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The Impact of Repealing State And Local Tax Deductabilty

by Kim Rueben

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Introduction

When President Bush convened a panel in 2005 to consider options for federal tax reform, he listed several goals, including tax simplification in a revenue-neutral way to promote long-term growth. He wanted the reform to maintain the progressivity of the income tax and incentives for homeownership and charity.

An important key provision not explicitly protected is the federal deductibility of state and local (income, general sales, and property) taxes, which is expected to have a tax expenditure cost of $65.8 billion in fiscal 2005 (as compared with $72.6 billion for home mortgage interest and $34.2 billion for individual charitable contributions).[1]

An additional impetus for tax reform is the individual alternative minimum tax. Although only 4 percent of taxpayers will owe AMT in 2005 because of a temporary provision that protects most middle-income taxpayers, 20 percent will become AMT taxpayers in 2006 after that provision expires. By 2010, almost one-third of taxpayers will owe AMT. The largest AMT preference item — that is, a deduction allowed under the regular income tax but not the AMT — is the deduction for state and local taxes. Therefore, as the AMT net widens, more households will get little or no benefit from the state and local tax deduction. In light of that, one possible reform could be the repeal of state and local tax deductibility from federal income taxes in conjunction with the repeal or reform of the AMT.[2]

Before reforms to federal policy are undertaken, it is important to understand the possible ramifications to subnational governments and to understand the theoretical justification for tax deductibility. There are concerns that the removal of state and local tax deductibility will lower support for public services and lead to a "race to the bottom" in terms of state and local expenditures as states compete to have the lowest taxes in order to attract higher-income households. The likelihood of that scenario depends on what factors affect the location decisions of households and how large the expected increase in tax liability is expected to be for households with different income levels.

This report will briefly discuss the history and arguments for and against the deductibility of state and local taxes. It presents some summary information on the distribution of state and local tax deductions and explores what factors will affect the future costs of repeal, focusing on who currently benefits most from those deductions across different states and income levels. The report presents projections of the cost savings to the federal government if the state and local deductions were eliminated under scenarios both with and without the AMT being repealed, and explores which groups of taxpayers

[1]Tax expenditures are taken from the Congressional Research Service (2004).

[2]Because the level of property taxes is directly related to the cost of owning a home, an argument could be made that the president's mandate to maintain incentives for home ownership would protect the deductibility of property taxes.

are expected to see changes in their tax bills over time. The report returns to the question of how that is expected to affect state and local governments, examining current estimates of the subsidy rate that tax deductibility gives to state and local governments and drawing lessons from the aftermath of the Tax Reform Act of 1986. The interaction with the AMT lessens the impact of repeal for many households, thus the effect on states and the question of whether the elimination of state and local tax deductibility will lead to a race to the bottom rests on the influence and mobility of the wealthiest taxpayers.

History of the Deductibility of State and Local Taxes[3]

State and local taxes have been deductible from the federal income tax since the inception of the federal income tax in 1913. Originally all taxes (including federal, state, and local taxes not directly tied to a benefit) were deductible against federal income. Over time the number and types of deductible taxes have changed. Before 1964 tax regulations allowed deductions for all taxes except those on an explicitly enumerated list. In 1964 legislation reversed course and created a list of explicitly deductible taxes, including state and local taxes on real and personal property, income, general sales, and the sale of gasoline and other motor fuels. The Treasury Department's original blueprint for tax reform in 1984 would have eliminated all state and local tax deductions, but the ultimate legislation — the Tax Reform Act of 1986 (TRA '86) eliminated only the deductibility of state and local sales taxes.

Sales taxes did not survive the TRA '86 cut because the deduction was thought to be inequitable, inefficient, and complex. The inequity issue arose because deductibility applied to general, not specific, sales taxes and because sales taxes were thought to be regressive, with lower-income households spending a larger percentage of their income on sales taxes while being relatively less likely to itemize. The deductibility of sales taxes was also seen as inefficiently complex because keeping receipts as proof of purchase for the deduction was seen as cumbersome while the alternative of using provided tax tables was seen as unrelated to the households' actual purchase patterns. Note that many of those arguments still hold despite the reinstatement of sales tax deductibility *in lieu* of income tax deductions as part of the American Jobs Creation Act of 2004.

[3]The discussion of the history of state and local tax deductibility is largely drawn from Maguire (2005).

Pro and Con Arguments About State and Local Tax Deductibility

The arguments for the elimination of state and local tax deductibility rest on the appeal of base broadening and fairness or equity issues. Those fairness issues are based on questions of income and geographic equity. Nonitemizers, who usually have lower incomes, do not benefit from specific deductions and, as a result, face a higher cost of government services than itemizers. Geographic inequity results from states having different levels and types of taxes. The current system benefits itemizers in higher-tax states over taxpayers in lower-tax states. Moreover, taxpayers in states heavily reliant on property taxes and either income or general sales taxes are subsidized by taxpayers in states that depend more on specific sales taxes and fees or states with more balanced tax systems.[4] As a result, deductibility distorts state and local governments' choice of tax instruments.

> ***The current system benefits itemizers in higher-tax states over taxpayers in lower-tax states.***

Opponents of state and local tax deductibility further argue that if taxes are viewed as payment for government services rendered, they should be treated no differently from other forms of consumption. They also argue that deductibility is a blunt way to provide intergovernmental assistance and that direct federal grants to state and local governments would be a more efficient way to subsidize certain subnational public services.

The argument for retaining the deductibility of state and local taxes is that it is unfair to ask taxpayers to pay taxes on taxes. That is, if another level of government is claiming that revenue, it is not really part of the individual's disposable income and paying taxes on it leads to double taxation. Also, proponents argue that the deduction may be necessary to encourage higher-income taxpayers to support programs that primarily benefit lower- and middle-income households within the same state.

In sum, arguments for and against the deductibility of state and local taxes rest on whether the state

[4]Since the current tax system includes the option of deducting either income or sales taxes it reduces prior inequities in place for states without income taxes. (States with no income tax are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming, while New Hampshire and Tennessee only have a state income tax on dividends and interest. The sales tax deduction is not relevant to taxpayers in New Hampshire as it does not have a general sales tax and is of limited benefit in Alaska, where there is no state sales tax though local governments are allowed to impose one.)

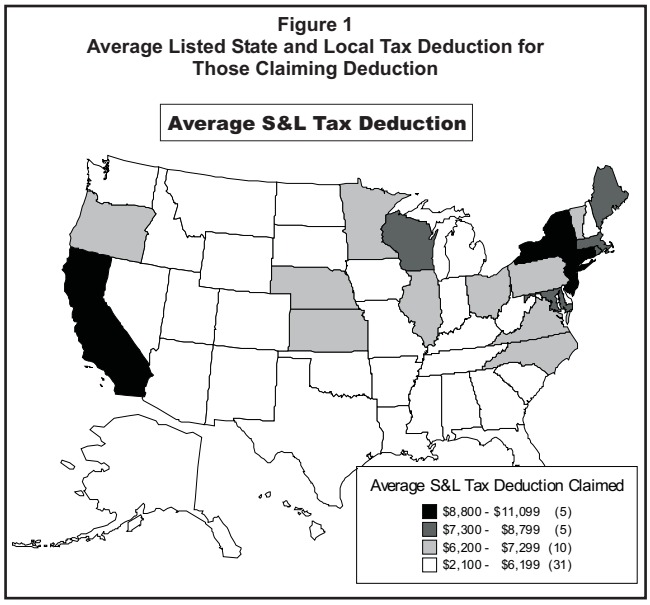


Figure 1
Average Listed State and Local Tax Deduction for Those Claiming Deduction

and local taxes a household pays reflect the public goods received by that household or whether taxes paid are not directly related to the benefits received. If taxes reflect benefits received, they reflect public (as compared to private) consumption; by choosing to live in a community, a household is deciding on the level of public services to purchase. In a scenario with enough local communities (as would occur under the Tiebout model[5]), the level of taxes would reflect the level of public services desired and there would be no justification for the deductibility of state and local taxes. However, in communities with mixed income levels, if it is assumed higher-income households pay more taxes than they receive in benefits, the presence of federal deductibility could in fact lead to an equalization of taxes with benefits across different income classes within a state.[6] If certain taxes are progressive (as the income is in many states) but benefits are distributed equally across all households within a community, deductibility may in fact be an imperfect way of equilibrating taxes to benefits.

A similar argument could also be made for an equalizing role of deductibility across geographic jurisdictions as well. Because federal taxes are not indexed to take into account cost-of-living differences across states, the higher tax levels in some states reflects in part higher prices of providing both public and private goods. If a household's higher income reflects higher prices in one area, the higher level of deductions can help equalize the after-tax incomes of households. That is, if higher taxes (and higher incomes) across different geographic areas reflect differences in the cost of living, deductibility can help offset (albeit again quite imperfectly) some of those geographic price differences.

Geographic and Income Distribution of Current Deductions

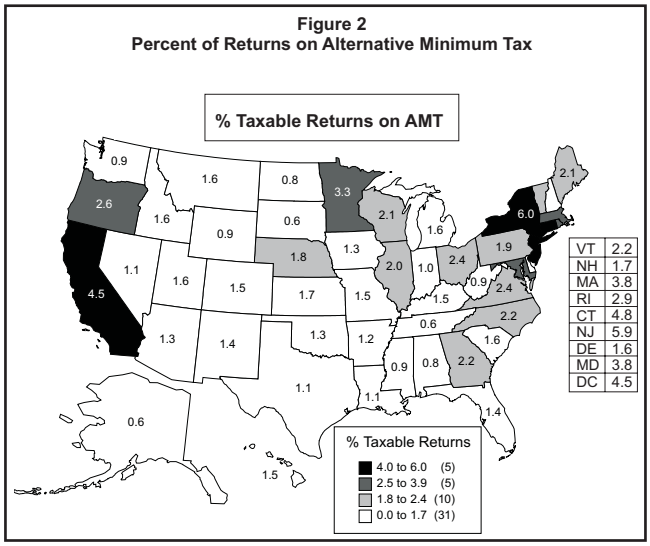
To explore the fiscal and distributional effects of eliminating the deductibility of state and local taxes, we will first examine the current distribution of those taxes across income and geographic areas and discuss the characteristics of taxpayers that lead to higher deductions. Virtually all of the 46 million households who itemized in 2002 claimed a deduction for state and local taxes paid, totaling $308.7 billion. Eighty-two percent of itemizers deducted state and local income taxes and 87 percent deducted real estate taxes. Table 1 (p. 501) presents information on the number and amount of state and local tax deductions by state. While households who take those deductions are in every state, they are concentrated in only a few. Taxpayers in California and New York make up 20 percent of those claiming deductions for all state and local taxes, 23 percent of those claiming state and local income taxes, almost 30 percent of the value of the total state and local tax deduction and one-third of the deductions from state and local income taxes.[7] Not surprisingly, states that receive a large share of those deductions also pay a large share of federal income taxes.

Figure 1 maps the average deduction claimed by itemizers in different states, with itemizers in New York, New Jersey, and Connecticut claiming on average over $10,000 per household, and California

[5]In his seminal paper, Tiebout (1956) hypothesized that voters will perfectly sort into communities that reflect their ideal tradeoff between public and private goods. The pure form leads to perfect sorting by income and assumes all households within a community receive the same level of public services. In practice there are limits to the number of communities (especially when considering states instead of municipalities) and there is mixing of income classes. Bergstrom and Goodman (1973) discuss the factors that influence demand for public goods.

[6]Note that from a theoretical perspective, the value of benefits received from state and local governments should be deducted from the taxes paid, and only the net tax payments should be deductible. For a thorough description of different ways of modeling this benefit and for more discussion of the case for or against federal deductibility of state and local taxes see Kaplow (1996).

[7]Given that these figures are from 2002, they do not include any costs for sales tax deductibility. Current estimates on the cost of the sales tax deductibility is about $5 billion (Joint Committee on Taxation) or $2.2 billion to $2.4 billion a year (CRS). These costs are mainly for deductions of taxpayers in states without income taxes or limited income tax. Florida households are estimated to receive a little over one-third of these deductions (or about $700 million annually), with taxpayers in Texas and Washington receiving approximately 27 percent and 22 percent of these deductions respectively.



and the District of Columbia not far behind with about $9,000 per household.[8]

That gross deduction is only part of the story, because the distributional implications of eliminating the deductibility of those taxes are complicated by the fact that under the current system, there are limits on overall deductions and phaseouts of those deductions under the AMT. Figure 2 maps the percentage of households that are subject to the AMT by state. Not surprisingly the top 10 states in the two maps are the same: Because of the preference status of state and local tax deductions, the states with high average tax deductions also have more households owing the AMT. In 2002 about two million AMT taxpayers lost part or all of the federal deduction. Under current tax law, the number of households facing the AMT limit will grow, further limiting the benefit of state and local deductions.

The geographic distribution of benefits can be explained in part by the distribution of wealth across states. State and local tax deductions are highest in places where state and local taxes are high, either because of relatively high or progressive income or property tax rates or relatively high incomes and property values or both. California and New York are at the top of the list because they have some of the most expensive real estate in the country, large concentrations of wealth, and progressive income tax systems. In 2002 the top 5 percent of California households (those with the highest income) paid 60 percent of California income taxes while the bottom 40 percent paid less than 1 percent.

Table 2 (p. 503) shows the distribution of returns and state and local tax deductions by income class. More than half of all state and local tax deductions were claimed by the 8 percent of taxpayers with incomes exceeding $100,000, and over 60 percent of state and local income taxes were claimed by households making $100,000 or more. Those are the same households that are most likely to be subject to the AMT because 90 percent of AMT revenues comes from households earning over $100,000 and itemizing deductions. If we examine the distribution of both taxes paid and deductions taken by state, we find that the highest-income households are taking the largest deductions. In California the 11 percent of households that earned $100,000 or more accounted for 46 percent of state adjusted gross income and claimed 46 percent of listed deductions. However, they claimed 63 percent of all state and local tax deductions and 72 percent of income tax deductions. The higher percent of income tax deductions reflects California's higher reliance on a progressive income tax and lower property tax rates (because of Proposition 13).[9] Again, that is before consideration of the AMT limitations faced by these households. Similar breakdowns exist for other states.

Modeling the Elimination of State and Local Tax Deductions

While examining the current distribution of deductions and AMT is informative, the changing rules governing both the AMT and the tax system mean that the effects of eliminating state and local tax deductibility will change over time. How much money would eliminating the state and local deductions save the federal government? Is the deduction already effectively being eliminated by the AMT? Would the elimination of those deductions be enough to offset the revenues lost by eliminating or indexing the AMT? To answer those questions, we examine simulation models of the revenue implications of eliminating state and local tax deductions for this year and then the cost over the next 10 years.

Eliminating the deduction for state and local taxes, while leaving the AMT in place, would generate $24.8 billion this fiscal year or $693 billion in federal revenues assuming a current-law baseline over the period 2006-2015. This includes annual

[8]The District of Columbia also has the highest average amount of income tax deductions listed by those who itemize, followed by New York, Connecticut, California, and somewhat surprisingly, Wyoming. Wyoming had few households that itemized their income tax (7,315 Wyoming households claimed the state and local income tax deduction and listed over $46 million in deductions).

[9]These calculations are based on information available from the IRS, Individual Tax — Statistics — State Income for 2002 and 2003, Tax Year 2002: Unpublished Version. Available at http://www.irs.gov/taxstats/article/ in file 02in54cm.xls.

Table 1
State and Local Tax Deductions by State
Tax Year 2002

Rank	State	Number of Returns (millions)	Percent of Returns Claiming Deduction	Percent of Returns in state	Amount ($billions)	Percent of Amount Claimed	Average Amount	Percent of Federal Income Taxes Paid	State and Local Deduction as Share Of State AGI
1	California	5.9	13.0	39.0	52.3	17.0	**$8,884**	13.2	6.8
2	New York	3.3	7.4	38.8	37.1	12.0	**$11,098**	8.7	8.2
3	New Jersey	1.8	4.0	44.6	18.2	5.9	**$10,003**	4.6	7.5
4	Illinois	2.1	4.6	36.3	13.5	4.4	**$6,475**	5.1	4.7
5	Ohio	1.9	4.3	35.2	13.0	4.2	**$6,721**	3.4	5.8
6	Pennsylvania	1.9	4.1	32.5	12.3	4.0	**$6,548**	4.1	4.8
7	Massachusetts	1.2	2.7	40.5	10.8	3.5	**$8,655**	3.3	6.2
8	Michigan	1.7	3.8	38.0	10.5	3.4	**$6,099**	3.2	5.1
9	Maryland	1.3	2.8	48.7	10.0	3.2	**$7,944**	2.3	7.2
10	Virginia	1.4	3.0	40.7	9.2	3.0	**$6,666**	2.9	5.3
11	Texas	2.0	4.5	21.9	8.7	2.8	**$4,288**	6.9	2.2
12	Georgia	1.4	3.2	39.1	8.5	2.8	**$5,960**	2.6	5.2
13	North Carolina	1.4	3.0	37.4	8.5	2.8	**$6,252**	2.2	5.6
14	Florida	2.1	4.7	27.5	7.9	2.6	**$3,707**	6.1	2.3
15	Wisconsin	1.0	2.2	39.3	7.8	2.5	**$7,692**	1.7	6.9
16	Connecticut	0.7	1.6	43.7	7.6	2.5	**$10,424**	2.3	7.0
17	Minnesota	1.0	2.2	42.3	6.9	2.2	**$6,804**	1.9	5.9
18	Oregon	0.7	1.5	42.2	4.8	1.6	**$7,222**	0.9	7.2
19	Indiana	0.9	2.0	32.6	4.8	1.5	**$5,192**	1.7	4.1
20	Missouri	0.8	1.8	32.1	4.7	1.5	**$5,768**	1.6	4.5
21	Colorado	0.9	1.9	42.1	4.6	1.5	**$5,293**	1.7	4.5
22	Arizona	0.9	1.9	39.0	4.2	1.4	**$4,816**	1.5	4.3
23	South Carolina	0.6	1.3	33.4	3.4	1.1	**$5,629**	0.9	4.9
24	Kentucky	0.6	1.2	32.0	3.4	1.1	**$6,028**	0.9	5.0
25	Washington	1.0	2.1	34.3	3.1	1.0	**$3,262**	2.4	2.3
26	Iowa	0.4	1.0	32.9	2.5	0.8	**$5,717**	0.7	4.7
27	Kansas	0.4	0.9	31.8	2.4	0.8	**$6,230**	0.8	4.7
28	Oklahoma	0.5	1.0	31.0	2.3	0.8	**$5,133**	0.8	4.3
29	Alabama	0.6	1.3	30.9	2.1	0.7	**$3,624**	1.0	2.9
30	Utah	0.4	0.9	41.5	2.0	0.7	**$5,089**	0.5	5.1
31	Nebraska	0.2	0.5	30.8	1.6	0.5	**$6,591**	0.5	5.1
32	Rhode Island	0.2	0.4	37.3	1.5	0.5	**$8,259**	0.4	6.7
33	Maine	0.2	0.4	32.3	1.4	0.5	**$7,301**	0.3	6.0
34	Louisiana	0.4	0.9	21.7	1.4	0.5	**$3,523**	1.0	2.1
35	New Hampshire	0.2	0.5	36.1	1.4	0.5	**$6,126**	0.5	4.4
36	Arkansas	0.3	0.6	25.0	1.4	0.4	**$4,883**	0.5	3.4
37	Tennessee	0.6	1.3	22.4	1.2	0.4	**$2,161**	1.6	1.2
38	New Mexico	0.2	0.5	27.3	1.1	0.4	**$5,076**	0.4	3.9
39	Mississippi	0.3	0.6	23.4	1.1	0.4	**$3,966**	0.5	2.8
40	Idaho	0.2	0.5	36.7	1.1	0.3	**$5,135**	0.3	5.0

Table 1
State and Local Tax Deductions by State
Tax Year 2002
(continued)

Rank	State	Number of Returns (millions)	Percent of Returns Claiming Deduction	Percent of Returns in state	Amount ($billions)	Percent of Amount Claimed	Average Amount	Percent of Federal Income Taxes Paid	State and Local Deduction as Share Of State AGI
41	Nevada	0.4	0.8	35.7	1.0	0.3	**$2,904**	0.9	2.2
42	Hawaii	0.2	0.4	33.6	1.0	0.3	**$5,299**	0.3	4.3
43	District of Columbia	0.1	0.2	40.1	1.0	0.3	**$9,234**	0.3	6.7
44	Delaware	0.1	0.3	37.5	0.8	0.3	**$5,492**	0.3	4.3
45	West Virginia	0.1	0.3	18.9	0.8	0.2	**$5,325**	0.3	2.9
46	Montana	0.1	0.3	32.1	0.7	0.2	**$5,296**	0.2	5.0
47	Vermont	0.1	0.2	32.4	0.7	0.2	**$6,926**	0.2	5.5
48	North Dakota	0.1	0.1	19.5	0.3	0.1	**$4,471**	0.1	2.4
49	Alaska	0.1	0.2	24.5	0.2	0.1	**$2,864**	0.2	1.6
50	South Dakota	0.1	0.1	16.4	0.2	0.1	**$2,778**	0.2	1.3
51	Wyoming	0.0	0.1	20.4	0.1	0.0	**$2,761**	0.2	1.3
	United States	45.4	100.0	34.7	308.7	100.0		100.0	5.1

Source: Internal Revenue Service.
Individual Tax Statistics — State Income for 2002 and 2003, Tax Year 2002: Unpublished Version. Available at http://www.irs.gov/taxstats/article/0,,id=103106,00.html.

savings of around $45 billion from 2007-2010. Beginning in 2011, the revenue gain increases and then almost doubles primarily because of the expiration of provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16), the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA; P.L. 108-27), and the resultant increase in top marginal tax rates and sharp reduction of the number of taxpayers subject to the AMT (Table 3, top panel, option 1 (p. 504)).[10] If we assume current EGTRRA and JGTRRA provisions will be extended, the annual federal savings remains about $45 billion a year (Table 3, third panel, option 1).

If both state and local tax deductions and the AMT are eliminated cumulatively, revenues would increase by $21.4 billion this fiscal year and $331 billion for fiscal years 2006-2015, assuming the president's tax cuts are not extended (Table 3, top panel, option 3). The largest revenue gain is in calendar year 2005, because the AMT is temporarily held in check for that years (Table 3, panel 2, option 3). As AMT revenue jumps in calendar year 2006, the cost of repealing it grows relative to the revenue gain from repealing the state and local tax deduction. The net revenue gain to the federal treasury declines and even becomes negative (that is, there is a revenue loss) in calendar year 2009 and 2010 as the AMT's scope would have expanded. That pattern is reversed in calendar year 2011 after the 2001 and 2003 tax cuts expire. However, if the tax cuts are extended, net revenue losses will continue to grow. On a fiscal year basis, revenues would decline by $142 billion over 10 years under the extended baseline, with revenue losses growing dramatically in the out years.

Retaining the property tax deduction would lead to smaller revenue gains for the federal government (Table 3, option 2) and would leave a larger gap to be filled from also repealing the AMT (Table 3, option 4). There is a federal revenue increase of $431 billion from fiscal years 2006-2015 if only the state and

[10]Because the savings or costs of different deductibility options vary with the assumptions made Table 3 presents information on the static impacts for both fiscal years and calendar years compared to the baseline as currently in place vs. extending current provisions as outlined in the 2006 Budget Proposal. Option 1 includes eliminating the deductibility of state and local income and sales taxes and property taxes. Option 2 retains the deduction for property taxes. Finally options 3 and 4 repeat this exercise but also include the estimated cost of repealing the alternative minimum tax.

Table 2
State and Local Tax Deductions by Adjusted Gross Income
Tax Year 2002

United States

Adjusted Gross Income (thous.)	All Returns		Total Itemized Deductions		State and Local Taxes		State and Local Income Taxes	
	# Returns (millions)	AGI (billions)	Number (millions)	Amount (billions)	Number (millions)	Amount (billions)	Number (millions)	Amount (billions)
Less than 20	50.25	385.37	3.93	59.40	3.65	10.25	2.24	3.03
20-30	18.65	461.86	3.66	47.90	3.56	9.12	2.77	3.10
30-50	24.32	950.26	9.52	129.03	9.40	30.19	7.91	13.70
50-75	17.63	1,081.04	11.29	176.58	11.23	51.12	9.69	26.80
75-100	9.13	784.95	7.52	141.27	7.49	46.23	6.49	25.84
100-200	8.39	1,103.52	7.74	201.43	7.72	75.60	6.69	45.68
More than 200	2.47	1,248.06	2.32	165.28	2.32	86.15	2.04	66.18
All	130.84	6,015.05	45.98	920.89	45.37	308.66	37.83	184.32
Percent for HH over $100,000	8%	39%	22%	40%	22%	52%	23%	61%
Percent for HH over $200,000	2%	21%	5%	18%	5%	28%	5%	36%

California

Adjusted Gross Income (thous.)	All Returns		Total Itemized Deductions		State and Local Taxes		State and Local Income Taxes	
	# Returns (millions)	AGI (billions)	Number (millions)	Amount (billions)	Number (millions)	Amount (billions)	Number (millions)	Amount (billions)
Less than 20	5.48	37.99	0.50	9.79	0.49	1.48	0.29	0.74
20-30	2.08	51.59	0.44	6.82	0.44	1.38	0.37	0.37
30-50	2.79	109.16	1.12	18.51	1.12	3.62	1.06	1.70
50-75	2.01	123.07	1.35	25.83	1.35	6.55	1.32	3.43
75-100	1.12	96.75	0.96	22.04	0.96	6.38	0.95	3.77
100-200	1.23	163.90	1.17	38.04	1.17	14.02	1.17	9.56
More than 200	0.37	191.30	0.36	33.86	0.36	18.92	0.36	15.86
All	15.09	773.76	5.91	154.89	5.89	52.34	5.52	35.43
Percent for HH over $100,000	11%	46%	26%	46%	26%	63%	28%	72%
Percent for HH over $200,000	2%	25%	6%	22%	6%	36%	7%	45%

local income tax and sales tax deductions are eliminated, or a savings of $318 billion if baseline provisions are extended and the AMT is not repealed or changed. If state and local income tax and sales tax deductibility were eliminated and the AMT was repealed, there would be a small cumulative savings of $48.3 billion from 2006 through 2015 under current law and a cost of about $437 billion if the tax cuts are extended.

Distributional Implications

We start by examining the effects of eliminating state and local tax deductibility in 2005 as compared to the current-law baseline (or the calculated increase of $62.1 billion in Table 3). Table 4 shows the distribution of federal tax costs and benefits of repealing the deduction for state and local taxes.[11] Low-income households are largely unaffected by those changes because of their taking the standard deduction and not being affected by the AMT. However, repealing the deduction for state and local taxes is expected to increase the tax bills of a majority of taxpayers in each income class over $75,000 (Table 4, column 3 (p. 506)). The average federal tax change is 3.5 percent on average, with tax increases averaging over 4 percent for those earning between $100,000 and $1 million and increasing by 3.6

[11]These estimates are again based on the effect of eliminating the deductibility of income, sales, and property taxes.

Table 3
State and Local Tax Deduction Options
Static Impact on Individual Income Tax Liability ($ billions), 2005-2015

	Year											
	2005	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2006-2015**
Current-Law Baseline												
Fiscal Years[a]												
Option 1: Repeal Deduction for State and Local Taxes	24.8	56.1	45.6	43.4	44.0	44.3	62.3	90.3	92.5	94.3	95.9	668.5
Option 2: Option 1 but Retain Deduction for Property Taxes	17.3	38.4	29.6	27.5	27.9	28.2	40.0	58.4	59.5	60.5	61.4	431.4
Option 3: Option 1 Plus Repeal AMT	21.4	41.2	18.6	8.6	0.7	-8.1	17.4	66.5	65.2	62.4	59.0	331.5
Option 4: Option 2 Plus Repeal AMT	13.4	20.4	-4.2	-16.1	-26.0	-36.8	-15.0	29.8	26.4	21.6	16.0	16.1
Calendar Years												
Option 1: Repeal Deduction for State and Local Taxes	62.1	47.2	43.2	43.7	44.3	44.3	89.3	91.7	93.6	95.2	96.9	689.4
Option 2: Option 1 but Retain Deduction for Property Taxes	43.2	31.2	27.4	27.8	28.2	28.2	57.8	59.2	60.1	61.0	61.9	442.7
Option 3: Option 1 Plus Repeal AMT	53.5	22.9	12.1	3.3	-3.2	-15.5	66.8	66.1	63.8	60.4	56.9	333.6
Option 4: Option 2 Plus Repeal AMT	33.4	0.9	-11.7	-22.7	-31.0	-45.5	30.9	28.2	23.8	18.3	12.5	3.6
Extended Baseline[b, c]												
Fiscal Years												
Option 1: Repeal Deduction for State and Local Taxes	24.8	56.7	47.3	45.4	46.0	46.4	46.6	46.8	47.0	47.1	47.5	476.9
Option 2: Option 1 but Retain Deduction for Property Taxes	17.3	39.0	31.4	29.5	30.1	30.4	30.7	31.0	31.5	32.0	32.8	318.3
Option 3: Option 1 Plus Repeal AMT	21.4	41.9	20.3	10.6	2.9	-5.8	-17.4	-28.4	-40.5	-55.2	-70.6	-142.3
Option 4: Option 2 Plus Repeal AMT	13.4	21.0	-2.4	-14.0	-23.8	-34.3	-47.9	-60.7	-74.7	-91.2	-108.7	-436.8
Calendar Years												
Option 1: Repeal Deduction for State and Local Taxes	62.1	48.7	45.1	45.8	46.3	46.6	46.7	47.0	47.0	47.2	47.8	468.3
Option 2: Option 1 but Retain Deduction for Property Taxes	43.2	32.7	29.3	29.9	30.3	30.5	30.8	31.3	31.8	32.4	33.3	312.4
Option 3: Option 1 Plus Repeal AMT	53.5	24.5	14.1	5.4	-1.0	-13.0	-24.0	-34.9	-49.0	-64.4	-79.9	-222.3
Option 4: Option 2 Plus Repeal AMT	33.4	2.4	-9.7	-20.5	-28.6	-42.8	-55.6	-68.3	-84.3	-101.7	-119.3	-528.4

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0305-3A).
[a]Fiscal year revenue numbers assume a 40-60 split. The actual effect on receipts could differ.
[b]Under current law, the deduction for state and local general sales taxes sunsets Dec. 31, 2005. This option makes the provision permanent.
[c]Baseline includes making permanent the provisions in Economic Growth and Tax Relief Reconciliation Act of 2001, Jobs and Growth Tax Relief Reconciliation Act of 2003, and Working Families Tax Relief Act of 2004 affecting the following: marginal tax rates; the 10 percent bracket; the child tax credit; the child and dependent care credit; the standard deduction, 15 percent bracket, and EITC for married couples; pension and IRA provisions; and expansion of student loan interest deduction (excludes other education provisions); as outlined in the administration's fiscal 2006 budget proposal. Also includes extension of the deduction for state and local general sales taxes enacted by the American Jobs Creation Act of 2004 that sunsets Dec. 31, 2005, under current law. Note that the baseline does not extend AMT provisions or the section 25B "saver's" credit.

percent for those earning more than $1 million. Repealing the AMT has little immediate effect for most taxpayers although it lowers the average cost of repealing the deductibility of state and local taxes for those earning over $200,000, and for 11 percent of households earning above $200,000, their tax bills are reduced. That reflects the fact that the AMT currently affects a much smaller percentage of households.[12]

However, the distribution of those affected changes dramatically in the following years because of the increased number of households subject to the AMT. Table 5 (p. 508) shows the percent of tax units with tax cuts or tax increases from eliminating the deductibility of state and local taxes in 2010.[13] Only 21 percent of tax units are actually subject to a tax increase. So while about 35 percent of taxpayers itemized state and local taxes in 2002, by 2010 only 21 percent of households would face a tax increase if those deductions were eliminated. The unaffected taxpayers fall into two broad groups — households that are not itemizers and those that have already lost the value of the deduction because of the AMT. The first group corresponds to the vast majority of the 75 percent of tax units that earn less than $75,000, who are largely nonitemizers, while the second group corresponds to those earning between $200,000 and $500,000, who face little cost of the elimination mainly because of the AMT. (About half of all households in the $75,000-$200,000 group are also not affected by the elimination of state and local tax deductibility because of either not itemizing or the previous loss of those deductions because of the AMT.) Thus, the two groups of taxpayers who will pay the largest share of this change are those earning between $100,000 and $200,000 and those earning over $1 million. The average federal tax change would be about 2 percent for households earning between $50,000 and $100,000, and 3.3 percent and 4 percent average tax changes for households earning between $500,000 and $1 million and over $1 million respectively. For households earning $1 million or more — the loss comes about because they are still eligible for a portion of their state and local tax deductions after the phase-out of deductions. Fully one-quarter of households earning $1 million or more would lose their incentive to itemize if the state and local income tax deduction was disallowed.

Eliminating the deduction for state and local taxes, while leaving the AMT in place, would generate $24.8 billion this fiscal year or $693 billion in federal revenues assuming a current-law baseline over the period 2006-2015.

Examining the effects of eliminating the state and local tax deductibility and also repealing the AMT gives a more mixed story both across income classes and within certain groups (Table 6, p. 509). About 20 percent of tax units will experience a tax increase while 16 percent will experience a tax cut. Lower-income households still have little change in their expected tax bills, due to the fact that they are not itemizing and are not subject to the AMT. The repeal of the AMT translates into tax savings for most households with incomes of $200,000 to $500,000. Households with higher incomes still largely face an increase in tax bills and an increase in their taxes of about 3 percent for those earning over a million dollars. By 2010, eliminating the deductibility of state and local taxes will mostly affect the wealthiest of households compared with current tax law. Thus, the number of taxpayers affected by elimination of deductibility of state and local taxes falls over time due to the de facto elimination caused by the AMT.

The story is more mixed for households earning between $75,000 and $200,000 with about an equal number facing tax cuts and tax increases. To further examine who wins and who loses from the elimination of state and local taxes and the repeal of the AMT, we examine differences within income classes for different types of households (Table 7, p. 510). Married households and households with children are more likely to experience tax cuts than tax increases as compared with unmarried households and households without children. This is largely due to the fact that the AMT inflicts relatively large penalties on households that are married or have children. Burman, et al. (2004) estimate that 48 percent of married couples versus 3 percent of single households will be on the AMT. Also, 94 percent of married households with two or more children and income between $75,000 and 100,000 are estimated to owe money under the AMT. Therefore, for married households and households with children with household income between $100,000 and $500,000 the repeal of the AMT more than makes up for the

[12]Information on the percent of households who face tax cuts and increases, and the average size of the tax increase faced by income class, are available from the author. Tables for the distribution of benefits and cuts if property tax deductibility is also retained is also available upon request.

[13]Note that the results for 2006-2009 will be more similar to the 2010 results if we assume that the temporary increase in the AMT exemption is not extended. If the baseline model was one where these increases were maintained then the number of affected households and distribution would fall somewhere in between.

Table 4
Repeal Deduction for State and Local Taxes
Distribution of Federal Tax Change by Cash Income Class, 2005[a]
All Tax Units

Cash Income Class (thousands of 2005 dollars)[b]	Percent of Tax Units[c]		Percent Change in After-Tax Income[d]	Share of Total Federal Tax Change	Average Federal Tax Change		Share of Federal Taxes		Average Federal Tax Rate[e]	
	With Tax Cut	With Tax Increase			Dollars	Percent	Change (% points)	Under the Proposal	Change (% points)	Under the Proposal
Less than 10	0.0	0.0	0.0	0.0	0	0.0	0.0	0.2	0.0	3.6
10-20	0.0	1.9	0.0	0.1	3	0.4	0.0	1.0	0.0	4.8
20-30	0.0	7.1	-0.1	0.5	15	0.6	-0.1	2.7	0.1	10.1
30-40	0.0	15.5	-0.1	1.0	42	0.8	-0.1	4.1	0.1	14.5
40-50	0.1	28.2	-0.3	2.1	113	1.5	-0.1	4.8	0.3	17.0
50-75	0.1	43.1	-0.5	8.6	263	2.3	-0.1	12.8	0.4	18.9
75-100	0.1	65.6	-0.8	10.6	557	3.2	0.0	11.3	0.7	20.7
100-200	0.1	81.6	-1.4	32.7	1,426	4.8	0.3	24.0	1.1	23.4
200-500	0.2	84.8	-1.4	18.3	3,038	4.2	0.1	15.4	1.1	26.4
500-1,000	0.1	80.2	-1.7	8.3	8,136	4.4	0.1	6.6	1.2	28.4
More than 1,000	0.2	81.2	-1.6	17.7	33,264	3.6	0.0	17.0	1.1	32.4
All	0.0	27.7	-0.9	100.0	435	3.5	0.0	100.0	0.7	21.4

Baseline Distribution of Income and Federal Taxes
by Cash Income Class, 2005[a]

Cash Income Class (thousands of 2005 dollars)[b]	Tax Units[c]		Average Income (dollars)	Average Federal Tax Burden (dollars)	Average After-Tax Income[d] (dollars)	Average Federal Tax Rate[e]	Share of Pretax Income	Share of Posttax Income	Share of Federal Taxes
	Number (thousands)	Percent of Total					Percent of Total	Percent of Total	Percent of Total
Less than 10	19,560	13.5	5,618	200	5,418	3.6	1.3	1.5	0.2
10-20	25,611	17.7	14,885	706	14,179	4.8	4.4	5.2	1.0
20-30	19,953	13.8	24,715	2,488	22,227	10.1	5.6	6.4	2.7
30-40	15,289	10.6	34,863	5,023	29,840	14.4	6.1	6.6	4.2
40-50	11,738	8.1	44,824	7,501	37,322	16.7	6.0	6.3	4.9
50-75	20,700	14.3	61,482	11,337	50,145	18.4	14.5	15.0	12.9
75-100	11,936	8.3	86,246	17,266	68,980	20.0	11.8	11.9	11.4
100-200	14,432	10.0	133,489	29,752	103,737	22.3	22.0	21.6	23.7
200-500	3,797	2.6	287,471	72,870	214,601	25.4	12.5	11.7	15.3
500-1,000	642	0.4	678,426	184,538	493,888	27.2	5.0	4.6	6.5

Table 4
Baseline Distribution of Income and Federal Taxes by Cash Income Class, 2005[a]
(continued)

Cash Income Class (thousands of 2005 dollars)[b]	Tax Units[c]		Average Income (dollars)	Average Federal Tax Burden (dollars)	Average After-Tax Income[d] (dollars)	Average Federal Tax Rate[e]	Share of PreTax Income	Share of PostTax Income	Share of Federal Taxes
	Number (thousands)	Percent of Total					Percent of Total	Percent of Total	Percent of Total
More than 1,000	335	0.2	2,943,745	919,580	2,024,165	31.2	11.3	9.8	17.0
All	144,573	100.0	60,566	12,546	48,020	20.7	100.0	100.0	100.0

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0305-3A).
[a]Calendar year. Baseline is current law.
[b]Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm.
[c]Includes both filing and nonfiling units. Tax units that are dependents of other taxpayers are excluded from the analysis.
d After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.
[e]Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.

Table 5:
Repeal Deduction for State and Local Taxes
Distribution of Federal Tax Change by Cash Income Class, 2010[a]
All Tax Units

Cash Income Class (thousands of 2005 dollars)[b]	Percent of Tax Units[c]		Percent Change in After-Tax Income[d]	Share of Total Federal Tax Change	Average Federal Tax Change		Share of Federal Taxes		Average Federal Tax Rate[e]	
	With Tax Cut	With Tax Increase			Dollars	Percent	Change (% points)	Under the Proposal	Change (% points)	Under the Proposal
Less than 10	0.0	0.0	0.0	0.0	0	0.0	0.0	0.2	0.0	4.2
10-20	0.4	1.3	0.0	0.1	2	0.2	0.0	0.8	0.0	5.0
20-30	1.0	5.8	-0.1	0.7	14	0.5	0.0	2.5	0.1	10.4
30-40	1.7	12.6	-0.1	1.3	35	0.6	0.0	3.7	0.1	14.5
40-50	2.0	22.4	-0.2	2.6	90	1.1	0.0	4.4	0.2	17.2
50-75	2.4	36.8	-0.4	11.9	235	1.8	0.0	12.0	0.4	19.7
75-100	1.8	49.8	-0.6	13.3	427	2.1	0.0	11.3	0.5	21.6
100-200	5.5	47.6	-0.4	19.8	487	1.4	-0.1	26.0	0.3	24.4
200-500	1.1	18.5	-0.1	3.3	304	0.4	-0.2	16.4	0.1	26.8
500-1,000	1.3	66.9	-1.2	11.9	6,631	3.3	0.1	6.5	0.9	27.3
More than 1,000	2.0	74.5	-1.7	35.1	38,219	4.0	0.3	16.2	1.2	31.3
All	1.8	20.8	-0.5	100.0	288	1.8	0.0	100.0	0.4	22.2

Baseline Distribution of Income and Federal Taxes
by Cash Income Class, 2010[a]

Cash Income Class (thousands of 2005 dollars)[b]	Tax Units[c]		Average Income (dollars)	Average Federal Tax Burden (dollars)	Average After-Tax Income[d] (dollars)	Average Federal Tax Rate[e]	Share of Pretax Income	Share of Posttax Income	Share of Federal Taxes
	Number (thousands)	Percent of Total					Percent of Total	Percent of Total	Percent of Total
Less than 10	17,298	11.2	6,190	257	5,933	4.2	0.9	1.2	0.2
10-20	24,828	16.1	16,653	830	15,823	5.0	3.6	4.4	0.8
20-30	21,679	14.1	27,490	2,836	24,655	10.3	5.3	6.0	2.5
30-40	16,440	10.7	38,628	5,578	33,050	14.4	5.6	6.1	3.7
40-50	12,893	8.4	49,638	8,452	41,186	17.0	5.6	6.0	4.4
50-75	22,442	14.6	68,192	13,212	54,980	19.4	13.5	13.9	12.0
75-100	13,870	9.0	95,865	20,233	75,632	21.1	11.7	11.8	11.3
100-200	18,051	11.7	149,322	35,878	113,444	24.0	23.7	23.1	26.1
200-500	4,875	3.2	317,752	84,855	232,897	26.7	13.6	12.8	16.7
500-1,000	794	0.5	752,123	198,726	553,397	26.4	5.3	5.0	6.4
More than 1,000	408	0.3	3,203,897	965,938	2,237,959	30.2	11.5	10.3	15.9
All	154,170	100.0	73,696	16,094	57,602	21.8	100.0	100.0	100.0

For notes, see Table 4.
Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0305-3A).

Table 6:
Repeal Deduction for State and Local Taxes and Repeal AMT
Distribution of Federal Tax Change by Cash Income Class, 2010[a]
All Tax Units

Cash Income Class (thousands of 2005 dollars)[b]	Percent of Tax Units[c]		Percent Change in After-Tax Income[d]	Share of Total Federal Tax Change	Average Federal Tax Change		Share of Federal Taxes		Average Federal Tax Rate[e]	
	With Tax Cut	With Tax Increase			Dollars	Percent	Change (% points)	Under the Proposal	Change (% points)	Under the Proposal
Less than 10	0.0	0.0	0.0	0.0	0	0.0	0.0	0.2	0.0	4.2
10-20	0.4	1.3	0.0	-0.3	2	0.2	0.0	0.8	0.0	5.0
20-30	1.1	5.8	0.0	-1.6	11	0.4	0.0	2.5	0.0	10.4
30-40	3.1	12.6	-0.1	-3.2	29	0.5	0.0	3.7	0.11	4.5
40-50	6.8	22.2	-0.1	-4.9	57	0.7	0.1	4.5	0.1	17.1
50-75	17.0	36.3	-0.2	-13.7	92	0.7	0.2	12.1	0.1	19.5
75-100	40.6	46.5	0.3	18.3	-197	-1.0	0.0	11.3	-0.2	20.9
100-200	54.0	41.5	0.5	69.9	-579	-1.6	-0.3	25.8	-0.4	23.6
200-500	81.9	16.2	1.6	122.8	-3,765	-4.4	-0.6	16.0	-1.2	25.5
500-1,000	31.5	63.8	-0.4	-12.4	2,342	1.2	0.1	6.5	0.3	26.7
More than 1,000	22.9	71.6	-1.2	-75.3	27,565	2.9	0.6	16.5	0.9	31.0
All	16.4	19.6	0.2	100.0	-97	-0.6	0.0	100.0	-0.1	21.7

Baseline Distribution of Income and Federal Taxes
by Cash Income Class, 2010[a]

Cash Income Class (thousands of 2005 dollars)[b]	Tax Units[c]		Average Income (dollars)	Average Federal Tax Burden (dollars)	Average After-Tax Income[d] (dollars)	Average Federal Tax Rate[e]	Share of Pretax Income	Share of Posttax Income	Share of Federal Taxes
	Number (thousands)	Percent of Total					Percent of Total	Percent of Total	Percent of Total
Less than 10	17,298	11.2	6,190	257	5,933	4.2	0.9	1.2	0.2
10-20	24,828	16.1	16,653	830	15,823	5.0	3.6	4.4	0.8
20-30	21,679	14.1	27,490	2,836	24,655	10.3	5.3	6.0	2.5
30-40	16,440	10.7	38,628	5,579	33,050	14.4	5.6	6.1	3.7
40-50	12,893	8.4	49,638	8,453	41,185	17.0	5.6	6.0	4.4
50-75	22,442	14.6	68,192	13,213	54,979	19.4	13.5	13.9	12.0
75-100	13,870	9.0	95,865	20,234	75,632	21.1	11.7	11.8	11.3
100-200	18,051	11.7	149,322	35,879	113,443	24.0	23.7	23.1	26.1
200-500	4,875	3.2	317,752	84,854	232,898	26.7	13.6	12.8	16.7
500-1,000	794	0.5	752,123	198,733	553,391	26.4	5.3	5.0	6.4
More than 1,000	408	0.3	3,203,897	965,941	2,237,957	30.2	11.5	10.3	15.9
All	154,170	100.0	73,696	16,095	57,601	21.8	100.0	100.0	100.0

For notes, see Table 4.
Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0305-3A).

Table 7:
Repeal Deduction for State and Local Taxes and Repeal AMT
Distribution of Federal Tax Change by Cash Income Class, 2010[a]
By Household Type

Cash Income Class (thousands of 2005 dollars)[b]	Percent of[a]									
	All Tax Units		Married Tax Units		Not Married Tax Units		With Children Tax Units		Without Children Tax Units	
	With Tax Cut	With Tax Increase	With Tax Cut	With Tax Increase	With Tax Cut	With Tax Increase	With Tax Cut	With Tax Increase	With Tax Cut	With Tax Increase
Less than 10	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.00.1	0.0	
10-20	0.4	1.3	0.4	0.2	0.4	1.6	0.2	0.0	0.4	1.7
20-30	1.1	5.8	1.0	4.0	1.2	6.5	1.7	2.7	0.9	7.0
30-40	3.1	12.6	2.3	8.3	3.5	14.6	5.3	11.9	2.1	12.9
40-50	6.8	22.2	3.7	18.4	8.4	24.1	13.0	23.0	4.3	21.9
50-75	17.0	36.3	17.0	33.9	16.9	38.4	34.9	38.4	7.6	35.2
75-100	40.6	46.5	50.5	43.8	19.4	52.4	56.1	41.6	30.6	49.7
100-200	54.0	41.5	61.8	36.8	23.9	59.5	78.0	21.2	34.8	57.8
200-500	81.9	16.2	88.5	10.5	48.0	45.4	93.0	6.3	72.5	24.4
500-1,000	31.5	63.8	31.7	64.3	30.2	61.2	25.6	70.9	35.9	58.5
More than 1,000	22.9	71.6	22.3	72.6	26.1	66.8	17.2	77.9	26.9	67.3
All	16.4	19.6	31.4	24.8	6.1	16.0	30.6	18.5	9.7	20.1

Baseline Distribution of Income and Federal Taxes
by Cash Income Class, 2010[a]

Cash Income Class (thousands of 2005 dollars)[b]	All Tax Units		Married Tax Units		Not Married Tax Units		With Children Tax Units		Without Children Tax Units	
	Number (thousands)	Percent of Total	Number (thousands)	Percent of Total	Number (thousands)	Percent of Total	Number (thousands)	Percent of Total	Number (thousands)	Percent of Total
Less than 10	17,298	11.2	2,750	4.4	14,548	15.9	3,624	7.4	13,674	13.0
10-20	24,828	16.1	4,89	47.8	19,935	21.8	6,53	913.3	18,289	17.4
20-30	21,679	14.1	6,043	9.6	15,636	17.1	6,22	312.6	15,455	14.7
30-40	16,440	10.7	5,139	8.2	11,301	12.4	5,075	10.3	11,365	10.8
40-50	12,893	8.4	4,267	6.8	8,626	9.4	3,772	7.7	9,120	8.7
50-75	22,442	14.6	10,565	16.8	11,877	13.0	7,727	15.7	14,715	14.0
75-100	13,870	9.0	9,468	15.1	4,402	4.8	5,482	11.1	8,388	8.0
100-200	18,051	11.7	14,312	22.8	3,740	4.1	8,016	16.3	10,035	9.6
200-500	4,875	3.2	4,080	6.5	795	0.9	2,224	4.5	2,651	2.5
500-1,000	794	0.5	663	1.11	31	0.1	337	0.7	457	0.4l
More than 1,000	408	0.3	342	0.6	66	0.1	166	0.3	242	0.2
All	154,170	100.0	62,753	100.0	91,417	100.0	49,306	100.0	104,864	100.0<

For notes, see Table 4.
Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0305-3A).

loss of deductibility largely because they are already losing the state and local deduction.

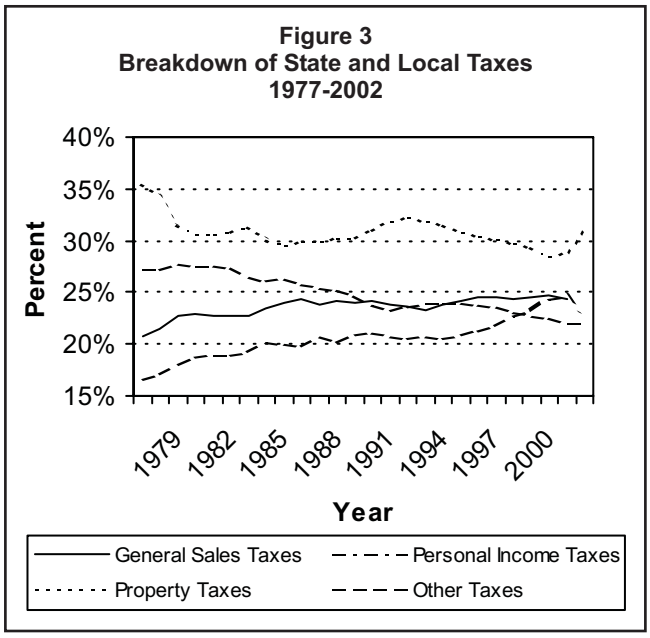
The above results are based on a comparison of changing the deductibility of state and local taxes (and the AMT) in a static model. The size and distribution of those effects will vary depending on what other changes are undertaken. If the higher AMT exemption is extended, the distribution of tax increases across taxpayers and the savings to the federal government will also change.

The Effects on State Revenues: Will There Be a Race to the Bottom?

Will the wealthiest households leave if state and local tax deductibility is removed? There are no recent estimates of the tax subsidy currently in place to state and local governments. Tannenwald (1997) estimated (based on 1995 taxes) that the elimination of state and local tax deductibility would lead to an average tax price increase of 8.5 percent, or increase the tax price from 84 cents to 91 cents.[14] The change would vary across states with Wyoming facing less than a 1 percent change in tax price and Maryland facing a 10 percent increase. However, those estimates assume all current itemizers would lose the deduction. The actual erosion faced by states will be lower because of the effective elimination of the deductions for many households because of the AMT. Thus, states already face the potential loss of deductibility albeit in a less transparent way. The marginal voter is not expected to face a tax increase due to the limit in deductibility, so median voter theory would lead us to expect no change in the level of services. However, taxes will increase for the highest-income households. If they have disproportionate influence, that could lead to a decline in the level of state and local taxes and services. (That could be due to political power or a fear that high-income households will leave due to the relative increase in their effective tax bills.)

For many households, elimination of state and local tax deductibility is already in place as part of the current tax system.

How did state and local government revenues change after TRA '86? Recall, it was argued that eliminating sales tax deductibility would raise the effective cost of sales taxes, compared with income and property taxes. Because federal marginal tax rates also declined, that lowered the value of all deductions and effectively raised the price of income and property taxes relative to fees and specific sales taxes. Figure 3 shows little change in the aggregate amount of state and local taxes coming from general sales taxes following TRA '86. Indeed, in the years immediately following TRA '86, no state lowered its general sales tax and 15 states had higher general sales tax rates in place in 1989 as compared to 1985.[15] However, because marginal tax rates were also lowered, that led in general to a decline in overall taxes for wealthy households. It could be that the income effect of paying lower federal taxes offset any pressure from households to change the tax burden in light of the elimination of the sales tax deductibility in 1986.



Even if there is not a direct shift down in state and local taxes, will the increase in cost lead the highest-income households to vote with their feet and leave higher-tax areas? The flight of high-income households could lead to a decline in revenues, especially in states that are more dependent on highly progressive income tax systems. Bakija and Slemrod (2004) examine issues of mobility among high-income older households by exploring how changes in state tax policy affect the number of federal estate tax returns across states. They find

[14]The tax price would still be less than $1 due to the continued ability of businesses to deduct state and local taxes as a business expense. Tannenwald (1997) includes a measure of the percent of taxes coming from businesses in his estimates. This work follows on that done by Feldstein and Metcalf (1987) which examined these issues prior to TRA '86.

[15]While none of the states that did not have income taxes switched from using sales tax revenues to introducing an income tax, the "fairness issue" was raised by parties in the seven states without an income tax. This pressure led to the inclusion of the ability to deduct sales taxes *in lieu* of income taxes adopted as part of the Jobs Act.

modest but statistically significant evidence that higher state inheritance and estate taxes and higher state income and property taxes can lead to wealthy elderly people changing their real (or reported) state of residence. They estimate that a 1 percentage point increase in the effective state estate tax leads to a 1.4 percent to 2.7 percent decline in the number of federal estate tax returns filed in the state.

While some evidence exists on the positive effect of higher relative tax rates on migration, the group examined is more mobile than all households with similar incomes because it is more likely to not be part of the labor force. Currently a disproportionate percent of households earning $200,000 or more live in states that have comparatively high taxes and progressive tax systems. Those households are choosing to live in relatively high-tax places either because they believe they are receiving commensurate levels of benefits or because of other locational considerations, such as job opportunities or climate. The change in effective tax rates caused by the elimination of state and local deductions is small relative to the current discrepancies in marginal tax burdens across different states. Also, if the goals of tax reform — simplification of the tax code and broadening the base — are met, it is likely that the net tax bill for those households (total federal, state, and local) could be lower — as found after TRA '86. However, one would have to further evaluate mobility decisions and the tax price faced by households with different income levels to estimate possible migration patterns.

Conclusion

This report has examined how the elimination of state and local tax deductibility would affect taxpayers across different states and income classes and how it would affect state and local government finances. While taxpayers in all 50 states claim the deduction, the benefits of the deductions are concentrated in relatively few states. Those are the states with a disproportionate share of high-income households and relatively high state and local taxes. Those taxpayers also pay a higher percent of federal income and are currently more likely to be subject to the AMT.

Whether the deductibility of state and local taxes is seen as theoretically justified depends crucially on whether taxes are judged to equal the benefits received by each household (in which case tax deductibility encourages public good consumption over private consumption) versus an argument that taxes paid are not necessarily related to benefits received. If taxes do not equal benefits, it is unclear why households locate in the communities they do, but that could be due to other locational considerations. The estimated federal savings and distribution of tax rate increases from eliminating the deductibility of state and local taxes depends on what assumptions are made concerning reform of the AMT. If we assume the current law in which AMT expansion largely eliminates deductibility, by 2010 only 20 percent of households will face an increase in their tax bill if deductibility is eliminated. Thus for many households, elimination of state and local tax deductibility is already in place as part of the current tax system.

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