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TAX REFORM PROPOSALS—XIX

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

JULY 25, 1985

INCOME TAX DEDUCTIONS OF STATE AND LOCAL GOVERNMENTS

Printed for the use of the Committee on Finance

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IMPACT OF THE TAX REFORM PROPOSAL ON STATE AND LOCAL GOVERNMENTS

THURSDAY, JULY 25, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m. in room SD-215, Dirksen Senate Office Building, Hon. Robert Packwood (chairman) presiding.

Present: Senators Packwood, Heinz, Durenberger, Symms, Grassley, Bentsen, Moynihan, and Bradley.

[The prepared statement of Senator Durenberger follows:]

WRITTEN STATEMENT OF

SENATOR DAVE DURENBERGER

ON

STATE AND LOCAL TAX DEDUCTIBILITY

BEFORE THE COMMITTEE ON FINANCE

JULY 25, 1985

Dear Mr. Chairman:

I appreciate this opportunity to address the Committee on this important issue--the federal income tax deduction for state and local taxes. This deduction has been a provision of the Internal Revenue Code since the creation of the federal income tax in 1913. The President's tax reform plan would eliminate this deduction.

The Administration considers this deduction to be an unfair subsidy to the rich in high-tax states with a penchant for big government. This rhetoric ignores the fact that the state and local tax deduction is part of a much larger system, called fiscal federalism.

In reality, national, state, and local taxes are combined in a Federal Tax System. And it is the federal tax system--not just national taxes--that is the engine for a successful domestic economy. So, if we are going to tinker with that engine, we had better know how its parts fit together; or we may not get it started again.

I speak to you today as the Chairman of the Senate Subcommittee on Intergovernmental Relations. As Chairman, I participated in the New Federalism debates in 1982. At that time, it was clear to those of us in the trenches that state and local tax deductibility is one of a number of ways in which the national government helps states and local governments to handle their own responsibilities.

The New Federalism initiative may have died, but de facto New Federalism is alive and well. Over the past four years, we have

thrust upon state and local governments more and more responsibilities with fewer and fewer national dollars to go with them. And, undoubtedly, we shall continue to do so.

It is only in this Federalism context that we are able to see state and local tax deductibility clearly. Deductibility allows states to raise and keep their own revenues. And it rewards them for handling their own responsibilities.

My subcommittee examined this issue at a hearing in June, and we received testimony from many groups and individuals--some of whom are here today. I'd like to read a few comments from them:

> "Federal budget cuts, and the elimination or reduction of certain federal programs have put additional burdens on state and local governments throughout the country. Removal of the federal deduction for state and local taxes would have a serious impact on the ability of these governments to raise the funds needed to meet their increasing obligations."

> "The proposed elimination of deductibility threatens to weaken our federation of states, which is the foundation of our nation. Factors such as state sovereignty, fiscal federalism, equity, and national security do not easily lend themselves to economic modeling and standardized indices. In today's uncertain time, it would be foolhardy to abandon these principles in pursuit of new goals which are framed more by rhetoric than careful and considered analysis."

These are strong words . . . expressing powerful sentiments. You're probably thinking they were spoken by Governor Mario Cuomo or Senator D'Amato or Senator Moynihan. After all, they are all

from New York, the highest tax state in the country, and citizens of New York have the most to lose if the deduction is eliminated. But it wasn't Governor Cuomo nor Alfonse D'Amato nor Pat Moynihan nor anyone from a high-tax state. These are the concerns and protestations of the Governors of Alaska and Wyoming--the two states that would be the biggest winners if the deduction were eliminated. They know that the issue of deductibility is more than an issue of winners and losers, and it must be viewed in the broader context of our federal system.

Our national, state, and local governments are joined in a single system of government, sharing responsibilities and resources. And while some states might not benefit as much from deductibility, they receive the benefits of our intergovernmental system through grants to state and local governments, defense contracts and procurement, and direct payments to individuals. For example, Governor Sheffield of Alaska knows that his state received the fourth highest per capita federal expenditure for defense contracts in 1983, a whopping $1,783 compared to the national average of $778 and a lowly $445 in Minnesota.

The Governor of Mississippi also wrote to me in support of the deduction, even though his is a low-tax state. His citizens might not receive much benefit from the deduction, but for every $1 that Mississippi pays in federal taxes, Mississippians receive $1.67 back in federal spending. On the other hand, Minnesotans receive less than they put in: only 87 cents, resulting in a ranking of 42 for Minnesota.

Now, I'm not suggesting that each state should receive the same level of federal spending. What I am saying is that states which levy high tax rates so they can take care of many of their problems without federal aid--states like Minnesota--should not be penalized. I think the Governors of Mississippi and Wyoming realize that while they might be low on the totem pole for some things, they are high for others. And for them to point the finger at high-tax states would be like the pot calling the kettle black.

By repealing the deduction, the Treasury Department is treating state and local tax deductions as though they were identical with tax subsidies for three-martini business lunches. In fact, under the Administration's proposal, those lunches fare better: That deduction is reduced but not eliminated.

The Administration says its plan is simple and fair. Well, repealing the deduction for state and local taxes is certainly a simple way to keep the plan revenue neutral. But that doesn't make it fair.

I believe the tax reform plan is grossly unfair to state and local governments. Consider these statistics: The estimated federal government revenue loss for tax expenditures which benefit individuals is $293 billion for Fiscal Year 1986. Deductibility of state and local taxes represents $33.2 billion--about 11 percent of the total. Yet, deductibility represents 67 percent of the Administration's proposed modifications of tax expenditures that would lower tax rates. I don't call this fair.

I will just mention briefly the reasons I believe the deduction of state and local taxes is critical for our intergovernmental system. First, the deduction prevents the national government from capturing all of the tax base and helps to preserve some portion of the base for state and local revenue sharing. Without the deduction, state and local governments will face increased voter resistance to raising taxes to finance needed expenditures. The Congressional Research Service estimates that revenues from state and local taxes paid by itemizers could decrease by up to 13 percent if deductibility is repealed. And this decrease would mean a decline in state and local spending, during a time when we are already asking states and local governments to assume more responsibilities.

The deduction also helps to cushion the harmful tax competition among states by reducing the effect of fiscal disparities among them. There are several factors, other than a preference for big government, which can cause differences in tax rates. For instance, large urban areas that have a higher than average percentage of the poor must impose a heavier burden on the non-poor so that ordinary public services--education, police, roads--are provided at adequate levels. Without the deduction, high-income taxpayers face an incentive to move to lower tax jurisdictions, leaving behind a depleted tax base which cannot support the low-income population.

Conversely, low-tax states don't necessarily have a preference for less government but might be able to generate revenue from other sources, such as natural resources, tourism,

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Thank you, Mr. Chairman.

Excellency, we are very honored to have you with us today. I have just a couple of questions I would like to ask and one general statement I would like to make. I think that this committee—at least some of us here—is concerned that in the course of undertaking to reform the Tax Code, which in all truth we do every other year, we are going to alter the Constitution. I mean by this we are going to change the constitutional balance in some fundamental way. Senator Javits has described so well of the increasing efforts of the Federal Government in the last quarter century to reduce inequities in the American Federal system. As a result of this effort, there arose some concern that the Federal Government was getting too large.

In response to this concern, President Kennedy initiated—and President Nixon finally adopted—revenue sharing. This was a very specific proposal to turn revenue back to State governments and local governments and to permit decisions to be made there.

Now we have lost revenue sharing. And if we lose State and local tax deductibility, there is going to be one ineluctable process—that is, more and more decisions will be made in Washington.

I would like to ask all of you one question. I was surprised to learn that the Treasury Department describes this provision, which has been in the Tax Code from the beginning, as a Federal subsidy. There is something perverse about this proposition—any money the Federal Government doesn't take from you, it has somehow allowed you to keep, as if it was theirs to begin with. A Federal subsidy, it would appear, is the amount of money that the Treasury does not collect as taxes.

And just this very word, subsidy, changes the whole political debate. It is a most arrogant assertion that the government owns your income—what it does not take from you is something it has given to you.

The CHAIRMAN. Let me interrupt and recall to memory. You weren't here at the time, Pat, but in 1974-75 Ed Levy who became our Attorney General but was then the dean of the Law School at Chicago testified—we were on tax reform then as we are now—and he took exactly this theory that you were talking about. About it belongs to us, but we will let you keep some of it. And he said I don't know where these tax reformers get this idea that that's a new theory. He said that's been around for centuries. We used to call it feudalism. [Laughter.]

Senator MOYNIHAN. Well, welcome to the court.

But there is another subsidy that I would like to ask you about: the Federal tax exemption for the interest on State and local government bonds. Would you consider it? For a number of years, the Office of Management and Budget would put out special analyses of different aspects of public finance, up until 1982 when they stopped it. There was a table, S9 which listed the present value of the subsidies for new issues of State and local government bonds.

In the year 1982, it was estimated that the tax loss to the Federal Government for new bond issues was $23 billion and the borrower benefit was $16.5 million, which meant to say that there was a difference of $8 billion that went solely to the people who owned