for the purposes of alerting Members and committees of Congress and their staff to the potential effects of tax decisions on state and local governments.

The new Administration as well as the 107th Congress have both indicated tax relief will be an important part of the legislative agenda. Some of the tax relief proposals for individuals may affect state and local government budgets. In the 106th Congress, H.R. 1433 (Representative Baird) and the Senate counterpart S. 1490 (Senator Thompson), would have legislated a federal deduction for sub-federal sales and use taxes for states that do not impose an income tax. Representative Clement has indicated a desire to propose similar legislation in the 107th Congress.[2]

To clarify the role of taxes in the fiscal relationship between the levels of government, this report analyzes selected components of the federal tax code that

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[1] Wallace E. Oates, "An Essay on Fiscal Federalism," *Journal of Economic Literature*, vol. 37, September 1999, pp. 1,120.

[2] Bureau of National Affairs, "Support Sought for State Sales Tax Deduction," in *The Daily Tax Report*, January 12, 2001, p. G-8.

directly affect state and local government finances. After a brief discussion of tax expenditures generally, four instruments are analyzed in turn. The first are tax-exempt bonds–state and local government bonds–the interest payments' on which are exempt from federal income taxation. The second is the federal estate tax credit for state death taxes. The third and fourth are federal income tax deductions for state and local taxes on property, and income, respectively.

What Is the Cost of Federal Fiscal Tax Transfers?

The value of federal transfers to states through taxes is difficult to identify and quantify. In contrast, the value of direct expenditures, such as federal grants-in-aid, is relatively easy to find. For example, the *Economic Report of the President*, which is published annually, states that the value of federal government grants-in-aid to sub-federal governments was approximately $224 billion in 1999. Estimates of the federal revenue transfers through tax-exempt bonds, federal deductions for state and local taxes, and the credit for state estate taxes are not as readily available.

For this report, estimates of the cost of the federal government transfers are provided where possible. The benefits to state and local governments arising from tax-exempt bonds and state death taxes, which are structured as an income exclusion and tax credits respectively, are not directly estimable. However, in the case of federal income tax deductions (for state and local property and income taxes), federally estimated tax expenditures are a close approximation. The tax expenditures estimates provided by the Joint Committee on Taxation were first introduced in the mid-1970s. Tax expenditures were defined by the Congressional Budget and Impoundment Control Act of 1974 ("The Budget Act", P.L 93-344)[3] as:

> ...revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion or exemption, or deduction from gross income or which provide a special credit, preferential rate of tax, or a deferral of tax liability.

An example of one tax instrument of fiscal federalism is a federal tax expenditure that benefits a state and local government through lowering the taxpayer's federal tax burden. For example, local real estate property taxes are deductible from federal income for taxpayers who itemize. The benefit to the local government is equivalent to the taxpayer's decrease in federal tax liability arising from the deduction. If the local government were to repeal the property tax entirely, the resident's real estate property tax bill would obviously drop to zero, however, his federal tax liability would increase because the deduction would no longer be available. The following sections explain each of the above mentioned tax instruments in more detail beginning with tax-exempt bonds.

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[3]U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2000-2004*, committee print, 106th Cong., (Washington: GPO, 1999), p.2.

Tax-Exempt Bonds[4]

Explanation. One of the most visible components of the federal tax code affecting state and local governments is the tax exemption for interest income generated by most bonds they issue. The tax exemption allows the issuers to sell bonds at a lower interest rate, thus lowering the cost of debt.[5] The lower interest cost is in fact a revenue transfer from the federal government to two entities: bond holders and sub-federal governments. Two questions need to be answered to better understand the tax transfer.

How do bondholders benefit from lower pre-tax interest rates on tax-exempt bonds? The holders of state and local tax-exempt bonds do not have to include the interest earned on the bonds as federal taxable income.[6] In equilibrium, the after-tax return on taxable and non-taxable bonds should be the same. If one type has an after-tax rate of return higher than the other, then investors would switch to the bond with the higher return, assuming the bonds are otherwise equal. Over time, as the investors bid away the differential, the after-tax returns on the two bonds converge. The implicit after-tax rate assumes there is one market clearing tax rate, although there are several tax brackets in the federal tax system. This fundamental incongruity generates windfall gains for taxpayers in tax brackets above the market clearing marginal tax rate.

Based on average annual interest rates on tax-exempt bonds and taxable corporate bonds, the market clearing marginal tax rate was about 23%. Thus, investors in tax brackets above 23% who held tax-exempt bonds received a windfall gain. Theoretically, investors in tax brackets below the market clearing rate should not invest in tax-exempt bonds. For 1998, 4.8 million returns reported a total of $50 billion in tax-exempt interest. If this interest income were taxable at the 28% rate, taxability would have generated $14 billion in federal revenue.[7]

How do state and local governments benefit? If state and local government bonds were stripped of their tax-exempt status, they would have to offer an interest rate at least equal to the prevailing taxable corporate bond rate. The transfer to sub-federal governments is equal to the difference between the interest rate

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[4]Tax-exempt bonds are commonly called "municipal bonds."

[5]For a more general review of tax-exempt bonds, see CRS Report RL30638, *Tax-Exempt Bonds: A Description of State and Local Governments Debt*, by Steven Maguire.

[6]However, some municipal bonds are taxable if they do not qualify for tax-exempt status. Or, in some cases, a sub-national government will issue taxable bonds to avoid having to comply with federal restrictions on the use of the bond proceeds. According to the *Bond Buyer 1999 Yearbook*, in 1998, taxable municipal bonds accounted for just 5.6% ($15.97 billion) of total municipal bond volume.

[7]This is a rough and probably understated estimate. In 1998, approximately $15.5 billion of tax exempt interest is reported on returns with AGI above $500,000. These returns are most likely in the 39.6% bracket which would yield $6.1 billion in tax revenue. If the remainder were in the 28% bracket, another $9.7 billion would be generated, or a total $15.8 for both groups.

on tax-exempt bonds and taxable bonds of equal term and risk.[8] In 1999, the spread between taxable bonds and tax-exempt bonds was 1.61%. Thus, for every $100 in tax-exempt bonds issued in 1999, the federal government effectively passed along savings of $1.61 in interest cost per year to sub-federal governments.[9] According to *The Bond Buyer*, the total amount of new debt (referred to as "new money" or debt that is not used to pay-off existing debt) issued in 1999 was almost $158 billion.[10] Thus, the total subsidy to state and local governments in 1999 was roughly $2.6 billion.

Economic Analysis. There are two main arguments for the tax exclusion. First, the federal government allows the subsidy because many believe the federal government should not interfere with the financing of sub-federal governments. However, the federal government is not constitutionally bound to the tax-exempt status for sub-federal debt. The Supreme Court ruled (*South Carolina v. Baker,* 485 U.S. 505, [1988]) that the federal government can tax the interest income derived from sub-federal debt instruments.

The second, and perhaps more compelling, reason for the tax exemption is that policy makers in the federal government are concerned that local public capital investment may be under-provided unless subsidized by the federal government. Tax-exemption is typically justified for reasons similar to those offered for direct expenditures like grants-in-aid.

The efficiency of the subsidy is questionable: for every dollar of lost federal tax revenue, the sub-federal government typically receives less than a dollar of interest cost saving.[11] The following numerical example best illustrates the inefficiency of the federal subsidy through tax-exempt bond interest. The example uses the 1999 average tax-exempt bond interest of 5.43% and the 1999 average interest rate on high grade corporate bonds of 7.04%.[12]

The interest cost saving to the state and local government is the same regardless of the tax status of the bond purchaser, whereas the tax savings to the purchaser (and the corresponding revenue loss to the federal government) rises with his marginal tax bracket (see Table 1 for a numerical example). The federal revenue loss arising from the tax exemption is approximately the tax saving of the investor. For example, when an investor in the 39.6% bracket buys a tax-exempt bond at 5.43% with a face value of $10,000 rather than taxable bond of equal face value at 7.04%, the federal government loses $279 of tax revenue, but the state and local government only

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[8]Most tax-exempt bonds are considered long-term bonds meaning they have terms of 13 months or more. In 1998, almost 90% of municipal bonds were long-term bonds.

[9]The calculations presented here do not include state and local income taxes that may apply to the interest income of the bonds.

[10]*The Bond Buyer*, "A Decade of Municipal Note Finance," June 7, 2000, p.41.

[11]Ronald C. Fisher, *State and Local Public Finance*, 2nd ed. (Chicago: Irwin Publishing, 1996), p. 256.

[12]U.S. Council of Economic Advisors, *Economic Report of the President*, (Washington: February 2000), Table B-71.

receives an interest cost savings of $161. Table 1 compares the varying federal revenue loss to the interest cost saving of the state and local government for taxpayers in four different marginal tax brackets. In each case, the revenue loss to the federal government exceeds the cost saving to the sub-federal government.

More generally, the subsidy for tax-exempt state and local debt induces high-tax-rate investors to buy this type of bond rather than taxable corporate bonds. In theory, the presence of tax-exempt bonds decreases the demand for taxable corporate bonds which in turn increases the interest cost for corporate borrowers. Were tax-exempt bonds eliminated, the demand for taxable bonds would likely increase and in turn corporate borrowing costs would go down.

State and local governments voice strong support for tax-exempt bonds because the bonds allow these governments to borrow at a lower cost. According to *The Bond Buyer*, total outstanding municipal debt for 2000 was $1.54 trillion, most of which was tax-exempt.[13] If all these bonds had to be issued as taxable bonds, the additional interest cost to sub-federal governments in 2000 would have been significant. However, the additional interest cost to state and local governments would likely be less than the increase in federal tax collections because of the revenue generated by taxable interest income. The example in Table 1 indicates that the federal government could compensate state and local governments for the lost subsidy and still have excess revenue to reduce other federal taxes.

Table 1. Federal Cost and Local Benefit from Tax-Exempt Bonds at Different Marginal Tax Rates

(Estimates are for $10,000 tax-exempt bond with a 5.43% rate compared to a taxable bond with a 7.04% rate)

Investor's Marginal Tax Rate	Income Tax Saving to the Investor Through Purchase of Tax-Exempt Bonds	Interest Cost Saving of the Sub-National Government from Tax-Exempt Status of Bonds
15%	Not a Typical Tax-Exempt Bond Investor	
23%*	$161	$161
28%	$197	$161
31%	$218	$161
36%	$253	$161
39.6%	$279	$161

*This tax rate is the hypothetical market clearing marginal tax rate.

If federal policy makers were to lower marginal tax rates, the tax exemption for the bonds would be worth less to investors. The immediate response to such a policy change could be a greater percentage of investors dropping below the existing market

[13] "Holders of Municipal Debt:1985-2000," *The Bond Buyer*, Friday, June 16, 2000, p. 7.

clearing marginal tax rate. In turn, the demand for, and the price of, tax-exempt bonds would decline. The lower price would then lead to higher interest rates on tax-exempt bonds generally. The higher interest rates on tax-exempt bonds would then increase borrowing costs for sub-federal governments.

Adopting a flat tax or a consumption based tax, where sub-federal bonds lose their tax-exempt status entirely, would have the same, though more pronounced, effect as a reduction in marginal income tax rates.[14] In a 1999 article, economists Joel Slemrod and Timothy Greimel investigated the relationship between the probability of electing a flat tax advocate President, Steve Forbes, and the U.S. tax-exempt municipal bond market. They found "... that the indicator of tax reform's prospects [the probability of electing Steve Forbes] was correlated with a decline in the spread on five and ten-year maturity bonds, although not for 30-year maturity bonds." [15] The "spread" identifies the difference between taxable corporate bonds and comparable tax-exempt bonds. Though their evidence was not overwhelmingly convincing, the existence of the paper attests to the potential relationship between federal tax rates and sub-federal government bonds and the cost of issuing those bonds.

Federal Credit or Deduction for State Death Taxes[16]

Explanation. Both federal and state governments maintain estate taxes. However, 35 states simply pick-up the federal credit (discussed below) as their death tax. In these states, the state death tax is commonly referred to as a "pick-up" tax. Eliminating the federal estate tax would eliminate the state death tax in these 35 states. Two additional states, Connecticut and Louisiana, will soon join the group of 35 pick-up tax states. Under the pick-up tax mechanism the state tax is set equal to the maximum federal credit allowed, the federal government credits the decedent's federal estate tax bill by the exact amount of the state death taxes paid. The credit for state death taxes is theoretically indistinguishable from a direct federal transfer to the states.

Economic Analysis.[17] The credit for state death taxes is unusual. In some cases, the federal government allows taxpayers to deduct taxes paid to state and local governments from their federally defined gross income. Two examples of allowable deductions are those for state income taxes and property taxes. Through offering a

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[14]For a review of the flat tax, see CRS Issue Brief IB95060, *Flat Tax Proposals and Fundamental Tax Reform: An Overview*, by Jim Bickley.

[15]Joel Slemrod and Timothy Greimel, "Did Steve Forbes Scare the US Municipal Bond Market?," *Journal of Public Economics*, vol. 74, 1999, p. 81-96.

[16]The politicized term "death tax" is commonly used in reference to the current federal estate tax. "Death tax" is used here because the tax code refers to the state credit as the "Credit for State Death Taxes" 26 I.R.C. Sec. 2011.

[17]The economic effect of the estate tax generally, such as the effect on saving, charitable giving, capital growth, and family businesses, is not explicitly reviewed in this report. Rather, the focus is on the fiscal relationship the tax has created between states and the federal government. For an overview of the estate tax, see CRS Report RL30600, *Estate and Gift Taxes: Economic Issues*, by Jane G. Gravelle and Steven Maguire.

credit, the federal government is in fact paying the entire state death tax (in states with a pick-up tax) for the decedent's estate.

The federal estate tax has been the object of considerable attention in the past and will likely generate interest in the current Congress. Proposals for reforming the estate tax in the 106th Congress ranged from complete elimination to expansion of special deductions for family owned and operated farms and businesses. As indicated above, these reforms could have a substantial effect on the revenue structure of state death taxes.

The Center on Budget and Policy Priorities (CBPP) estimated that if the repeal of the federal estate tax had been in place in 2000, "... states together would have lost approximately $5.5 billion in revenue ...."[18] The lost revenue would have to be made up with one of the following: a cutback in state services; increases in other taxes; or through bond sales. Another option would be to reform the state death tax to remove the link to the federal estate tax.

Tax Credit versus Deduction. An alternative reform of the estate tax would change the state credit to a deduction. Absent other reforms, changing the credit to a deduction would increase the federal estate tax burden and induce a behavioral response to the tax at the state level. For expository purposes, assume there are two options available to mitigate or reduce the state death tax burden. Policy A is based on current law and includes a federal tax credit for state death taxes paid. Alternatively, Policy B allows a general deduction for state death taxes. The current rate schedules for both the estate tax generally and the state death tax credit are applied to a hypothetical estate. In addition, the calculation for state death taxes assumes the decedent resided in one of the 35 states that has adopted the federal credit for state death taxes as its estate tax.

Policy A (Current Law): A Credit for State Death Taxes. Under current law, estates are allowed a credit for state death taxes paid up to a specified maximum. Consider an estate valued at $1 million. After applying the federal estate tax rate schedule, the estate has a tentative tax liability of $345,800. The unified credit in 2001 of $220,550 lowers the federal tax liability (before the credit for state death taxes) to $125,250. Under current law, an estate this size can claim a credit of $33,200 for state death taxes paid which lowers the federal tax bill to $92,050. Thus, for this estate, the state and federal estate taxes combined are $125,250.

Policy B: Deduction from Estate for State Death Taxes. Assume the same estate as above, however, the executor is allowed to deduct state death taxes rather than claim a credit. Under this policy, the estate deducts $33,200 from the estate, leaving $966,800 in the taxable estate.[19] The current federal estate tax schedule (the

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[18]Elizabeth C. McNichol, Iris J. Lav, and Daniel Tenny, "Repeal of the Federal Estate Tax Would Cost States Billions in Revenue," *Center on Budget and Policy Priorities*, August 30, 2000, Washington, D.C., [http://www.cbpp.org].

[19]The implicit assumption is that the state credit is calculated based on the value of the estate before the state death tax deduction. A similar assumption is made when calculating state (continued...)

same schedule used above) is applied and yields a tentative federal estate tax liability of $332,852. The same unified credit is available, which lowers the federal tax bill to $112,302 ($332,852 less $220,550). Thus, the sum of the federal and state estate taxes is $145,502.

In both cases (summarized in Table 2), the state receives $33,200 from the decedent's estate. However, under current law (Policy A), if the state did not have an estate tax, the estate would still have a total tax liability of $125,250, with the state receiving nothing. This implies that the existence of the state death tax under current law does not increase tax liability, or that the state death taxes under current law in most states have a zero marginal tax rate for the estate.

In contrast, Policy B would increase the federal burden and introduce a positive marginal tax rate for state death taxes. The deduction reduces the federal estate tax liability, but not by the entire amount of the state death tax as is the case with the credit under current law. Algebraically, the federal tax decrease is equal to the federal marginal rate (39% for the estate in our example) multiplied by the state estate tax burden. Clearly, the reduction in combined tax liability is less than state death taxes.

Table 2. Tax Credit for State Death Taxes vs. Tax Deduction

	Tax Credit for State Death Taxes (Policy A)	Tax Deduction for State Death Taxes (Policy B)
Net Estate Value	$1,000,000	$1,000,000
Deduction for State Death Tax	$0	($33,200)
Taxable Estate	$1,000,000	$966,800
Tentative Federal Estate Tax	$345,800	$332,852
Unified Credit (in 2001)	($220,550)	($220,550)
Tax Before State Death Tax Credit	$125,250	$112,302
Credit State Death Tax	($33,200)	$0
Federal Estate Tax Liability	$92,050	$112,302
State Death Tax Liability	$33,200	$33,200
Combined Federal Estate and State Death Tax Liability	$125,250	$145,502

For these reasons, legislation that proposed to change the federal estate tax would most likely generate considerable interest from state and local governments.

[19](...continued)
income taxes based on federal adjusted gross income.

Even though state death taxes are not a large part of most states' revenue structure, the prospect of losing revenue as a result of federal action may not be well received.

Deduction for Local Property Taxes

Explanation. Under the federal income tax, taxpayers can deduct ad valorem[20] local property taxes from taxable income.[21] However, taxpayers must itemize deductions (rather than use the standard deduction) on their income tax return to claim the deduction. The tax savings from the deduction is equal to taxpayers' marginal tax rate multiplied by the size of the deduction. Because our income tax rate regime is progressive,[22] a deduction, in contrast to a tax credit, favors taxpayers in higher income tax brackets.

For example, an itemizing individual owning a home with an assessed value of $100,000, and who pays a 1% property tax, can deduct $1,000 from his or her adjusted gross income. If this taxpayer is in the 36% marginal tax bracket, taking $1,000 out of taxable income saves $360 ($1,000 multiplied by 36%).[23] In most cases, both the taxpayer's tax bracket and home value increase with income. Thus, taxpayers in higher brackets receive a greater tax savings because of the progressive income tax and the assumed positive relationship between home value and income.

Economic Analysis. The property tax deduction is used by about one-quarter of taxpayers, though perhaps twice that many pay property taxes on owner occupied housing; only those who itemize can take the deduction. Table 3 provides data for the years 1993 through 1997 on 1) the number of returns that itemize, and 2) the number of returns that have a property tax deduction. The gradual growth in the percentage of itemizers may reflect income growth that has outpaced inflation. Income growth that exceeds the inflation-adjusted expansion of income tax brackets implies a higher marginal tax bracket, which ultimately increases the tax saving from itemizing.

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[20]The Latin phrase "ad valorem" in tax jargon means the tax is calculated as a percentage of value. The alternative tax is one levied per unit. Generally, only ad valorem property taxes are deductible.

[21]There are usually two types of property taxes, real estate (on owner-occupied housing) and personal. The focus of this report is the real estate property tax. For ease of exposition, the modifier "real estate" is not used for the remainder of the report.

[22]A progressive tax is one in which the rate of tax increases with income.

[23]Marginal tax rates are sometimes referred to as tax brackets. There are currently five individual income tax brackets: 15%, 28%, 31%, 36%, and 39.6%.

Table 3. Number of Itemizers, 1993 to 1997
(Return Numbers in 000s)

	1993	1994	1995	1996	1997
Total Returns:	114,602	115,943	118,218	120,351	122,422
w/ Itemized Deductions	32,821	33,018	34,008	35,415	36,625
w/ Property Tax Deduction	29,083	29,294	30,111	31,348	32,250
Percentage of Total Returns with:					
Itemized Deductions	28.64%	28.48%	28.77%	29.43%	29.92%
Property Tax Deduction	25.38%	25.27%	25.47%	26.05%	26.34%

Source: U.S. Department of Treasury, Internal Revenue Service, Statistics of Income Division, *Individual Income Tax Returns, 1997*, Publication 1304 (Washington: April 2000).

In theory, if a particular tax is favored in the federal tax code, the state and local governments may rely more upon that tax source. In effect, local governments and taxpayers recognize that residents are only paying part of the tax, and that the federal government, through federal deductibility, is paying the remainder. Holtz-Eakin and Rosen (1990) found that "... if deductibility were eliminated, the mean property tax rate in our sample would fall by 0.00715 ($7.15 per $1,000 of assessed value), or 21.1% of the mean tax rate."[24] Analogously, deductibility of local property taxes might increase reliance on that tax and lower the reliance on other non-deductible taxes such as the local sales and use tax.

Property taxes are a major source of local government revenue, and thus the federal transfer through deductibility is also quite large. State governments, alternatively, are less dependent upon property tax revenue, and instead rely more upon income and sales and use taxes. A common measure of a government's reliance on a particular tax is the portion of total tax revenue generated by that tax. Nationally, real estate property taxes comprised 73.7% ($199.5 billion in FY1996) of all local government tax revenue and just 2.4% ($9.8 billion in FY1996) of all state government tax revenue.[25]

The combined $209.3 billion collected by state and local governments in 1996 was, in many cases, deducted by taxpayers who itemized on their federal income tax returns. The federal tax expenditure estimated by the Joint Committee on Taxation approximates this tax saving. Thus, the itemizing taxpayer is partially reimbursed, by way of a federal deduction, for state and local property taxes.

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[24] D. Holtz-Eakin and H. Rosen, "Federal Deductibility and Local Property Tax Rates," *Journal of Urban Economics*, vol. 27, 1990, pp. 269-284.

[25] U.S. Bureau of Census, *State and Local Government Finance Estimates, by State: 1995-1996*, available at the following website: [http://www.census.gov/govs/www/esti96.html].

Table 4 presents the tax expenditure over the 2000-2004 estimating window for taxpayers who claim a deduction for state and local property taxes. The tax expenditure is roughly equivalent to the extent the taxpayers in the sub-federal governmental jurisdictions benefit from the federal tax preference. In economic theory, if the property tax deduction were eliminated, over time taxpayers would likely reduce their level of housing consumption, and thus the size of their property tax bill. However, a reduction in the property tax may not match the existing tax expenditures. The five-year total is estimated to be just over $100 billion.

Table 4. Federal Tax Expenditure on the Real Property Tax Deduction

	2000	2001	2002	2003	2004	Total
Deduction for Property Taxes on Owner Occupied Housing (in $billions)	18.9	19.6	20.3	20.9	21.6	101.3

Source: U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2000-2004*, joint committee print, JCS-13-99, 106th Congress, (Washington: GPO, 1999).

Deduction for State and Local Income Taxes

Explanation. In addition to property taxes, taxpayers may also deduct state and local income taxes. As with local property taxes, the federal deduction is equal to the taxpayer's individual tax rate multiplied by the amount of state income tax paid. In some states, taxpayers may also deduct federal income taxes from their state income taxes. However, the reciprocal deduction for federal income taxes is only practiced in four states, and partial or limited deductibility is available in an additional four states. Because few states offer the reciprocal deduction for federal income taxes, the focus here is limited to the deductibility of state income taxes as a federal tax transfer.

State governments collected $134.0 billion in individual income taxes in 1996, and local government collected $13.2 billion in FY1996.[26] In 1997, state income tax collections were $144.6 billion, which would probably represent a little more than ten times local collections for the same year. Unfortunately, data more recent than FY1996 for local governments are not available.

Federal deductions claimed for both state and local income taxes in 1997 totaled $137.0 billion. If one assumes the ratio of local income taxes to state income taxes did not change from 1996 to 1997, then approximately $158.8 billion in state and local income taxes was collected in 1997. The estimated $21.8 billion disparity between state and local income tax revenue collected and the amount taken as a

[26] Generally in U.S. Bureau of Census publications, state government data are for the calendar year and the local government data is based on the fiscal year which began on July 1, 1995, and ended on June 30, 1996.

federal deduction most likely arises because only itemizing taxpayers can claim the federal deduction.

Personal property taxes (not real estate property taxes), such as annual car taxes based on the value of the car, generated just $7 billion in deductions. The tax expenditure estimates below include the personal property tax expenditure in the estimate. The fiscal transfer generated by the personal property tax is a small fraction of the total deduction.

Economic Analysis. The federal transfer is equal to the amount by which federal taxes are reduced as a result of the deduction. Table 5 provides estimates of the tax expenditure for the 2000 to 2004 projection period. If deductibility of state and local income taxes were eliminated, it is uncertain how much of the existing subsidy would be raised through other sub-federal taxes.

Table 5. Federal Tax Expenditure on the State and Local Income and Personal Property Tax Deductions

	2000	2001	2002	2003	2004	Total
Deduction for State and Local Income and Property Taxes (in $billions)	35.5	36.8	38.1	39.2	40.4	190.0

Source: U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2000-2004*, joint committee print, 106th Congress, (Washington: GPO, 1999).

In theory, the deduction for state and local income taxes is expected to affect the revenue structure of states in two ways. This provides an incentive for states to maintain a progressive tax system because the tax offset (from the federal deduction) is greater for the high income taxpayers. One, the deduction should increase the degree of progressivity in state taxes. (A progressive state income tax levies higher rates as income increases.) In addition to facing higher federal rates, the probability of itemizing on federal returns increases with income. States that wish to offset a greater percentage of income tax burden should then concentrate the income tax burden in the income ranges characterized by a higher probability of itemizing. The larger deduction for high rate taxpayers is effectively “exported” to all federal taxpayers.

The second effect on state income taxes is similar to the effect described in the analysis of real estate property taxes. A deduction for state income taxes allows states to collect revenue that exceeds the state taxpayer’s net tax cost. For this reason, deductible tax sources are expected to be favored over non-deductible taxes. The following example illustrates the incentive effect if a state were to consider a tax increase.

Consider an individual who reports $100,000 in taxable income, is in the 31% federal income tax bracket, and is currently in the top state income tax bracket of 5.75%. An increase in the tax rate to 7% increases the state tax on this individual by

$1,250. However, the higher tax bill is deductible which reduces the taxpayer's federal tax liability by his marginal tax rate (31%) multiplied by the change in the amount of the tax deduction ($1,250) or $387.50. The taxpayer's combined federal and state tax bill increases only $862.50, but the state receives $1,250 in additional revenue. In essence, federal taxpayers are paying part of the tax increase. Alternatively, increasing a tax that is not deductible, such as the sales and use tax, is not offset by federal taxpayers.

The cumulative effect of the deduction on states without a deductible tax source is also important to recognize. Currently, Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not impose state personal income taxes. Tennessee and New Hampshire levy taxes only on income earned on capital, such as interest and dividends. These states do not benefit much from the federal deduction for state income taxes. They instead must rely upon taxes which are not deductible, such as the sales and use tax. This arguably inequitable treatment is the basis of the legislation proposed in the 106th Congress (H.R. 1433 and S. 1490) that would have reinstated the sales and use tax deduction for states without an individual income tax.[27]

Concluding Observations

The new Administration and the incoming 107th Congress have both indicated that tax relief is high on their legislative agendas. Although no firm proposals or legislation have been offered, many of the proposed changes would likely affect state budgets. This report has reviewed and analyzed four tax instruments that link the federal tax code to state and local budgets. The four tax items together represent a range of tools in the federal tax code that are used (intentionally or not) to influence sub-federal budgets: 1) *income exclusion* for interest earned on qualified tax-exempt bonds; 2) the *tax credit* for state death taxes; and *income tax deductions* for 3) local property and 4) income taxes. These tools essentially maintain the current tax code and offer exceptions to the code. Alternatively, fundamental tax reform, such as changing to a consumption based tax or lowering rates across the board, would also have a significant, though perhaps less understood, impact on the fiscal relationship between the federal government and state and local governments

[27]Before the "Tax Reform Act of 1986," (110 Stat. 2085, Sec. 134) state and local sales and use taxes were deductible from federal income.