

Written Testimony of Scott A. Hodge, President, Tax Foundation

Hearing on Tax Reform and Tax Provisions Affecting State and Local Governments
Before the U.S. House of Representatives Committee on Ways and Means

March 19, 2013

Mr. Chairman, Mr. Ranking Member, and members of the Committee:

Thank you for the opportunity to speak to you today on the issues related to tax reform and the tax provisions affecting state and local governments.

Founded in 1937, the Tax Foundation is the nation's oldest organization dedicated to promoting economically sound tax policy at the federal, state, and local levels of government. We are a non-partisan 501(c)(3) organization.

For 75 years, the Tax Foundation's research has been guided by Adam Smith's immutable principles of tax policy which say that taxes should be neutral to economic decision making, they should be simple, transparent, stable, and they should promote economic growth.

In other words, the ideal tax system should do only one thing—raise a sufficient amount of revenues to fund government activities with the least amount of harm to the economy. By all accounts, the U.S. tax code is far from that ideal. Our current tax system is a Byzantine monstrosity that spans 70,000 pages, costs taxpayers more than \$160 billion per year to comply with, and is undermining our nation's economic potential.

Contributing to this complexity are the more than 170 different tax expenditure programs in the tax code, which have a total budgetary cost exceeding \$1 trillion. These myriad tax provisions were enacted to achieve all manner of social and economic objectives, such as encouraging people to buy hybrid vehicles, turn corn into gasoline, buy a home, replace the home's windows, adopt children, put them in daycare, then help them go to college, and the list goes on.

Contrary to conventional wisdom, not every tax expenditure is a "loophole." However, there are dozens of tax provisions that produce harmful side effects that outweigh whatever public policy reason motivated their creation. These are the most obvious kind of tax breaks the Committee should target for elimination as you look to simplify the tax code while lowering tax rates.

There is a considerable amount of economic evidence suggesting that the various provisions benefiting state and local governments do have such harmful effects that they should be targeted for elimination within the broader context of fundamental tax reform.

The evidence suggests that these state and local tax provisions:

- Increase state reliance on deductible taxes;
- Lead to higher state and local tax burdens;
- Encourage higher state and local spending;
- Encourage higher state and local debt; and
- They disproportionately benefit high-income states and high-income taxpayers at the expense of low-income states and low-income taxpayers.

Should you choose to eliminate these tax provisions within the broader context of tax reform, it would deliver long-term economic benefits. Using the Tax Foundation's Tax Simulation and Macroeconomic Model, our economists find that a revenue-neutral plan that eliminates the taxes-paid deduction and municipal bond exemption while lowering income tax rates accordingly would boost GDP, wages, private investment, and federal revenue on a dynamic basis.

However, we find that if these provisions were to be eliminated without corresponding cuts in tax rates, such a plan would reduce GDP by \$1 for every \$1 of new revenues raised, while lowering wages and private investment.

I would like to take a minute to address each of these issues separately.

These Tax Provisions Alter the Behavior of State and Local Governments

While most tax provisions are intended to motivate the behavior of individuals or businesses, we find that the taxes-paid deduction and municipal bond exemption encourages some unwanted behavior from state and local governments.

In the same way that the mortgage interest deduction may encourage some families to purchase a much larger home than they otherwise could afford, the taxes-paid deduction and the municipal bond exemption encourage many states to tax more, spend more, and borrow more than they otherwise would.

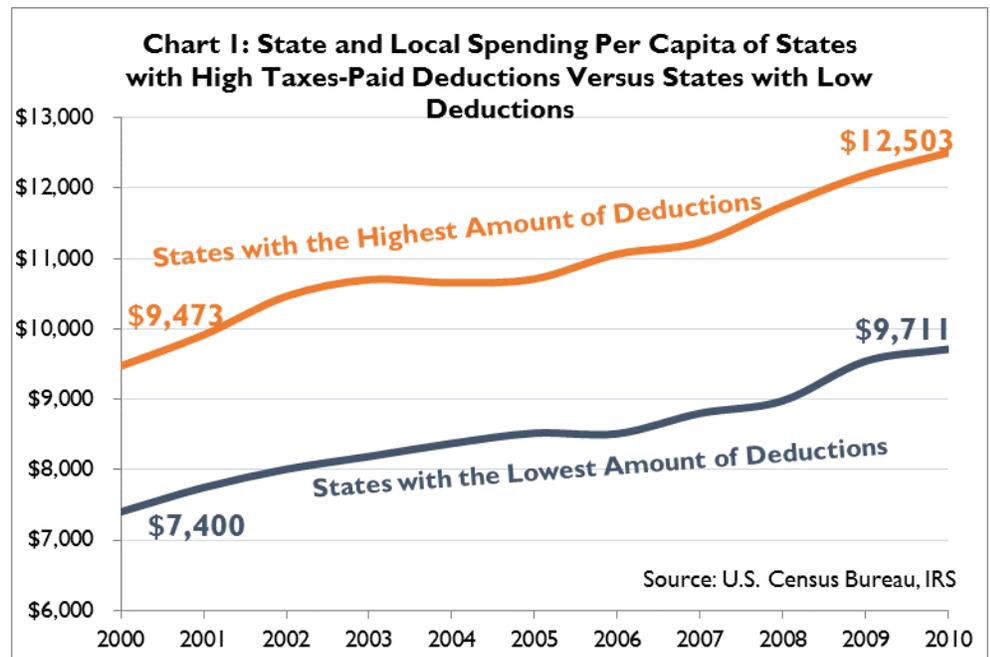
For example, academic research indicates that the taxes-paid deduction leads to greater reliance on tax-deductible taxes—such as progressive income taxes and property taxes—and ultimately leads to increases "in state and local spending of own-source revenue."¹

¹ Gilbert E. Metcalf, *Assessing the Federal Deduction for State and Local Tax Payments*, NATIONAL TAX JOURNAL, June 2011, 64 (2, Pt. 2), 565-590.

The Taxes-Paid Deduction is Linked to Higher State Spending

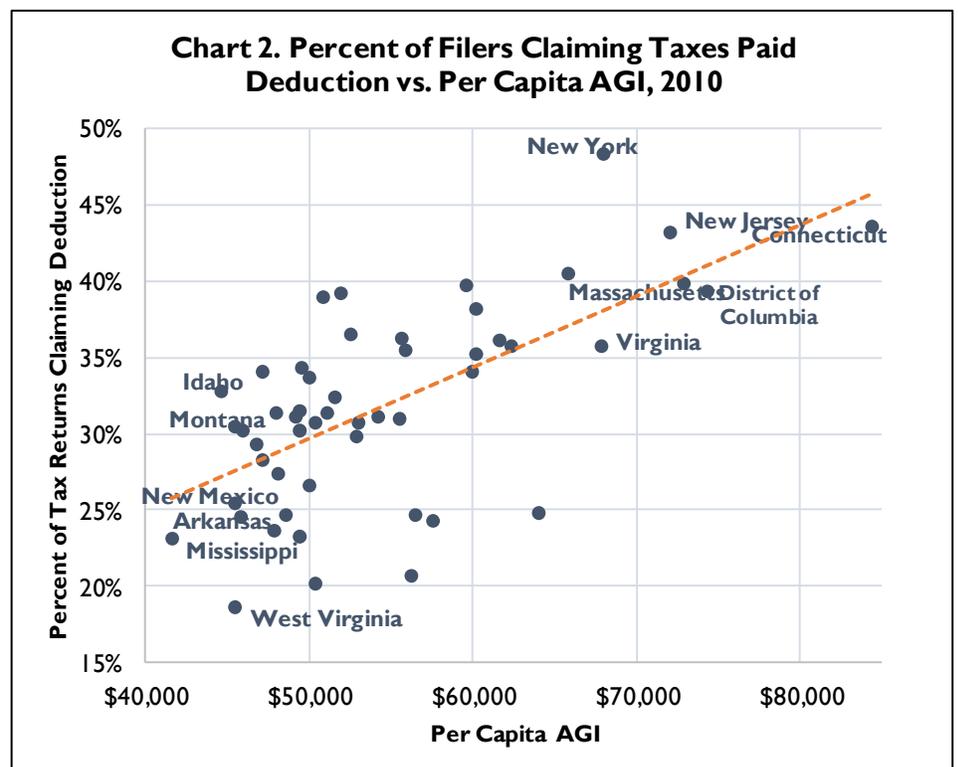
A simple way of illustrating the effect of the taxes-paid deduction on state and local spending is to compare the spending levels of states that benefit most from the taxes-paid deduction with those that benefit the least.

Chart 1 compares the per capita spending of the states with the largest amount of taxes-paid deductions (as a share of state AGI) with the states with the lowest amount of deductions. Not only do the states with the largest amount of taxes-paid deductions currently spend nearly \$2,800 more on average per person than states with lower amounts of deductions, but the gap between their relative spending levels had increased over the past decade.



Furthermore, the taxes-paid deduction not only tends to benefit higher-income taxpayers over lower-income taxpayers, but it also tends to benefit the wealthiest states.

For example, Chart 2 plots the relationship between the percentage of filers in each state who claim the taxes-paid deduction and state incomes per capita. The results show a stark difference between high-income states and low-income states. The highest-income states—such as New York, New Jersey, Connecticut, Massachusetts, and Virginia—all have among highest percentage of filers claiming the deduction of all 50 states.



By contrast, low-income states, such as Arkansas, Mississippi, New Mexico, and West Virginia, have among the lowest percentage of filers claiming the deduction.

Table 1 shows the distribution of taxpayers claiming the taxes-paid deduction and the value of the deduction for each income group. About 55 percent of the tax benefits accrue to taxpayers with incomes above \$200,000 and fully 88 percent of the benefits go to taxpayers earning over \$100,000.

Table 1: Distribution of Tax Expenditure for State and Local Income, Sales, and Personal Property Tax Deduction

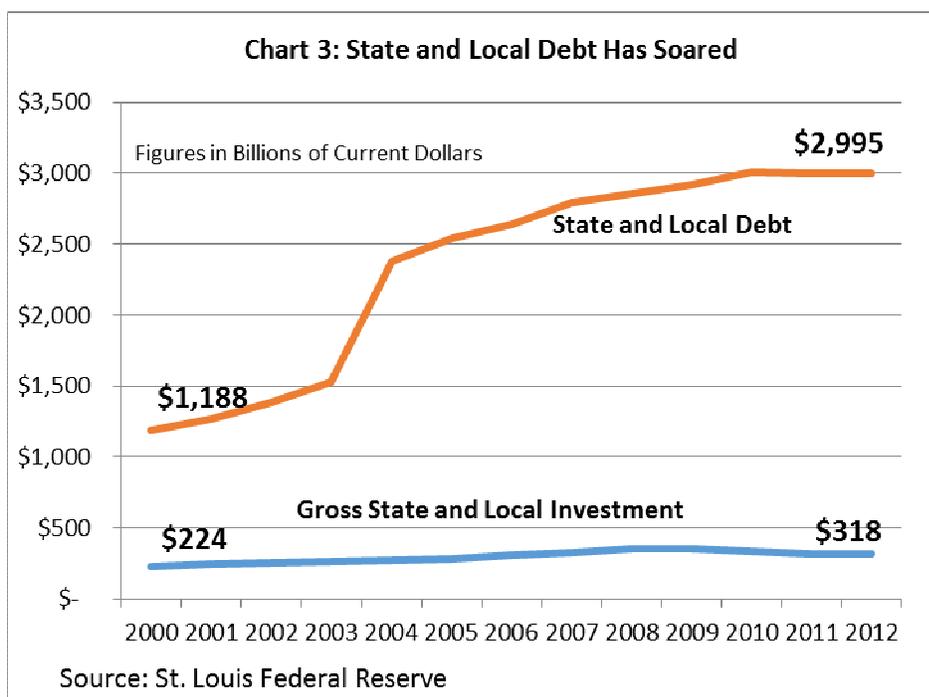
| Income Class | Returns (Millions) | Share of Total | Amount (\$Thousands) | Share of Total |
|------------------------|-----------------------|----------------|-------------------------|----------------|
| Below \$10,000 | 6 | 0.0% | - | |
| \$10,000 to \$20,000 | 163 | 0.4% | \$5 | 0.0% |
| \$20,000 to \$30,000 | 621 | 1% | \$39 | 0.1% |
| \$30,000 to \$40,000 | 1,343 | 3% | \$126 | 0.3% |
| \$40,000 to \$50,000 | 2,304 | 5% | \$303 | 1% |
| \$50,000 to \$75,000 | 7,781 | 19% | \$1,927 | 4% |
| \$75,000 to \$100,000 | 7,850 | 19% | \$3,027 | 7% |
| \$100,000 to \$200,000 | 17,143 | 41% | \$14,262 | 33% |
| \$200,000 and over | 4,805 | 11% | \$24,135 | 55% |
| Total..... | 42,016 | 100% | \$43,826 | 100% |

Source: Joint Committee on Taxation

For those members of the Committee who are concerned with the equity of the tax code, eliminating the taxes-paid deduction would seem to be a fair thing to do.

The Tax Exemption for State and Local Bonds

Let's now turn to borrowing and the tax exemption for state and local bonds—so called muni bonds. The ostensible purpose of these bonds is to allow state and local governments to borrow at a much lower interest rate to finance infrastructure projects and other large public investments. However, it turns out that this is a very inefficient way for the federal government



to subsidize such local spending and it has led to an explosion of state and local debt.

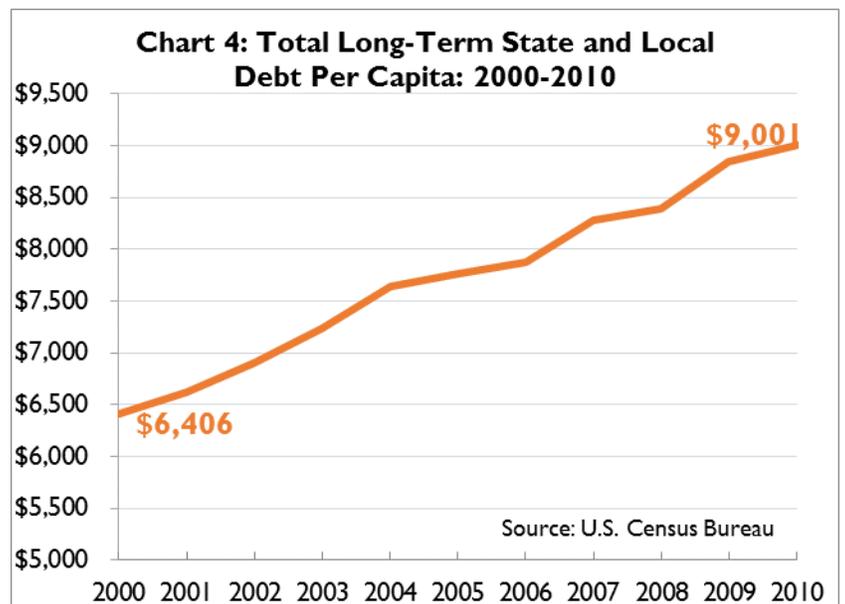
While state and local governments are intended to be the primary beneficiaries of the federal tax subsidy, bondholders also benefit. As the Joint Committee on Taxation has illustrated, depending upon the interest rate and the tax bracket of the bondholder, \$1 million in tax-exempt bonds can confer \$15,000 in interest savings to the local government and \$6,000 in tax savings to the bondholder. Thus, in order to generate a "public" benefit of \$15,000 the federal government actually forgoes \$21,000. This seems like an expensive way to subsidize local investment.

State and Local Debt Explodes

Speaking of state and local investments, in recent years local governments have taken on an enormous amount of new debt, which does not seem to be financing much new investment. Chart 3, above, compares the growth in state and local debt to the amount of annual amount of gross investment at the state and local level. Since 2000, state and local debt has increased by 152 percent, from roughly \$1.2 trillion to nearly \$3 trillion.

It does not appear, however, that this new borrowing has financed an increase in state and local investment. Over the past twelve years, gross investment has grown by 42 percent, not adjusting for inflation. In other words, investment has been mostly flat for the past twelve years while borrowing has ballooned. We have to ask ourselves: where has all of that borrowed money gone?

What all of this new borrowing has done is place a huge burden on future taxpayers. Chart 4 shows the increase in long-term state and local borrowing per capita between 2000 and 2010. Over that ten year period per capita borrowing increased by 40 percent, from \$6,406 per person to over \$9,000 per person.



To be sure, the municipal bond exemption not the sole cause of all of this new borrowing. But the availability of this source of cheap financing does create a moral hazard that can only be cured by eliminating the exemption.

While it is certainly true that tax-free municipal bonds provide a steady source of income for many low-to-moderate income retirees, the majority of tax-exempt interest income is earned by upper-

income taxpayers. As Table 2 shows, some 52 percent of tax-exempt interest income is earned by taxpayers with incomes over \$200,000 and 24 percent is earned by taxpayers with incomes above \$1 million. By contrast, about 23 percent of tax-exempt income is earned by taxpayers with incomes below \$75,000.

Table 2: Distribution of Taxes-Paid Deduction in 2010

| | Returns (Thousands) | Percent Share | Amount (\$Thousands) | Percent Share |
|--------------------------|------------------------|------------------|-------------------------|------------------|
| \$0 to \$50,000 | 1,800,138 | 29% | \$11,553,362 | 15% |
| \$50,000 to \$75,000 | 889,104 | 15% | \$ 5,755,015 | 8% |
| \$75,000 to \$100,000 | 765,213 | 13% | \$ 5,538,264 | 7% |
| \$100,000 to \$200,000 | 1,403,272 | 23% | \$13,083,218 | 17% |
| \$200,000 to \$500,000 | 832,455 | 14% | \$13,692,386 | 18% |
| \$500,000 to \$1 million | 240,177 | 4% | \$ 7,600,674 | 10% |
| \$1 million and above | 172,823 | 3% | \$17,940,450 | 24% |
| All Returns, Total | 6,103,182 | 100% | \$75,163,368 | 100% |

Source: SOI 2010 Tax Year

Again, if equity is a concern of any members of the Committee, this unbalanced distribution of tax-free interest income should prompt a reconsideration of this policy.

Macroeconomic Simulations

To help members of the Committee understand the economic effects of eliminating these state and local tax provisions, Tax Foundation economists performed a series of simulations using our Tax Simulation and Macroeconomic Model. In our first simulation, we eliminated the taxes-paid deduction to see what impact it would have on the economy over the long term. In this simulation, we assumed that all of the new revenue generated by eliminating the deduction would be used for deficit reduction and none would be used to lower individual income tax rates.

| <i>SIMULATION #1: ELIMINATE STATE & LOCAL TAX DEDUCTION—NO CHANGE IN RATES</i> | |
|---|---------|
| ECONOMIC AND BUDGET CHANGES VERSUS 2013 LAW (billions of 2012 dollars except as noted) | |
| GDP | -0.23% |
| Private business GDP | -0.25% |
| Private business stocks | -0.45% |
| Wage rate | -0.09% |
| Private business hours of work | -0.16% |
| Federal revenue (dynamic)(\$ billions) | \$36.9 |
| Federal spending (\$ billions) | -\$0.9 |
| Federal surplus (+ = lower deficit) (\$ bil.) | \$37.8 |
| Static revenue estimate (\$ billions) | \$44.9 |
| % Revenue reflow vs. static | -17.8% |
| \$GDP (\$ billions) | -\$35.6 |
| \$GDP/\$tax increase (dollars) | -\$1.1 |

The model shows that eliminating the taxes-paid deduction would reduce the long-term level of GDP by 0.23 percent, or about \$36 billion. The tax change would also reduce private business stocks by 0.45 percent and wages by 0.09 percent. While these are not major economic effects, the policy would effectively reduce GDP by \$1 for every \$1 of new revenues it raised for deficit reduction. Lawmakers will have to assess whether such a policy is worth the tradeoff.

The table below shows the distributional effects of eliminating the taxes-paid deduction without any corresponding reduction in income tax rates. On a static basis (not accounting for the economic effects), the average tax return would see a -0.48 percent reduction in their after-tax income, or \$289. However, the lowest income taxpayers would not be impacted.

By contrast, when we account for the long-term economic effects of eliminating the deduction, we find that taxpayers in every income group would see a decline in their after-tax income and the average reduction would be slightly greater than the static estimate (-\$394 versus \$289).

DISTRIBUTION EFFECTS OF ELIMINATING THE STATE AND LOCAL TAX DEDUCTION WITH NO OFFSETTING RATE CHANGES

| (Billions of 2012 dollars) | Average after-tax income per return | | | | |
|----------------------------|-------------------------------------|--------------------|-------------------|---------------------|--------|
| All Returns AGI Class | Static Change | Static % Change | Dynamic Change | Dynamic % Change | |
| < 0 | | \$0 | 0.00% | \$232 | -0.24% |
| 0 - 5,463 | | \$0 | 0.00% | -\$6 | -0.21% |
| 5,463 - 10,925 | | \$0 | 0.00% | -\$18 | -0.22% |
| 10,925 - 21,850 | | -\$4 | -0.03% | -\$39 | -0.24% |
| 21,850 - 32,775 | | -\$30 | -0.11% | -\$85 | -0.32% |
| 32,775 - 43,700 | | -\$84 | -0.22% | -\$159 | -0.42% |
| 43,700 - 54,625 | | -\$187 | -0.38% | -\$279 | -0.57% |
| 54,625 - 81,938 | | -\$378 | -0.56% | -\$502 | -0.75% |
| 81,938 - 109,250 | | -\$680 | -0.72% | -\$849 | -0.90% |
| 109,250 - 163,875 | | -\$1,178 | -0.90% | -\$1,399 | -1.07% |
| 163,875 - 218,500 | | -\$776 | -0.42% | -\$1,086 | -0.58% |
| 218,500 - 273,125 | | -\$858 | -0.35% | -\$1,227 | -0.51% |
| 273,125 - 546,250 | | -\$839 | -0.23% | -\$1,404 | -0.38% |
| 546,250 - 1,092,500 | | -\$3,523 | -0.48% | -\$4,618 | -0.62% |
| > 1,092,500 | | -\$13,958 | -0.39% | -\$19,584 | -0.54% |
| TOTAL FOR ALL | | -\$289 | -0.48% | -\$394 | -0.65% |

Simulation #2

In our second simulation, we modeled a revenue-neutral plan that eliminated the taxes-paid deduction and the municipal bond exemption (on a prospective basis) while lowering income tax rates across-the-board. The revenue gains from eliminating these provisions allowed for a corresponding reduction in income tax rates of 5.0 percent.

As the table below shows, this sort of revenue-neutral tax reform could boost the future level of GDP by 0.26 percent, or about \$41 billion. Not a huge effect, admittedly, but enough to boost private business investment by 0.29 percent, wages slightly, and hours worked by 0.26 percent—equal to

roughly 240,000 private sector jobs. While the plan is revenue neutral on a static basis, the greater economic growth does increase federal revenues slightly on a dynamic basis.

The distributional effects of this revenue-neutral plan are generally positive for all taxpayers. On a static basis, some taxpayers in the upper-middle income groups would see a slight reduction in their after-tax incomes. Obviously, the taxes-paid deduction is most beneficial to taxpayers in these income bands. However, when we take into consideration the positive economic effects of the tax change, we see that most of these taxpayers are made whole and, in many cases, would enjoy higher after-tax incomes.

The results of these simulations make very clear that given the choice between eliminating the state and local tax provisions solely for deficit reduction or doing so within the context of tax reform, the tax reform option produces the biggest bang for the economy, investment, wages, and living standards.

*SIMULATION #2: ELIMINATE STATE & LOCAL TAX DEDUCTION
AND INTEREST EXEMPTION ON FUTURE MUNI BONDS.
REDUCE ALL RATES ON REVENUE NEUTRAL BASIS*

ECONOMIC AND BUDGET CHANGES VERSUS 2013 LAW

(billions of 2012 dollars except as noted)

| | |
|---|--------|
| GDP | 0.26% |
| Private business GDP | 0.29% |
| Private business stocks | 0.37% |
| Wage rate | 0.03% |
| Private business hours of work | 0.26% |
| Federal revenue (dynamic)(\$ billions) | \$9.3 |
| Federal spending (\$ billions) | \$0.8 |
| Federal surplus (+ = lower deficit) (\$ bil.) | \$8.5 |
| Static revenue estimate (\$ billions) | \$0.0 |
| % Revenue reflow vs. static | N/A |
| \$GDP (\$ billions) | \$41.2 |
| \$GDP/\$tax increase (dollars) | \$4.9 |

**DISTRIBUTION EFFECTS OF A REVENUE NEUTRAL RATE CUT AND
ELIMINATION OF TAXES-PAID DEDUCTION AND MUNI BOND EXEMPTION**

(billions of 2012 dollars)

| All Returns AGI Class | Average after-tax income per return | | | |
|--------------------------|-------------------------------------|--------------------|-------------------|---------------------|
| | Static Change | Static % Change | Dynamic Change | Dynamic % Change |
| < 0 | -\$8 | 0.01% | -\$287 | 0.30% |
| 0 - 5,463 | \$0 | 0.00% | \$7 | 0.24% |
| 5,463 - 10,925 | \$1 | 0.02% | \$22 | 0.27% |
| 10,925 - 21,850 | \$10 | 0.06% | \$50 | 0.31% |
| 21,850 - 32,775 | \$19 | 0.07% | \$83 | 0.31% |
| 32,775 - 43,700 | \$23 | 0.06% | \$111 | 0.29% |
| 43,700 - 54,625 | -\$18 | -0.04% | \$89 | 0.18% |
| 54,625- 81,938 | -\$84 | -0.13% | \$61 | 0.09% |
| 81,938 - 109,250 | -\$223 | -0.24% | -\$25 | -0.03% |
| 109,250 - 163,875 | -\$435 | -0.33% | -\$176 | -0.13% |
| 163,875 - 218,500 | \$256 | 0.14% | \$622 | 0.33% |
| 218,500 - 273,125 | -\$13 | -0.01% | \$418 | 0.17% |
| 273,125 - 546,250 | \$80 | 0.02% | \$749 | 0.20% |
| 546,250 - 1,092,500 | \$2,108 | 0.28% | \$3,436 | 0.46% |
| > 1,092,500 | \$15,314 | 0.42% | \$22,126 | 0.61% |
| TOTAL FOR ALL | \$0 | 0.00% | \$124 | 0.20% |

Conclusion

Mr. Chairman, I applaud the Committee for reconsidering the tax preferences that benefit state and local governments within the broader context of fundamental tax reform. I think we all know that the defenders of these provisions will put enormous pressure on Members of Congress to not eliminate them, as was done successfully in 1986.

However, the evidence is very clear that these provisions produce more harmful effects than benefits. They encourage higher taxes, higher spending, and more debt by state and local governments. And our simulations show that eliminating these provisions while lowering tax rates would lead to higher GDP, higher private investment, higher wages, and better living standards for all Americans.

Thank you for the opportunity to testify before you today. I'm happy to answer any questions you may have.

ABOUT THE TAX FOUNDATION

The Tax Foundation is a non-partisan, non-profit research institution founded in 1937 to educate taxpayers on tax policy. Based in Washington, D.C., our economic and policy analysis is guided by the principles of sound tax policy: simplicity, neutrality, transparency, and stability.