

## What Federal Tax Reform Means for State and Local Tax and Fiscal Policies

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Chairman Baucus, Ranking Member Hatch, and Members of the Senate Finance Committee, thank you for inviting me to appear today to discuss federal tax reform and what it means for the tax and fiscal policies of state and local governments.

With increasing concerns about the federal deficit, fairness, and the complexity and inefficiency of our tax system, the need for fundamental federal tax reform is critical. Often overlooked, however, is the fact that any such reforms will also affect the tax and fiscal policies of state and local governments. As you consider possible changes in federal policy and, I hope, move toward a tax system that more efficiently raises revenue to provide federal services, it is important to recognize how federal actions affect state and local governments, as well as how state and local government actions can interact with and sometimes undo federal policy.

This hearing will touch on many subjects that affect state and local governments: broad fiscal policy, tax coordination and competition, tax-exempt bond markets, and fundamental income tax reform. I will focus my remarks on the current structure of state and local tax systems and how uncertainty about federal tax policy affects state and local governments' ability to forecast their own revenues. I will then examine how the federal tax code affects state and local budgets and how fundamental changes in the federal tax code may affect state and local governments. Our current system could definitely benefit from improvement: it is important to take into account how any changes shape not only federal revenues and economic activity but

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also the ability of state and local governments to access funds as well as the fiscal choices state and local governments make.

Although the country's economic condition is improving, state and local governments are still struggling to balance their budgets. Thus, decisions about changing federal policy should take into account the potential effects on state and local government budgets in both the short and the long run.

I will make seven points today about the relationship between federal tax reform and state and local fiscal policies.

1. Although state revenues are recovering, state and local governments are still under enormous financial stress in the aftermath of the Great Recession. Although the federal budget is roughly twice as large as states',<sup>1</sup> many federal programs are actually managed by the states. For example, state and county governments administer most Medicaid spending. Similarly, state and local governments are chiefly responsible for the development of transportation infrastructure. Aided by transfers from the federal government, state and local governments run about half of all public programs. They are predominant funders of K-12 education. But effective administration of those programs depends on states having stable revenue sources to finance their share of costs.
2. Although federal grants and stimulus have helped states weather the downturn, other federal policies have exacerbated states' problems.<sup>2</sup> Federal policy affects how attractive certain taxes are for state and local governments and, therefore, how those governments organize their tax and revenue systems. State revenue sources—especially income taxes—often piggyback on federal rules. More specifically, statutory changes in federal law can result in significant increases or decreases in state revenue. For example, state income tax revenue increased after the 1986 tax reform expanded the federal income tax base. On the other hand, state revenues have become

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<sup>1</sup> According to the National Income and Product Accounts, state and local government current receipts exceeded \$2 trillion in 2010, including \$500 billion in federal grants in aid. While federal revenues totaled \$2.4 trillion, federal expenditures were \$3.7 trillion (including grants in aid to state and local governments). When federal defense spending is excluded, state and local government spending is roughly equivalent to federal spending (15 percent vs. 18 percent of GDP) (BEA 2011).

<sup>2</sup> Gordon (2012) examines what lessons the federal government can learn from states and examines the federal/state relationship in the aftermath of the Great Recession.

more volatile over time as states have become more reliant on income taxes.<sup>3</sup> This is partly a result of the deductibility of state and local taxes on federal income tax returns. Deductibility effectively subsidizes state and local governments by offsetting the cost to taxpayers. By its very design, the deduction for state and local taxes favors certain fiscal choices over others. For example, only taxpayers who itemize their returns can benefit from the deduction. Because high-income taxpayers are more likely to itemize their deductions, state and local governments have an incentive to make their tax systems more progressive as a means of shifting more of the state's tax burden onto federal taxpayers.<sup>4</sup> This effect is intensified by the fact that deductions are most valuable to taxpayers with the highest marginal tax rate – the federal deduction is worth more to a taxpayer subject to a 35 percent tax rate than a taxpayer subject to a 15 percent tax rate. Again the clear incentive introduced by federal law is for states to concentrate their tax burdens on high-income households. This is not inherently bad; however, progressive income taxes tend to be more volatile than alternative revenue sources, thereby creating problems for governments that operate under balanced budget rules. In particular, they have less flexibility to respond to changing economic conditions.

3. *Unstable federal tax policy trickles down to the states.* Problems with state tax systems are exacerbated by uncertainty in federal tax rules. Temporary extensions of credits, deductions, and tax rates complicate state forecasting, particularly for state tax systems that piggyback on the federal code. Policy changes and uncertainty can lead taxpayer to change their behavior in ways that can indirectly affect state and local revenues and make projecting state revenues more difficult. For example, the California Legislative Analyst's Office 2012–2013 Budget: Economic and Revenue Outlook says that “Perhaps the most significant economic risks for this forecast relate to the unknown future direction of federal fiscal and tax policy.” Especially problematic has been uncertainty about future federal estate taxes and tax rates on dividends and capital gains.

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<sup>3</sup> Increasing income inequality and income volatility have made state income tax receipts more volatile—up in good times, sharply down in bad (Pew Center 2011).

<sup>4</sup> Metcalf (2011) finds that federal deductibility continues to have a significant and large effect on the use of deductible taxes at the state and local level.

4. *The federal tax code makes the value of deductions and credits uncertain.*  
Because of phaseouts of tax preferences as well as the alternative minimum tax (AMT), taxpayers often cannot predict whether they will benefit from particular tax breaks. For example, the deduction for state and local taxes reduces the net cost of these taxes for taxpayers who can claim a deduction for them. The AMT disallows the deduction, however, and taxpayers often don't know whether they will be subject to the AMT before they fill out their tax returns. That uncertainty has been greater in recent years as Congress has temporarily increased the AMT exemption every year or two, sometimes only at the end of the tax year. Further, the probability of having to pay the AMT varies both across states (depending on the characteristics of their tax systems and other factors like house prices) and across types of households. Families in New York and California, for example, pay above-average state and local taxes and are also more likely to be subject to the AMT.<sup>5</sup>
  
5. *Reform of the federal tax system could benefit state and local governments if the effects on their tax systems are explicitly considered.* A streamlined federal income tax with fewer deductions and straightforward credits and deductions could allow for simpler state income tax returns. Many states already offer earned income credits and child care credits that piggy-back on the federal credits. Similarly, if federal tax reform includes the introduction of a value-added tax, state and local governments could replace their existing sales taxes with a consumption tax using the federal tax base which would likely be broader than the existing retail sales tax base including services plus web purchases. However, if federal reform is not done carefully, it could exacerbate existing problems and further complicate tax preparation, if states feel the need to introduce more provisions into their own codes to maintain their tax bases.
  
6. *The current state of the economy and still-fragile state and local budgets may require that transition relief to state and local governments accompany tax reform.* That could be especially true if the federal government moves quickly to change tax provisions that affect states and localities. For example, changing the deductibility of mortgage interest on second homes or moving from a deduction to a credit for mortgage interest could affect both house

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<sup>5</sup> Rueben and Stark (2012) examine differences across states in the prevalence and average size of the state and local tax deduction and the AMT; they also examine the distributional effects of varying the characteristics of the state and local tax deduction.

values and property-tax revenues. Changing the deductibility of state and local taxes and effectively eliminating the subsidy from the federal government could create pressure to cut state income tax rates just as revenues are recovering from the recession. Understanding the economic impact of such changes is critical. Providing relief through a transition period could lessen the impact on state and local revenues. Note, however, that temporary provisions and announced future changes can both affect taxpayer behavior.

7. *Congress can take specific actions to help coordinate and protect existing state and local tax systems.* State and local governments' ability to raise revenue can be hobbled by limitations that Congress could remove. Most notably, Congress could enact legislation that would enable state and local governments to collect taxes on internet and mail-order sales. Doing so could help stop the erosion of sales tax receipts as more and more commerce takes place online.

Thank you again for inviting me to appear today. I look forward to your questions.

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