FEDERAL TAX REFORM AND STATE-LOCAL ECONOMIC DEVELOPMENT POLICY

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INTRODUCTION

The type of federal tax reform under active consideration for the past three years or so—broadening the base of taxable income and applying lower rates to that base—can have a major impact on state and local governments and their economic development strategies. President Reagan's 1985 plan for tax reform (Treasury II) would have affected state and local governments more than any other sector of the economy.[1] Those provisions were substantially changed in the Tax Reform Act of 1986, and the state-local sector did not escape unscathed.[2]

This paper explores the likely effects of the major provisions affecting state and local governments, specifically the restrictions on the deductibility of state and local taxes and on tax-exempt borrowing by state and local governments. The strongest of such provisions were not enacted in 1986. Given the precarious state of the federal budget, however, some of the revenue-enhancing tax reform proposals may be adopted in the future to reduce the deficit. Such measures are particularly attractive because they do not involve across-the-board increases in tax rates. Indeed, in 1982 and 1983, Congressional committees devoted a good deal of attention to these measures, and Congress enacted some minor changes as revenue-increasing rather than tax reform measures.[3] Moreover, if the restrictions on state-local tax deductibility and state-local tax-exempt borrowing enacted in 1986 do not yield the revenue projected, Congress may act further along the same lines. Therefore, in this paper, I will address both the provisions of the 1986 Act and the more severe restrictions of the earlier tax reform proposals that concern state-local tax deductibility and tax-exempt borrowing.

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1. U.S. DEP'T OF THE TREASURY, THE PRESIDENT'S TAX PROPOSAL TO THE CONGRESS FOR FAIRNESS, GROWTH AND SIMPLICITY, 62-69, 243-46, 281-92 (May 1985) [hereinafter TREASURY II]. The provisions affecting state and local governments in Treasury II were identical to those in 1 U.S. DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT, 78-81, 135-37 (November 1984) [hereinafter TREASURY I]; 2 TREASURY I at 62-68, 249-52, 288-97.

2. Pub. L. No. 99-514, §§ 134, 1301, 1312-1319, 100 Stat. (codified at I.R.C. §§ 103, 103A, 141-150, 164 (CCH 1986)).

3. *See* D. ZIMMERMAN, TREATMENT OF STATE-LOCAL TAXES AND TAX-EXEMPT BONDS UNDER TAX REFORM PROPOSALS: EFFECT ON THE STATE-LOCAL SECTOR, Cong. Research Service, Rep. No. 85-503 E, at 8 (January 18, 1985).

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I
STATE-LOCAL TAX DEDUCTIBILITY

Both versions of the Reagan administration's plan for tax reform—Treasury I in November 1984 and Treasury II in May 1985—provided for complete elimination of deductibility of the following state and local taxes on Schedule A (itemized deductions) of individual income tax returns: state and local income, sales and property taxes.[4] Both plans did, however, allow the deduction of these taxes when incurred as business expenses.[5] The 1986 Act eliminates deductibility for state[6] and local sales[7] taxes, but retains it for property[8] and income[9] taxes. Like Treasury I and II, the 1986 Act allows taxpayers to deduct sales taxes when incurred as business expenses.[10]

The Constitution apparently does not require the deductibility of state and local taxes on federal tax returns. In 1963, Congress ended the deductibility of all personal taxes levied by state and local governments other than income, general sales, property and gasoline taxes.[11] No state or city challenged the constitutionality of these provisions. Congress has also removed gasoline taxes from the list of possible itemized deductions,[12] again without constitutional challenge. Since the debate over deductibility raises public policy and not constitutional concerns, this paper will address the issue of whether deductibility is sound policy.

A. The Case Against Deductibility

The arguments against deductibility rest on principles of equity and economic efficiency.[13] The inequity of deductibility relates to the progressivity of the income tax with respect to total income. With a graduated rate structure, all exemptions, exclusions, and deductions permitted in calculating taxable income from total income reduce the progressivity of the tax. This is especially true of itemized deductions (such as state and local taxes), because the tax code is so structured that the advantage of itemizing deductions increases with income level. But the reduction in progressivity is not so regular that the allowance of a given type of itemized deduction can be viewed as a close substitute for lower and less graduated nominal tax rates. The reduction in

4. 2 TREASURY I, *supra* note 1, at 62-68; TREASURY II, *supra* note 1, at 62-69.
5. 2 TREASURY I, *supra* note 1, at 63; TREASURY II, *supra* note 1, at 64.
6. I.R.C. § 164(a) (CCH 1986).
7. *Id.*
8. *Id.*
9. *Id.*
10. *Id.* § 162(a).
11. Revenue Act of 1964, Pub. L. No. 88-272, § 207(a), 78 Stat. 19, 40-42 (1964) (current version at I.R.C. § 164(a) (CCH 1986).
12. Revenue Act of 1978, Pub. L. No. 95-600, § 111(a), 92 Stat. 2763, 2777 (1978) (current version at I.R.C. § 164(a) (CCH 1986).
13. "Efficiency means there is no waste... [T]he economy is operating efficiently when it cannot produce more of one good without producing less of another. . . ." P. SAMUELSON & W. NORDHAUS, ECONOMICS 28 (12th ed. 1985).

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progessivity caused by deductibility thus appears to be, at least in part, unintended.

There is, however, a key question buried in this argument: should progressivity be measured with respect to total income or ability to pay? The traditional argument for personal deductions was that they refined the measure of ability to pay by excluding personal expenses that reduce ability to pay from taxable income. The validity of this argument depends greatly on the extent to which the expenses in question are involuntary rather than discretionary. If the expenses are involuntary, then allowing the deduction may be equitable.

Similar reasoning applies to the argument that the deductibility of state and local tax payments is inequitable among residents of different states and localities. If the residents of some states or localities choose freely to supply themselves generously with public services, resulting in higher state-local taxes, then federal income tax deductibility produces an unfair geographic distribution of the federal tax burden. But if interstate and interlocality differentials in taxation are mainly the result of factors not within the control of the voters and governments of the separate states and localities—or if the tax differentials are in considerable part the result of expenditures that state-local governments finance in pursuance of national rather than localized interests—then deductibility is essential for interstate and interlocality equity.

The efficiency question is closely related to this point. If there are few if any national benefits from state and local tax-financed expenditure (aside from the national benefits that would result automatically from the level of spending and taxation that local voters would choose in the absence of federal deductibility), then deductibility induces inefficiency, *i.e.*, an excessive level of resources devoted to the state-local sector. This inefficiency is due to the lower price of those servies to local decision-makers. If there are substantial benefits external to any given state, then—in the absence of federal grants designed to elicit the externalities—deductibility serves economic efficiency. Deductibility will allow for higher tax rates than ordinarily would be chosen by state and local voters on the basis of the costs and benefits confronting those voters.

Scholars disagree on the extent of externalities in current patterns of state-local spending;[14] therefore, they disagree about the efficiency of deductibility as a subsidy to state-local spending, and about its locational conse-

14. *See* Netzer, *The Effect of Tax Simplification on State and Local Governments*, in FEDERAL RESERVE BANK OF BOSTON, ECONOMIC CONSEQUENCES OF TAX SIMPLIFICATION 224 (1985) ("A high estimate might be that interstate benefit spill-overs are associated with about twenty percent of state-local tax-financed expenditures (that is, above and beyond the spill-overs already presumably paid for from federal grants); a low estimate would set the figure at well below 10 percent."); *but see* Gramlich, *The Deductibility of State and Local Taxes*, 38 NAT'L TAX J. 447 (1985); Kenyon, *Federal Tax Deductibility of State and Local Taxes*, 1 FEDERAL-STATE-LOCAL FISCAL RELATIONS, TECHNICAL PAPERS 469-73 (Office of State and Local Finance, U.S. Dep't of the Treasury ed. September 1986).

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quences.[15] The scholars do agree, however, that the "transfer efficiency" of deductibility, *i.e.*, the cost to the Treasury of a dollar increase in state-local spending elicited by deductibility, is quite low relative to the transfer efficiency of grants of various types.[16] But in the current policy environment, increased grants are not an alternative to deductibility.

If the external benefits are small or trivial, deductibility has an inefficient effect on location choices by federal income taxpayers. Because deductibility lowers the cost of state-local taxes per dollar of state-local services received, it encourages some people to locate in high-tax, high-service jurisdictions when their preferences are otherwise. On the other hand, if the external benefits are very significant (that is, local residents appropriate only a fraction of the benefits generated by the public expenditure), deductibility (or grants) is essential to prevent migration away from high tax states that provide services worth a lot less than 100 cents on the dollar to local residents.

Treasury I and II, which would eliminate deductibility, entail a conception of the state-local sector as dominated by private voluntary exchange; in this view, almost all variation in expenditure can be explained by the voters' free choices. (Those choices may not be recent ones: high current taxes may be the result of extravagance years ago, in pension contracts, for example.) According to this conception of the state-local sector virtually all the nationwide benefits of state-local expenditure are compensated by federal grants. The alternative view is that state and local governments do spend a good deal involuntarily to cope with the consequences of poverty and other types of social distress. Clearly such spending is in the national interest, possibly more than it is in the local interest. The local interest may be maximized by parsimony in social programs in order to induce migration of the poor and other needy populations to other places. Poverty and distress aside, state and local governments provide us with essential services in our capacities as "citizens of the United States" rather than as citizens of any one state.[17]

B. *The Impact of the Elimination of Deductibility*

1. *Differential Effects Among the States*

It seems likely that the aggregate effects of elimination of deductibility would be small, perhaps a two percent reduction of total state-local expendi-

15. For an analysis of the state of knowledge about the locational effects of state differentials and what that means for state economic development policy, see Netzer, *State Tax Policy and Economic Development: What Should Governors Do When Economists Tell Them that Nothing Works?*, 9 NEW YORK AFFAIRS No. 3, at 19 (1986).

16. STAFF OF SENATE SUBCOMM. ON INTERGOVERNMENTAL RELATIONS, 98TH CONG., 1ST SESS., LIMITING STATE-LOCAL TAX DEDUCTIBILITY IN EXCHANGE FOR INCREASED GENERAL REVENUE SHARING: AN ANALYSIS OF THE ECONOMIC EFFECTS 7-11 (Comm. Print 1983); Oakland, *Consequences of the Repeal of State and Local Tax Deductibility Under the U.S. Personal Income Tax*, in 1 FEDERAL-STATE-LOCAL FISCAL RELATIONS, TECHNICAL PAPERS 398-402 (Office of State and Local Finance, U.S. Dep't of the Treasury ed. September 1986).

17. Henry Aaron, Remarks at Federal Reserve Bank of Boston Conference on the Economic Consequences of Tax Simplification (October 1985).

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ture over time.[18] It also seems likely that the expenditure effects would be more substantial for social programs in high-tax states and for public schools in high-spending suburbs.[19] One issue has dominated the literature and parallels the concerns of elected officials: what effects will restriction or elimination of deductibility have on the high-tax states in respect to their tax structures, the health of their economies and their ability to pursue economic development policies? Individual taxpayers, even in high-tax states, may gain, net, from the federal tax reform plans as a whole, because all the major plans involve some shift in the total federal income tax burden from individuals to corporations. Thus, even in high-tax New York, Treasury II would produce a net savings in 1987 of approximately $588 million for state residents, while the House bill passed in late 1985 would produce a net savings of approximately $1.7 billion.[20]

But the issue that should be addressed in considering the wisdom of eliminating or restricting deductibility is the impact of deductibility by itself. The real question is: how much would federal individual income tax liability for residents of a certain state change if the only reform were the elimination (or restriction, as in the 1986 Act) of deductibility and the percentage reduction in federal income tax rates that such elimination would permit? The elimination of deductibility would result in substantial transfers among federal taxpayers in different states. The source of the disparities is the variation in the size of state and local taxes relative to income. Total state-local tax revenue in 1982-83 ranged from 8.9 percent of personal income in New Hampshire to 15.3 percent in New York, with the median at 10.5 percent.[21] The range for deductible personal taxes, however, is considerably greater than the range for all state and local taxes combined.[22] The variation is especially great for high-income households. For 1982, the range for couples with $100,000 adjusted

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18. Netzer, *supra* note 14, at 225-27.

19. Gramlich, *supra* note 14, at 456-63; Oakland, *supra* note 5, at 407-10.

20. New York State Comptroller, Office of the Special Deputy Comptroller for the City of New York, Letter Report No. 31-86, Table I (December 12, 1985).

21. BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, GOVERNMENTAL FINANCES IN 1982-83, at 81 (1984). This range of total state-local tax revenue excludes Alaska and Wyoming, which derive much of their revenue from severance taxes on resource extraction and little revenue from personal taxes. *See id.*

22. There is less variation among the states in corporate income tax rates than there is in personal income tax rates. New York State Assembly Speaker Mel Miller & Assembly Ways and Means Committee Chairman Saul Weprin, Democratic Leaders Unveil Single-Rate Tax Reform Plan: Questions and Answers on the Fast Plan 3, Press Release, February 26, 1987; *see also* ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, SIGNIFICANT FEATURES OF FISCAL FEDERALISM 1985-86 EDITION 80, 103 (1986) (data on state income tax rates) [hereinafter SIGNIFICANT FEATURES OF FISCAL FEDERALISM]. A few of the states without personal income taxes do have corporate taxes. Moreover, property tax exemptions and classification schemes produce a higher order of interstate variation in effective rates of property taxes on owner-occupied housing than on less favored types of property. *See* 2 U.S. BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, 1982 CENSUS OF GOVERNMENTS xlix, 1-8, 20-25 (1984) (data on property tax rates).

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gross income is from $1,998 in Jacksonville to $12,731 in Detroit.[23] The standard deviation is forty-two percent of the median, compared to fourteen percent for all state and local taxes as a percentage of personal income.[24]

Assume that, for all taxpayers combined, the tax liability increase from the elimination of deductibility is roughly equivalent to the tax liability decrease from the reduction in tax rates. Under such a version of tax return, state taxpayers would gain or lose, net, from the tax reform as follows: in 1982, there would be a net loss for federal taxpayers in sixteen states and the District of Columbia, and a net gain in the other thirty-four states.[25] For the most part, the net gains and losses per capita are rather modest, in contrast with the number for gross losses (losses without taking into account the lower tax rates) per return for itemizers. If deductibility were eliminated, gross losses would be more than $900 for itemizers in ten states in 1982.[26] The distribution of states by net gains and losses per capita is as follows:[27]

$ per capita	Gains	Losses
0-9.99	5	3
10-24.99	11	4
25-49.99	9	6
50-74.99	6	3
75 or more	1	1
Totals	32	17

On a per capita basis, potentially deductible state-local taxes in 1982-83 amounted to $657, and total state-local tax revenue was $1,216, compared to median gains or losses of about $25, or only about two percent of total state-local tax revenue.

2. State-Local Responses

These statistics indicate that it would not be all that difficult for a state government to offset the federal tax change for all its residents collectively by changing state tax provisions. This is true for those states with an increase in federal income tax liability (net gain) or decrease (net loss) of less than $25 per capita. But there are ten states where the net loss to resident taxpayers is not at all trivial, and fifteen in which the net gain will be considered very worthwhile. For example, in total dollars, the 1982 loss for New Yorkers would have been $2.0 billion and the gain for Texans $1.3 billion.[28]

The states whose residents face significant federal tax increases can of

23. Kenyon, *supra* note 14, at 451. This range of hypothetical tax burdens excludes Alaska and Wyoming, which impose negligible personal taxes. *See supra* note 10.
24. Calculated by the author.
25. *See* Kenyon, *supra* note 14, at 437-42.
26. *Id.*
27. *Id.* This distribution excludes Alaska and Wyoming. *See supra* note 10.
28. *See* Kenyon, *supra* note 14, at 437-42.

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course take action to offset these increases by state-local tax reductions targetted at those residents who would lose from the ending of deductibility.[29] But, first, suppose that those states do not take such action. The most important consequence, from the standpoint of economic development policy, is that what are perceived as widened personal tax burden differentials among the states will affect the location of people and jobs. If all other factors are held constant, an increase in the disparity of personal taxes among states will result in more net migration from high-tax states to the low-tax states. The major question is whether the adverse economic effects to high-tax states are so serious that state and local policy-makers should give up the revenue or change the distribution of the tax burden.

The answer to this question has always seemed clear to policy-makers, but it has varied according to economic circumstances. When an area, a region, state, or city has been doing very well economically (for example, New York City and State in the 1960s), it has been obvious to officials that state and local tax burdens have no serious effects on the location of economic activity and residents. When an area is not doing well (for example, Mississippi forty years ago, New York City in the 1970s, the industrial Midwest in the 1980s), it has been equally obvious to officials that there is no more important variable than state and local tax burdens.

As for the researchers, the prevailing finding, until fairly recently, has been either that state-local tax differentials in practice have little impact on location[30] or that regression equations with location as the dependent variable and tax burdens or rates among the independent or explanatory variables do not yield statistically significant coefficients.[31] Other researchers have found strong locational effects associated with tax differences.[32] New empirical studies have resulted in statistically significant coefficients (with the correct sign), even for personal income taxes.[33] The new findings suggest that tax burden

29. *See supra* text accompanying notes 21-27.

30. The classic article taking the latter position was Due, *Studies of State-Local Tax Influences on Location of Industry*, 14 NAT'L TAX J. 163 (1961); *see also* R. SCHMENNER, MAKING BUSINESS LOCATION DECISIONS (1982); M. KIESCHNICK, TAXES AND GROWTH (Studies in Development Policy vol. 11, 1981); R. VAUGHAN, STATE TAXATION AND ECONOMIC DEVELOPMENT 113-31 (1979).

31. R. Schmenner, *supra* note 30; M. Kieschnick, *supra* note 30; R. Vaughan, *supra* note 30, at 113-31.

32. *E.g.*, Levin, *An Analysis of the Economic Effects of the New York City Sales Tax*, in FINANCING GOVERNMENT IN NEW YORK CITY 635 (1966); Grieson, Hamovitch, Levenson & Morgenstern, *The Effect of Business Taxation on the Location of Industry*, 4 J. URB. ECON. 170 (1977).

33. Grieson, *Theoretical Analysis and Empirical Measurements of the Effects of the Philadelphia Income Tax*, 8 J. OF URB. ECON. 123 (1980); D. Netzer, D. Gayer & J. Miller, Taxation of Telephone Service in New York State (1981) (unpublished report to the New York Telephone Company); M. Wasylenko, The Effect of Business Climate on Employment Growth (June 1984) (unpublished report to the Minnesota Tax Study Commission); M. White, Property Taxes and Firm Location: Evidence from Proposition 13 (1985) (unpublished paper presented at a National Bureau of Economic Research State & Local Public Finance Project conference). For a comprehensive review of the recent work, see M. Wasylenko, Business Climate, Industry

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changes in some states due to the elimination of federal deductibility are likely to have locational effects that are of some consequence. The impact may not be cataclysmic but certainly will be large enough to disturb anyone persuaded that the state-local public sector really is a matter of importance to us as citizens of the United States, as well as citizens of the individual states.

The states can and will act to avoid the expected adverse economic effects. Indeed, because most states link their income tax provisions to the Internal Revenue Code,[34] the base-broadening features of the various federal tax reform plans will increase state and local income tax revenue in most cases. The high-tax states would apparently want to avoid such increases in order to minimize the heightened interstate tax disparities that will result from the federal tax reform.[35] What can they do in addition to offsetting the revenue increases?

The most obvious course is to enact large tax reductions, particularly in those taxes that are no longer deductible. Such reductions would not be wholly positive from the standpoint of economic development policy. The revenue loss would reduce the capacity of the state and its local subdivisions to spend money in ways that foster the local economy. Few states spend much from current tax revenue for positive economic development efforts (most of the money comes from borrowing), but they do spend tax revenue on services that directly or indirectly bolster the economy, for example, physical infrastructure and education. Presumably, the sage official would reduce the budget while minimizing the economic damage, but it is not always clear how this can be accomplished. For example, the elimination of deductibility would greatly increase tax disparities among affluent suburbs in metropolitan areas that spill over state lines, like those of New York City and Philadelphia.

The high-tax state could offset the higher net burden of local school property taxes by increasing state school aid to the affluent suburbs. But, if the state were simultaneously reducing state income and/or sales taxes, the increase in school aid would be impossible to finance without substantial cutbacks elsewhere. Is it worse for the state's economy if the rich suburbanites move across the state line or if they are made whole by increases in state school aid financed by major reductions in school aid to the central city, where

and Employment Growth: A Review of the Evidence (Oct. 1985) (unpublished Occasional Paper No. 98 for the Syracuse University Maxwell School of Citizenship and Public Affairs, Metropolitan Studies Program). (Unpublished studies and reports on file with the author.)

In part, the change in findings may result from the considerably higher state tax burdens in the past fifteen or twenty years. The higher burdens would tend to make it easier to find statistical significance. The new findings also result from advances in the capacity to analyze the locational effects of tax differentials: there are better data sets, improved analytic technology, and a considerable corpus of past work. *See* SIGNIFICANT FEATURES OF FISCAL FEDERALISM, *supra* note 22, at 52, Table 37.1.

34. *See, e.g.*, New York State Department of Taxation and Finance, Resident Income Tax Return, Form IT-201, Lines 1-20 (1986).

35. Even if deductibility is retained, any federal tax reform plan that reduces marginal tax rates will make the differentials in net state-local tax burdens larger.

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there are fewer itemizers? Under the latter course, there might be long-run adverse effects on labor supply quality, in addition to the immediate problem of inferior education for city residents.

Perhaps the easiest response, politically, would be for the high-tax state to lower the rates of the no-longer deductible personal taxes and increase the rates of those taxes—property and income taxes—that continue to be deductible.[36] This approach is problematic, because a state with high personal taxes generally does not have low business taxes; high business taxes and high personal taxes are complementary, although the range among states for business tax burdens is less than the range for personal taxes.[37] In any case, increasing business taxes is not a promising economic development strategy. Policy-makers often exaggerate the positive effects of their proposed business tax preference schemes, but overall business tax increases cannot possibly be helpful. Indeed, there are some targetted business tax reductions that should be high-priority components of economic development policy in many states. Such reductions are in the national interest as well as in the interests of the specific state.[38]

Another approach to mitigate the feared locational effects of eliminating deductibility is to re-structure the state-local revenue system so as to diffuse the burden over a larger part of the population, notably those who do not now itemize on federal tax returns and itemizers in low rate brackets. Reducing the degree of graduation in state personal income tax rates clearly has this effect. Employing user charges rather than general taxes to finance specific services is likely to work in the same direction in many cases, but by no means all.[39] Even substituting currently nondeductible state-local taxes for property, income and sales taxes (higher gasoline taxes, for example) would tend to have this effect. Selective excises, however, are usually not very good tax choices. This general approach is probably the best choice a state has, but political and other constraints may severely limit its implementation.

In conclusion, elimination of deductibility would have adverse economic effects for the high-tax states which the states could not escape by their own public policy actions. Furthermore, there is a distinct possibility that the income-redistributive consequences of the end of deductibility might be quite harsh for low-income households. This would result in part from changes in the state-local tax structure, but also because expenditure reductions probably would focus on services to the poor. In addition, the intra-metropolitan migration of the affluent from central cities to high-income suburbs would increase due to the tax cost of services in central cities that do not directly

36. I.R.C. § 162(a) (CCH 1986).

37. *See supra* note 22.

38. *See* Henry Aaron, *supra* note 17.

39. For example, the income profile at some state universities is such that the incidence of increased tuition would be similar to the incidence of the increase in the net burden of state-local taxes for all except the top 5-10 percent of income recipients in the state.

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benefit the affluent.[40]

C. Singling Out the Sales Tax: The 1986 Act

The 1986 Act, which eliminates only state and local sales taxes from the list of deductible taxes, will have a much smaller effect on high-tax states than the complete elimination of deductibility would have had. General sales taxes paid by consumers currently amount to only about one-third of all taxes eligible for deduction and a considerably smaller fraction of taxes actually claimed as deductions. Some taxpayers use the Optional State Sales Tax Tables[41] to estimate their deductions, instead of keeping careful records of actual sales tax payments. The sales tax deduction using the tables is capped at the $100,000 gross income level.[42] Therefore, the deductions taxpayers take for sales tax often do not reflect their economic behavior as consumers. Moreover, it is to be expected that, over time, states will substitute deductible property and income taxes for non-deductible sales taxes. These substitutions will further reduce the impact of the change in the federal income tax provision.

When federal marginal income tax rates were very high, from 1942 until 1981, there was an obvious rationale for continuing deductibility of state-local income taxes, even if deductibility of other state-local taxes was ended: without income tax deductibility, few states or localities would have dared to impose more than very nominal income tax rates. Deductibility was required to permit any significant use of this tax base by the states. Moreover, any substantial taxes that the states imposed arguably reduced the ability to pay federal income taxes.

That rationale did not apply to the other deductible taxes with the same force, for the amount of both property and sales taxes paid by any particular household is largely a function of consumption choices. Taxpayers could choose to own or occupy less expensive housing in order to minimize their property taxes. (Occupation of rental property results in property taxes being passed through, to some extent, to the tenant.) Likewise, they could choose to spend less on goods and services subject to sales taxes than on objects not so taxed in order to minimize their sales taxes. But it is possible to distinguish between the sales and property tax in regard to their worthiness for deductibility. The preservation of deductibility of the sales tax is preferable because the great bulk of sales tax revenue is collected by state governments, which spend primarily for redistributive purposes and for true public goods. Therefore, the sales tax cannot be seen as the price a household pays voluntarily in exchange for a set of public services of immediate benefit to that household. In contrast, most property taxes are collected by local governments. Local governments, especially those outside the larger cities, spend significant amounts

40. *See* Chernick & Reschovsky, *Federal Tax Reform and the Financing of State and Local Governments*, 5 J. POL'Y ANALYSIS AND MGMT. 683, 701 (June 1986).
41. IRS, Instructions for Preparing Form 1040, at 44-45 (1986).
42. *Id.*

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for largely private goods. Under current conditions, there is no reason for singling out the sales tax, aside from the crass fact that sales tax payments are relatively invisible to voters, in contrast to the much more visible income and property taxes.

II
TAX-EXEMPT BORROWING

A. Criticism of Tax-Exempt Borrowing

Nearly thirty years ago, economists began proposing the complete elimination of the exemption of interest on new issues of state and local government obligations from federal income taxation. Critics of the exemption pointed out that it was a highly inefficient subsidy of state-local debt service costs, with the losses to the Treasury greatly exceeding the gain to state and local borrowers; that it was an even more inefficient way of subsidizing state-local capital spending since the subsidy was linked to borrowing for any purpose, not spending for specific purposes; that it effectively precluded state and local government from tapping the growing resources of nontaxable entities like pension funds; and that it undermined the progressivity of the federal income tax.[43] In the late 1960s and throughout the 1970s, Congress considered (eventually with Treasury sponsorship) proposals for offering a "taxable bond option."[44] Under this proposal, the Treasury would subsidize a specified percentage of the interest cost of new state and local securities, if the issuer elected to make the securities taxable. The proponents assumed that nearly all issuers would choose the taxable bond option, and that the tax-exempt borrowing problems would, therefore, disappear as outstanding tax-exempts matured.

Most defenders of the exemption argued that the Constitution required it, but for many of them this argument was as patriotism is to the scoundrel.[45] Most state and local issuers defended the exemption because they distrusted the willingness of the federal government to maintain its commitment to subsidize interest costs directly. The municipal securities industry, which would disappear as a distinct entity without tax exemption, offered the most vehement defense of the exemption.

Although the taxable bond option made no legislative progress, Congress was persuaded that the tax-exempt borrowing privilege was being "abused", *i.e.*, used for purposes of which the Congress did not approve. Congress enacted various restrictions prior to the post-1984 comprehensive tax reform ef-

43. *See* D. OTT & A. MELTZER, FEDERAL TAX TREATMENT OF STATE AND LOCAL SECURITIES (1963); R. ROBINSON, POSTWAR MARKET FOR STATE AND LOCAL GOVERNMENT SECURITIES (1960).

44. Morris, *The Taxable Bond Option*, 29 NAT'L TAX J. 356-59 (1976).

45. J. BOSWELL, LIFE OF JOHNSON 615 (Oxford Std. ed. 1953) ("Patriotism is the last refuge of a scoundrel.").

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forts.[46] One "abuse" was recognized twenty years ago as state and local financial administrators began to become money managers: they borrowed at the tax-exempt rate long in advance of need and invested the money in higher-yielding taxable Treasury issues in order to gain the profit on the spread. Complex Treasury rules limited this type of arbitrage.[47] Another "abuse" was the use of tax-exempt low-interest-rate borrowing to finance private economic ventures. The modern-day "industrial revenue bond" dates back about forty years, when it was used to attract industry to small towns in the Deep South. As more states adopted the device, it became clear that while this was most likely a zero-sum game for the states, it was a negative-sum game for the Treasury. This was especially true as the device was used increasingly by major corporations for large plants, with the tax-exempt bonds merely a substitute for other investment funds readily available to the firms. Congress responded with restrictions on this practice, including limits on the size of individual issues.[48]

A newer "abuse" emerged in the late 1970s, when home mortgage interest rates were reaching record levels.[49] States were using tax-exempt borrowing to finance single-family owner-occupied houses. In this case, the interest rate subsidy constituted in essence a transfer from the Treasury to the borrower. Tax-exempt borrowing for housing was hardly new; there were California and New York precedents in the 1920s. But the recent programs threatened large revenue losses because they were not restricted, as the earlier ones had been, to special groups, such as war veterans or low-income people. Here, too, Congress imposed limits before Treasury I.[50]

Congress itself invented another "abuse" when it authorized private entities—in this case, ordinary for-profit firms—to issue tax-exempt bonds to finance water pollution control facilities.[51] Congress extended the privilege to other worthy borrowers (like nonprofit hospitals), and the states threw the cloak of state-local governmental status over a variety of other "private-purpose" endeavors.[52] By 1982, Congressional sentiment had shifted, and efforts to restrict this "abuse" were mounted.[53]

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46. Major legislative restrictions on tax-exempt borrowing began with the Revenue and Expenditure Control Act of 1968, Pub. L. No. 90-364, § 107, 82 Stat. 251 (1968). For the most important restrictions, see the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, §§ 214-221 96 Stat. 324, 466-478 (1982) [hereinafter TEFRA]; *see also* the Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§ 621-632, 98 Stat. 494, 915-939 (1984).

47. For an explanation of the arbitrage rules see 2 TREASURY I, *supra* note 1, at 293-95.

48. *See* Deficit Reduction Act of 1984, *supra* note 46, at § 621.

49. *See* BUREAU OF ECONOMIC ANALYSIS, U.S. DEP'T OF COMMERCE, BUSINESS STATISTICS 1984 at 65 (1985).

50. *See, e.g.*, TEFRA, *supra* note 46, at § 220.

51. OFFICE OF STATE AND LOCAL FINANCE, U.S. DEP'T OF THE TREASURY, FEDERAL-STATE-LOCAL FISCAL RELATIONS, REPORT TO THE PRESIDENT AND THE CONGRESS 284-85 (Sept. 1985) [hereinafter REPORT TO THE PRESIDENT].

52. *Id.* at 298-99.

53. *Id.* at 301-02.

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B. Reform Plans and Tax-Exempt Borrowing

The kind of comprehensive tax reform that was debated during 1985 and 1986 and finally enacted is radical, in the sense that it seeks to base the federal income tax on a set of coherent principles about what makes for a good tax system. One important principle of the tax reform movement is that the income tax system should be used as a device to raise money, not to influence economic behavior, even in a favorable way. Given this orientation, one would have expected the reform plan to provide for complete elimination of tax-exempt borrowing, with or without a taxable bond option. In fact, neither the Administration plans, the House bill, the Senate bill, nor the final 1986 Act achieved this result. Instead, each embodied a number of restrictions on tax-exempt borrowing. Some of the restrictions were logically consistent with the rest of the reform plan, but the major ones were ad hoc restrictions, along the lines of the congressional actions preceding wholesale reform. Because so much of state economic development policy is implemented by borrowing capital funds at prefernatial tax-exempt interest rates, it is worth examining these restrictions.

The reduction in the top marginal tax rates, by itself, will have an effect on state and local government tax-exempt borrowing. The top marginal rate is the effective ceiling on the savings in interest costs that can be realized by state-local borrowers. If the top tax rate is fifty percent, then no one will accept a tax-exempt return that is less than fifty percent of the return on a taxable security of equivalent quality. If the top tax rate is thirty-three percent (the highest marginal rate for individuals in the new law), then thirty-three percent is the maximum "spread" between taxable and tax-exempt yields. Therefore, lowering federal income tax rates will tend to reduce the savings in interest costs on tax-exempt bonds. This will constrain the fiscal capacity of state and local governments to some extent. But since the spread has rarely been as much as thirty-three percent during the past fifteen years, these effects should not be serious.

More significant effects should flow from two long overdue provisions included in the 1986 Act. The first, a simplification of the rules that limit arbitrage, will virtually eliminate arbitrage gains by state-local borrowers.[54] These provisions will cost state and local governments money, but it is money to which they have no claim. The second will eliminate commercial banks' ability to deduct as a cost to the interest they pay on money they borrow to carry tax-exempt securities in their portfolios.[55] This is a clearly equitable provision, since no one else can deduct interest on debt incurred to carry tax-exempt securities. The provision will reduce, perhaps substantially, commercial banks' willingness to invest in tax-exempts and thus lead to higher interest

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54. *See* I.R.C. § 148 (CCH 1986); *cf.* 2 TREASURY I, *supra* note 1, at 293-97; TREASURY II, *supra* note 1, at 288-92.

55. I.R.C. § 265 (CCH 1986); *cf.* 2 TREASURY I, *supra* note 1, at 249-52; TREASURY II, *supra* note 1, at 243-46.

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burdens for the state-local sector. The impact, however, will be delayed for some time by anticipatory purchases of tax-exempts by banks before the effective date; there was such heavy buying in late 1985.[56]

1. Restrictions on Advance Refunding

Two provisions of the Treasury Proposals and the 1986 Act, of great significance to the Treasury, were designed to reduce drastically the volume of new issues of tax-exempt securities.[57] In the first, the Treasury would have eliminated nearly all so-called "advance refunding."[58] State and local borrowers often issue bonds to refund outstanding bonds prior to the earliest date at which the outstandings can be called for redemption. The borrowers which engage substantially in advance refunding are the larger, more frequent and aggressive borrowers. New York's Municipal Assistance Corporation ("MAC"), the State of California, and the public power authorities are prime examples. Borrowers usually engage in advance refunding to take advantage of lower market interest rates, but they also do so to escape from restrictive bond-indenture provisions. The original issue remains outstanding, with the proceeds of the new issue put into escrow to meet the scheduled interest and redemption payments on the original issue.

The Treasury objected to this practice on the grounds that it results "in twice as many bonds being outstanding as are required for a given project,"[59] and thus increases the federal revenue loss associated with tax-exempt bonds. Therefore, the Treasury proposed to limit refunding bonds to those whose proceeds are used immediately for redemption of outstanding bonds.[60] Also, the Treasury claimed the additional volume of tax-exempt bonds outstanding "raises the interest rates that must be paid to finance State and local government projects."[61] The 1986 Act falls far short of a complete prohibition of advance refunding bonds. Instead, it will end the occasional practice of repeated advance refunding of the same issue, and it will eliminate advance refunding entirely only for so-called "non-governmental" tax-exempt bonds.[62]

But the reasoning behind any restriction on advance refunding is faulty. The advocates of restrictions on advance refunding appear to ignore the specific use of the proceeds of the advance refunding issues: they are invested in U.S. Treasury obligations whose maturities and interest rates match those of the original issue, with those obligations held by a trustee. Money is lent to

56. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, ANNUAL STATISTICAL DIGEST 1985, at 99 (1986).

57. *See* I.R.C. §§ 103, 149 (CCH 1986); 2 TREASURY I, *supra* note 1, at 288-97; TREASURY II, *supra* note 1, at 281-92.

58. 2 TREASURY I, *supra* note 1, at 293-97; TREASURY II, *supra* note 1, at 288-92; *cf.* I.R.C. § 149 (CCH 1986).

59. *See* 2 TREASURY I, *supra* note 1, at 295.

60. *Id.*

61. *Id.* at 296.

62. I.R.C. § 149 (CCH 1986).

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the Treasury at interest rates lower than those it must otherwise pay,[63] thereby offsetting most of the additional revenue loss from the greater amount of outstanding tax-exempt bonds. Moreover, rational participants in the market for municipals will not view the original issue as an ordinary tax-exempt issue any longer. The original issue has been converted, in effect, to an issue of Treasury securities that should trade as low-coupon Treasuries; the original issue is no longer part of the outstanding volume of obligations of the advance refunders. Therefore, the effect of advance refunding on the level of yields on state-local obligations appears to be negligible.

Thus, the 1986 provisions are pointless restrictions on the ability of state and local governments to minimize their borrowing costs by adept debt management practices. The overall adverse effects on state and local government should be relatively small, because advance refunding issues do not usually account for a large share of total offerings and in fact tend to appear only when the spreads between taxable and tax-exempt issues are large.[64] Nevertheless, the aggressive borrowers that exploit advance refunding opportunities are often sensitive to economic development questions and often finance projects that support economic development.

3. *Attempted Elimination of Tax-Exempt Borrowing for "Private Purposes"*

The second, and more far-reaching provision affecting tax-exempt borrowing in the Administration proposals and the 1986 Act, was the prohibition of tax-exempt borrowing or "private purposes" (also called "non-governmental" borrowing).[65] Treasury I defined such borrowing as use of more than one percent of the proceeds directly or indirectly by any person other than a state or local government, unless all members of the general public use the facilities built with the proceeds, on the same basis.[66]

If taken literally, this definition of "private purposes" would cover a wide variety of programs and institutions funded by state and local governments. Almost all state and local debt-financed facilities are "used" mainly by private parties: public schools by pupils, public hospitals by patients, jails by prisoners, water and sewer lines by households and business establishments, and transportation facilities by shippers and passengers. Moreover, such use is seldom offered on precisely the same basis to all members of the general public. There is generally some degree of inherent exclusivity in use which produces differential access. The first house on a block has exclusive access to the water and sewer lines passing in front of the house. Likewise, school districts usually allocate pupils to schools based on location of residence. The tax re-

63. Money is loaned to the Treasury at lower-than-usual rates because state and local governments borrow at lower interest rates than the Treasury.

64. A. GURWITZ, THE POTENTIAL IMPACT OF RECENT TAX REFORM PROPOSALS ON MUNICIPAL BOND MARKETS 7 (May 1985).

65. 2 TREASURY I, *supra* note 1, at 288-92; TREASURY II, *supra* note 1, at 281-87; I.R.C. § 107 (CCH 1986).

66. 2 TREASURY I, *supra* note 1, at 291.

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formers did not aim to eliminate borrowing in any of these cases. The purposes Treasury I sought to avoid were bonds for industrial development, pollution control, student loans, non-governmental hospitals, multi-family housing and owner-occupied housing.[67] In 1983, these bonds accounted for sixty-two percent of the dollar volume of all new long-term tax-exempt offerings.[68]

The 1986 Act does not provide for a complete prohibition of tax-exempt bonds but instead continues the process begun a few years earlier of imposing further quantitative and qualitative restrictions on so-called nongovernmental borrowing.[69] The most important restrictions include ceilings on the dollar amount of bonds issued for housing and "industrial development" (essentially, the construction of commercial facilities, like stadiums, but not including airports) and on tax-exempt borrowing by private institutions (like universities). To gain tax exemption as "governmental," not more than ten percent of the use of the facility may be by private parties.[70]

Although the final legislation is much milder than Treasury I, even its milder restrictions are based on bad logic. The notion that some purposes of tax-exempt borrowing generated by state and local government action are essentially "private," while other purposes are "public," requires a non-arbitrary dividing line. In most discussions the dividing line is based on unarticulated readings of history which indicate that state and local governments have "traditionally" borrowed money for certain functions and not for others. The trouble with this conclusion is that the historical record is full of examples of state-local borrowing for what is now considered private-purpose tax-exempt borrowing. Moreover, for most of the last 210 years, at least half of all state and local government borrowing has been for purposes that are, arguably, more private than public, whatever the assertions about "tradition."

In addition, Treasury I and II manifested an exaggerated concern with the nominal ownership of assets: if a governmental entity is the owner and operator, then the borrowing has a public purpose; if a non-governmental entity is the owner and operator, the purpose must be private, regardless of the function.[71] But governmental and non-governmental ownership and operation are often close substitutes. This is particularly true with regard to hospitals and education, as recognized in the final 1986 legislation.[72]

This substitutability suggests that restrictions on tax-exempt borrowing

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67. *Id.* at 289-92.

68. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, STRENGTHENING THE FEDERAL RESERVE SYSTEM: IMPLICATIONS FOR STATE AND LOCAL TAXING AND BORROWING 125 (1984). The interstate variation is considerable. In four states, tax-exempt borrowing amounted to less than 20 percent of all new long-term borrowing, while in four others the percentage was 80 or more. Also, the composition of "private-purpose" issues by type varied considerably. *Id.*

69. *See supra* note 46 and accompanying text.

70. I.R.C. § 141 (CCH 1986).

71. *See* 2 TREASURY I, *supra* note 1, at 289-92; TREASURY II, *supra* note 1, at 282-87.

72. *See* I.R.C. §§ 141, 145-47 (CCH 1986).

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rely primarily on the legal status of the borrowers will be defeated by state legislation redefining that status. The restrictions, however, will have some substantive effects that are relevant for economic development policy. First, the industrial revenue bond instrument can indeed be eliminated, if need be by denying deductibility for a company's lease payments for facilities constructed with tax-exempt debt. Elimination of industrial revenue bonds would be beneficial for state economic development programs. If any state uses industrial revenue bonds to lure businesses, then all other states must use them to avoid losing businesses. If all states use the instrument, then none gain more from its use than if none of them used it. In fact, the states are likely to be better off without them. A smaller volume of total tax-exempt borrowing will entail somewhat lower interest rates on the remaining borrowing. The lower rates can contribute to economic development, unlike the industrial revenue bonds when universally used.[73]

Second, the restrictions are likely to prevent some useful projects. Changing state statutes and regulations to enable the borrowing to qualify under the new IRS regulations may take so long to get a project underway that it will discourage the state from attempting the project. In unusual cases, there simply may be no way to get around the rules. States may have to forego the building of housing intended to be financed at tax-exempt interest rates, but not aimed at low-income people. If the supply and costs of housing are factors limiting economic growth, as alleged to be the case in a number of high-housing-cost metropolitan areas (the allegation probably is not valid), then the new rules will hurt economic development. The new rules may make it more difficult to use tax-exempt financing for convention centers, stadiums and other commercial sports facilities, which may also have a detrimental impact from an economic development standpoint.

In any event, the new rules will cause state and local officials to devote a good deal of entreprenuerial time and energy to circumventing them. This is surely a loss, from the standpoint of economic development efforts, for that time and energy are among the scarcest of resources in state and local government.

CONCLUSION

A large majority of the public finance economists who have considered the question of deductibility have concluded that it should be eliminated as bad public policy. That position is sometimes the result of comparing deductibility to alternative means of financing the federal interest in state and local government services. It is important to note that these alternatives are not

73. About 21 percent of total tax-exempt new issues in 1986 were for industrial revenue bonds (other than pollution-control bonds); a reduction in the volume of new offerings of that magnitude might reduce interest rates by as much as one-tenth, although some estimates are much lower. *See* REPORT TO THE PRESIDENT, *supra* note 51, at 300; Zimmerman, *Federal Tax Policy, IDBs and the Market for State and Local Bonds*, 37 NAT'L TAX J. 411-20 (Sept. 1984).

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part of the policy packages confronting the decision-makers today. Often, the anti-deductibility position is based on a conception (only occasionally articulated) at the federal system as comprising a central government with limited responsibilities beyond national defense, on the one hand, and a "collection of separate villages," on the other hand. According to this view, there is no nationwide interest in what happens in those villages.[74]

If one starts with the opposite conception—that there is a national interest in what state and local governments do—then federal taxpayers *qua* federal taxpayers do receive some benefits from the revenue loss that deductibility represents. Given the current policy agenda, deductibility may be the only way to realize those benefits. "[D]eductibility may be a fourth-best way to generate those benefits, as compared to a third-best set of conventionally-designed federal grants. . . . But neither of those superior alternatives is on offer. The fourth-best is not an infrequent or dishonorable solution in public life."[75]

Therefore, there is a case for deductibility, beyond the tactical infighting that appears to have preserved deductibility of property and income taxes in the 1986 Act. That case includes both equity and economic efficiency considerations. One of them is the fact that, as discussed above, the elimination of deductibility could create serious difficulties for state economic development efforts in the high-tax states. But the case for deductibility does not require continuation of the present system. Indeed, 100 percent deductibility of non-business income and property taxes entails an excessive loss of federal revenue, relative to the benefits generated. Partial deductibility is a better idea, provided that the form is one that mitigates, rather than exacerbates, the differentials among the states.

There is an obvious mechanism to that end, consistent with the treatment of some other itemized deductions. The tax code could permit people to deduct only those state-local tax payments that exceed a floor expressed as a percentage of adjusted gross income. Like the existing provisions for medical expenses[76] and casualty losses[77] (extended to "miscellaneous deductions" in the 1986 Act),[78] the floor provides for horizontal equity among individual households. It offers deductions for truly burdensome and extraordinary expenses that are likely to impair the ability to pay of some but not all families. In addition, the floor avoids increasing the differentials among the states in the net burden of state and local taxes.

The best federal tax policy in regard to tax-exempt borrowing might be its complete elimination. This option was not considered in the 1985 and 1986 tax reform debate. In effect, it is an element of those plans that would effec-

74. R. Musgrave, Speech to American Economic Ass'n (Dec. 1985) (comment critical of the view that states and localities are not of national interest).

75. *See* Netzer, *supra* note 14, at 249.

76. I.R.C. § 213 (CCH 1986).

77. I.R.C. § 165(h) (CCH 1986).

78. I.R.C. § 67 (CCH 1986).

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tively tax only consumption, not savings, because then all investments would be treated equally and state-local securities would no longer have any special federal income tax advantage. If the tax-exemption feature is to continue, then the proposals to distinguish among the purposes of state-local borrowing and remove tax-exemption from some—"private-purpose" and advance refunding borrowing—rate poorly. They are badly designed and essentially pointless actions that further undermine political federalism and complicate state-local policy actions, including economic development policies.

Finally, another side to federal tax reform is of importance to state and local economic development: if federal tax reform does have strong positive effects on the economy, those effects could very well offset or even overwhelm the negative effects discussed in this article. The rising tide could float even the boats of the high-tax, high-borrowing states. But it is not obvious that the macroeconomic effects will be all that great, nor is it clear that federal tax reform requires the elimination of deductibility or the imposition of foolish restrictions on state-local borrowing.

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RESPONSE

ROBERT W. RAFUSE, JR.:* I find very little in Professor Netzer's paper with which to quarrel. Instead of commenting directly on his paper, I would like to address tax reform in light of my involvement with the current policy debates in Washington. From that perspective, I will emphasize the issue of efficiency, which means, as I am using the term, the relationship between the benefits and costs of an action or policy. An efficient action or policy is one in which the benefits exceed the costs, measured typically in dollars. It is remarkable to what extent people in Washington discuss issues without reference to benefits as well as costs, or without reference to costs as well as benefits.

The cost to the federal budget of grants and other direct aid to state and local governments is about $100 billion per year.[1] The tax expenditure cost of the deductibility of state and local taxes is approximately $30 billion per year, and the tax expenditure cost of the tax exempt status of the interest on state and local securities is roughly $20 billion per year.[2] These figures add up to an annual federal budgetary cost, in tax revenue forgone and direct outlays, of $150 billion.

The imperative, in an age of budgetary austerity, is to improve the efficiency with which that $150 billion is allocated. With improvements in efficiency, we might be able to achieve the same level of benefits at the state and local level at a cost of perhaps $100 billion to the federal government.

There are numerous opportunities for such improvements in efficiency. Tax exemption and deductibility are terribly inefficient mechanisms. A conventional description of the benefits of deductibility to state and local governments is the amount by which state and local government expenditures are higher with deductibility than they would be without it. In other words, the benefit is measured by an estimate of how much state-local taxpayers would force state and local officials to reduce spending if deductibility were repealed.

Our recently completed studies of federal-state-local fiscal relations indicate that state and local outlays with deductibility are higher by about 2 percent or less than they would be without it.[3] Total general expenditures now are approximately $500 billion a year for all state and local governments.[4] Therefore, about $8 billion to $10 billion of spending by state and local gov-

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1. OFFICE OF MANAGEMENT AND BUDGET, SPECIAL ANALYSES, BUDGET OF U.S. GOVERNMENT, 1987 at H-5 (1986) [hereinafter 1987 U.S. BUDGET].

2. *Id.* at Table G-1.

3. OFFICE OF STATE AND LOCAL FINANCE, DEP'T OF THE TREASURY, FEDERAL-STATE-LOCAL FISCAL RELATIONS, REPORT TO THE PRESIDENT AND THE CONGRESS 260-61 (Sept. 1985) [hereinafter REPORT TO THE PRESIDENT].

4. U.S. BUREAU OF THE CENSUS, GOVERNMENTAL FINANCES IN 1983-84, at 21 (1985).

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ernments probably would not occur if deductibility were repealed. When compared with the $30 billion cost in forgone federal revenues, the $10 billion benefit (at most) to state and local governments reveals that deductibility has a terrible benefit-cost ratio. In other terms, the inefficiency of deductibility results in an annual $20 billion waste out of a total $30 billion in foregone federal revenue. There is currently no proposal to increase the efficiency of deductibility.

Though the numbers are slightly better, the same line of reasoning applies to the tax exemption for interest on state and local borrowing. The estimate is that about 50 percent of the $20 billion cost constitutes a benefit to state and local governments in the form of interest cost savings.[5] The other 50 percent of the benefit goes to wealthy federal taxpayers. People in high tax brackets achieve major tax savings by receiving tax-free income from the purchase of state and local securities.

Deductibility and the tax exemption are not likely to continue much longer in their present forms. There is going to be tremendous pressure to change both provisions in order to increase federal revenue. I am not as pessimistic as Professor Netzer about the existence of alternatives.[6] I suggested earlier that benefits and costs are often discussed, but rarely at the same time. Much of the debate on deductibility concerns exclusively the revenue loss of $30 billion; nobody ever discusses the benefits.

Revenue Sharing,[7] a program for which I am responsible at the Department of Treasury, is also commonly addressed only in terms of its costs. It is argued that we have no revenue to share: the program costs $4.6 billion, since we do not have a spare $4.6 billion, the program should be eliminated.[8] The argument leaves benefits out of the equation altogether.

Revenue Sharing is very inefficient, but it is much less inefficient than deductibility and tax exemption. In this context, efficiency means that assistance is targeted to those who need it most. In the case of deductibility, tax exemption, and Revenue Sharing, large amounts of the benefits are received by governments that do not need the assistance, for example, Nassau and Westchester Counties. Relative to its need, substantially smaller benefits are realized by New York City.[9]

It is important to press for options that improve the efficiency of general fiscal assistance programs, including Revenue Sharing, since so much of the $150 billion is devoted to these programs.[10] For example, in the case of Reve-

5. *See* REPORT TO THE PRESIDENT, *supra* note 3, at 311.

6. *See generally* Netzer, *Federal Tax Reform and State-Local Economic Development Policy*, 15 N.Y.U. REV. L. & SOC. CHANGE 147 (1987).

7. *See* 31 U.S.C. §§ 6701-24 (1982 & Supp. III 1985).

8. *See* 1987 U.S. BUDGET, *supra* note 1, at H-34.

9. OFFICE OF REVENUE SHARING, DEP'T OF THE TREASURY, SEVENTEENTH PERIOD ENTITLEMENTS: REVENUE SHARING, OCTOBER 1, 1985 - SEPTEMBER 30, 1986, at 327-45 (1986).

10. *See* 1987 U.S. BUDGET, *supra* note 1, at H-5.

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nue Sharing, there is a major effort by Senator Durenberger and a number of members of the House of Representatives in support of a proposal to cut the program approximately in half, from $4.6 billion to $2 billion, and to change drastically the formula by which the funds are distributed.[11] The proposed changes would eliminate payments to places like Nassau and Westchester Counties. New York City would continue to receive about the same amount, approximately $240 million a year. Payments would increase very substantially to those governments in New York State that are in significantly worse fiscal shape than New York City, for example, Buffalo. More importantly, the proposal would increase payments to truly desperate governments, such as those in the Rio Grande Valley in Texas and in rural areas in Arkansas and West Virginia.[12]

In conclusion, I reiterate that numerous policy options deserve attention as potential ways of vastly improving the efficiency of these policy measures. The taxable bond option, which Professor Netzer mentioned,[13] is one example, although I would enter the caveat that one has to define what kind of investment is eligible for the direct subsidy. Thus, the taxable bond option poses exactly the same set of problems as tax exemption.[14] I am convinced, from contact with those involved in discussions with congressional staff over the years, that these problems may be disabling and that, therefore, the prospects for the taxable bond option are less than bright.

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11. *See* S. 2037, 99th Cong., 2nd Sess. (1986); GENERAL ACC'G OFFICE, REP. GAO/HRD-86-113, REPORT TO THE CHAIRMAN, SUBCOMM. ON INTERGOVERNMENTAL RELATIONS OF SENATE COMM. ON GOVERNMENTAL AFFAIRS (1986).

12. Dep't of the Treasury, Office of State and Local Finance & General Accounting Office, Human Resources Division, *Computer Simulations* (unpublished analysis of S. 2037, *supra* note 9).

13. *See* Netzer, *supra* note 6, at 157.

14. *Id.* at 37-41.

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RESPONSE

DEBORAH SCHENK:* While Dr. Netzer's paper[1] could be titled "The Effect of Federal Tax Reform on State-Local Economic Development Policy," I would like to title my comments: "The Effect of State-Local Economic Development on Federal Tax Reform." As Dr. Netzer points out, federal tax reform has an obvious effect on economic development policy.[2] What is less obvious is the effect that economic development policy has on federal tax reform. My thesis is that economic development policy, or any other social policy, cannot be the tail that wags the dog of tax reform.

Most scholars agree that reform of the federal income tax system is critically needed and long overdue.[3] The method most often proposed is to broaden the base and lower the rates.[4] Base-broadening means that additional items are brought into the tax base and thus are subject to taxation. In addition to raising revenues, base-broadening promotes equity by treating all taxpayers equally. Ideally, a taxpayer with a dollar income from capital and a taxpayer with a dollar income from labor should be taxed the same. Lowering the rates makes the plan politically palatable.

Given that a comprehensive tax base is the goal, then all deviations, *i.e.*, exclusions or deductions, must be carefully scrutinized. Deviations fall into two categories: they are either tax expenditures or they are required to properly define the income tax base. Tax expenditures are exclusions or deductions from the normative comprehensive income tax base, adopted for the purpose of carrying out a social or economic goal.[5] An exclusion or deduction which is necessary for a proper definition of the income tax base is not subject to additional scrutiny. A tax expenditure, on the other hand, is subject to a further line of inquiry; it should be evaluated and defended in the same way as a

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1. *See* Netzer, *Federal Tax Reform and State-Local Economic Development Policy*, 15 N.Y.U. REV. L. & SOC. CHANGE 147 (1987).

2. *Id.*

3. *See, e.g.*, DEP'T OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 1-3 (1977).

4. *See* Netzer, *supra* note 1, at 147; *see also* H.R. 800, S. 409, 99th Cong., 1st Sess. (1985) (Bradley-Gephardt "Fair Tax Act"); H.R. 777, S.325, 99th Cong., 1st Sess.(1985) (Kemp-Kasten "Fair and Simple Tax Act"); H.R. 3838, 99th Cong., 1st Sess. (1985)("Tax Reform Act of 1985").

5. For a full discussion of the tax expenditure concept, see Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970); S. SURREY & P. MCDANIEL, TAX EXPENDITURES (1985). The concept has been criticized in that its use depends on an understanding of the ideal or correct income tax base so that one can isolate deviations therefrom. *See, e.g.*, Bittker, *Accounting for Federal 'Tax Subsidies' in the National Budget*, 22 NAT'L. TAX J. 244 (1969). Although I agree that a determination of the ideal or correct income tax base is unlikely, I fully accept the position that once an item is identified as the equivalent of a federal subsidy, it should be evaluated as such. *See* S. SURREY & P. MCDANIEL.

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direct budget outlay.[6]

Dr. Netzer directs our attention to two widely proposed changes in the federal income tax laws that he argues would have a significant impact on state and local governments and their economic development strategies:[7] the repeal of the deduction for state and local taxes[8] and limitations on the exemption of interest on certain state and local government bonds.[9] The implication of his paper is that the effects of these proposed reforms on economic development policy are serious enough to require a rethinking of reform. My limited purpose is to raise several questions before we concede that the effect of tax reform on economic development policy is significant enough to allow economic development policy to have an effect on tax reform.

The threshold issue is whether the items in question are tax expenditures. Some analysts make the case that the deduction for state and local taxes is necessary to define the tax base. According to this argument, state and local taxes should be deductible to the extent they restrict the taxpayer's ability to pay federal income tax more than they result in any benefit to the taxpayer. These analysts assert that state and local income taxes are used to provide not only local taxes, but also public welfare transfer payments which are national in character and spill-over goods whose benefits extend beyond the taxing jurisdiction; there is no accurate correspondence between taxes paid and services received, the full amount of the taxes should be excluded from the federal income tax base.[10] If this argument is correct, no further defense of the deduction is needed and the effect of its repeal on development policy is irrelevant.

Other analysts argue that the deduction is not necessary to define the base, and thus should be analyzed as a tax expenditure.[11] That is clearly true

6. *See Tax Subsidies as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures: Hearings Before the Subcomm. on Priorities and Economy in Government of the Joint Economic Comm.*, 92d Cong., 1st Sess. 48-58 (Jan. 1972) (statement of Stanley S. Surrey, Professor of Law, Harvard University).

7. *See* Netzer, *supra* note 1.

8. The Internal Revenue Code of 1954 permitted taxpayers to deduct state and local income taxes, real estate taxes and sales taxes. Pub. L. No. 83-591, § 164, 68A Stat. 3, 47 (1954). The Tax Reform Act of 1986 eliminates the deduction for sales taxes. Pub. L. No. 99-514, § 134, 100 Stat. 2085, (codified at I.R.C. § 164 (a) (CCH 1986)). Recent tax reform proposals recommended elimination of the deduction for all state and local taxes. *See* U.S. TREASURY DEP'T, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT vol. 1, 77-81 (November 1984) [hereinafter TREASURY I]; THE PRESIDENT'S TAX PROPOSAL TO THE CONGRESS FOR FAIRNESS, GROWTH AND SIMPLICITY 62-69 (May 1985) [hereinafter TREASURY II].

9. Gross income does not include interest on the obligation of a state or any political subdivision thereof. I.R.C. § 103(a) (CCH 1986). General obligation bonds are not subject to any limitation. (A general obligation bond is one for which the government pledges tax receipts to secure payment of the debt.) An industrial development bond (IDB), by contrast, is eligible for tax exemption only for certain activities. *See* I.R.C. §§ 103(b), 141, 142 (CCH 1986).

10. Billman & Cunningham, *Nonbusiness State and Local Taxes: The Case for Deductibility*, 28 TAX NOTES 1107 (1985); *see also* U.S. DEP'T OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 92-93 (1977).

11. *See, e.g.*, TREASURY I, *supra* note 8, vol. 1, at 78; Bartlett, *The Case for Eliminating Deductibility of State and Local Taxes*, 28 TAX NOTES 1121 (1985).

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of the exemption for interest on bonds issued by state and local governments. An exemption for such interest is not necessary to define the base; rather, the exemption is used to subsidize interest so that local governments can compete in the bond market. Therefore, the resulting loss of revenue must be treated as an appropriation.

In order to evaluate the merits of these two proposals, I will discuss the advantages and disadvantages of the state-local tax deduction and the government bond exemption as tax expenditures. One advantage of the deduction and exemption is that the administrative mechanism is already in place. No new federal bureaucracy is necessary to administer either program to states and municipalities. This existing mechanism avoids the costs of direct supervision by the federal government. Without federal supervision, state and local governments can make their own decisions as to how the deduction and exemption "subsidies" should be spent. Conversely, if the eligibility requirements are carefully tailored, regulation can also be achieved through use of a tax expenditure.

Unlike the fairly straightforward administrative advantages of the state-local tax deduction and the government bond exemption, the disadvantages of these programs are fraught with tax policy issues. These issues bear some elaboration. One disadvantage of these programs is that, due to the progressive rate structure, they are generally inefficient and wasteful. Because the tax rates are progressive, the higher an individual's income, the higher her marginal tax rate. Similarly, a tax deduction is worth more to an individual in a higher bracket than a lower bracket. For example, if a taxpayer in a 50% bracket pays $1000 in state and local taxes, the government essentially reimburses her for $500. If the same taxpayer were in the 30% bracket, the government's share would only be $300.

This flaw applies to exclusions such as tax-exempt interest as well. Assume the interest rate paid by a corporate borrower is 10%. A taxpayer in a 50% bracket would view a tax-exempt bond with an interest rate of 5% as an equivalent. For a $10,000 bond, the taxpayer would net $500 in either case. The amount of tax avoided, $500, is considered an implicit tax. If, however, the taxpayer is in a 30% bracket, the interest rate paid by the local government would need to be set at 7%, since a 5% rate would make the corporate bond more attractive. Obviously, taxpayers in the 50% bracket will also purchase the 7% tax exempt bond. In that case such a taxpayer will have $200 more than he would have had if he had purchased the 10% taxable corporate bond. The federal government loses the revenue from $700 of income, but the local government only receives a $300 subsidy (10% - 7%). Given that there is a limited pool of investors in the 50% bracket, a local government will have to raise the interest rate to attract investors away from competing tax exempt bonds.

Taxpayers with marginal rates resulting in a tax-free return ($700 in the example above) exceeding the implicit tax ($500 in the example above) benefit

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by splitting the subsidy with the local government. The local government receives $300 of the $500 avoided taxes; the taxpayer receives $200. As the bondholder's marginal rate rises, the amount of the subsidy she receives increases. Sharing the subsidy with the bondholder is inefficient.

Second, the deduction and the exemption also violate the principle of horizontal equity, because a taxpayer who consumes in one way will be given preferential treatment over a taxpayer who consumes in another. Horizontal equity means that two taxpayers with the same amount of income should pay the same amount of taxes. A taxpayer who invests in a tax-exempt bond pays an implicit tax equal to the taxes avoided. Thus, there can be horizontal equity between the purchaser of the taxable security and the tax-exempt bond. If, however, the tax-exempt rate exceeds the implicit tax, the exemption violates horizontal equity.

Third, the state and local tax deduction and the government bond exemption skew marginal rates and violate the principle of vertical equity by creating artificially low tax rates for certain taxpayers. Vertical equity concerns the distribution of the tax burden among income classes. Under a progressive tax system, taxpayers in different circumstances are taxed differently—a taxpayer's fractional share of taxes increases as her wealth increases. Vertical equity is violated when a taxpayer with more income is taxed at a lower rate than a taxpayer with less income. Let us assume that the marginal rate for Taxpayer A with $60,000 of income is 30 percent and the marginal rate for Taxpayer B with $40,000 is 20 percent. There is a violation of vertical equity if Taxpayer A has $40,000 of wages and $20,000 of interest from municipal bonds, and Taxpayer B has $40,000 of wages only. Taxpayer A should be taxed at a higher marginal rate than Taxpayer B because she has more economic income. But if the income from the bonds is tax-exempt, she will be treated as if she were in the same circumstances as Taxpayer B.

Fourth, the deduction and the exemption are indistinguishable from other entitlement programs which, as part of the appropriations process, are subject to control. The most significant difference between entitlements funded by a direct appropriation and a tax expenditure is that there is no limit on the amount to be spent. In the case of tax-exempt bond interest, there is generally no ceiling on the amount of bonds which a local government may issue nor any accurate way to predict the amount of the federal subsidy. The same is also true for the deduction for state and local taxes since a taxpayer is not limited in the amount of the deduction.

Fifth, these tax expenditures add a significant amount of complexity to the law.[12] The complexity of administering these programs affects both Congress, the Internal Revenue Service, and state and local governments. Thus, the existing mechanism for administering these tax expenditures is not without its costs.

12. *See generally*, FEDERAL INCOME TAX SIMPLIFICATION (C. Gustafson ed. 1979).

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In considering whether the deduction for state and local taxes should be retained as a tax expenditure, tax scholars would generally ask these questions:[13]

1. Is there a need for the program? How would the deduction enable state and local governments to do what they otherwise could not? Specifically, how would the elimination of the deduction adversely effect economic development policy? The assumption is that the deduction permits higher taxes which will fund increased government programs.[14] New York State, for example, can levy higher taxes than might otherwise be politically acceptable so long as the taxpayer is subsidized through a tax deduction. Without the "subsidy," taxpayers arguably would be unwilling to pay the same amount of state taxes, and thus government programs would be curtailed.[15]

2. Would direct spending be a preferable way to achieve the goal? Dr. Netzer correctly dismisses this alternative.[16] Given the federal budget deficit, direct outlays are not forthcoming.

3. Is the social and economic policy goal worth the loss of revenue,[17] the distortion of economic decision-making and the violation of equity?[18] The deduction for state and local taxes is a significant revenue drain,[19] and the future of tax reform may hinge on its repeal. There are other objectionable tax preferences, but unfortunately, repeal of this deduction appears to be the most politically acceptable.

What does the deduction accomplish that might justify this loss of revenue? If the deduction were eliminated, would there be a significant negative impact on the ability of cities and states to pursue economic development policy? Are other methods available to attract industry and housing construction? Given that taxes will be reduced, which government benefits will be eliminated? Legislatures may eliminate benefits, such as welfare and subsidized housing, which are targetted at low income taxpayers instead of benefits such as economic development, which are targetted at the state's population generally. Alternatively, if taxes are not reduced, is it clear that taxpayers will vote with their feet? Dr. Netzer suggests that high tax states will be required to reduce taxes because widened tax burden differentials may cause migration

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13. These questions are largely taken from the work of Stanley Surrey and Paul McDaniel. *See* S. SURREY & P. MCDANIEL, *supra* note 5.

14. *See* Netzer, *supra* note 1, at 147.

15. This argument does not conclusively prove that the "subsidy" is necessary. On the one hand the deduction may allow a local government to impose taxes to pay for unpopular, but essential social programs, such as housing for the homeless. On the other hand, the local government can be viewed as a separate entity which must fund its own programs, even unpopular ones.

16. *See* Netzer, *supra* note 1, at 147.

17. *See, e.g.*, JOINT COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1987-1991, at 15 (Comm. Print 1986) (estimation that the deduction for nonbusiness state and local government taxes other than on owner-occupied homes will account for $22.7 billion in 1987).

18. *See* Netzer, *supra* note 1, at 148-49 nn. 12-14.

19. *See* JOINT COMM. ON TAXATION, *supra* note 17.

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from high tax states to low tax states.[20] A tax differential already exists, and people do live in high tax states. Would the elimination of the tax deduction tip the balance? If so, what would be the consequences of such migration? Obviously it is impossible to quantify the negative economic effects of repeal of the deduction, but, as Dr. Netzer points out, *some* adverse economic effects are likely.[21] The question from a tax reform perspective is: are they significant enough to derail tax reform?

The same analysis applies to the tax exemption for the interest on bonds issued by state and local governments. Its shortcomings—the negative effects on equity, efficiency and neutrality—have been well-documented elsewhere.[22] The potential benefits to local governments are also well-known.[23] Let me focus on only one aspect:[24] the various proposals to limit tax-exempt borrowing for private purposes.[25] Dr. Netzer makes two basic points: First, the proposals to distinguish public and private borrowing are badly designed and are likely to result in inefficient use of time and energy to circumvent them.[26] Second, economic development will be adversely affected by the proposed restrictions.[27] I concede the second point since, as I will argue, it is largely irrelevant.

As to the first point, Dr. Netzer is right that the lines are difficult to draw and that a perfect solution has not been found. The exemption for municipal bond interest can be justified only as a direct subsidy for interest rates so that state and local governments can compete with corporate debt in the marketplace in order to finance public facilities. There is no theoretical justification for the government to subsidize interest when the actual borrower is a business or corporation that could compete in the market. Therefore, the interest exemption should not be permitted when the local government acts as a mere

20. *See* Netzer, *supra* note 1, at 153.

21. *See id.* at 9, 15-17.

22. *See, e.g.*, D. OTT & A. MELTZER, FEDERAL TAX TREATMENT OF STATE AND LOCAL SECURITIES (1963); R. GOODE, THE INDIVIDUAL INCOME TAX 133-38 (1976).

23. *See* D. OTT & A. MELTZER 34, *supra* note 22, at 17-23.

24. These remarks do not address the complete elimination of the exemption for interest on new issues.

25. Currently there are no proposals afloat to totally eliminate the exemption for interest. There are, however, numerous proposals to curb the use of the exemption for so-called private purpose bonds. *See, e.g.*, TREASURY I, *supra* note 8, at vol. 2, 288-92 (proposal that interest on obligations would be taxable if more than one percent of the proceeds were used directly or indirectly by any person other than a state or local government); TREASURY II, *supra* note 8, at 282-287 (same); I.R.C. § 141, (CCH 1986) (for a facility to qualify for the exemption, no more than 10% of its use may be by private parties).

Over the last decade there has been a significant increase in the amount of tax-exempt borrowing for private purposes. The amount of nonguaranteed state and local obligations rose from $6 billion in 1952 to $318 billion in 1984. U.S. DEP'T OF COMMERCE, BUREAU OF THE CENSUS, HISTORICAL STATISTICS ON GOVERNMENTAL FINANCES AND EMPLOYMENT, 1982 CENSUS OF GOVERNMENTS, vol. 6, at 44 (1985); U.S. DEP'T OF COMMERCE, BUREAU OF THE CENSUS, GOVERNMENTAL FINANCES IN 1983-84, at 40 (1985). Some of these obligations may be said to be for public purposes, for example, student dormitories at public universities.

26. *See* Netzer, *supra* note 1, at 162.

27. *Id.*

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conduit for private business. For example, a government acts as a conduit when it issues an Industrial Development Bond (IDB) to purchase an asset, such as a factory, which the private user leases on a net lease basis. The subsidy is used by the private lessee.[28] Taken together with the other shortcomings of a tax expenditure, the ability of local governments to act as conduits requires that a line be drawn somewhere, even though economic development will be affected. If our only concern were local economic development, the tax exemption could be used to subsidize interest for all development, both in the public and private sector.

Why is the line between permissible governmental use of the exemption and impermissible private use so difficult to draw? The local government should not be allowed to determine what is a public function. It costs the local government nothing to claim that a project is public when in fact the government is acting as a conduit because the interest on the obligation will ultimately be paid by the private borrower.

One possibility is to rely on the local government's determination except when the government acts as a pure conduit. But a government can easily avoid this restriction by acting as a guarantor instead of a conduit. A government guarantees a transaction when the proceeds of an IDB are used to build a facility with either rent or user fees servicing the debt. In such cases, an exemption for the IDB should be prohibited since the debt service will not actually be paid out of general taxes. The ability of local governments to act as guarantors explains the Treasury's attempt to look at ownership of the assets as a way of restricting tax-exempt borrowing.[29] But ownership is also easy to circumvent. Perhaps more useful is a subjective test that permits an exemption only when the government is obligated for the debt service and is not a mere guarantor. This test would require an investigation into the ultimate obligation of the local fisc for the debt. This test, however, would be so subjective as to be difficult to draft, comprehend and administer.

Another possible way of drawing the line between governmental and private use of the exemption is the one chosen by Treasury I: if any significant amount of the proceeds are to be used by any person for private purposes, the tax exemption is lost.[30] As Dr. Netzer points out, this proposal is probably unworkable.[31] Any statute based on this proposal would provide a list of acceptable uses, such as schools, hospitals, or roads, and a list of unacceptable uses. First, it would be difficult to draw up such a list; arguably that is a task best left to the local government. Second, clever lawyers will be able to describe any project in such a way that it satisfies the statutory test.

28. Industrial development bonds are currently eligible for tax exemption for certain purposes. I.R.C. §§ 103(b), 141, 142 (CCH 1986).

29. *See* Netzer, *supra* note 1, at 162.

30. The proposal would eliminate the exclusion if more than one percent of the proceeds are used directly or indirectly by a person other than a state or local government. *See* TREASURY I, *supra* note 8, vol. 2, at 291.

31. *See* Netzer, *supra* note 1, at 162.

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In short, the solution is not likely to be perfect. Dr. Netzer is correct on both points. It is admittedly difficult to distinguish between public and private debt, and there will be negative effects on economic development if the IDB market is curtailed. So why bother trying?

In the case of the tax exemption for interest on state and local government bonds, the answer seems obvious. Despite a significant negative impact on economic development, this tax expenditure must be restricted. Few would support wholeheartedly a direct government outlay paying interest on purely private development, even if it might bolster economic development in a given geographical area. Why then are we willing to effect the same end through the tax system where there are no limits, no standards, and no strings attached?

Furthermore, the issuance of IDB's causes interest rates to rise on concededly public purpose bonds. The more IDB's and municipal bonds in the market, the more difficult it is to raise funds through the tax-exempt privilege. The effect on economic development is secondary to the issue of what activity the tax exemption should subsidize. The answer is usually that the subsidy should only be available for an activity providing public benefits. Thus, anti-reformers must make the case that there are public benefits from subsidizing private purpose bonds which would justify the exemption. The fact that these bonds may stimulate investment and employment in the private sector is not a sufficient justification for the expenditure.[32] Absent a public benefit, the current expenditure is clearly inappropriate.

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32. *See* Zimmerman, *Limiting the Growth of Tax-Exempt Industrial Development Bonds: An Economic Evaluation*, Congressional Research Service Report No. 84-37E (1984).

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RESPONSE

MARK WILLIS:* I will elaborate on New York City's position that there is no possible compromise on the issue of state and local deductibility. Broadening the base and lowering the rates both have wonderful objectives. But there are some very important issues that have to be examined in the case of this tax reform, in particular, and perhaps concerning the tax reform in general.

Professor Schenk stated that the elimination of deductibility may be essential for federal tax reform.[1] The issue is whether the revenue that the federal government would gain is essential. The original Treasury proposal provided for tax rates of fifteen, twenty-five and thirty-five percent.[2] If deductibility is factored into that proposal, rates would only have to be raised to sixteen, twenty-six and a half and thirty-seven percent to maintain the same level of revenue.[3] Therefore, state and local deductibility is not essential for this reform to work. In fact, lowering the marginal rates already substantially reduces the costs of state and local deductibility. If, for example, the marginal rate drops from fifty percent to thirty percent, then the cost to the Federal government is reduced from fifty to thirty cents on one dollar of deductible state and local taxes. Furthermore, state and local governments may react to the elimination of deductibility by shifting more of the tax burden onto business.[4] Since the average marginal tax bracket for business is forty-six percent, and the average marginal tax bracket for those who deduct state and local taxes is twenty-seven percent, it is evident that shifting just half of the burden to business costs the U.S. Treasury as much as the present system. If more than half of the tax burden is imposed on business, then the Treasury will actually lose money as a result of the elimination of deductibility.[5]

In New York City, we have considered a number of responses to the elimination of deductibility. One option is a payroll tax which would remain deductible as a business cost. A payroll tax might not lead to an increase in labor costs in the City because of the after-tax benefit of eliminating local personal income taxes. The City has also considered shifting the burden to businesses and commercial buildings. Such proposals would decrease the projected revenue gain to the federal government from elimination of deductibility.

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1. *See* Schenk, *Response*, 15 N.Y.U. REV. L. & SOC. CHANGE 171 (1987).

2. U.S. TREASURY DEP'T, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH: TREASURY DEP'T REPORT TO THE PRESIDENT vol. 2, at 1 (November 1984).

3. Calculated by Mark Willis with the Office of Tax Policy, New York City Dep't of Finance.

4. Feldstein, *Tax Reform: Harmful if Passed*, Wall St. J., Feb. 14, 1986, at 20, col. 4.

5. *Id.*

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A more fundamental issue is why eliminate deductibility at all? Whether deductibility of state and local taxes was a mistake from the beginning is irrelevant. A rule of thumb I learned in graduate school was that an old tax is a good tax. The elimination of deductibility threatens to disrupt New York City's economy, which admittedly is much stronger than it was a few years ago. The elimination of deductibility would drain New York State's economy of two billion dollars.[6] The supporters of the elimination of state and local deductibility need to establish that the long-term efficiency gain justifies taking economic resources from New York State and reallocating them to the rest of the country. There is much dispute over whether New York would receive its fair share in return. New York State has, in essence, a deficit with the federal government.[7] Elimination of state and local deductibility would obviously increase this deficit dramatically.

Another point of controversy is the potential impact on taxpayers' location decisions. If deductibility is eliminated, the tax burden for someone earning one hundred thousand dollars is four thousand dollars greater in New York City than in New Jersey or Connecticut.[8] Although someone earning one hundred thousand dollars may be able to afford to lose four thousand dollars, four thousand dollars is not insignificant. In the short run, until land prices adjust and general equilibrium is regained, there will be disruptions. People will move to states with lower taxes. New York City has an aggressive income tax system partly because of the tradition of helping the poor. The large poor population in New York City will suffer as a result of the migration of high income families to other states.

As for tax-exempt bond financing, I disagree with Professor Netzer's assertion that the use of Industrial Development Bonds ("IDBs") is a zero-sum game for the states.[9] In New York City, IDBs have been a good tool for convincing businesses not to relocate. In the long run, however, we should find other less expensive mechanisms to accomplish the same end.

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6. Netzer, *Federal Tax Reform and State-Local Economic Development Policy*, 15 N.Y.U. REV. L. & SOC. CHANGE 147, 152 (1987).
7. SEN. MOYNIHAN, NEW YORK STATE AND THE FEDERAL FISC X, THE DEFICIT BECOMES STRUCTURAL 3 (1986) (on file at N.Y.U. REV. L. & SOC. CHANGE).
8. Calculated by Mark Willis with the Office of Tax Policy, New York City Dep't of Finance.
9. Netzer, *supra* note 6, at 158.

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