



Federal Deductibility of State and Local Taxes

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September 30, 2008

Congressional Research Service

7-5700

www.crs.gov

RL32781

Summary

Under current law, taxpayers who itemize can deduct state and local real estate taxes, personal property taxes, and income taxes from federal income when calculating taxable income. In addition, a temporary deduction for sales taxes in lieu of income taxes expired December 31, 2007. The federal deduction for state and local taxes results in the federal government paying part of these taxes through lower federal tax collections. Theory would suggest that taxpayers are willing to accept higher state and local tax rates and greater state and local public spending because of lower federal income taxes arising from the deduction. In addition, there is some evidence that state and local governments rely more on these deductible taxes than on nondeductible taxes and fees for services.

Repealing the deductibility of state and local taxes would affect state and local government fiscal decisions, albeit indirectly. Generally, state and local public spending would decline, although the magnitude of the decline is uncertain. And, repealing the deduction for state and local taxes would shift the federal tax burden away from low-tax states to high-tax states. Maintaining the current deductibility would continue the indirect federal subsidy for state/local spending.

Expanding deductibility, such as extending the sales tax deduction option or allowing non-itemizers to deduct taxes paid, would likely increase the subsidy for state and local spending. The sales tax deduction option would primarily benefit taxpayers in states without an income tax that are already itemizing. The effect of allowing non-itemizers to deduct taxes paid would depend on the type of deductible tax. For example, property taxes are only paid (directly) by property owners whereas all consumers pay sales taxes in states that levy a sales tax.

On December 20, 2006, the Tax Relief and Health Care Act of 2006 (P.L. 109-432) was enacted, extending the sales tax deduction option for the 2006 and 2007 tax years. In the 110th Congress, legislation has been introduced that would (1) extend the sales tax deduction option through 2008 or (2) make the sales tax deduction permanent. H.R. 6049, which was approved by the Ways and Means Committee on May 15, 2008, would extend the sales tax deduction one year, through 2008. S. 2886 and H.R. 7060 (which passed the House on September 26, 2008) would both extend the sales tax deduction option for two years, through 2009. The Senate-amended version of H.R. 6049, which was approved in the Senate on September 23, 2008, also includes a two-year extension of the sales tax deduction. Making the sales tax deduction option permanent would cost \$37.1 billion over the FY2009 to FY2018 budget window (\$3.0 billion in FY2009).

Other legislation expanded the deduction for property taxes paid. On July 30, 2008, the President signed H.R. 3221 (P.L. 110-289), which includes a provision that allows non-itemizers to deduct up to \$500 (\$1,000 for joint filers) of property taxes paid for the 2008 tax year. H.R. 7060 includes a one-year extension of the recently enacted above-the-line property tax deduction for non-itemizers.

This report will be updated as legislative events warrant.

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Introduction

The interplay between the federal and state and local tax systems through the federal deductibility of state and local taxes is the focus of this report. Generally, individual taxpayers who itemize deductions are allowed to deduct real and personal property taxes, and general sales taxes or state and local income taxes from federal taxable income. Taxpayers must choose between sales taxes or income taxes; they cannot deduct both. In 2004, Congress modified the deductibility of state and local taxes—adding the sales tax deduction option for 2004 and 2005—and the 109th Congress extended the sales tax deduction option for 2006 and 2007.

In the 110th Congress, 11 bills have been introduced that would make the sales tax deduction permanent: H.R. 60, H.R. 411, H.R. 2734, H.R. 3592, H.R. 3906, H.R. 4086, H.R. 5242, H.R. 5744, S. 143, S. 180, and S. 2233. Four bills, H.R. 3680, H.R. 3970, H.R. 6049 (the version that passed in the House on May 21, 2008), and S. 3335 would extend the sales tax deduction option for one year. S. 2886 and H.R. 7060, which passed the House on September 26, 2008, would both extend the sales tax deduction option for two years, through 2009. The Senate-amended version of H.R. 6049, which was approved in the Senate on September 23, 2008, includes a two-year extension of the sales tax deduction.

The recent housing crisis has generated interest in Congress to modify the deduction for real property taxes. H.R. 3221, (P.L. 110-289), the *Housing and Economic Recovery Act of 2008*, signed by the President on July 30, 2008, includes a provision that allows non-itemizers to deduct up to \$500 (\$1,000 for joint filers) of property taxes paid. The special deduction is available for the 2008 tax year under the legislation. H.R. 7060 includes a one-year extension of the recently enacted above-the-line property tax deduction for non-itemizers.

The tax savings from the property tax deduction under current law, which will be realized in spring 2009 when taxpayers file 2008 returns, will likely benefit taxpayers that do not have other potentially deductible expenses that are high enough to merit itemizing. Taxpayers with no mortgage (or low mortgage debt) in states with relatively low state and local tax burdens would likely benefit the most from this new tax provision.

The President's Advisory Panel on Federal Tax Reform (the tax reform panel) recommended repealing the deduction for all state and local taxes as part of a more comprehensive base broadening plan. The President's FY2009 budget proposal does not include an extension of the sales tax deduction option. This report addresses the potential impact of changing the status of federal deductibility on state and local government tax systems, individual taxpayers, and the federal budget.

Brief History

The deduction from federal income for state and local taxes paid dates from the inception of the current income tax under the Revenue Act of 1913.¹ A provision in that act allowed the deduction for “all national, State, county, school and municipal taxes paid within the year, not including

¹ The 16th Amendment allowed for the taxation of income without regard to apportionment among the states. With the new constitutional authority, Congress passed The Revenue Act of 1913, initiating the current federal income tax.

those assessed against local benefits.” State sales taxes, however, were not introduced until 1932 (Mississippi was the first) and a deduction for those taxes for individuals was not explicitly stated in the tax code until passage of the Revenue Act of 1942 (P.L. 77-753). The deductibility provision was frequently modified over the years, including the introduction of the standard deduction in lieu of itemizing deductions in 1944, but significant revision did not occur until 1964 with enactment of the Revenue Act of 1964 (P.L. 88-272).

Before the 1964 act, a deduction was allowed for all state and local taxes paid or incurred within the taxable year except those taxes explicitly excluded. After the 1964 Act, only taxes explicitly mentioned were deductible. Included in the list of deductible taxes were state and local taxes on: real and personal property, income, general sales, and the sale of gasoline, diesel fuel, and other motor fuels. A new subsection in the 1964 act spelled out the test for deductibility of general sales taxes. First, the tax must be a sales tax (a tax on retail sales) and second, it must be general, that is, imposed at one rate on the sales of a wide range of classes of items. “Items” could refer either to commodities or services.

The deductibility provision remained largely unchanged until the sales tax deduction was repealed by the Tax Reform Act of 1986 (TRA 1986, P.L. 99-514). One of the primary goals of TRA 1986 was to broaden the base of the federal income tax. Eliminating the deduction for all state and local taxes paid was one of the policy options considered to broaden the tax base. The final version of TRA 1986 repealed the deduction for general sales taxes but preserved the deduction for ad valorem property taxes and income taxes. The Joint Committee on Taxation (JCT) summary of TRA 1986 suggested that Congress chose to repeal the sales tax deduction and not income or property taxes, because:

- only general sales taxes were deductible and not selective sales taxes (e.g., tobacco and alcohol taxes) which created economic inefficiencies arising from individuals changing consumption patterns in response to differential taxation;
- the deduction was not allowed for taxes paid at the wholesale level (and passed forward to the consumer), thus creating additional inequities and inefficiencies;
- the sales tax deduction was administratively burdensome for taxpayers who chose to collect receipts to justify sales tax deduction claims; and
- the alternative sales tax deduction tables generated by the Internal Revenue Service (IRS) did not accurately reflect individual consumption patterns, thereby diminishing the equitability of the tax policy.²

The American Jobs Creation Act of 2004, (AJCA 2004, P.L. 108-357), reinstated deductible sales tax *in lieu of* income taxes.³ The *in lieu of* treatment in AJCA 2004 is in contrast to the “in addition to” treatment in pre-TRA 1986 tax law. The concerns noted above would still hold. A secondary concern—presented during the debate before repeal in 1986—that states would alter their tax structures in response to the elimination of sales tax deductibility, would not arise. The AJCA 2004 sales tax deductibility provision expires after the 2005 tax year, but was extended through 2007 by the Tax Relief and Health Care Act of 2006 (P.L. 109-432).

² For more on the 1986 Act, see U.S. Congress, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986 (H.R.3838, 99th Congress; P.L. 99-514)*, 100th Cong., 1st sess., JCS-10-87 (Washington: GPO, 1987), pp. 47-48.

³ IRS Publication 600, *Optional Sales Tax Tables*, provides a explanation of the new sales tax deduction.

The remainder of this report will describe and analyze the deduction for the following state and local taxes: (1) real estate property taxes; (2) personal property taxes; (3) income taxes; and (4) sales and use taxes. As Congress considers possible extension of the sales tax deductibility provision and proposals for fundamental tax reform, a better understanding of the existing deductible state and local taxes is important.

Deductible State and Local Taxes

Generally, taxpayers may deduct state and local taxes from income. Individual taxpayers, however, must itemize deductions (rather than use the standard deduction) on their income tax return to claim the deduction for taxes paid. Business taxpayers, in contrast, may deduct state and local taxes as a cost of doing business. The federal tax savings from the deduction is equal to the taxpayer's marginal tax rate multiplied by the size of the deduction. Because the federal income tax rate regime is progressive,⁴ a deduction for itemizers, in contrast to a tax credit for all taxpayers, favors taxpayers in higher income tax brackets. **Table 1** reports the number and percentage of returns with itemized deductions for the four state and local taxes described and analyzed in this report.

The 1986 tax year is included in **Table 1** to exhibit the utilization of the deduction for sales taxes paid, which was repealed by TRA 1986. In 1986, the sales tax deduction was the most common itemized deduction for taxes paid. More taxpayers would claim a sales tax deduction because all but five states imposed a sales tax and, in contrast to property taxes, paying the tax is not conditioned on owning property, real or personal. The current sales tax deduction will not be as common because it is *in lieu of* income taxes. In 2006, 11.2 million taxpayers claimed a deduction for sales taxes paid, and the number who claimed a deduction for income taxes paid declined slightly from 35.9 million in 2003 to 35.7 million in 2006.

The gradual growth in the percentage of itemizers through 2002 (exhibited in **Table 1**) may reflect income growth that has outpaced inflation. Income growth that exceeds the inflation-adjusted expansion of income tax brackets (bracket creep) implies a higher marginal tax bracket, which ultimately increases the tax saving from itemizing. The decline in 2003 may reflect the impact of lower marginal tax rates. The total number and percentage of itemizers increased from 43.9 million in 2003 to 46.3 million in 2004, likely reflecting introduction of the sales tax deduction option.

Table 1. Number and Percentage of State and Local Taxes Paid Itemizers, 1986 and 1998 to 2006
(return numbers in millions)

	1986	1998	1999	2000	2001	2002	2003	2004	2005	2006
	Number of returns									
All Returns:	103.0	124.8	127.1	129.4	130.3	130.1	130.4	132.2	134.4	138.4
Itemized Deductions	40.7	38.2	40.2	42.5	44.6	45.6	43.9	46.3	47.8	49.1
—Income Taxes	33.2	31.9	33.6	35.4	37.0	37.6	35.9	33.5	34.6	35.7

⁴ A progressive tax is one in which the rate of tax increases with income.

	1986	1998	1999	2000	2001	2002	2003	2004	2005	2006
—Sales Taxes	39.0	n/a	n/a	n/a	n/a	n/a	n/a	11.2	11.4	11.2
—Real Estate Taxes	32.9	33.6	35.4	37.1	38.7	39.7	38.3	40.5	41.3	42.6
—Personal Property Taxes	11.5	18.2	19.0	19.6	20.0	20.6	20.0	21.1	21.3	21.5
—Other Taxes	9.1	3.4	3.4	3.3	3.7	3.4	3.2	3.0	2.8	3.1
	Percentage of all returns									
All Returns	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Itemized Deductions	39.5	30.6	31.7	32.9	34.2	35.1	33.7	35.0	35.6	35.5
—Income Taxes	32.2	25.6	26.4	27.4	28.4	28.9	27.5	25.3	25.7	25.8
—Sales Taxes	37.8	n/a	n/a	n/a	n/a	n/a	n/a	8.5	8.5	8.1
—Real Estate Taxes	32.0	27.0	27.9	28.7	29.7	30.5	29.4	30.6	30.7	30.8
—Personal Property Taxes	11.1	14.6	15.0	15.2	15.3	15.8	15.3	16.0	15.8	15.5
—Other Taxes	8.8	2.7	2.6	2.6	2.8	2.6	2.5	2.3	2.1	2.2

Source: U.S. Department of Treasury, Internal Revenue Service, Statistics of Income Division, *Individual Income Tax Returns, various years*, Publication 1304.

Economists have theorized that if a particular state and local tax is favored by deductibility in the federal tax code, then state and local governments may rely more upon that tax source.⁵ In effect, local governments and taxpayers recognize that residents are paying only part of the tax, and that the federal government, through federal deductibility, is paying the remainder. For example, economists Douglas Holtz-Eakin and Harvey 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."⁶

Deduction for Property Taxes

Under the federal income tax, taxpayers can deduct ad valorem property taxes (taxes levied as a percentage of assessed value) from taxable income.⁷ For example, an itemizing individual owning a home with an assessed value of \$100,000, and who pays a 1% property tax, can deduct the \$1,000 tax from his or her adjusted gross income. If this taxpayer is in the 28% marginal tax bracket, taking \$1,000 out of taxable income reduces taxes by \$280 (\$1,000 multiplied by 28%).⁸ In most cases, both the taxpayer's tax bracket and home value increase with income. Thus,

⁵ Lawrence B. Lindsey, "Federal Deductibility of State and Local Taxes: A Test of Public Choice by Representative Government," in *Fiscal Federalism: Quantitative Studies*, edited by Harvey Rosen, (Chicago: University of Chicago Press), pp. 137-176.

⁶ Douglas Holtz-Eakin and Harvey Rosen, "Federal Deductibility and Local Property Tax Rates," *Journal of Urban Economics*, vol. 27, 1990, pp. 269-284.

⁷ There are two types of property taxes, real estate (e.g., owner-occupied housing) and personal (e.g., cars and boats). 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.

⁸ Marginal tax rates are sometimes referred to as tax brackets. There are currently six individual income tax brackets: 10%, 15%, 25%, 28%, 33%, and 35%.

higher-income taxpayers in higher tax brackets receive a greater tax savings than low-income taxpayers because of the typically progressive state income tax. The effect is even greater because the assumed positive relationship between home value (and property tax bill) and income.

H.R. 3221 (P.L. 110-289), the *Housing and Economic Recovery Act of 2008*, signed by the President on July 30, 2008, includes a provision that allows non-itemizers to deduct up to \$500 (\$1,000 for joint filers) of property taxes paid. The special deduction is available for the 2008 tax year under the legislation.

Analysis

The property tax deduction was claimed on approximately 31% of all tax returns. However, not all homeowners itemize, and only those who itemize can take the deduction. In 2006 there were 72.3 million owner-occupied households yet only 42.6 million taxpayers claimed an itemized deduction for real estate property taxes in 2006.⁹ **Table 1** above provides data for the years 1986, and 1997 through 2006 on the number of returns that claimed a property tax deduction, the most common itemized deduction claimed.

Property taxes are a major source of local government revenue, and thus the federal transfer through deductibility is also quite large. State governments, in contrast, are less dependent upon property tax revenue and instead rely more upon income and sales taxes. Nationally, property taxes comprised 45.2% (\$347.3 billion in FY2006) of all local government general own-source revenue and 1.2% (\$11.8 billion in FY2006) of all state government general own-source revenue.¹⁰

Less than half of the combined \$359.1 billion in property taxes collected by state and local governments in FY2006 was deducted by individual taxpayers who itemized on their federal income tax returns or by businesses as a business expense. In 2006, \$156.4 billion of real estate property taxes were claimed as itemized deductions on individual federal income tax returns. Personal property taxes, such as annual car taxes (based on the value of the car), generated \$9.0 billion in deductions in 2006. The amount collected and the amount deducted are different because only one-third of taxpayers itemize on individual returns and businesses (including landlords) pay a large share of property taxes that would not appear as itemized deductions on individual income tax returns.

The federal tax expenditure estimated by the Joint Committee on Taxation (JCT) approximates the amount of federal revenue lost (or approximately the amount taxpayers benefit) as a result of the deductibility. **Table 2** presents the tax expenditure over the FY2007-FY2011 estimating window for taxpayers who claim a deduction for state and local real estate property taxes. The five-year total expenditure is estimated by the JCT to be approximately \$87.1 billion. The annual expenditure increases from \$16.8 billion in 2007 to \$27.9 billion in 2011. The increase likely reflects the expiration of the lower marginal tax rates enacted in 2001.

⁹ According to the U.S. Census Bureau, Current Housing Reports, Series H15/01, *American Housing Survey for the United States: 2006*, (Washington: GPO, August, 2006).

¹⁰ U.S. Census Bureau, *State and Local Government Finances: 2005-06*, the data are available at <http://www.census.gov/govs/www/estimate06.html>, visited July 16, 2008. The property tax in the census data includes both real estate property taxes and personal property taxes.

Table 2. Estimated Federal Tax Expenditure on the Real Estate Property Tax Deduction
(in \$ billions)

	2007	2008	2009	2010	2011	Total
Deduction for Property Taxes on Owner-Occupied Housing	16.8	14.3	14.2	13.9	27.9	87.1

Source: U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2007-2011*, joint committee print, JCS-03-07, 110th Congress (Washington: GPO, 2007).

In theory, if the property tax paid deduction were eliminated, taxpayers would gradually reduce their level of housing consumption, and thus their property tax bill. This shift would be gradual as housing consumption choices are not as responsive as other expenditures to changes in after-tax price given the relatively illiquid nature of housing assets. In addition, as noted earlier, state and local governments may lower tax rates and shift to other revenue sources if the relative tax price of raising revenue through property taxes increases. Local governments would have more at stake than state governments, because the real property tax is primarily a local source of revenue. Across taxpayers, high-income property owners in states with relatively high local property values (and taxes) would likely see the greatest increase in total tax burden if property tax deductibility were repealed.

Deduction for Income Taxes

From 2004 through 2007, taxpayers who itemize may choose between deducting either state and local income taxes or sales taxes, but not both. In 2008, the sales deduction option is no longer allowed. As with local property taxes, the federal deduction is equal to the taxpayer's individual tax rate multiplied by the amount of state and local income tax paid.¹¹

The income tax is a source of revenue primarily for states, not local jurisdictions. In FY2006, state governments collected \$245.9 billion in individual income taxes and local governments collected \$22.7 billion (\$268.6 billion combined). Federal deductions claimed on federal income tax forms for both state and local income taxes in the 2006 tax year totaled \$246.4 billion. The difference between what was collected and what was claimed on federal returns stems from taxpayers who did not itemize or individuals who were not required to file federal returns. Both groups are significantly more likely to be relatively low-income.

Two estimates of the tax expenditure for the deduction of state and local taxes are included in **Table 3**. One estimate was calculated before the American Job Creation Act (AJCA) of 2004 was enacted and the second is the most recent estimate of the tax expenditure. In December of 2006, P.L. 109-432 was enacted, extending the sales tax deduction option through 2007. Note that both of the annual tax expenditure estimates below include the personal property tax deduction. The tax expenditure generated by the personal property tax, however, is a small fraction of the federal tax expenditure reported below. The Joint Committee on Taxation (JCT) estimated that extending

¹¹ In some states, taxpayers may also deduct federal income taxes from income when calculating state taxable income. The reciprocal deduction, however, for federal income taxes is practiced only in six states. Partial or limited deductibility is available in an additional three states. Because few states offer the reciprocal deduction for federal income taxes paid, the focus here is limited to the deductibility of state income taxes when calculating federal taxable income.

the deduction for sales tax options through 2008 would reduce federal revenues by \$2.3 billion over the 2008 to 2012 budget window.¹²

Analysis

The deduction for state and local income taxes affects the distributional burden of both state and federal taxes. First, the deduction could increase the progressivity of *state taxes* if it causes states to rely more on progressive taxes such as the income tax. The cost of the deduction for high rate taxpayers is effectively “exported” to all federal taxpayers. A state that collects a relatively larger share of income taxes from taxpayers in high federal income tax brackets, is most effective at exporting a portion of its state tax burden to all federal taxpayers.

Table 3. Estimated Federal Tax Expenditure on the State and Local Income, Sales, and Personal Property Tax Deductions

(in \$ billions)

Pre-AJCA Estimate	2004	2005	2006	2007	2008	Total
Deduction for State and local Income & Personal Property Taxes ^a	44.3	40.9	37.9	36.7	35.4	195.2
Most Recent Estimate	2007	2008	2009	2010	2011	Total
Deduction for State and local Income, Sales , and Personal Property Taxes ^b	33.9	29.6	29.6	30.0	52.0	175.1

a. U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2004-2008*, joint committee print, JCS-08-03, 108th Congress (Washington: GPO, 2003).

b. U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2007-2011*, joint committee print, JCS-03-07, 110th Congress (Washington: GPO, 2007).

The federal tax burden, however, could be shifted to the majority of taxpayers who do not itemize deductions. Before the alternative sales tax deduction was enacted by AJCA, taxpayers in states without an income tax were more likely to be non-itemizers; thus taxpayers in these states bore a relatively higher tax burden than taxpayers in states with an income tax. The sales tax deductibility provision has partially muted this shift in tax burden.

Deduction for Sales and Use Taxes¹³

Explanation

The deduction for state and local sales taxes was temporarily reinstated in 2004 with enactment of the AJCA and expired after the 2007 tax year. Unlike the pre-TRA 1986 deduction, the AJCA version allowed for a deduction for sales taxes *in lieu of* income taxes. Taxpayers may choose between reporting actual sales tax paid, verified with saved receipts indicating sales taxes paid, or

¹² U.S. Congress, Joint Committee on Taxation, *Estimated Revenue Effects of the Chairman’s Amendment in the Nature of a Substitute to H.R. 3996, the “Temporary Tax Relief Act of 2007,”* scheduled for markup by the Committee on Ways and Means on November 1, 2007, JCX-105-07, 110th Congress, October 31, 2007.

¹³ A use tax is a tax on the use of a product. In the early years of the sales tax, states began with general sales then added the use tax. The intent of the use tax is to capture the sales tax due on purchases made out-of-state yet used in-state. Eventually, states adopting a sales tax included the use tax in the enacting legislation.

an estimated amount found in tables provided by the IRS.¹⁴ The table amounts do not include the sales taxes paid for cars, motorcycles, boats, aircraft, or a home, and local sales taxes paid. Taxpayers may add taxes paid for these items to the table amount. Taxpayers are asked to calculate the ratio of the local sales tax rate to the state sales tax rate, then multiply the result by the table amount to arrive at an estimate of local sales taxes paid. The estimated local sales taxes paid are then added to the state sales taxes paid table amount. The provision expired on December 31, 2007.

Analysis

Allowing the deduction for state and local sales taxes in lieu of income taxes likely diminishes the progressivity of the federal income tax system because the deduction from income is available only to taxpayers who itemize. Itemizers in states that do not impose an income tax benefit the most from the optional sales tax deduction (see **Table 4**, footnote “a” for these states). The gradual reduction in allowable itemized deductions for wealthy taxpayers and the alternative minimum tax (AMT) do limit the benefit at the highest end of the income distribution.

It is also true that states without an income tax rely more on sales and property taxes than do states with an income tax. As a result, itemizers in states without an income tax will be able to deduct proportionately more of their state and local taxes than taxpayers in states with both an income and sales tax. As shown in **Table 4**, in states without an income tax, state and local governments rely on sales and property taxes for 69.3% of total tax revenue. In contrast, in states that levy an income tax, state and local governments rely on income and property taxes for 56.0% of total tax revenue.

The differential treatment of states based on the reliance on the income tax was likely unintended. Nevertheless, states without an income tax are considerably better off with the sales tax deduction option relative to income tax states. As such, extension of the sales tax deduction option would benefit non-income tax states relatively more than other states.

¹⁴ See IRS publication 600, noted earlier.

Table 4. Type of Tax Revenue, Non-Income Tax States and Income Tax States, FY2006

Type of tax	Type of tax revenue as percent of total state and local tax revenue		
	All states and DC	Non-income tax states ^a	Income tax states and DC
Total	100.0%	100.0%	100.0%
Property tax	30.0%	35.8%	28.8%
General sales	23.6%	33.5%	21.5%
Individual income	22.5%	0.1%	27.2%
Other taxes	23.9%	30.5%	22.5%
Maximum deductible	58.3%	69.3%	56.0%

Source: CRS calculations based on Census Bureau data. FY2006 is the latest year for which data are available by individual states.

a. Includes AK, FL, NH, NV, SD, TN, TX, WA, and WY. The income tax percentage is positive for states without an income tax because New Hampshire and Tennessee levy an income tax on dividend and interest income (or capital income).

Policy Alternatives and Current Legislation

The President's Advisory Panel on Federal Tax Reform proposed eliminating the state and local tax deduction as part of comprehensive tax reform. Eliminating deductibility of state and local taxes would affect the distributional burden of federal, state, and local taxes. Other provisions in the tax reform panel's recommendations would interact with the elimination of the deduction for state and local taxes paid. The magnitude of the impact would depend significantly on the response of state and local governments to the federal changes.

In the 110th Congress, 11 bills have been introduced that would make the sales tax deduction permanent: H.R. 60, H.R. 411, H.R. 2734, H.R. 3592, H.R. 3906, H.R. 4086, H.R. 5242, H.R. 5744, S. 143, S. 180, and S. 2233. Four bills, H.R. 3680, H.R. 3970, H.R. 6049, and S. 3335 would extend the sales tax deduction option for one year. H.R. 6049 passed in the House on May 21, 2008. The Senate-amended version of H.R. 6049, which was approved in the Senate on September 23, 2008, includes a two-year extension of the sales tax deduction. S. 2886 and H.R. 7060, which passed the House on September 26, 2008, would both extend the sales tax deduction option for two years, through 2009.

As described earlier, Congress has also turned attention to property taxes paid by non-itemizers. H.R. 3221 (P.L. 110-289), the *Housing and Economic Recovery Act of 2008*, signed by the President on July 26, 2008, includes a provision that allows non-itemizers to deduct up to \$500 (\$1,000 for joint filers) of property taxes paid. The special deduction is available for the 2008 tax year under the legislation.

Federal Tax Base Broadening: Eliminate Deductibility of State and Local Taxes

If deductibility were eliminated and state and local governments are policy neutral (i.e., do nothing in response to the federal changes), then the impact on the distributional burden of state and local taxes will remain essentially unchanged. The federal tax burden, however, will shift

from low tax state taxes toward high tax states. Under current tax rules, taxpayers in high tax states can deduct more from federal income than can those in low tax states.¹⁵

For example, potentially deductible state and local taxes in New York comprise approximately 8.8% of total personal income whereas deductible taxes in nearby Delaware account for approximately 4.8% of total personal income.¹⁶ Thus, taxpayers in New York can deduct significantly more from federal income than can taxpayers in Delaware.

Assuming that other federal taxes were maintained after the elimination of the federal deduction for state and local taxes, the tax burden would shift toward high-tax states from low-tax states. If the federal government reduces tax rates to maintain revenue neutrality—the base is larger with the elimination of the deductibility allowing for lower rates to yield the same revenue—then the effect is even more pronounced. The higher the state and local tax burden (as percentage of total income), the lower the new federal tax rate would be under revenue neutrality.

More generally, if state and local tax deductibility were eliminated, the federal tax burden would shift from all federal taxpayers toward itemizers. As noted earlier, itemizers tend to be higher income, thus, federal income taxes may become more progressive if the state and local taxes paid deduction were eliminated.

Some secondary effects, however, are anticipated at the state and local level. If deductibility were eliminated, state and local governments might be less willing to finance projects that generate benefits that extend beyond the taxing jurisdiction. The tax price to a community of these projects would increase as the federal “contribution” through deductibility is lost. Projects and initiatives whose benefits extend beyond the local jurisdiction would likely be the most sensitive to changes in the tax price as the benefits are more widely dispersed.¹⁷ A reduction in state and local public good provision may adversely affect low-income individuals relative to high-income individuals.

Quantifying the magnitude of the state and local spending response is difficult because many other factors influence state and local spending decisions such as state and local political considerations and overall economic conditions. Nevertheless, most research has found that state spending declines or would decline, but by how much? Before sales tax deductibility was eliminated in 1987, one researcher estimated that “... the overall responses are on the order of zero to ten percent, much less than estimates used in the political debate.”¹⁸ In contrast, another economist found that the “... level of state and local spending is significantly affected by deductibility.”¹⁹

¹⁵ The tax reform panel reform package would counter, or at least offset, the distributional effect of the state and local taxes paid deduction through elimination of the AMT and the highest tax bracket.

¹⁶ State personal income data are from the U.S. Census Bureau, Bureau of Economic Analysis, available at http://www.bea.gov/newsreleases/regional/spi/spi_newsrelease.htm, visited on July 17, 2008. State tax data are from U.S. Census Bureau, *State and Local Government Finances: 2005-06*, the data are available at <http://www.census.gov/govs/www/estimate06.html>, visited July 16, 2008.

¹⁷ Robert Jay Dilger, “Eliminating the Deductibility of State and Local Taxes: Impacts on States and Cities,” *Public Budgeting & Finance*, winter 1985, p. 77.

¹⁸ Edward M. Gramlich, “The Deductibility of State and Local Taxes,” *National Tax Journal*, vol. 38, no. 4, December 1985, p. 462.

¹⁹ Lawrence B. Lindsey, “Federal Deductibility of State and Local Taxes,” in Harvey Rosen, editor, *Fiscal Federalism: Quantitative Studies* (Chicago, IL: University of Chicago Press, 1988), p. 173.

Making the Sales Tax Deduction Permanent

Under the AJCA, the sales tax deduction expired January 1, 2006. On December 20, 2006, the deduction was extended through 2007 by the Tax Relief and Health Care Act of 2006 (P.L. 109-432). Making the provision permanent would benefit itemizing taxpayers in states without an income tax the most. The cost of making the sales tax deduction option permanent (continuing with the *in lieu of income taxes* language) would generate an annual federal revenue loss of approximately \$37.1 billion over the FY2009 to FY2018 budget window (\$3.0 billion in FY2009).²⁰

Other Policy Considerations

Two concepts or issues were not directly addressed in this report yet will likely arise during the debate surrounding the federal income tax treatment of state and local taxes. One, are the tax expenditures for state and local taxes paid truly federal tax “expenditures?” Or, do these “expenditures” represent a return of taxpayer income that was never the federal government’s to begin with? Two, would the absence of a federal deduction for state and local taxes paid amount to “taxing a tax?” The foundation of these arguments can be traced to the difference between a theoretically ideal income tax and the federal income tax as it currently exists.

The ideal federal income tax would include wage income plus all accretions to wealth (including imputed income) over a designated time period, one calendar year, for example.²¹ This definition of income should, theoretically, accurately measure an individual’s ability to pay income taxes. Any exclusions or deductions from this definition of income would represent a departure from the rule and thus generate a tax “expenditure” or federal subsidy.

There are two ways to view taxes paid for state and local government services under an ideal income tax.²² If one views state and local taxes paid as payment for government provided services which could be privately provided, then the federal deduction for state and local taxes is not appropriate. In contrast, if one views state and local taxes as lost income resulting in a reduced ability to pay federal income taxes (a loss), then a deduction for those taxes seems reasonable. The more tangible, less theoretical, tax-on-a-tax issue arises from this last observation.²³

There is not a clear consensus on which view is “correct.” For some state and local taxes and taxpayers, the fee-for-specific-services view is more accurate. Taxpayers with government-provided trash collection who pay property taxes for government spending on trash collection, for example, are receiving a tangible quasi-private benefit. Similar federal taxpayers in two otherwise equivalent jurisdictions—except that one provides garbage collection and one does not—would face different federal tax burdens. Generally, this would contradict the concept of horizontal equity across federal taxpayers.

²⁰ Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2008 to 2018*, January 2008, p.101.

²¹ This definition of an ideal income tax is credited to Haig and Simons, who did much of their research in the 1930s. For more, see Simons, Henry Calvert, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (Chicago, IL: University of Chicago Press, 1938).

²² Note that the benefits received by taxpayers are not included in federal taxable income.

²³ When top federal income tax rates were much higher in the 1970s and 1980s (the top rate was 70% in 1981), it is true that combined with state and local rates of 10% to 15% would create almost confiscatory cumulative income tax rates. The current federal rate structure with much lower rates minimize this effect.

The reduction-in-ability-to-pay view seems more reasonable for those paying general sales taxes for general government provision of public goods such as fire and police protection. Note that a federal deduction for sales taxes and not property taxes would theoretically seem more desirable.

President's Advisory Panel on Federal Tax Reform

The tax reform panel has recommended elimination of the deduction for all state and local taxes as part of a broader effort to simplify the tax code. Under the reform plan, the repeal of the deduction would be accompanied by repeal of the alternative minimum tax (AMT), a switch from personal exemptions and a standard deduction to a family credit, and a lower top marginal tax rate. Each of the additional proposals affect the overall impact of state and local deductibility repeal. As outlined earlier in this report, under current law, the deductibility benefits itemizers in high-tax jurisdictions more than non-itemizers in low-tax jurisdictions. Thus, elimination of the deduction would shift the burden from low-income taxpayers to high-income taxpayers, all else held constant.

Elimination of the AMT and a lower top regular income tax rate, however, will benefit primarily high-income taxpayers. Note that AMT filers cannot take the deduction for state and local taxes paid, thus elimination of the deduction is mostly inconsequential. The elimination of the 10% bracket amount and the narrower 28% income tax bracket will increase taxes for all taxpayers. Low-income taxpayers will likely encounter a greater increase in relative tax burden (based on taxes as a percentage of income) under the tax reform plan. Thus, on balance, the tax reform panel package of tax code changes, taken together, may not significantly shift the federal tax burden.

The proposed tax reform plan(s) will also have an indirect effect on state and local government finances if implemented. Federal income taxes will not vary based on the residence of the itemizing taxpayer as is currently the case. Some may argue that the “neutral” treatment of all taxpayers, regardless of state and local tax burden, may be inequitable because taxpayers in high-tax jurisdictions have a reduced ability to pay federal income taxes. Alternatively, others argue that the federal income tax should be neutral with regard to state and local taxes. Nevertheless, the use of uniform credits will increase the relative price of state and local government services. High-tax/high-government-service jurisdictions would fare less well than low-tax/low-government-service jurisdictions.

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