"WORKING PAPER"

BATTLE OVER STATE/LOCAL TAX DEDUCTIONS

HIGH INCOME TAX BURDENS - II

SEPTEMBER 9, 1985

TAX FOUNDATION, INCORPORATED
ONE THOMAS CIRCLE, N.W., #500
WASHINGTON, DC 20005
BATTLE OVER STATE/LOCAL TAX DEDUCTIONS

There is growing opposition to the Reagan tax reform proposal to eliminate the personal deduction for state/local taxes. This proposal is particularly important to the overall reform plan because it would provide over 40 percent of all of the individual base-broadening measures (in dollar volume) or $40 to $46 billion by fiscal 1990. If the provision is dropped or severely curtailed, the opportunity for reducing marginal rates obviously would be restricted, too, or some large new alternative revenue source would have to be developed. Needless to say, the latter would be extremely difficult.

While the Administration maintained a no-compromise position on removing the state/local tax deduction through the Spring and after releasing the Reagan I program, there is lots of talk in Congress of accommodating the critics of the proposal. Suggestions range from limiting the deduction by a dollar cap to retaining it for some state/local taxes and not others. Unfortunately, most of the compromises being talked about do not make for sound tax policy.

In this regard it is important to note the traditional justification for deductibility—that state/local taxes reduce income involuntarily and thus reduce ability to pay. This rationale was part of the original income tax structure going back to the Civil War. The deduction as a subsidy to taxpayers in high-tax states was a non-argument.

Over the years certain tax reformers have attacked the state/local tax deduction for eroding the progression of the income tax— it being of most value to upper-income taxpayers. Followers of the Haig-Simons school claim that state/local taxes are really payments for "consumer services"— schools, fire and police protection, local roads, etc.— of benefit to the taxpayer and, therefore, should not be excluded from a comprehensive income tax base. If so, however, these are "services" over which individual taxpayers have very limited choice. Unless you happen to live at a marina in a state with no income tax, with a food/drug exemption from sales tax and acquire your other goods from an out-of-state mail-order house, you are going to pay state/local taxes whether or not you enjoy their "services."

In the Treasury I reform plan of November 1984, the theme of state/local taxes as consumer payments was picked up again but in a most unconvincing manner. Since then, justifying the elimination of the deduction has relied almost totally on the charge that the present deduction subsidizes taxpayers in high-tax state/localities relative to low-tax areas. In this writer's opinion, at least, nobody has come forth to date with a compelling case that state/local tax payments -- which can amount to a very significant
portion of a family budget -- do not reduce ability to pay Federal income tax. One can argue, of course, that the objective of lower marginal rates is overriding -- that the deduction should be foregone because of the economic and other benefits of rate reduction. But particularly if rate reduction is to be compromised by retaining some deductibility of state/local taxes, it behooves the policymakers to pay close attention to the method chosen.

**Threat of Double Taxation.**

One recurring proposal is to change the state/local deduction into a credit which could be set at a level low enough to minimize revenue loss and at the same time continue some benefit for middle-income taxpayers. A simple dollar cap on the amount of deduction that could be taken would serve the same objective. But in either case the result would be a haphazard increase in the progression of the tax structure. And depending on the extent of the credit or remaining deduction, there would be less opportunity for offsetting rate relief.

Question must be raised as to whether this is an appropriate way to change the distribution of tax burdens. It is not at all unusual for an upper-income resident in New York State to have state/local tax liabilities in excess of $10,000 annually. Perhaps one needn't feel too sorry about the circumstances of such taxpayers. But the fact remains that while they may have a degree of control over the level of their property and sales taxes, they have virtually no choice with respect to New York's hefty personal income tax -- even if it, of course, for New York City residents. To indicate to such taxpayers, as did the November 1984 Treasury report, that they could exercise a lower tax choice by moving to another state is hardly a viable option for most individuals tied to jobs and other circumstances. Their net income available for other purposes certainly is reduced by such payments, and eliminating or severely curtailing the Federal deduction could well be construed as a form of double taxation. From a policy viewpoint, to impose a selective double taxation on top of this, according to income, makes matters worse. The greater the "contribution" to state/local public services the higher the Federal tax penalty would be.

Congress, of course, could choose another route and allow deductibility of state/local taxes only above a certain level -- say one or two percent of gross income as proposed initially for charitable contributions. This would answer in part the above objection but then would accentuate the difference in treatment between high-tax and low-tax states. It would give relatively more advantage to taxpayers in high-tax states -- the very problem that the Administration program seeks to correct.

Yet another tack Congress could take is to retain deductibility for income and property taxes while eliminating it for sales taxes as was proposed in the draft program of the Carter Administration in 1977. Or perhaps retain deductibility of income taxes only. This type of program would have less impact on the distribution of tax burdens and would minimize the double tax question. It also would be a powerful club over state/local tax policy and initiative. It would direct the states away from sales taxes by Federal edict. And that doesn't seem to accord with either the new or old Federalism.
A Straight Percentage Best

Probably the purest form of compromise that Congress could make in this area would be to allow a straight percentage of the existing deduction regardless of income or type of tax. This would be the least disturbing of tax policy measures. It would have a neutral effect on tax burden distribution, at least on those continuing to itemize. The percentage could be set at whatever level Congress determines to reconcile the base-broadening revenue need with the political objections of states/localities. But just because it seems logical on this score, don't bet on it or any other particular measure that could evolve from this Fall's turbulent markup of tax reform legislation.

Tax Foundation, Incorporated
The Tax Foundation's June-July Tax Features carried an article on high income tax burdens indicating the very small number and proportion of those with incomes over $200,000 who managed to avoid any Federal income tax liability. The article was based on the latest available data from the IRS Statistics-of-Income (S-O-I) covering the calendar year 1982.

In the meantime, at the request of Representative Jake Pickle (D-TX), Chairman of the House Ways and Means Oversight Subcommittee, the Treasury Department has released a special study of 1983 high income tax returns (over $250,000 in income) using a different definition of income and highlighting the role of partnership losses in reducing tax liability. The headline in Congressman Pickle's news story on the study read, "30,000 wealthy Americans paid little or no tax."

That makes quite a contrast with the only 295 individuals with expanded income(1) of $200,000 or more reported to pay no Federal income tax in 1982, according to the earlier data. Congressman Pickle was quick to point out, of course, how the latest data should be taken into account in the current tax reform consideration and especially called for a "strong and effective minimum tax provision that would require all wealthy taxpayers to pay a certain amount of tax." Tax reform should take aim at provisions which permit minimal effective tax rates among the wealthy. But a "strong" minimum tax may not be the answer.

**Stretching the Figures.**

There is something a little suspect about creating a new statistical measure in the midst of a highly charged political debate over the matters being measured. To prove your point you order up a new batch of figures. But apart from that, there are a couple of obvious explanations for the much higher numbers on tax avoidance.

First, including those who pay relatively minor amounts of tax--less than 5 percent of income--along with non-payers in the same pot greatly expands the principal target group. Secondly, the definition of income used--total positive income (TPI)--is far, far broader than either adjusted gross income or expanded income. Basically, TPI is gross income for tax returns before losses. It includes positive income items from 1040 returns which, in the Treasury's words, "essentially equal the sum of (1) wages and salaries, (2) Expanded income equals adjusted gross income plus items of tax "preference" --mainly the excluded 60 percent of long-term capital gains--less investment expense.

---

(1) Expanded income equals adjusted gross income plus items of tax "preference" --mainly the excluded 60 percent of long-term capital gains--less investment expense.
(2) interest, (3) dividends, and (4) income from profitable business and investments." For capital gains it counts long-term and short-term gains before the 60 percent exclusion and before any losses. It includes rents, royalties and partnership income with gain excluding net losses.

The rationale for TPI is to account for the above-the-line offsets to income--especially partnership losses but also IRA and Keogh contributions, etc.--that reduce adjusted gross income and expanded income measures but still represent, in the Treasury's view, "economic" income. Treasury admits that TPI will not reflect some real economic losses but claims that most of the reported current losses are a result of partnership investment activities which typically show accounting losses for tax purposes but not actual economic loss.

The case for not reflecting capital gains losses seems much weaker. In this area the chances of real economic loss are certainly greater. High income returns very often involve extensive capital gains transactions and the extent to which real capital losses are not reflected in TPI obviously overstate income and make the effective rates of tax look smaller. Some changes in the coverage of TPI could make a significant difference in the reported rate of tax, just as relatively small changes in the definition of "tax expenditures" can dramatically alter both the level and distribution of the tax expenditure budget.

If we accept Treasury's TPI as a reasonable measure of income, there are a considerable number of high income returns over $250,000 paying a lesser effective rate of tax than the average for upper-middle income returns. But the overall pattern of tax burden distribution apparently would not change significantly from that based on adjusted gross income or expanded income. The effective rate of tax for the high income group as a whole is still significantly above that for upper-middle income returns. (Other income groups were not taken into account in the Treasury study.) Those 29,800 returns in the high income group paying tax less than five percent of TPI still are only 11 percent of the total high income returns.

**EFFECTIVE RATE OF FEDERAL INCOME TAX ON TOTAL POSITIVE INCOME, 1983**

<table>
<thead>
<tr>
<th>Description</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Returns with TPI of $250,000 or more</td>
<td>20.2%</td>
</tr>
<tr>
<td>with tax under 5% of TPI</td>
<td>1.7%</td>
</tr>
<tr>
<td>with tax over 20% of TPI</td>
<td>30.6%</td>
</tr>
<tr>
<td>Returns with TPI $30,000 - $75,000</td>
<td>12.7%</td>
</tr>
</tbody>
</table>

Scalpel Better Than Blunderbuss

Tax policy, of course, should not be comfortable with almost 30,000 high income returns paying 1.7 percent of income even if that measure of income is suspect. A legislative urge to do something about it is understandable. A stiffer minimum tax could help ensure higher effective rates. But as developed in detail in the May 1985 Federal Tax Policy Memo the minimum tax is a blunderbuss weapon and can have untoward economic effects.

One "strong" minimum tax measure (H.R. 2424) has been proposed by Representatives Schumer (D-NY) and Russo (D-IL). An analysis by Arthur Andersen & Co. indicates the Schumer-Russo minimum tax, which, among other items, would include vested benefits of pension plans in the alternative base, could result in a more than doubling of taxes on an upper-middle income taxpayer even if such taxpayer received no additional disposable income. (See Washington Tax Letter, June 28, 1985, Arthur Andersen & Co.) The extensive combination of preference income items in such a minimum tax base and an unfortunate timing of events could subject many taxpayers in virtually all income groups to sudden, sharp increases in tax liabilities whether or not they indulged in tax-motivated partnerships or other sheltered investments.

Contrary to some current sentiment, the high income tax avoidance issue could be diffused substantially without resort to the complexities of the minimum tax. The Treasury data do indicate the extent to which tax-motivated shelter investments are responsible for reducing tax liability of high income tax returns. For those returns over $250,000 paying less than five percent of TPI in tax, 67 percent of such income was offset by current business losses--mainly partnership losses. Below-the-line itemized deductions and credits accounted for only 19 percent of offset to such income.

The President's tax reform program contains specific provisions to reduce the attractiveness of such shelters by limiting allowable interest deductions and extending at-risk limitations. There are other proposals in Congress to make the rules even tougher on tax-motivated shelters. And, in fact, these proposals already are having an impact. The sales of leveraged real estate programs through shelter-oriented partnerships are down in dollar volume this year and comprise a significantly smaller share of overall real estate investment programs.

The scalpel is preferable to the blunderbuss.

Tax Foundation, Incorporated