

#### Part D. Preferred Uses of Income

The Administration proposals would curtail itemized deductions for certain personal expenditures, in order to broaden the tax base, simplify compliance and administration, and allow rates to be reduced. The deduction for State and local taxes would be repealed, and the charitable contribution deduction would be eliminated for nonitemizers. The itemized deductions for charitable contributions, medical expenses, casualty losses, and principal-residence mortgage interest would be left unchanged. Changes to the itemized deduction for interest expense are described in Chapter 13.01 (limit on interest deduction). The deduction for miscellaneous expenses would be replaced with an adjustment to income. (See Chapter 4.01).

## REPEAL DEDUCTION OF STATE AND LOCAL TAXES

### General Explanation

#### Chapter 3.09

##### Current Law

Individuals who itemize deductions are permitted to deduct certain State and local taxes without regard to whether they were incurred in carrying on a trade or business or an income-producing activity. The following such taxes are deductible:

- State and local real property taxes.
- State and local personal property taxes. (In some States, payments for registration and licensing of an automobile are wholly or partially deductible as a personal property tax.)
- State and local income taxes.
- State and local general sales taxes.

Other State and local taxes are deductible by individuals only if they are incurred in carrying on a trade or business or income-producing activity. This category includes taxes on gasoline, cigarettes, tobacco, alcoholic beverages, admission taxes, occupancy taxes and other miscellaneous taxes. Taxes incurred in carrying on a trade or business or which are attributable to property held for the production of rents or royalties (but not other income-producing property) are deductible in determining adjusted gross income. Thus, these taxes are deductible by both itemizing and nonitemizing taxpayers. Taxes incurred in carrying on other income-producing activities are deductible only by individuals who itemize deductions. Examples of these taxes include real property taxes on vacant land held for investment and intangible personal property taxes on stocks and bonds. State and local income taxes are not treated as incurred in carrying on a trade or business or as attributable to property held for the production of rents or royalties, and therefore are deductible only by individuals who itemize deductions.

##### Reasons for Change

**Fairness.** The current deduction for State and local taxes disproportionately benefits high-income taxpayers residing in high-tax States. The two-thirds of taxpayers who do not itemize deductions are not entitled to deduct State and local taxes, and even itemizing taxpayers receive relatively little benefit from the deduction unless they reside in high-tax States. Although the deduction for State and local taxes thus benefits a small minority of U.S. taxpayers, the cost of the deduction is borne by all taxpayers in the form of significantly higher marginal tax rates.

The unfair distribution of benefits from the deduction for State and local taxes is illustrated by recent tax return data. For example, in 1982 itemizing taxpayers in New York received an average tax savings of \$1292 from the deduction, whereas itemizers in Wyoming on average saved only \$257. In effect, the deduction requires taxpayers in certain communities to subsidize taxpayers in other communities. Moreover, the deduction effectively skews the burden of State and local taxes within particular communities. Consider the variation in effective sales tax rates for three persons facing a 6 percent State sales tax: a nonitemizer, an itemizer in the 50 percent tax bracket, and an itemizer in the 20 percent bracket. The nonitemizer pays the full 6 percent sales tax rate, whereas the two itemizers pay effective rates of 3 and 4.8 percent, respectively. The deduction thus causes effective sales tax rates to vary with a taxpayer's marginal income tax rate and with whether a taxpayer itemizes, and produces the lowest effective rate for high-bracket/high income taxpayers.

Erosion of the Tax Base. The deduction for State and local taxes is one of the most serious omissions from the Federal income tax base. Repeal of the deduction is projected to generate \$33.8 billion in revenues for 1988. Recovery of those revenues will permit a substantial reduction in marginal tax rates. Indeed, unless those revenues are recovered, tax rates will almost certainly remain at the current unnecessarily high levels.

The Fallacy of the "Tax on a Tax" Argument. Some argue that the deductibility of State and local taxes is appropriate because individuals should not be "taxed on a tax." The argument is deficient for a number of reasons. First, it ignores the effect of State and local tax deductibility on the Federal income tax base. Deductibility not only reduces aggregate Federal income tax revenues, it shifts the burden of collecting those revenues from high-tax to low-tax States. High-tax States effectively shield a disproportionate share of their income from Federal taxation, leaving a relatively greater share of revenues to be collected from low-tax States. Absent the ability to impose Federal income tax on amounts paid in State and local taxes, the Federal government loses the ability to control its own tax base and to insist that the burden of Federal income taxes be distributed evenly among the States.

Second, the "tax on a tax" argument suggests that amounts paid in State or local taxes should be exempt from Federal taxation because they are involuntary and State or local taxpayers receive nothing in return for their payments. Neither suggestion is correct. State and local taxpayers have ultimate control over the taxes they pay through the electoral process and through their ability to locate in jurisdictions with amenable tax and fiscal policies. Moreover, State and local taxpayers receive important personal benefits in return for their taxes, such as public education, water and sewer services and municipal garbage removal. In this respect, the determination by State and local taxpayers of their levels of taxation and public service benefits is analogous to their individual decisions over how much to spend for the purchase of private goods.

It is, of course, true that not all benefits provided by State and local governments are directly analogous to privately purchased goods or services. Examples include police and fire protection, judicial and administrative services and public welfare. These services nevertheless provide substantial personal benefits to State and local taxpayers, whether directly or by enhancing the general quality of life in State and local communities.

Finally, the "tax on a tax" argument is contradicted by the practice of most States with respect to their own tax systems, including many of those with high tax rates. Federal income taxes are allowable as a deduction from State individual income taxes in only 16 States and from State corporate income taxes in only seven States. New York and California, States with very high tax rates, are among the States that deny a deduction for Federal income taxes.

Inefficient Subsidy. The deduction for State and local taxes may also be regarded as providing a subsidy to State and local governments, which are likely to find it somewhat easier to raise revenue because of the deduction. A general subsidy for spending by State and local governments can be justified only if the services which State and local governments provide have important spillover benefits to individuals in other communities. The existence of such benefits has not been documented.

Even if a subsidy for State and local government spending were desired, provision of the subsidy through a deduction for State and local taxes is neither cost effective nor fair. On average, State and local governments gain less than fifty cents for every dollar of Federal revenue lost because of the deduction. Moreover, a deduction for State and local taxes provides a greater level of subsidy to high-income States and communities than to low-income States and communities. In addition, a deduction for taxes does not distinguish between categories of State and local spending on the basis of their spillover effects, but is as much a subsidy for spending on recreational facilities as for public welfare spending. Finally, the deduction distorts the revenue mix of State and local governments by creating a bias against the imposition of user charges in favor of more general taxes.

### Proposal

The itemized deduction for State and local income taxes and for other State and local taxes that are not incurred in carrying on a trade or business or income-producing activity would be repealed. State and local taxes (other than income taxes) which currently are deductible only by itemizers, but which are incurred in carrying on an income-producing activity, would be aggregated with employee business expenses and other miscellaneous deductions and would be deductible subject to a threshold. See Ch. 4.01.

## Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

## Analysis

While only one-third of all families itemized deductions in 1983, this group included most high-income families (more than 95 percent of families with income over \$100,000 itemized tax deductions) and very few low-income families (2 percent of families with income of \$10,000 or less itemized tax deductions). (Table 1.) Two-thirds of the total deductions for State and local tax payments were claimed by families with economic income of \$50,000 or more. The benefits are even further skewed toward high-income families because deductions are worth more to families which face higher marginal tax rates.

The tax savings from deductibility vary widely among the States and, as shown in Table 2, provide the greatest benefits to individuals in high-income States. Because this tax expenditure requires tax rates for all individuals to be higher than they otherwise would be, those in the 15 States with above-average tax savings per capita currently gain at the expense of taxpayers in the other 35 States. Even within the high-tax States, less than one-half of all taxpayers itemize deductions.

Recent estimates indicate that the effect of tax deductibility on the level of State and local government spending is not large. A National League of Cities study found that total State and local spending is about 2% higher because of the existence of tax deductibility. This estimated effect is low in part because less than one-third of total State and local spending is financed by taxes potentially deductible from the Federal individual income tax. Because State and local spending has been growing by about 7% per year since 1980, the elimination of tax deductibility would not reduce the absolute level of State and local spending, but only reduce its rate of growth. However, because the proportion of taxpayers who itemize varies a great deal among the States as well as among local governments within a State, the effect on spending for a particular State or local government would be larger than 2 percent for a high-income community and may not affect spending at all in low-income communities where few residents itemize deductions.

The three most important sources of State and local tax revenue in the U.S. are general sales, personal income and property taxes. Some argue that itemized deductions should be eliminated for some of these taxes, but retained for others. As Table 3 shows, however, elimination of any one tax deduction would have an uneven effect on taxpayers among the States. In addition, since State and local governments would be likely to increase reliance on the remaining deductible taxes, disallowing deductions for particular taxes is likely to lead to sizeable distortions in State and local revenue

mixes. For example, disallowing only the sales tax deduction might force a State, like Washington, that relies heavily on a general sales tax but does not have an individual income tax, to adopt one.

Table 3.09-1

**Distribution of Deductions for Taxes Paid  
by Economic Income - 1983**

Family Economic Income	Number of Families (thousands)	Percentage with State and Local Deduction	State and Local Taxes Deducted <sup>1/</sup> (millions)	Average Amount Deducted <sup>2/</sup>
\$ 0 - 9,999	337	2 %	\$ 233	\$ 691
10,000 - 14,999	516	4	465	901
15,000 - 19,999	1,009	9	1,009	1,089
20,000 - 29,999	3,894	22	5,307	1,363
30,000 - 49,999	10,820	51	22,012	2,034
50,000 - 99,999	11,298	80	36,408	3,223
100,000 - 199,999	1,793	95	12,150	6,776
200,000 or more	426	97	9,090	21,338
All Families	30,093	33	86,762	2,883

Office of the Secretary of the Treasury

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<sup>1/</sup> Net of income tax refunds.<sup>2/</sup> For families that itemize deductions.

Table 3.09-2

**States Ranked by Per Capita Tax Savings from  
Tax Deductibility Under Current Law, 1982**

State	Tax Savings Per Capita	Income Per Capita	Rank of Income Per Capita
New York	\$233	\$12,314	7
District of Columbia	198	14,550	2
Maryland	185	12,238	9
New Jersey	167	13,089	4
Delaware	162	11,731	14
California	155	12,567	5
Massachusetts	155	12,088	11
Minnesota	150	11,175	19
Michigan	144	10,956	22
Wisconsin	137	10,774	26
Connecticut	135	13,748	3
Oregon	117	10,335	31
Hawaii	116	11,652	15
Rhode Island	116	10,723	28
Virginia	113	11,095	20
Colorado	110	12,302	8
U.S. Average	106	11,107	-
Illinois	101	12,100	10
Utah	91	8,875	46
Georgia	87	9,583	37
Nebraska	87	10,683	29
Oklahoma	89	11,370	18
Pennsylvania	83	10,955	23
Ohio	82	10,677	30
Kansas	80	11,765	13
North Carolina	77	10,044	41
Arizona	76	10,173	32
Iowa	75	10,791	25
Vermont	75	9,507	39
South Carolina	73	8,502	49
Maine	70	9,042	42
Missouri	70	10,170	34
New Hampshire	68	10,729	27
Kentucky	65	8,934	44
Idaho	64	9,029	43
Washington	63	11,560	16
Nevada	57	11,981	12
Indiana	51	10,021	35
Florida	50	10,978	21
Alabama	49	8,649	48
Arkansas	49	8,479	50
Alaska	45	16,257	1
Texas	43	11,419	17
North Dakota	42	10,872	24
Montana	41	9,580	38
Mississippi	39	7,778	51
New Mexico	38	9,190	40
West Virginia	34	8,769	47
Tennessee	33	8,906	45
Wyoming	33	12,372	6
Louisiana	31	10,231	32
South Dakota	20	9,666	36

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Source: Advisory Commission on Intergovernmental Relations.

Table 3.09-3

**Percentage Reliance on Different Deductible  
Taxes by States in 1982 <sup>1/</sup>**

State	Property Taxes	General Sales Taxes	Individual Income Taxes
Alabama	19.8 %	50.7 %	29.5 %
Alaska	89.1	10.9	0
Arizona	38.7	42.4	18.9
Arkansas	31.6	37.4	31.0
California	33.1	37.3	29.6
Colorado	43.0	37.3	19.7
Connecticut	60.6	34.7	4.7
D.C.	34.0	24.8	41.2
Delaware	26.8	0	73.2
Florida	53.1	46.9	0
Georgia	35.3	34.6	30.1
Hawaii	22.8	51.8	25.5
Idaho	37.9	24.7	37.4
Illinois	47.2	31.1	21.7
Indiana	42.7	37.9	19.5
Iowa	50.5	20.8	28.7
Kansas	51.0	25.7	23.2
Kentucky	27.0	33.5	39.5
Louisiana	22.4	68.9	8.7
Maine	48.6	27.9	23.5
Maryland	33.9	18.9	47.2
Massachusetts	47.4	14.8	37.8
Michigan	53.1	20.2	26.7
Minnesota	36.5	23.0	40.5
Mississippi	30.5	57.1	12.4
Missouri	35.7	36.2	28.1
Montana	76.1	0	23.9
Nebraska	55.6	26.5	17.8
Nevada	33.0	67.0	0
New Hampshire	97.3	0	2.7
New Jersey	61.8	19.7	18.6
New Mexico	25.4	72.8	1.7
New York	40.2	23.3	36.5
North Carolina	33.0	27.4	39.6
North Dakota	52.2	38.5	9.3
Ohio	45.7	26.0	28.3
Oklahoma	26.2	42.0	31.8
Oregon	56.8	0	43.2
Pennsylvania	39.0	25.1	35.9
Rhode Island	54.0	22.1	23.9
South Carolina	32.6	33.8	33.6
South Dakota	56.8	32.2	0
Tennessee	37.2	60.8	1.9
Texas	55.7	44.3	0
Utah	33.5	39.2	27.3
Vermont	59.0	12.2	28.7
Virginia	40.6	22.7	36.7
Washington	40.8	59.2	0
West Virginia	22.2	55.8	22.0
Wisconsin	43.9	20.4	35.7
Wyoming	60.4	39.6	0
U.S. Average	42.5%	31.4%	26.2%

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<sup>1/</sup> These figures include some general sales and property taxes with an initial impact on business rather than individuals. Certain other taxes can also be itemized deductions. Property, general sales, and individual income taxes accounted for 94 percent of total taxes itemized in 1982.

Source: Advisory Commission on Intergovernmental Relations.

ACCELERATE EXPIRATION OF CHARITABLE CONTRIBUTION  
DEDUCTION FOR NONITEMIZERS

General Explanation

Chapter 3.10

Current Law

Contributions to or for the benefit of religious, charitable, educational, and certain other tax-exempt organizations are deductible, subject to certain limitations. Prior to 1981 individuals who did not itemize their deductions could not deduct their charitable contributions. The Economic Recovery Tax Act of 1981 (ERTA) extended the charitable contribution deduction to nonitemizing taxpayers, phased in over a five-year period. For contributions made in the 1984 tax year, individuals who did not itemize deductions were permitted to deduct 25 percent of the first \$300 of contributions made. For 1985 and 1986, the \$300 limitation is removed, and the percentage of contributions deductible by nonitemizers is increased to 50 percent and 100 percent, respectively. Thus, under current law, the charitable contribution deduction will be allowed in full to nonitemizers in 1986. The charitable deduction for nonitemizers is scheduled to expire after 1986, however, so that after that time the deduction will again be unavailable to individuals who do not itemize their deductions.

Reasons for Change

Taxpayers are not subject to tax on their incomes up to the zero bracket amount (ZBA). This exemption generally is regarded as an allowance for certain personal expenses that ought not to be included in income and that all taxpayers are deemed to incur. In lieu of the ZBA, a taxpayer may itemize deductible personal expenses, such as certain medical expenses, interest expenses, and, prior to the ERTA changes, charitable contributions. Allowing a deduction for charitable contributions by nonitemizers in effect creates a double deduction for such contributions -- first through the ZBA, which is available only to nonitemizers, and second through the charitable contribution deduction.

In addition, the allowance of a charitable contribution deduction for nonitemizers is administratively burdensome for the Internal Revenue Service and complicated for taxpayers. In particular, it is extremely difficult for the Internal Revenue Service to monitor deductions claimed for countless small donations to eligible charities; the expense of verification is out of proportion to the amounts of tax involved. Dishonest taxpayers are thus encouraged to believe that they can misrepresent their charitable contributions with impunity. Moreover, taxpayers who claim charitable contribution deductions are required to maintain records substantiating those

contributions. In the case of smaller gifts, the effort required to comply with the necessary substantiation requirements may be out of proportion to the amounts involved.

Finally, allowance of the deduction for nonitemizers would make it much more difficult to implement the proposed return-free system described in Ch. 5.01 for large numbers of taxpayers.

### Proposal

The scheduled expiration date of the charitable contribution deduction for nonitemizers would be accelerated.

### Effective Date

Expiration of the charitable contribution deduction for nonitemizers would be effective for contributions made in taxable years beginning on or after January 1, 1986.

### Analysis

There is little data indicating whether the charitable contribution deduction for nonitemizers has significantly increased the level of charitable giving. Because nonitemizers generally have lower incomes and thus lower marginal tax rates than itemizers, their contributions generally are not affected significantly by tax considerations. Rather, contributions made by nonitemizers are influenced far more by non-tax considerations such as general donative intent. Therefore, any adverse effect of the proposal on charitable giving is not expected to be significant, particularly in relation to the proposal's effect on tax revenues. The repeal of the charitable contribution deduction for nonitemizers is estimated to increase revenues in fiscal years 1986 and 1987 by \$419 million and \$2,687 million, respectively.

The proposal would simplify both the regular tax form (1040) and the short-form (1040A). The current deduction requires that a "worksheet" be included in the tax form instructions, on which the taxpayer makes calculations, the results of which are subsequently transferred onto Form 1040 or 1040A. The proposal would eliminate these computations and would relieve nonitemizers of recordkeeping burdens.