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The Deductibility of State and Local Taxes

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President Reagan's tax reform proposals of May 1985 recommended eliminating the deduction of state and local taxes in computing federal taxable income. Arguments for and against deductibility appeal to equity for taxpayers facing levies from multiple governments and to concern for the roles and responsibilities of governments in a federal system. Intense criticism and lobbying against the president's proposal was spearheaded by New York. The debate was soon recast to emphasize the impact of change on other states, especially in the Northeast and Midwest, and the potential widespread negative effects on government services, especially education. The broadened base of opposition to change was sufficient to sustain deductibility in the bill passed by the House of Representatives in December 1985, illustrating that a cohesive lobbying effort invoking the concept of federalism as a partnership can be fashioned by appealing to states on the basis of the negative consequences of change.

The deduction of state and local taxes in calculating income subject to the federal income tax came under intense scrutiny in 1985. President Ronald Reagan pressed for elimination of this "most sacred of cows"[1] even while interest groups organized for its retention. At issue were competing historical, philosophical, and economic claims about the proper structure of taxation in a federal system. The major arena for activity was the Congress, where the legislative struggle made for odd bedfellows. At the end of 1985, the House of Representatives, after active intervention by the president, enacted tax reform legislation that left intact the practice of deducting state and local taxes. The future of deductibility, however, remained clouded in the absence of Senate action on tax reform in 1985.

State and local taxes, along with federal taxes, were the only deductions specified in the Revenue Act of 1862, the country's first income tax, enacted to finance the Union effort in the Civil War. What was the original rationale for such deductions? What have been the arguments over the years for and

[1]Harvey E. Brazer, "The Deductibility of State and Local Taxes Under the Individual Income Tax," U.S. Congress, House, Committee on Ways and Means, *Tax Revision Compendium*, vol. 1, 1959, p. 407.

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tually deducted (representing only 16 percent of all state and local expenditures) is sensitive to changes in the tax price. This reasoning suggests that ending deductibility would reduce spending by only 2 percent.[33] Significantly, the president chose to cite this estimate in his reform proposal.

STRATEGIC RESPONSES

Public debate about the repeal of state and local tax deductions took two distinct forms during 1985. The debate at first revolved about the interests of a single state, New York. The participants in the debate were the state's leading officials, including the governor and members of the New York delegation in the Congress, on the one hand, and top federal officials, including the president and several of his key advisors, on the other. Later, the debate agenda was broadened to center on a wider set of interests which cut across all states. The National Coalition Against Double Taxation—representing local governments and states, education groups, and labor unions—helped to advance those interests in lobbying efforts in the Congress.

The battle was joined when President Reagan stated in an interview that he had "no sympathy for high-tax states trying to protect their wealthy taxpayers."[34] Treasury Secretary Regan asserted, "My heart will not break if New Yorkers lose the right to deduct billions in state and local taxes from their taxable incomes."[35]

New York's Governor Cuomo became a leading and highly visible spokesperson for the retention of deductibility—despite public and private concerns that his posture was a risky one, both for his own political future and for the ultimate resolution of the deductibility issue.[36] His involvement was part of a strategy to activate support for retention of state and local tax deductibility both inside New York and across the country.

The governor's calls for vigilance in the face of "tax restructuring proposals that would work, unfairly, to the serious detriment of New Yorkers,"[37] were part of the "inside" strategy. His strong position helped to stimulate bipartisan unity among officials within New York. The Republican majority leader of the state senate, the state comptroller, the mayor of New York City, and many local officials testified at hearings conducted by U.S. Senator D'Amato around the state during June and July 1985. One urban county executive contended that "the net effect of the Treasury's proposal would be that the cost of providing local services would go up at a time when the federal government wants to shift more responsibility down."[38] The Republican leadership of the state senate even sponsored a

[33]Ibid., pp. 58-59.
[34]Interview on Cable News Network, 1 December 1984.
[35]"Drop Dead Again," *The New York Times*, 4 December 1984.
[36]See Mary McGory, *The Washington Post*, 23 June 1985.
[37]Mario M. Cuomo, "State of New York Annual Budget Message 1985-1986" (Albany: 22 January 1985), p. m9.
[38]Lucien A. Morin, "The Effect of Repeal of the State and Local Tax Deduction on Monroe County and Its Residents," U.S. Congress, Joint Economic Committee, Hearings, 24 June 1985.

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resolution in June 1985 proposing that the U.S. Constitution be amended to require the deduction of state and local property, income, and general sales taxes in calculations of income for federal income tax purposes.

The fact that deductibility was a high personal priority for the governor was critical in promoting solidarity among the state's delegation in the Congress—a delegation normally characterized as anything but cohesive.[39] The governor's strong position, communicated by letter to each member of the delegation, was followed by a request that the members cosponsor a resolution crafted by Representative Raymond J. McGrath, a Republican from Long Island and member of the Ways and Means Committee. The resolution declared deductibility "essential to the well-being of moderate-income Americans, state and local governments and the housing industry."[40] Thirty-two of the thirty-four House members from New York agreed to cosponsor it.

The New York strategy was also, and more critically, directed toward the national arena, namely the Congress, where the decision about the fate of deductibility would occur. With the support of the New York delegation secured, Governor Cuomo moved to broaden the base of his appeal outside the state. Speaking before national audiences, he evoked the principles of federalism as partnership:

> The administration's proposal to repeal deductibility overturns a central idea at the heart of our republic—that we are one nation, not fifty nations, and that we are strongest when we stand together and help each other. . . . The most dangerous thing about the proposed tax plan is that it would divide our house.[41]

Recasting the terms of the debate was a key tactic of the New Yorkers at the forefront of the battle to preserve deductibility. Their goal was to downplay deductibility as a "New York" issue that pitted high-tax states against low-tax states, high-income itemizers against persons with lower incomes, and, instead, to emphasize the widespread negative effects on government services that might result from ending deductibility. Their basic argument was that repeal of deductibility would produce "irresistible taxpayer pressure to cut state and local taxes, resulting in reduced government services."[42]

Such negative effects were projected to occur disproportionately in the Northeast and Midwest regions of the nation and in the field of public education. The Northeast-Midwest Congressional Coalition in the House of Representatives, representing eighteen states, took a firm position against

[39] James Barron, "The New York Delegation," *New York State Today*, ed. Peter Colby (Albany: State University of New York Press, 1985), pp. 203-210.

[40] House Resolution 105.

[41] Mario M. Cuomo, Testimony before the House Committee on Ways and Means, 17 July 1985.

[42] Clark, *National Journal*, 29 June 1985, p. 1510.

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repeal of state and local tax deductibility, arguing that "repeal would place an unfair and disproportionate burden on taxpayers" in the two regions.[43] The coalition estimated that "with 44 percent of the nation's population, [Northeast and Midwest] taxpayers would have to pay 57 percent of the cost of eliminating the deduction for non-business state and local taxes."[44] That estimate was derived from data indicating that the Northeast and Midwest states rely most heavily on revenues from personal income, sales, and property taxes, while states least hard hit by the repeal of deductibility rely on energy severance taxes that "would be considered business taxes and would remain deductible."[45] An unlikely source of support for the position of the Northeast-Midwest Coalition came from the Western Governors' Association which feared that "ending deductibility might bring about potentially explosive regional tax warfare. . . . Elimination of deductibility could rekindle efforts by those [Northeast and Midwest] states to limit the ability of states [rich in natural resources] to levy and collect severance taxes."[46]

Besides estimating the regional disparities flowing from repeal of deductibility, the national strategy emphasized how it would reduce public services. While many services could be affected, including public safety and public health, the major target for service cuts was thought to be education. About 36 percent of all state and local expenditures are earmarked for education. As noted earlier, the effects of repeal of deductibility on revenues for public education could be expected to be especially large. Concern about the effects of repeal was shared by all major lobby groups for public education, including the American Federation of Teachers, the National Education Association, and the National School Boards Association. These lobby groups, together with others representing organized labor, state legislators, county officials, mayors, and providers of services to the poor, joined forces under the aegis of a broader coalition called the National Coalition Against Double Taxation.[47]

Within this coalition, the action group known as SALT-D (State and Local Taxation-Deductibility) was concerned with developing awareness of the implications for public education of repealing deductibility. A two-pronged effort was launched, with the single goal of rallying a broad cross section of localities and states to lobby members of Congress to retain deductibility. The first prong involved broadening the argument about regional effects. To do this, the SALT-D action group generated data for each state concern-

[43]Northeast-Midwest Congressional Coalition, "Fact Sheet, State and Local Tax Deductibility," 12 September 1985.

[44]Ibid.

[45]Ibid.

[46]Clark, *National Journal*, 29 June 1985, p. 1514.

[47]The National Governors' Association (NGA) was alone among major state associations that did not officially join the National Coalition Against Double Taxation. While the NGA adopted a position opposing outright elimination of the deduction, it did signal its willingness, on 26 February 1986, to "consider some limited modification of the . . . tax expenditures that benefit state and local government."

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ing relative reliance on sales, property, and income tax revenues for funding education. The second prong of the SALT-D effort focused on equity in funding public and private education. Albert Shanker, president of the American Federation of Teachers, in testimony before the House Ways and Means Committee, contended that it would be unfair to continue allowing taxpayers to take deductions for charitable contributions to private educational institutions while at the same time repealing the deduction for state and local taxes to aid public education.[48]

By fall 1985, the president and his treasury secretary were ranged against a well constructed coalition of interests, with New York state in the lead. The president viewed deductibility as the linchpin of his tax reform proposals. It was necessary as a base-broadening element to achieve a revenue-neutral outcome, and it was equitable, in his view, for it would eliminate a loophole of special advantage to wealthy taxpayers in high-tax states. New York, whose residents gain more from deductibility than the residents of any other state, countered with a strategy geared to build support for retention. That strategy emphasized that deductibility is not a New York issue, but a national one. Its repeal would generate negative effects on taxpayers in the Northeast and Midwest, not just in New York, and on public education in all the states.

STRANGE BEDFELLOWS

The course of tax reform in the House of Representatives was anything but smooth. Between May 1985, when the president's Tax Proposals for Fairness, Growth and Simplicity were introduced, and 17 December 1985, when the House passed the Tax Reform Act of 1985 (H.R. 3838), the process was characterized by fits and starts and unexpected outcomes. The president's initiative, in fact, was compared to "'the target bear' in a shooting gallery. It gets hit. It rises, pauses, turns a bit—and then it keeps going."[49]

The principal actors and allies on tax reform were President Reagan and Dan Rostenkowski (D-Ill.), chairman of the House Ways and Means Committee. Although their imputed motivations differed, tax reform was a high priority for each. The president viewed tax reform as an issue with populist appeal, one with the potential to enlarge the base of support for the Republican party.[50] Chairman Rostenkowski, whose aspirations to succeed Thomas P. O'Neill as Speaker of the House of Representatives in 1987 were widely known, viewed his successful management of tax reform in the House and, after Senate passage, in the Conference Committee, as a significant step toward outdistancing Majority Leader James C. Wright, Jr. (D-Tex.) in the race for the Speaker's office.[51]

[48]U.S. Congress, House, Committee on Ways and Means, Summary of Testimony on the Comprehensive Tax Reform Proposal of the President, 99th Cong., 1st sess., pp. 26–27.

[49]Dick Kirschten, "White House Notebook," *National Journal*, 21 December 1985, p. 2918.

[50]Ronald Reagan, Radio Address, April 1985.

[51]Richard E. Cohen, "Democrats, GOP Wary of Long Term Political Fallout from Tax Reform," *National Journal*, 8 June 1985, p. 1347.

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Agreement between Chairman Rostenkowski and President Reagan on the importance of tax reform, however, did not portend smooth sailing in the House of Representatives. Tax politics is normally characterized by pluralistic interests and incremental outcomes;[52] comprehensive tax reform poses difficult challenges for the politician who would achieve this goal. Chairman Rostenkowski initiated the process by presenting his own version of tax reform to the Ways and Means Committee on 26 September 1985. Rostenkowski's bill modified many aspects of Treasury II, but retained the three individual tax brackets. The Chairman's main goal in the bill—or "mark"—was not to preserve tax policy principles, but to obtain a winning bipartisan coalition in the Ways and Means Committee.

One such modification involved the deduction of state and local taxes. Rostenkowski staked out a middle ground between Treasury II—which proposed total repeal of these deductions—and the New York delegation—which advocated total retention. He proposed repealing the deduction for sales and personal property taxes and limiting the deduction for income and real property taxes. Taxpayers would be allowed to deduct $1,000 in state and local income and real property taxes ($500 for unmarried individuals) or the amount of such taxes exceeding 5 percent of their adjusted gross income, whichever is greater.[53]

This modification on deductibility was offered by Chairman Rostenkowski both to enhance federal revenues and to mollify New York. However, the three New Yorkers on the committee—Charles B. Rangel (Democrat), Thomas J. Downey (Democrat) and Raymond McGrath (Republican)—viewed the Chairman's modification as an unacceptable incursion into the present law. Retention of current state and local deductions was the price that these three members demanded for support of tax reform.

Under the chairman's direction and with the participation of Treasury Secretary Baker, the Ways and Means Committee worked in closed session for two months. The process involved both atypical and typical elements. Atypical was the use of task forces—on pensions, housing, taxable bonds, business entertainment—whose members were carefully selected by Rostenkowski to craft various tax legislation details. Typical was the bargaining among committee members that led to trade-offs on issues across regions. New York committee members used data on losers and gainers, such as those in Table 1, in their efforts to gain allies. Downey, who had campaigned against the oil depletion allowance when first elected to Congress in 1974, found himself supporting oil drilling incentives in return for support of deductibility by committee members from Texas and Oklahoma. It was, in the words of one observer, "classic down-in-the-dirt legislative politics." The process produced what Rostenkowski himself said was "not a perfect law. But politics,"

[52]See John F. Witte, "Democratic Procedures and Tax Policy," in Joseph A. Pechman, *A Citizen's Guide to the New Tax Reforms* (Totowa, N.J.: Rowman and Allanheld, 1985).
[53]*Congressional Quarterly Weekly Report*, 28 September 1985, p. 1913.

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he acknowledged, "is an imperfect process."[54] In any case, the lobbying efforts of Governor Cuomo and the National Coalition Against Double Taxation were successful: the Ways and Means Committee bill reported out on 23 November 1985 retained full deductibility for state and local taxes.[55]

Despite the "strange bedfellows" coalition of the Republican president and the Democratic chairman of the House Ways and Means Committee, tax reform did not yield bipartisan unity. On the final committee vote, only five of the thirteen Republicans joined all twenty-three Democrats. The Republican leadership of the House, in fact, actively opposed the Ways and Means bill, charging that it fell far short of the president's goals of simplicity, fairness, and economic growth. They were also dissatisfied with the administration's efforts to push a tax overhaul bill through the House despite the reluctance of party members.[56] Eliminating the deduction for state and local taxes apparently played no role in the opposition of most of the House Republicans to the Ways and Means Committee bill. Deductibility had not been a partisan issue in the committee debate, and it did not become one in the floor debate in the House. Rather, the substantive concerns of the Republican minority members centered on provisions in the bill which, they believed, would dampen the climate for business investment.[57]

The opposition of the Republican minority was demonstrated quite tangibly on 11 December 1985, when 164 of 178 Republicans, together with 59 Democrats, voted against a rule that would have allowed debate on the Ways and Means Committee bill on the floor of the House. The rule was defeated by a vote of 202–223; "Republican leaders . . . declared victory."[58]

That "victory" was short-lived. President Reagan, after meeting personally with Republican House members and then promising in a letter to them that he would veto any tax bill that failed to meet specific minimum requirements for tax reform,[59] succeeded in inducing fifty-six additional Republicans to vote for the rule when it was reintroduced on 17 December. The rule carried

[54]"Ways and Means Finishes Tax Code Overhaul," *Congressional Quarterly Weekly Report*, 30 November 1985, p. 2483.

[55]Chairman Rostenkowski's concession on deductibility was reported to have "stunned his colleagues. When Representative Thomas Downey, a New York Democrat expressed his surprise to Rostenkowski, the chairman said, 'I was always going to give you state and local taxes.' Replied Downey, 'If you were, you deserve an Academy Award,'" *Time*, 11 November 1985, p. 68.

[56]"GOP Defeats Attempt to Consider Tax Bill," *Congressional Quarterly Weekly Report*, 14 December 1985, p. 2613.

[57]See David E. Rosenbaum, "House Committee Completes Draft for Tax Revision," *The New York Times*, 24 November 1985 and "Companies Upset by Tax Bill," *The New York Times*, 26 November 1985.

[58]"GOP Defeats Attempt to Consider Tax Bill," *Congressional Quarterly Weekly Report*, 14 December 1985, p. 2613.

[59]These requirements were "a full $2000 personal exemption for both itemizers and non-itemizers, basic tax incentives for American industries, a minimum tax which allows no individual or business to escape paying a fair share of the overall tax burden, a rate structure with a maximum rate no higher than in my proposal, and tax brackets that are fully consistent with our desire to reduce taxes for middle-income working Americans." *The New York Times*, 18 December 1985.

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by a vote of 258 to 168. The Ways and Means bill subsequently carried on a voice vote, and the matter of tax reform moved to the Senate for consideration. However, whether the deduction for state and local taxes would remain intact or, indeed, whether the Senate would enact tax reform legislation at all remained a matter of speculation at the end of 1985.

CONCLUSION

President Reagan's tax reform initiative in 1985 was intended, according to the president, to produce fairness, growth, and simplicity in the nation's federal income tax structure. At the same time, it provoked a national debate on basic premises of American federalism. The debate was stimulated by the president's proposal to eliminate the deduction of state and local taxes in computing federal taxable income. Such deductibility—an accepted practice since the Civil War—was long assumed to be an appropriate incentive to the states to tax themselves as partners with the federal government in responding to national needs and in implementing national goals.

Public justifications for eliminating the deduction included its economic inefficiencies and disproportionate benefits to higher income taxpayers in high-tax states. The more pragmatic reason for elimination was to raise revenues to compensate for proposed cuts in federal tax rates.

Lobbying against elimination of deductibility was spearheaded by New York, a high income and high spending state whose residents stood to be the biggest losers. The New York strategy, articulated by its governor, was intended to activate support in other states by downplaying deductibility as a New York issue and emphasizing instead its disproportionately negative effects on states in the Northeast and Midwest, and its potential widespread negative effects on government services, especially education. The bipartisan cohesion of New York officials and members of Congress in opposition to any compromise on full state and local tax deductibility, together with the "nationalizing" of the issue, led to a defeat for the president on this issue in the House Ways and Means Committee and in the House as a whole.

What does the action in the House of Representatives tell us about the state of American federalism? First, it suggests that such traditional practices as the deduction of state and local taxes are not sacrosanct when they collide with a need for enhanced federal revenues. Second, it suggests that perspectives diverge on the role of state governments vis-a-vis each other. Third, it suggests that the perspective of federalism as partnership may prevail when a cohesive lobbying effort is fashioned to appeal to other states on the basis of negative consequences of change.

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