The Effect of Tax Simplification on State and Local Governments

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The essence of any serious program of federal tax simplification is the same today as it was when Pechman first broached the idea more than 30 years ago: include as taxable income a larger share of economic income and subject that broader base to much lower marginal rates of tax. The lower marginal rates themselves will reduce the relative attractiveness of whatever tax shelters remain. As part of the base broadening, nearly all federal tax reform plans would narrow—in some cases eliminate—deductibility of state and local taxes. These proposals are an extension of a trend that began with the exclusion of excises and license taxes in 1964, extended to gasoline taxes in 1978 and was seriously considered for the sales tax in the debate that led to TEFRA in 1982. Current tax reform plans also either eliminate tax-exempt borrowing or restrict it by removing tax exemption from some types of borrowing.

The Deductibility of State and Local Taxes

Eliminating or substantially restricting deductibility raises the net costs of state-local taxes to itemizers; if their voice is politically effective, there should be some reduction in the revenue raised by currently deductible taxes, especially in the states with relatively high tax rates, with possible effects on the level of state-local spending and on the structure

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of state-local revenue systems. If their voice is ineffective, there should be, in the long run, an impact on the location of economic activity, because net interstate tax differentials will be higher than they were before deductibility was reduced or eliminated.

The Rationale for Deductibility

At one extreme, if all taxes imposed by state and local governments are used to buy either ordinary private goods that happen in some places to be provided by something called a unit of government (perhaps in large part so provided simply *because* of federal income tax deductibility) or what are sometimes called "club goods," then deductibility is both inequitable horizontally and inefficient, as an inducement to overspend on some goods and services, with possible inefficiencies in the location of economic activity. Even apart from deductibility's effect on the distribution of tax burdens by income class, no case could be made for it, and all the consequences of its removal would be to the good.

At the other extreme, if all the proceeds from currently deductible taxes were used to finance pure public goods, then each individual's taxes are involuntary payments not attached to any specific benefits to that individual, and therefore reduce his or her ability to pay income taxes. Pure public goods do generate benefits but those benefits are unrelated to the taxes paid to finance them and must be disregarded in comparing the relative taxpaying ability of individuals and households. Thus, taxable income *should* be measured net of these taxes. The only hitch in this argument is that public goods do confer benefits over different geographic areas. If the benefits stop at the state lines, then there is no case for the federal government to recognize state and local taxes as an impediment on ability to pay, since all federal taxpayers within the state, as a group, have benefits that offset the taxes paid. Federal deductibility, under the circumstances assumed, would treat taxpayers with the same net ability to pay differently in different states. Federal recognition of the impact of state and local taxes on ability to pay therefore should extend, in an ideal fiscal system, only to taxes imposed to finance public goods whose benefits spill over state lines.

This equity argument is mirrored on the efficiency side: public goods provided by the state-local sector that have significant positive externalities (external to the state providing) will be under-supplied in the absence of a federal subsidy for their provision. The trouble with this proposition is that the "transfer efficiency" of deductibility of taxes as a subsidy is exceedingly low. This is because the state and local governments gain revenue only to the extent that voters are willing to bear higher state-local taxes, now that deductibility has lowered the net costs

of one dollar of tax payments to something less than one dollar. If the price elasticity of demand for state-local expenditure is -0.5 (a widely used figure that many now believe to be on the high side), the marginal tax rate of itemizers is 30 percent and itemizers are decisive in state-local decision making, then state-local revenue will be increased by 15 cents for each 30-cent loss in federal revenue. If itemizers are not decisive, the figure will be much lower.

If the transfer efficiency is that low, then it would take a relatively small increase in federal matching grants for specific purposes[1] to offset the loss in allocational efficiency—the under-supplying of state-local public goods with benefit spillovers—that eliminating deductibility would cause, even if those spillovers loomed large in state-local spending. They probably do not, however, even in the most generous of estimates. At least one-third of spending financed from state-local tax revenue is for public safety, transportation, local environmental services and general government administration, a mixture of private goods and public goods with few if any interstate spillovers. About one-half is for education, where surely spillovers account for far from 100 percent of spending. The remaining one-sixth is for explicitly redistributive activities in health, welfare and housing, where the interstate spillovers may be considerable (but even here there are private goods aspects). A high estimate might be that interstate benefit spillovers are associated with about 20 percent of state and local tax-financed expenditures (that is, above and beyond the spillovers already presumably paid for from federal grants); a low estimate would set the figure at well below 10 percent.

Of course, for policy purposes, one must be concerned about whether, at the margin, these percentages are different. The fiscal crises of the 1970s in major cities and states, and their responses to reductions in federal grants during the 1980s, suggest that redistributive expenditures are seen as marginal at the state-local levels. If this is so, then the extent of interstate benefit spillovers affected by the withdrawal of deductibility may be considerable. So some subsidy, beyond present federal grants, should be provided for state-local spending.

While some argue for discriminating among tax forms or disallowing of one or the other of the currently deductible taxes, these arguments are not very persuasive. In 1982, deductibility of sales taxes was under attack in part on the ground that the payment of sales taxes involved

[1] The grants literature makes it clear that matching categorical grants not only should be, but actually are, far more stimulative of state-local spending than are unconditional grants like general revenue sharing; for a review of that literature, see Gramlich (1977). Oakland (1985) argues that the transfer efficiency of deductibility may be greater than that of general revenue sharing. In contrast, Noto and Zimmerman (1983) consider general revenue sharing to have the better of the argument, based on the observed "flypaper effect," explored in Courant, Gramlich and Rubinfeld (1979), which Oakland asserts may be an aberration tied to the specific circumstances of the 1970s.

some degree of voluntary choice. But the difference in the degree of volition among a broad-based sales tax, the property tax (one can buy or rent a cheaper house) and the income tax (there is also the choice between work and leisure) seems far too insignificant to be an element in tax policy-making. Differential treatment of the property tax with regard to deductibility is closely connected with the polar views on the appropriate federal income tax treatment of owner-occupied housing: if one sees favorable discrimination as all wrong, then deductibility of the property tax should be removed, whatever is done with respect to other state and local taxes. If one sees virtue in tax subsidies to owner-occupied housing, then property tax deductibility should be retained, whatever is done with respect to other taxes.

Some case can be made for differential treatment of property tax deductibility, aside from the owner-occupied-housing question. The property tax is the province of local governments and a larger fraction of local spending is for private goods and public goods whose benefits are realized in small geographic areas than is the case for state governments. Another reason for differential treatment of the property tax is connected with its incidence, which presumably is quite different from that of state and local income and sales taxes.

Whatever the theoretical case may be, a powerful pragmatic argument can be made against differentiating among the tax forms: state and local governments can offset the federal revenue effects by changing the composition of their tax systems. To be sure, the shift might never completely undo the federal tax reform, but it could go a long way within a few years. The question of the effects on the composition of state-local revenue systems is treated further in a later section of the paper.

Effects on the Aggregate Level of Public Spending

The removal of deductibility, or its substantial narrowing, may lower after-tax incomes and raise the price of public spending financed from previously deductible taxes. How large are the resulting income effects and substitution effects likely to be?

A generally accepted estimate of the income elasticity for aggregate state-local spending is +0.6 or, alternatively, an increase in expenditure of about nine cents for each one dollar increase in income (see Inman, 1979, and Gramlich, 1977). So, if state and local taxes had not been deductible in 1982—and all other provisions of federal tax law had been unchanged—after-tax personal income would have been $24.5 billion lower, and state-local spending financed from own-source revenue would have been about $2.2 billion lower.

The effect is not only small; it is also irrelevant to consideration of deductibility in the context of revenue-neutral federal tax reform (the

income effects are not irrelevant in considering the differential impact among the states, although they will be small here too). The price effect is the one of importance in this context. With the exception of a reform plan that provides a threshold expressed as a percentage of adjusted gross income, below which state-local taxes are not deductible, all other proposals for limiting deductibility raise the net cost, at the margin, of state-local tax payments to those who claim itemized deductions, and thus have a price effect.

Accepting -0.5 as an uneasy consensus on price elasticity, the next question is the size of the price change. In theory, that should be the price increase confronting the median voter; if the median voter is an itemizer, it is the marginal tax rate for the voter divided by the present price, one minus the marginal tax rate. If the median voter is not an itemizer, prices do not increase at all. The data allow us to estimate the marginal tax rate for itemizers by income class and by state, but it is not clear just how to identify the median voter. Kenyon (1985) places that voter in the $25,000 to $30,000 range of adjusted gross income for 1982, on the basis of Census data on voting by income level. She then calculates a weighted price for state-local services financed by deductible taxes of .85, in the income class containing the median voter. Thus, elimination of deductibility would raise the price by about 18 percent.

If the price elasticity is -0.5, then state-local tax rate reduction in response to voter pressure should in time reduce by 9 percent the revenue from taxes that are currently deductible. Or, if the uncompensated price elasticity is -0.5 and the compensated price elasticity therefore -0.4 (with an income elasticity coefficient of $+0.6$ and state-local spending at 10 percent of aggregate income), that revenue will decline by about 7 percent. But this revenue finances only a fraction of total state-local government spending—about 27 percent in 1982–83. So the expected decline in total state-local spending from all sources of revenue is a bit less than 2 percent—and it would be a good deal lower if the "correct" price elasticity is significantly lower than a (compensated) -0.4. It would also be lower if voters decided to increase nondeductible revenue sources to partially compensate for the loss of deductible revenues.[2]

Thus, the effect on the aggregate level of state-local spending from the ending of deductibility is likely to be very small (and smaller still if deductibility is narrowed, rather than ended entirely). Given that the additional spending induced by the presence of deductibility is in part in the form of private goods and wholly local public goods—which is both inefficient and horizontally inequitable—there seems very little basis to argue for continuation of deductibility from the standpoint of the aggre-

[2] Inman's 1985 paper finds substantial degrees of both complementarity and substitution between deductible and nondeductible revenue sources.

gate level of public spending. If there is a case for deductibility, it must be based on the national interest, if any, in the composition of the revenue systems of state and local governments and/or the national interest in the interjurisdictional disparities in the effects of ending deductibility.

The Structure of State-Local Revenue Systems

It is likely that the existence of deductibility has encouraged state and local governments to rely more heavily on deductible personal taxes than on alternative revenue sources, including user charges, nondeductible taxes paid by households (mainly selective excises) and taxes paid by businesses (which will remain deductible in any conceivable tax reform plan). Therefore, we might expect the end of deductibility to foster a shift to those other revenue sources.

Increased use of selective excises seems the least likely of these possibilities, because the most popular objects of such excises—alcoholic beverages, cigarettes, motor fuel and (at the local government level) public utilities gross receipts—usually are subject to high rates of tax already.[3] Conceivably, the end of deductibility might reduce the opposition to higher rates of taxation of motor fuel in some states (although the post-1973 experience should convince us that the political decision-makers believe that low taxes on gasoline have the appeal in most states that rent control has in New York, Cambridge and Santa Monica), and perhaps some new "demerit good" with price-inelastic demand (legal marijuana?) in the future may attract excise taxation. But these seem unlikely and minor occurrences.

Increased reliance on user charges would be welcomed by most analysts, if the user charges were properly designed. However, if we look beyond New England, user charges already finance a considerable share of expenditures for private goods provided through state and local governments, with the non-trivial exceptions of education (at all levels), public transportation (the only service for which the share of finance coming from user charges has declined since 1970), and local expenditure for roads and streets. For example, local government costs for sewerage are now wholly user-charge-financed, a big change from 20 years ago, and user-charge financing (and privatization) have increased for refuse collection and disposal.[4] Although the easy opportunities for user charge financing have generally been taken already (even Boston and

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[3] As of 1982, combined federal-state-local selective sales tax revenue amounted to the following percentages of the dollar volume of sales (measured variously) excluding those taxes: motor fuel, about 13 percent; alcoholic beverages, about 21 percent; tobacco products, about 37 percent; and electric, gas and telephone utility sales, about 4 percent. Calculated from NIPA, *Statistical Abstract* and Census of Governments data.

[4] For a discussion of the change in reliance on user charges by local governments during the 1970s, see Netzer (1983).

New York no longer subsidize water supply, as they did until a few years ago), the elimination of deductibility should make some of the more difficult opportunities more attractive.

One difficulty here is that the potential efficiency advantages of user charges depend entirely upon proper design. Conventional user-charge designs—flat transit fares, admission charges to facilities and events with considerable unused capacity, uniform all-hour tolls on bridges, motor vehicle registration fees as highway-user charges, for example—can be less efficient than general taxes. Unconventional designs seem hard to sell, even to sophisticated politicians, and marginal cost pricing does not seem to mix well with populism, especially populism of the right.

A likely response to the elimination of deductibility of taxes paid by households would be a shift to taxes paid by businesses, which remain deductible, although the shift will be contained by worries about adverse effects on economic development. Increased state corporate income tax rates and narrowing of various tax-reducing features would be one response. Another would be to sweep more intermediate business purchases into the net of the general sales tax (in concept, one of the most unneutral tax actions possible, although the quantitative effects overall may be small).

No doubt, the movement toward classification in the property tax would be encouraged. As of the 1982 Census of Governments, 17 states and the District of Columbia had formal constitutional or statutory provisions for taxing different classes of real property at different effective rates, in all or some parts of the state. Business property is almost always in the higher effective rate classifications. Most of these provisions were adopted within the last decade, as part of the response by homeowning voters to the combination of rapid increases in housing prices and improved assessment administration. An alternative, of long tradition in a few states in the south, would be to provide very large homestead exemptions, such that the tax base was reduced essentially to business property.

The elimination of deductibility also could result in shifts in relative reliance among the state and local deductible taxes and in changes in the specific features of those taxes. Most important are state and local income taxes. About half of the dollar amount of the total deductions for taxes paid is for individual income tax payments, and well over half the U.S. Treasury's revenue loss due to state-local tax deductibility is attributable to income taxes alone.[5] Moreover, recent empirical work by Kenyon (1985) and Inman (1985) finds that residents' savings from deductibility are an important determinant of a state or local government's

[5] U.S. Congressional Budget Office (1985), pp. 291–293.

dependence on income taxes. This implies that the loss of deductibility is likely to significantly reduce reliance on personal income taxes.

If the elimination of deductibility does lead to a major movement to reduce the importance of individual income taxes in the state-local tax structure, this will be a sharp reversal of a major, but largely unremarked, trend over the past 20 years or so. Most of us are familiar with the observations that the state-local sector relies a lot less on own-source revenue than it did 20 years ago (although more than it did at the peak in federal aid in 1978); that nontax revenue has increased somewhat more than tax revenue; and that, within the tax component, the role of the property tax has decreased sharply. There has been less commentary, however, about the role of individual income taxes per se.

Between 1962 and 1982–83 (using Census Bureau data here), the percentage distribution of state-local tax revenue by major type of tax changed as follows:

	1962	1982–83
Property	45.9	31.4
Individual income	7.3	19.4
Corporate income	3.1	5.0
General sales	14.5	22.8
Selective sales	18.0	12.4
All other	11.2	9.0

Thus, the relative role of the consumption taxes as a group has changed very little; selective sales taxes declined in importance while general sales taxes increased, a result consistent with the ending of deductibility of the former between 1962 and 1982–83. The real change was the displacement of the property tax by the individual income tax, mostly as a result of deliberate choices to shift from local taxation, largely based on the property tax, to state government taxation, based on other sources. The increase in the individual income tax percentage was a result of new adoptions of the tax; increases in the rates of many existing taxes (not consistently, for the period was marked by numerous rate reductions as well as rate increases); and the rapid growth of money income, with tax structures usually quite good at capturing that growth. At the state government level, the individual income tax increased from 13.3 percent of total tax revenue in 1962 to 29.0 percent in 1982–83, for all states combined. Moreover, the increase in reliance on the individual income tax was widespread, not concentrated in a few states (although 11 states continue to have no general income tax).

One obvious way to mitigate the elimination of deductibility for individual taxpayers in states with an income tax is to flatten the rate

structure (or its equivalent in exemptions and credits). However, to avoid a loss of revenue, states will have to raise taxes for some taxpayers, presumably those who do not itemize now and who therefore will not lose from the elimination of deductibility. Not only will this be unpopular (itemizers in 1982 accounted for fewer than 50 percent of federal taxpayers in all but five states, according to the data in Kenyon, 1985), but it also will reduce the responsive of tax revenue to growth in money income.

To some extent, rate reduction can occur without revenue loss in those states whose income tax base is tied to the federal definitions of taxable income, because the state's own income tax base will expand automatically. Thirty-five of the 39 income tax states have such linkages, in one form or another.

In short, the one quantitatively important effect on the state-local revenue structure that is highly likely to occur is lesser dependence on state income taxes as part of the revenue system of the sector as a whole, and probably some flattening of income tax rates.

The National Interest in the State-Local Revenue System. Does it really matter, to the country at large, if the states revise their revenue systems as this analysis suggests? The general answer is yes.

First, if user charges are substituted for currently deductible taxes to finance services with private-goods characteristics, the country will be better off if the new user charges are at all sensible in design. There will be efficiency gains, and most of us would argue that any real equity changes are likely to be to the good, with less subsidizing of well-off users by poorer non-users.

Second, greater reliance on selective excises seems not in the national interest. The efficiency losses from taxes with a narrow base and considerable potential for substitutability are greater than the deadweight losses from broader-based taxes, quite apart from questions about the costs of administration. (Administrative costs are very low for public utilities taxes but far from trivial for the other selective excises, if a high order of compliance is the target.) Few still believe that consumption of motor fuel and public utility services is price-inelastic.

Third, public finance economists do not think much of state and local business taxes. Both are typically replete with provisions that are unneutral in effect with respect to sectors, inputs and location. Hence, greater use of this revenue source would not be expected to improve the efficiency of the national tax system. The only countervailing possibility is that the political desire to shift the tax burden to business might lead the states to adopt value-added taxes in place of existing business taxes. A value-added tax would generate substantial additional revenue and permit reductions in the currently deductible personal taxes. Since a state-level value-added tax is not the equivalent of a tax on final con-

sumption in that state, it might be easier to sell. The neutrality attributes of value-added taxation afford efficiency gains.

Fourth, from the national perspective, a reduction in the use of property taxation should reduce the progressivity of the national tax system. The effect should be quite small, but if the tax simplification plan adopted is really intended to be distributionally neutral, like Treasury I, that effect might be considered a drawback. The ideal property tax, from the standpoint of efficiency, is one that is completely uniform, not only across jurisdictions, but across types of assets. Therefore, if the end of deductibility promotes more differential taxation of types of assets, that is, shifts the burden from housing to business-owned assets, it is also promoting some loss in efficiency. That shift may be the most likely response to the elimination of deductibility, and the dollar amounts could be large over time.

The overall conclusion here is that from the national standpoint, the end of deductibility may create more losses than gains in the revenue structure; this negative balance stems from the likelihood that dumping property taxes on business will be a widespread response. The losses are not huge, but even so make a case for the narrowing, rather than elimination, of deductibility.

Interjurisdictional Variation in Effects

In political terms, the disparities in impact among the states constitute the most important effects of ending deductibility. Within the context of a federal revenue-neutral tax reform, the elimination of deductibility will result in substantial transfers among federal taxpayers in different states.

The reason for the disparate effects is of course the variation in the ratio of state and local taxes 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 (this excludes two outliers, Alaska and Wyoming, with their huge revenue from severance taxes on resource extraction). However, the range for deductible personal taxes is considerably greater than the range for all state and local taxes combined.[6] The variation is especially great for high-income households.

Kenyon (1985) gives the distribution of states by net gains and losses per capita as follows (again, excluding Alaska and Wyoming):

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[6] There is less variation in corporate income tax rates than there is in personal income tax rates among the states, and 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 the less favored types of property.

Estimated Net Changes in Federal Tax Liability for 1982
with End of Deductibility

	Number of States with	
$ Change 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 for the country as a whole, potentially deductible state-local taxes in 1982–83 amounted to $657, and total state-local tax revenue to $1,216. It would not be difficult for those states with a net saving or loss of less than $25 per capita to offset the aggregate federal tax change for their residents by changing state tax provisions. But for 10 states the net loss to resident taxpayers is not at all trivial, and for 15 states the net gain will be seen as very worthwhile.

Is it a matter of national concern that New Yorkers lose $2.0 billion ($115 per capita) from the elimination of deductibility and attendant rate reduction while Texans gain $1.3 billion ($84 per capita)?[7] It clearly would be in the national interest for such a transfer to take place if the current deductibility amounts to a subsidy to New Yorkers—paid by Texans and others in the 34 states that now lose net from deductibility—to spend extravagantly on services with no benefit outside the state's boundaries, or simply to pay high salaries to a swollen civil service. Are those the facts?

It is difficult to tell from the data at hand. Superficially, table 1 seems to support the opponents of deductibility. Residents of 13 states and the District of Columbia will lose substantially from the ending of deductibility. In 1982–83 per capita state-local expenditure financed from tax revenue in these states was $387 more, or 40 percent higher, than tax-financed expenditure in the rest of the states. Of the differential, about 30 percent was accounted for by the lesser proportionate use of nontax revenue. Employment-related variables—staffing relative to population, public employee compensation levels, and employee retirement spending—together accounted for 35 percent of the differential, and spending for welfare, net of federal aid, accounted for another 18 percent. The remaining one-sixth of the differential was accounted for by a variety of

[7] It should be kept in mind that this analysis ignores the other aspects of federal tax reform plans. It has been estimated that New York residents will gain, net, from Treasury II—which is *not* revenue-neutral with respect to the individual income tax—about $31 per capita in 1987, although the gain for New Yorkers is proportionally far below the national average. New York State Special Deputy Comptroller (1985).

Table 1
Analysis of Differences in State-Local Expenditure Per Capita between States[a] Whose Residents Lose Significantly from the Ending of Deductibility and All Other States, 1982–83:

	Total per capita difference in state-local expenditure, less federal aid	$517
Less:	Per capita expenditure financed from nontax revenue from own sources	130
Equals:	Additional per capita expenditure financed from state-local tax revenue	$387

Causes of additional expenditures from state-local tax revenue (in per capita amounts):

Lesser use, proportionally, of nontax revenue[b]	$118
Higher number of employees in relation to population[c]	18
Higher salaries per employee[d]	93
Higher expenditure for employee retirement	25
Higher expenditure for public welfare, net of federal aid for welfare	70
Other causes, net	63
	$387

[a] The states whose residents would have lost more than $10 per capita in 1982, without deductibility, in descending order: New York, Maryland, Minnesota, the District of Columbia, Delaware, Wisconsin, Michigan, California, Massachusetts, Oregon, New Jersey, Rhode Island, Utah and Hawaii.

[b] Nontax revenue accounted for 23.8 percent of total expenditure less federal aid for the losing states and 29.5 percent for the other states.

[c] Employees per 1,000 population were about 3.5 percent higher in the losing states than in the other states.

[d] Wages and salaries per full-time equivalent employee averaged $21,325 in the losing states and $17,403 in the other states.

Source: U.S. Bureau of the Census, Governments Division, 1982–83 data.

other expenditures, including interest on debt and transfer payments not classified under the welfare function.

So, close to two-thirds of the differential is explained by factors that may involve discretionary action by state and local decisionmakers—the decision not to rely much on user charges, as in Massachusetts; the decision to staff extravagantly, as in the District of Columbia; the decision to pay high salaries, also in the District; past decisions that produce generous employee pension plans, once again in the District. But things are not that simple. The mix of expenditure—and the allocation of responsibilities between the public and private sectors—very much affect the use of nontax revenue sources. Most of these states have no major public power operations, an important generator of nontax revenue. It hardly is consistent with the argument against deductibility to assert that the states without public power systems "over-tax" because the data for them show less reliance on user charges. On the other hand, in numerous cases a feasible choice for user charges rather than taxes has been rejected—as is so characteristic of New England—and deductibility encourages that uneconomic decision.

Similarly, the level of expenditure for personal services is partly a matter of choice, partly a matter of pressures that politicians have no power to ignore, such as court orders and other federal requirements with respect to prisons, mental hospitals, and special education; regional differences in wage rates and living costs; and the accident of being the point of entry for large numbers of immigrants (California and New York). The same considerations apply to spending for welfare purposes: there is an element of choice, but discretion is less than complete unless the public and officials are prepared to tolerate very high levels of distress indeed. To be sure, in the long run, substantially lower levels of spending for what now seems socially necessary purposes in the high spending states will produce migration of problem populations to other states: a harsher prison regime will affect the distribution of miscreants; a more porous safety net will speed the dispersion of immigrants away from the initial points of entry.

During the past 15 years, there have been numerous budgetary "crises" in the state-local sector, some clearly cyclical (and thus amenable to solution by various short-term expedients), but some—especially in economically weak places—evidently of a secular nature, requiring a lower level of spending in the absence of rescue from without (and perhaps even with such a rescue, as occurred in the New York City fiscal crisis of 1975). What expenditure has been reduced in these crisis situations? Almost invariably, there has been a reduction in labor costs in real terms, some combination of reductions in real wages and reductions in staffing. The reductions in staffing usually have been sharpest in connection with social services and education. Also, states in crisis have frequently reduced the level of public assistance payments in real terms, and restricted the scope of and eligibility for various social services.

It is not necessarily the case that the reduction in staffing reduced, proportionately, the level of social and educational services provided—and thus the extent of redistribution through public spending—but the pattern suggests that officials and voters saw the pre-crisis package of public spending in a way that gives some support to deductibility. There was a slice of the spending that was a very private good indeed—excess wages to public employees in that jurisdiction, which could be eliminated. There was another slice, protective services, whose benefits were perceived as equal to at least 100 cents on the tax dollar, that should be cut as little as possible. And there was a large slice of redistributive spending, with benefits to median voters well below 100 cents on the tax dollar, to be cut substantially. Presumably, the sudden, large downward pressure on expenditure that would be caused by the end of deductibility in high tax areas would result in a similar pattern of spending reductions, with itemizers viewing social services and other redistributive activities as being of low benefit to them.

If, as seems to be the case, the redistribution branch (to use the Musgrave terminology) is especially large in the high-tax states, then deductibility can be supported on the ground that the high taxes are not simply a result of local political decisions in which there is no national interest. Instead, deductibility is a subsidy for redistribution that is appropriate, given the probable absence during the next few years of federal grant aid to support redistributive spending at the state-local level that is now financed from state-local taxes. However, this position is by no means unchallenged in the public finance literature. Gramlich and Rubinfeld (1982) found a pro-rich bias in public spending in Michigan, which may be characteristic of some other high-tax states and which is compounded by federal tax deductibility.

Redistributive expenditure is not the only aspect of the national interest that is at issue in connection with the interjurisdictional effects of ending deductibility. With the end of deductibility, the absolute magnitudes of differential interjurisdictional tax burdens are likely to rise sharply, and that should produce some locational shifts over time. The shifts might be especially pronounced if political pressures lead the states to substitute business taxes for currently deductible personal taxes.[8]

In theory, the country will be better off, not worse off, from the migration that follows the elimination of deductibility, if the principal effect of deductibility had been to lower the tax price of entirely local or private goods. In that case, deductibility surely was encouraging people to locate inefficiently. If, on the other hand, externalities and redistribution loom large in the present pattern of gross differentials in state-local taxes, the migration that will be induced by the ending of deductibility will be inefficient.

Kenyon (1985) has a useful hypothetical illustration of the migration question, reproduced in table 2. She puts the question in terms of how residents perceive the value of benefits from net local tax payments, with a low ratio of benefit value to tax payments an indication of inefficiency in government production and of the presence of externalities. An alternative formulation would include all redistributive expenditure in the zero-benefit category (for itemizers), as well as "defensive" expenditures that are designed to make a city as tolerable for itemizers as competitive locations. (High-income taxpayers in most large central cities probably view a large fraction of their state-local tax payments as

[8] Note that the locational effects need not be restricted to the states whose residents as a whole are net losers from the end of deductibility. The end of deductibility will widen the differentials in state-local tax burdens as such; the lower marginal rates of the federal income tax may offset the end of deductibility for any individual, but those lower marginal rates are available anywhere in the country, so migration to avoid high state-local taxes makes sense regardless of the net federal tax liability change.

Table 2
Possible Effects of Tax Deductibility on Migration[a]

	(1) Gross Taxes	(2) Taxes Net of Deductibility	(3) Perceived Value of Benefits	(4) Before Deductibility	(5) After Deductibility
CASE 1: Perceived Benefits = ¼ Taxes					
High-Tax City	$12,000	$9,000	$ 3,000	$3,000 incentive to move from high-tax to low-tax city	$2,000 incentive to move from high-tax to low-tax city
Low-Tax City	$ 8,000	$6,000	$ 2,000		
CASE 2: Perceived Benefits = ½ Taxes					
High-Tax City	$12,000	$9,000	$ 6,000	$2,000 incentive to move from high-tax to low-tax city	$1,000 incentive to move from high-tax to low-tax city
Low-Tax City	$ 8,000	$6,000	$ 4,000		
CASE 3: Perceived Benefits = ¾ Taxes					
High-Tax City	$12,000	$9,000	$ 9,000	$1,000 incentive to move from high-tax to low-tax city	No incentive for migration
Low-Tax City	$ 8,000	$6,000	$ 6,000		
CASE 4: Perceived Benefits = Taxes					
High-Tax City	$12,000	$9,000	$12,000	No incentive for migration	$1,000 incentive to move from low-tax to high-tax city
Low-Tax City	$ 8,000	$6,000	$ 8,000		

[a] Tax and benefit levels are assumed. A federal marginal tax rate of 25% is also assumed.

Source: Reproduced from Kenyon (1985).

producing zero benefits in these senses.)

If Case 4 is a good description of the real world of state-local finance, then deductibility's influence on location is entirely pernicious: people have an incentive to move to a high-tax location to receive benefits at a below-cost tax price. If the real world is like Case 1, and the gap between the value of benefits and taxes is largely due to externalities and redistribution, then the elimination of deductibility would increase the existing incentive for inefficent locational shifts.

Opinion among public finance economists, like opinion generally, has shifted to the right in recent years. A few years ago, there was little doubt expressed in the literature that a substantial part of the disparities in taxes and spending was connected with the composition of the population and the consequent redistributive aspect of state-local finance. In a classic article in 1974, Bradford and Oates explored the consequences, in theory and empirically for northeastern New Jersey, of consolidating all local governments in a large metropolitan area into a single unified government. They predicted substantial inefficencies in a Tiebout sense, a good deal of income redistribution and a pronounced locational effect; that is, reduction of the incentive of the affluent to move to income-segregated suburbs to escape taxation for redistributive purposes. This was consistent with the findings in the literature of urban economics that large U.S. metropolitan areas were a good deal more decentralized than would be predicted by nonfiscal variables alone. If Bradford and Oates had included the elimination of deductibility as one of their scenarios, they surely would have predicted an exacerbation of the incentive for the affluent to shift to income-segregated communities, and they would have seen this both as a consequential loss in equity and as locationally inefficient.

The literature of the past dozen or so years sees multilevel public finance rather differently. As summarized succinctly by Gramlich (1985a), subnational governments play a useful role in the economic stabilization branch; income redistribution is best done at the local level, on the whole, although Gramlich himself argues that long-term interstate migration and the existing large disparities in public assistance levels argue for a direct federal income support system. In the allocation branch, the present division of functions does closely match the nature of the benefits generated by the various functions. The last position is based on viewing elementary and secondary education as generating little other than private benefits to children and their parents. If the present distribution of responsibilities among the levels of government is close to right, and the system of grants from the federal government to the state and local governments not too defective, then the subsidy in deductibility has no positive merits to offset its demerits as an inefficient stimulus to overspending on public services without positive spillovers.

In effect, it serves as a gift to high-income people and an inducement to inefficent patterns of residential location; it is, to use Gramlich's adjective, pernicious.

About 65 percent of deductible taxes are paid to state, not local, governments, and state individual income and retail sales taxes surely are very far from being wholly or largely benefit taxes. If deductibility could be restricted to residents of large central cities and other low-income places (as proposed in Gramlich 1985b), then there would be only efficient locational effects. But this is perhaps the most unlikely of political outcomes.

One final point can be made about the interjurisdictional effects, this one political, not economic. The American federal system works on the basis of simultaneous interregional bargaining over many points; the bargaining is continuous and depends on the current positions. The inflicting of large windfall losses on particular states or regions does not fit this bargaining pattern: the fact that some places did well in the past because of a set of arrangements that are now seen as poorly conceived has never justified reversing those arrangements, if only because the people who will lose today are not those who gained in the past, because of both mortality and mobility. Perhaps the classic example is federal policy with respect to Western water resource development and the distribution of federal water. In comparison with the inefficiencies and inequities in these policies, state-local tax deductibility is Pareto-optimal. Those inefficiencies and inequities are now widely recognized, but the policies have not been reversed, only slowly and marginally modified; reversal and the windfall losses associated with reversal strike most Americans, not only real property owners in the arid West (the winners from past federal policies), as unfair and inconsistent with the politics of our federalism. The complete elimination of deductibility would be of that political character.

This argument appears, in more formal terms, in Hochman (1973): fiscal institutions tend to be capitalized and reversal of longstanding practices can lead to haphazard patterns of gains and losses, perhaps more harmful socially and politically than the ills that were to be corrected by the reform in question. As Hochman put it recently (in a comment on an earlier version of this paper):

> The tax code is but one aspect of Federal law; but it was not a painting created in isolation. All of the other legislation that affects state and local relations and defines the federal system, etc., was enacted under some assumptions, perhaps implicit, about the tax code, the constitution, etc.

While this is an argument against any non-incremental reform of the tax structure, it is peculiarly apposite for a reform, the central feature

of which (in Treasury II) is a drastic change in the system of fiscal federalism and the balance of interregional relations. Treasury II *is* incremental in virtually every other feature (for example, taxability of fringe benefits); it is radical when it deals with the federal structure.

Conclusions on Deductibility

It is both attractive and useful to view the finances of state and local governments as if they were all manifestations of a Tiebout world, in which state-local taxes are the equivalent of prices paid through voluntary exchange in markets and locational choice is the process through which these markets are cleared. A great deal of worthwhile analysis has flowed from that construct. If we use the construct, then there is no argument at all for tax deductibility (other than the political one in the preceding paragraph): deductibility inefficiently increases aggregate spending, induces state and local governments to use the revenue instruments that they would otherwise disdain (in particular, steeply graduated personal income taxes), and provides incentives for inefficient locational patterns (in particular, encouraging high-income people to live in high-tax jurisdictions). But in a world with externalities and redistribution at the state-local level and long-established institutions and practices, the argument must change.

It does not change greatly with respect to the effect on the aggregate level of state-local spending. The elimination of deductibility might cause some loss in spending for externalities and redistribution, but since the total effect would be so small—a reduction of less than 2 percent of total spending—the efficiency and equity losses on this score must be trivial.

The effects of deductibility, or its elimination, on the revenue structure of the state-local sector are in practice somewhat equivocal. Elimination would marginally encourage substitution of user charges for personal taxes, an efficient result if the charges are properly designed but not if they are the conventional clumsy lot. There would also be an inducement to substitute business taxes for personal taxes, which is probably undesirable, and to rely more on selective sales taxes that are not now deductible, which is even less desirable. Reduced reliance on the property tax would lower the progressivity of the national tax system, as would reduced reliance on state-local personal income taxation (how much depends on the actual form of the tax cuts that state and local governments make). So, the likely revenue structure effects are mostly undesirable, although perhaps not strongly so.

The interjurisdictional effects in the real world are harder to appraise. Based on the view that the non-Tiebout aspects of the finances of the states and of large central cities predominate for those units, I con-

clude that the losses from complete elimination of deductibility will exceed the gains, in regard to interjurisdictional effects. Together, these conclusions suggest restricting, rather than eliminating, deductibility: raising tax prices, but not to 100 cents on the dollar (for example, by only permitting the deduction of some fraction, not 100 percent, of personal taxes paid), and also employing a threshold—appropriate for *any* personal deduction alleged to be provided in order to refine the measurement of ability to pay, including charitable contributions.

Exemption from Taxation of Interest on State and Local Bonds

If after tax revision the interest on some debt obligations of state and local governments continues to be exempt from federal taxation, the lower marginal rates will reduce the value of the exemption to holders of the debt, thus making them less likely to buy such obligations unless their yields rise relative to yields on taxable obligations. Although the efficiency and equity costs of tax-exempt borrowing seem a good deal higher than those of deductibility of state and local taxes, complete elimination of deductibility is more popular in current tax reform plans than is complete elimination of tax-exempt borrowing.

The Demand for Municipals

If the only change in the federal income tax being contemplated were to reduce the top marginal rates to 35 percent for individuals and 33 percent for corporations, there should be some reduction in the demand for tax-exempt fixed-income securities and—if the supply is unchanged—an increase in yields.[9] Nevertheless, demand should not collapse, under the conditions that have prevailed for most of the past 15 years, during which time the spread between yields on similar long-term tax-exempt and taxable bonds generally has been less than 30 percent. At a 30 percent spread, the tax-exempt bond continues to offer a higher net yield than a taxable bond, even after top marginal rates are reduced to 35 and 33 percent.

However, interest costs to state and local governments over time will be higher for several reasons. First, average rates relative to taxable securities must be somewhat higher over the years than they have been in the past, since we would be unlikely to experience again periods

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[9] An excellent summary of the likely effects of the proposed changes in the treatment of tax-exempt securities can be found in Gurwitz (1985).

when the spread was greater than 35 percent. Second, the spread on short-term borrowing has been 40 percent or more for most of the past 15 years, so the cost of short-term tax-exempt borrowing surely will increase.

The third reason is a bit less obvious. Up to this point, the assumption has been that the investor's decision is confined to the choice between taxable and tax-exempt fixed-income securities of similar quality. But of course investors' choices and investment objectives range more widely. There are questions about liquidity, risk and the opportunity for capital appreciation, in addition to considerations of current after-tax returns. Indeed, in well-functioning markets, the net return on municipals should *never* be greater or less than the net return on equivalent-quality taxable bonds, unless investors are acting on these other considerations. With lower marginal rates, one might expect tax-exempt obligations to be less attractive relative to some other types of investments.

The reduction in marginal rates is by no means the only feature of tax simplification plans that would affect the demand for municipals. Treasury I and II both propose that commercial banks no longer be permitted to deduct interest paid to finance the carrying of tax-exempt securities (since 1984, only 80 percent of those costs have been deductible). That might substantially reduce commercial banks' willingness to hold municipals, and thus lead to increases in yields for the maturities favored by commercial banks.

Other features will work to increase the demand for tax-exempt obligations. As other tax shelters are closed down, demand will shift to those that continue to operate. The elimination of the investment tax credit and changes in depreciation rules will work in this direction, especially through their effects on limited partnership and leasing deals. In addition, if the maximum marginal tax rate on capital gains is reduced by less than the marginal rate on ordinary income (as in Treasury II, a reduction from 20 percent to 17.5 percent for capital gains), there should be a marginal shift from investment for capital gain to investment for current income, and that might spill over to municipals.

"Private-Purpose" Municipal Bonds

The principal effects on tax-exempt borrowing come in most proposals from restrictions on the supply side, in the form of limits on the types of new borrowing for which the interest will continue to be tax-exempt. Most important are restrictions on advance refunding bonds and prohibition of tax-exempt borrowing for "private purposes." Private purpose is defined in Treasury I and II as use of more than 1 percent of the proceeds directly or indirectly by any person other than a state or

local government, except where the facilities built are used by all members of the general public on the same basis.

What those words would mean in practice is not at all clear, for in some sense almost all state and local 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 connected to the lines, transportation facilities by shippers and passengers. Moreover, that use is seldom offered on precisely the same basis for all members of the general public, for there is generally some degree of inherent exclusivity which produces differentiation in access: the first house on a single-family lot has the exclusive access to the water and sewer lines passing in front of the house; school districts usually allocate pupils to schools on the basis of residence; there may be queuing for some types of hospital beds. Presumably, the tax reformers do not aim to eliminate borrowing in any of these cases, but their targets seem not all that different, taking the words of the definition literally. The principal targets, according to Treasury I, are bonds for industrial development, pollution control, student loans, nongovernmental hospitals, multi-family housing and owner-occupied housing, which in 1983 accounted for 62 percent of the dollar volume of all new long-term tax-exempt offerings.[10]

The notion that some purposes for tax-exempt borrowing are essentially "private," while other purposes are appropriately "public," calls for some non-arbitrary dividing line between the two classes. It appears that in most discussions the dividing line is based on some unarticulated readings of history: state and local governments have "traditionally" performed certain functions for which they often borrowed money, but "traditionally" did not borrow money for all sorts of things that now entail tax-exempt borrowing.

The trouble is that the historical record is full of examples of state-local borrowing for what is now often called private-purpose tax-exempt borrowing. As late as 1950, the states had very little debt for purposes that are unequivocally public: about 30 percent of their outstanding debt was for highways (highways usually have positive externalities only because users rarely pay high enough charges); about 42 percent for grants and loans to veterans (of which a large share went into the purchase of single-family houses); and about 5 percent for other loans to private parties, for housing and to farmers. Ten years later, with a huge

[10] ACIR (1984) contains a state-by-state listing by type for 1983, citing the Treasury as the source. The interstate variation is considerable: in four states, these types of 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.

increase in state debt, 45 percent was for highways (mostly for toll roads), 16 percent each for veterans, farm and housing credit and another 8 percent for such "private purposes" as port facilities and electric power plants. As late as 1970, such purposes accounted for about half of state debt. Local governments too have a long history of borrowing for purposes whose character is private in important ways. In 1863, New York City borrowed for the most private of purposes: to pay the bounties that could keep young men from being conscripted into the Union army. By the late nineteenth century, city governments commonly were putting in streets, sidewalks, street lighting and water and sewer lines—all financed by borrowing—in close conjunction with subdividers' plans for new housing development on the edges of built-up areas. There was substantial municipal borrowing for transit purposes—streetcar lines and later rail systems in the biggest cities—with the facilities always operated by private companies and often owned by them as well. Municipal public utilities—in no way different from their private counterparts—were widespread by the turn of the century, in water supply, electric power and gas. Until around 1950, utilities accounted for about half of all municipal debt.

Another problem with the dividing line between public and private purpose in the current discussions is that the Treasury and others seem infatuated with the nominal ownership of the assets: If a governmental entity is the owner and operator, then the borrowing may have a public purpose; if a nongovernmental entity is the owner and operator, the purpose must be private, regardless of the function carried out. But governmental and nongovernmental ownership and operation are often close substitutes, notably with regard to hospitals and education, where historical accident very often has determined the extent to which there is private provision by nonprofit organizations. Similar conditions of substitutability exist with regard to housing finance and a good many other things.

This substitutability suggests that restrictions on tax-exempt borrowing that rely primarily on the legal status of the entities involved will be defeated by state legislation that redefines that status. Thus, Congress will be compelled to list, in detail, permissible and impermissible uses of funds borrowed under tax exemption. Presumably, there is nothing constitutionally improper about this, but—given that there is no "tradition" to provide the dividing line and that money is fungible, so clever people will find ways around the restrictions—it seems both foolish and impractical to do so. To a considerable extent, then, the proposal amounts to a federal tax on the choice of mechanisms made by state and local governments in their borrowing, which hardly seems to serve any national purpose.

Industrial revenue bonds—and any other borrowing to finance ac-

tivities of ordinary taxable entities (for example, industrial water pollution control) where the tax exemption accorded the interest payments on the debt is the sole or principal element of public subsidy—provide one exception to the conclusion that in practice sensible dividing lines will be hard to draw and not make much sense once drawn. Such borrowing could be eliminated by simply denying businesses any deduction for rent or interest payments if the underlying indebtedness is tax-exempt. That would not preclude state and local governments from finding other subsidy devices; however, it would end the conventional device of simply passing through the interest tax exemption.[11] A similar provision could be applied to tax-exempt borrowing for single-family house mortgages that are not confined to households with relatively low incomes (by making the mortgage interest not deductible on Schedule A for taxpayers with incomes above, say, $30,000).

Of course, some would argue that the tax exemption should not apply to the financing of any assets whose services are private goods in the economists' sense of the term. That position has logic but it is far from the position in the Treasury and other proposals, which would allow tax exemption for some bonds issued to finance the production of private goods but deny tax exemption for others. One could also argue that the tax exemption on borrowing ought to be eliminated entirely because most of the subsidy "leaks" into spending for which there is no national interest at all, such as borrowing to construct a new city office building—permissible under the Treasury plan since the proceeds are clearly used by no one other than the city government.

Another line of attack on tax-exempt borrowing in general is that it is an inefficient subsidy to state-local capital spending because the Treasury's loss in tax revenue is so much greater than the value of the subsidy to state and local governments. And in any case, why should the federal government subsidize state-local capital spending, involving one kind of input, rather than spending for operating purposes, involving mainly labor inputs, or spending for transfer payments? The inefficiency argument has been well explored in the literature for more than a quarter of a century, and an obvious solution offered: the states and local governments to issue taxable bonds, in return for a direct federal subsidy of interest payments, set at an appropriate rate that continues the subsidy but at a lower cost to the Treasury.[12] That deal, however, is not on offer

[11] Industrial development bonds per se accounted for 34 percent of all "private-purpose" bonds issued in 1983 (ACIR, 1984), and over 50 percent of such borrowing in 12 states. The 1982 tax law provides that industrial development bonds will no longer be tax-exempt after 1986.

[12] Presumably, the transfer efficiency of tax-exempt borrowing will be improved by the federal income tax rate structure in the Treasury plan. That is, the spread between taxable and tax-exempt yields is likely to be closer to the (lower) marginal rates paid by investors in state-local obligations than is now the case.

now: the Treasury proposal on "private-purpose" bonds owes nothing to the transfer-efficiency argument.

Public finance economists generally disapprove of subsidies directed at particular inputs in the state-local sector rather than subsidies for outputs that are considered in the national interest (see, for example, Zimmerman, 1984 and 1985a). If particular inputs are to be subsidized, a case could perhaps be made for federal subsidy of borrowing costs. Interest rates are highly volatile over time, more so than most other input costs, and interest rates matter a lot for the financing of long-lived assets for which most state-local borrowing is undertaken. The federal government is the major determiner of interest rates, through its macroeconomic policy and its management of its own finances. Therefore, in an era of high interest rates for which federal policy bears much responsibility—the last 15 years or so—it maybe appropriate that the federal government subsidize this particular input, rather than others.

The case for ending tax exemption for "private-purpose" municipal bonds may be weak, but suppose the proposal is enacted: what will its effects be? Gurwitz (1985) has a good summary. First, there would be a flood of new financings to get under the wire, as happened in the last quarter of 1984 in the face of a far less rigorous tax change. Second, considerable ingenuity will be devoted to altering the legal arrangements for the now-proscribed type of borrowing to get within the tax-exemption net, for example by substituting direct public ownership and operation of waste-to-energy facilities for contracts with private owners and operators. Paradoxically for these times and this Administration, the change will slow the move toward private provision of public services.

Third, where it is impossible to circumvent the proscription, the cost of capital to the beneficiaries of these types of borrowing will rise. Fourth, there will be some reduction in the volume of tax-exempt borrowing, how much depending on the precise language of the legislation, the Treasury regulations issued pursuant to that legislation and the court decisions subsequently, and the ability of state and local officials to find ways around the restrictions. Gurwitz sees the reduction as "unknown but probably substantial," industry observers see it as enormous, but it could also be very small in the end.

Finally, whatever the decrease in the volume of tax-exempt financing, that decrease will reduce interest rates for the remaining tax-exempt borrowing. Only a few careful estimates of the magnitude of the decrease are available, and they vary by a factor of more than ten to one. (See ACIR, 1984, p. 127, and Zimmerman, 1984.) The low estimates suggest that a 25 percent reduction in the volume of new offerings might

reduce interest rates by as little as 1 percent (not percentage points), the high estimates by more than 11 percent.[13]

Other Effects on the Supply of Municipals

State and local borrowers, particularly the larger, more frequent and more aggressive borrowers (New York's Municipal Assistance Corporation (MAC) is a prime example), often issue bonds to refund outstanding bonds prior to the earliest date at which they can be called for redemption. This is done to smooth future debt service schedules (the usual motive of MAC), to take advantage of lower market interest rates, or 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. On the grounds that the practice results in "twice as many bonds being outstanding as are required for a given project" (U.S. Treasury, 1984, vol. 2, p. 295) and thus increases the federal revenue loss associated with tax-exempt bonds, the Treasury proposes to limit refunding bonds to those whose proceeds are used immediately for redemption of outstanding bonds. The Treasury also alleges that the additional volume of tax-exempt bonds outstanding "raises the interest rates that must be paid to finance state and local government projects" (p. 296).

The reasoning is peculiar. It ignores the specific use of the proceeds of the advance refunding issues: they are invested in special U.S. Treasury obligations issued for this purpose, whose maturities and interest rates precisely match those of the original issue, with those obligations held by a trustee. That means that money is lent to the Treasury at interest rates lower than those it must otherwise pay, 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, for the original issue has been in effect converted to an issue of Treasury securities that should trade as low-coupon Treasuries, rather than as part of the outstanding volume of obligations of the refunder. Therefore, the effect of advance refunding on the level of yields on state-local obligations should be negligible.

The Treasury proposal thus seems a pointless restriction on the ability of state and local governments to minimize their borrowing costs by

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[13] In addition to the other criticisms of the "private-purpose" bond prohibition, it appears that the Treasury's estimates of the revenue gains are grossly exaggerated. A Coopers & Lybrand study for the Public Securities Association, using plausible methods and assumptions, finds that the cumulative revenue gain for the fiscal 1986–90 period will be less than $2 billion, not the $13 billion the Treasury estimates. Public Securities Association, 1985.

adept debt management practices. If the proposal is adopted, the long-term effect (after an initial flood of issues to beat the deadline) will be to raise the cost of capital to municipal borrowers. They will be unable to exploit temporary interest rate declines and likely will make sure that future new issues, especially during periods when interest rates are high, can be called for redemption at early dates, a provision that will have a cost in the form of higher interest rates on the original offerings. The overall supply effect should be relatively small, however, because advance refunding issues (unlike "private-purpose" issues) tend to appear only when the spreads between taxable and tax-exempt issues are large.

At one time, it was possible for state and local governments to earn considerable amounts by borrowing at tax-exempt yields and investing the proceeds in higher-yielding taxable securities. The current law and Treasury regulations impose complicated restrictions on such arbitrage. The restrictions, however, vary by type of obligation and still permit significant arbitrage earnings under certain circumstances, so that state and local governments still have an incentive to manage their borrowing so as to maximize the earnings. The Treasury proposes to eliminate virtually all such arbitrage. The Treasury argues that the present situation increases the volume of tax-exempts outstanding, by encouraging borrowers to issue more bonds than are necessary for a project and to issue them sooner or keep them outstanding longer in order to maximize reinvestment earnings, and by making economic some issues that because of high issuance costs would be uneconomic otherwise. On the other hand, it has been argued that, because reinvestment earnings are expected to defray part of project costs in many cases, a larger initial issue would be required to replace those earnings. The Treasury seems to have the better of this argument.

If deductibility of state and local taxes is eliminated, the effects on the volume of state and local borrowing and the levels of yields will be mixed. First, if the elimination of deductibility triggered tax rate reductions in forms analogous to Proposition 13, then the units of government affected surely would be seen as less creditworthy. They would have to pay higher interest rates and at worst they would not be able to borrow at all for a time, which would reduce yields for everyone else. Second, the combination of the ending of the federal subsidy to current tax revenue and the continuation of the subsidy to borrowing would make borrowing seem a sensible substitute to current-revenue financing. While the two are far from complete substitutes, at the margin a good deal is possible, such as borrowing for longer terms and borrowing rather than current financing of quasi-durable assets (for example, police cars). This too would result in higher interest rates, holding other things constant. Third, there would be some offsetting effects on issuers in

states with high income tax rates where the interest exemption is confined to within-state issuers, as in New York, Minnesota and California. The effective rate of state and local income taxes would be higher and therefore the value of the interest exemption increased significantly, inducing residents to replace whatever out-of-state municipals they hold with in-state obligations.[14]

Conclusions on Tax-Exempt Borrowing

The effects of the full package of Treasury proposals with respect to state and local tax-exempt borrowing—after the initial efforts to beat the deadlines—will be a mixture of positive and negative impacts on volume of offerings and rates of interest. The lowering of marginal tax rates and the disallowing of banks' carrying costs will reduce demand somewhat, while the elimination of "private-purpose" and advance refunding bonds will reduce supply (on the assumption that not all "private-purpose" offerings can be legitimized by institutional changes). On balance, it seems likely that supply will be more restricted than demand, which should mean marginally lower interest costs on the remaining borrowing.

Is this desirable? Or, rather, which features of the entire package are desirable, from the standpoint of the national interest? One thing must be said first: the case for eliminating tax exemption entirely is stronger than the case for any one of the Treasury proposals that are specific to tax exemption per se. The Treasury proposals reject the former case, and have to be assessed within the context of a substantial volume of continued tax-exempt borrowing. In that context, the restrictions on "private-purpose" and advance refunding borrowing rate poorly, as badly-designed and economically pointless actions that further undermine political federalism. On the other hand, restrictions on arbitrage are indeed proper if there is to be tax-exempt borrowing, and the Treasury proposal is superior to the present web of regulations. The disallowance of banks' carrying costs also seems an appropriate concomitant to tax exemption of interest earnings.

Summing Up

The deductibility of state and local taxes and the exemption of interest on state and local obligations are highly imperfect instruments of federal compensation for the uneven incidence among state and local governments of special burdens or responsibilities for the production of

[14] Proctor and Rappaport (1985).

positive externalities. But then most policy instruments are far from perfect. Are these so imperfect that they warrant the treatment proposed in the Treasury plan—complete elimination of deductibility and substantial restriction of tax-exempt borrowing?

My own answer to the question, as indicated previously, is that there is indeed a plausible case for complete elimination of the tax exemption on state and local borrowing, but no persuasive case for the major restrictions the Treasury proposes. On the other hand, with respect to deductibility, the persuasive case is for restriction, not abolition.

The more ardent advocates of elimination appear convinced that the national-interest benefits per dollar of revenue lost to the Treasury from deductibility are close to zero, while the more outspoken defenders sometimes read as if they believed that those benefits exceeded 100 cents on the dollar of revenue loss. In the absence of hard fact, the debaters rely on agreeable suppositions (of the type some leading politicians use even when facts are at hand) about the character of the state and local spending differentials supported by deductible taxes. The suppositions agreeable to me suggest that the national-interest benefits per dollar of revenue loss to the Treasury are less than 50 cents, but far above zero. So deductibility may be a fourth-best way to generate those benefits, as compared to a third-best set of conventionally designed federal grants and to a second-best set of properly designed grants (say, those spelled out by Gramlich, 1985). But neither of those superior alternatives is on offer. The fourth-best is not an infrequent or dishonorable solution in public life.

Of course, if one believes that domestic government is evil (except, possibly, when it regulates private morals), then it is highly appropriate to use the happy occasion of tax simplification for more than one purpose, to shrink the size of subnational as well as national government. Even for that purpose, the elimination of deductibility is a clumsy instrument, but it is at hand.

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Discussion

*Edward M. Gramlich**

I have approximately the same efficiency objectives as Dick Netzer and I agree with almost all of the technical arguments in his wide-ranging and balanced paper. I do get to a somewhat different bottom line, however. On deductibility of state and local taxes generally, he favors an intermediate approach between continuation and the Treasury's proposed complete elimination. I can see an intermediate approach that is preferable to complete elimination, but it is not the one he, or anybody else, favors. Barring that, I am with the Treasury in favoring complete elimination. On the tax preferences for state and local borrowing, he favors complete elimination, but is not impressed with the Treasury's case for partial restriction of borrowing preferences. I favor complete elimination too, but I would take the Treasury's partial restriction measures as a second best.

In my remarks I will make a few comments on tax reform in general, and then discuss deductibility and borrowing preferences separately. I do not repeat Netzer's arguments in those many cases where I agree totally, but just jump in where I feel the weighting of various pros and cons should be different.

Tax Reform in General

As has been said often at the conference, the worst two words in the whole tax reform discussion are "revenue-neutral." It is as if the United States is starting off in a position where its wealth accumulation ratio (defined to include net exports as part of capital formation) had not

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declined, and as if fiscal policy were innocent in any decline. I state things in this awkward way to indicate that the problem I am thinking of is the large budget deficit, but the reason I am thinking of it is not that I fear budget deficits per se, but that I don't like to see my generation go on consumption binges, and we appear to be embarking on a big one.

Given this initial condition, my objective in any tax reform measure would be to end with a substantial reduction in the budget deficit. Tax increases do not have to cover the entire deficit, of course, but base-broadening should be one of the first things considered in raising the $100 billion or more required to bring fiscal policy back into balance. To quote none other than David Stockman, it seems "preposterous" to limit tax reform possibilities by the revenue-neutrality constraint. Accordingly, my point of view throughout will be that the country needs to cut back fiscal policy by $100 billion or more.

Presently about $35 billion is given away by state and local tax deductibility and another $20 billion by borrowing preferences. Is there merit in these subsidies? On balance I find about zero merit, which is less than Netzer finds, though he doesn't find anything close to full merit. My preference would be to get rid of the subsidies—preferably with some adjustments to cover some social losses—but as a political strategy I am happy to take complete elimination now and worry about those losses some other day.

Tax Deductibility

On its surface, the deductibility of state and local taxes appears to be one of the most pro-rich subsidies there is. The vast majority of taxpayers with a taxable income over $30,000 itemize and claim this preference; very few with a taxable income under $20,000 do so. Why then are the conservatives proposing to kill the subsidy and the liberals so obsessed with retaining it?

Assuming noble motives and intelligence on the part of liberals, the answer must be some sort of a "social offset." The benefit appears to go to the rich, but actually goes to somebody else or for some other purpose. Dick comes up with three broad social offsets.

State and Local Spending

Eliminating deductibility will raise the tax price of state and local spending and reduce it, and that is socially bad if there are benefit spillovers that should be paid for outside of the district. Netzer correctly (in my view) places little stock in all this. The impact on spending should be modest given low price elasticities and the fact that most voters do not

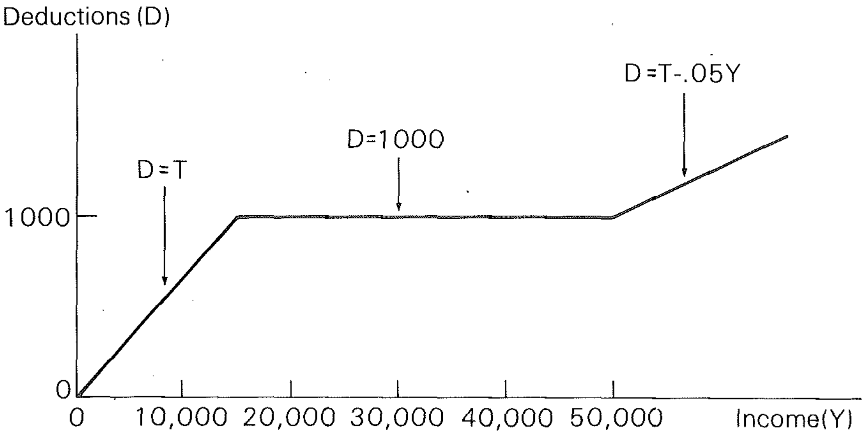
itemize, and it is hard to think of many spillovers where there is not already some categorical grant that shares the burden. I have no disagreement with Netzer here, except that I place even less stock in this argument for a reason that he mentioned but I think did not give sufficient emphasis.

The problem with the argument is not merely that a minority of voters itemize, it also involves who is doing the itemizing. In a separate paper that Netzer had not seen when he wrote his, I used some micro data in Michigan to try to compute, more precisely than some of the prevailing estimates, in my humble opinion, the impact of eliminating deductibility on median spending demands. For overall local spending, I found a 5 percent reduction, close to the 2 percent number Netzer feels is reasonable. But there is no reduction at all in a low-income place like Detroit, where relatively few voters itemize, and more than a 10 percent reduction in a high-income place like the Detroit suburbs, where most voters itemize. What we have is a measure that helps the people in high-income areas support their schools, which are already good, and doesn't help at all people in low-income areas, where schools are not good. I am strongly opposed to such a subsidy, even if it can be shown that schools have external benefits and that aggregate school spending will drop when deductibility goes.

One should, of course, insert some caveats in making this argument. To the extent that states have power equalization plans that help poor districts with their schools, some partial deductibility of state taxes may be called for. The same is true for AFDC and Medicaid, two state-funded programs that directly help the poor. While I would favor adjustment of the matching grants supporting these programs to maintain spending on them, I also think that these impacts are modest enough that I would take complete elimination of deductibility even without the offsets.

As a final point here, failure to recognize this rich community–poor community point can lead to some pervasive mischief in attempting to reform the tax code. I use as evidence the treatment of deductibility in the early House Ways and Means Committee modification of Treasury II, something not covered by Netzer. As the figure shows, taxpayers can deduct actual state and local taxes (excluding sales taxes) up to $1000, then $1000, and then actual taxes less 5 percent of income when that total exceeds $1000. There would appear to be a public spending price effect for very poor and very rich communities. (Income numbers have been inserted in the figure, based on prevailing national averages; they would be lower or higher in different states depending on the size of revenues and expenditures.) But even this appearance is deceiving, because very few in low-income communities now itemize and even fewer will, under the Ways and Means bill. Hence there will now be a price

Deductions in the Ways and Means Committee Bill



$$D = \begin{cases} T, & T<1000 \\ 1000 & \\ T-.05Y, & (T-.05Y)>1000 \end{cases}$$

Price of public spending reduced when $\frac{\partial D}{\partial T} > 0$

effect only in a few extremely rich communities. Over time, if the $1000 amount is not indexed, the price subsidy will be extended to more communities, but still on the top end of the community income distribution. What looks like a compromise between those wanting to eliminate and those wanting to preserve deductibility then becomes a highly perverse, almost sinister, incentive for public spending in just the richest communities—all because Congress apparently does not recognize the unholy interaction between income stratification and itemization. I wish Netzer had brought the point out more forcefully, and I really wish Congress would take intercommunity equity into account in forming its deductibility provisions.

State and Local Revenues

I had thought that any social offsets here would be minor. Presently user charges, arguably the most economically efficient state and local revenue source, are not deductible, and other less efficient taxes are. It would seem that putting all revenue sources on the same basis, or on a level playing field, to use present-day jargon, would be a step in the right direction. It still may be, but Netzer has persuaded me to be careful with the argument. On the one hand, many user charges are not that efficient since they have not been designed with principles of marginal cost pricing in mind. On the other hand, we are likely to get an increase in generally inefficient business taxes, which still remain deductible.

Netzer's general discussion here covered all the bases and I have little to add. However, I am left with a vague sense that he overemphasizes the potential inefficiencies in any new user charges imposed by states and localities. There can't be that much difference between average and marginal costs in the long run for a range of services such as transportation, refuse collection, and even higher education, and in a competitive world there can't be that much scope for nuisance taxes on business. Netzer makes the case for a slight social offset; my own best guess after reading his argument is that the offset is either zero or not an offset at all.

Migration

Here Netzer argues two new points. The first is that there could be a reduced incentive for rich people to live in poor areas now that they no longer get the subsidy for living in areas where their own tax prices are high. In the paper cited above, I tried to work through all this for my Detroit area voters, and find, with Netzer, that there is something to the argument. Other things equal, tax prices do seem to be higher for rich people if they live in poor areas, and they can benefit by moving if deductibility goes. But they do not seem to benefit very much, because the real quantity of public goods consumed is higher in the rich areas, and the net impact is modest, again on the order of 5 percent of tax payments. Frankly, I would doubt that many people would relocate for fiscal differentials this small, but in the long run, who can say? In any event, if this is a worry, the sensible way to protect against it is to retain deductibility for low-income areas but not high-income areas. The last point is put in just to show that I too can think up cockamamie schemes that nobody else in the world takes seriously. As above, I would propose it seriously if I had more confidence that such an idea would not get bent totally out of shape in the hurly-burly of political horse trading on tax reform plans.

Netzer's second point here is a good one, albeit a frustrating one. It is that whatever the social inefficiencies of deductibility, they have been capitalized and taking them away now is horizontally inequitable. This is, of course, an argument against *any* radical tax reform or expenditure reform—really an argument that the United States should stay locked into its consumption binge. I am so strongly opposed to that notion that I can find lots of counterarguments. Given the publicity tax reform has received, some reverse capitalization may have already taken place. To maintain intergenerational horizontal equity, some present-day fiscal subsidies must be given up, even if they are capitalized. To maintain horizontal equity between the East and the West in this country, fiscal subsidies must be given up simultaneously. If giving up deductibility is

the way we get water and farm subsidies to be cut back, so much the better. But I admit that on this one there is no very good objective response.

My overall verdict here is that I make a negative out of Netzer's first offset, a zero out of his second, and I'll go along with part of his third. Hence he gets positive offsets on balance and wants to restrict but not eliminate deductibility; I get zero offsets on balance and agree with the Treasury on eliminating deductibility.

Borrowing Preferences

The second half of Netzer's paper involves borrowing preferences, some of which will be attacked by the Treasury. Netzer doesn't like the preferences, a point on which we have no disagreement, but he doesn't like the attacks either. I confess to being basically out of my depth in the world of tax arbitrage, but I do find merit in the attacks.

A recent paper by Gordon and Slemrod helps in bringing order to this messy area by identifying several types of arbitrage. Assume a taxable interest rate r, an after-federal-tax interest rate $r(1-t)$, and a state/local nontaxable interest rate s. If these rates differ, as they will in our present tax structure, three types of arbitrage are possible:

1. Communities can borrow at the nontaxable rate s and invest at the higher taxable rate r. This form of blatant arbitrage is illegal, but it is hard to know how well the Treasury enforces restrictions against it. Netzer argues that the result of lots of shifts is that we simply cannot tell what will happen to s relative to r, and hence to the potential of this arbitrage loophole. He also supports the Treasury's general attempt to prevent this form of tax arbitrage.

But then, for reasons that were not as convincing to me, he came out against two specific attempts to restrict it. One is the Treasury's attempt to end arbitrage on "private purpose" bonds by denying nontaxable status; the other is a similar attempt to deny nontaxable status to end arbitrage on advance refunding bonds. Netzer appears to be against curbing private purpose bonds because they are hard to identify and any restrictions are easily avoidable. Of course this is true, but I still think the Treasury should step up the monitoring. Why isn't any blockage of the arbitrage channel, including even some uncertainty about IRS enforcement, a step in the right direction?

Then Netzer criticizes curbs on advance refunding bonds because they are invested in Treasury securities at rates lower than would otherwise be the case. I read this as saying that the arbitrage profits on these bonds are returned to the Treasury. If so, it is irrelevant whether the Treasury curbs them or not. If not so, and it does take some extreme

assumptions to get all the arbitrage profits passed back to the Treasury, it matters and the Treasury is properly trying to impose curbs. At one extreme, therefore, the curbs are appropriate and at the other extreme irrelevant. That sounds to me like an argument for imposing the restrictions.

2. Communities can raise taxes at a cost of $(1-t)$ per dollar, invest and earn r per dollar of taxes, and give it back. Having your friendly municipality handle your assets then avoids the tax on interest income. Gordon and Slemrod find, seemingly to their surprise, that there is not much of this because rich people don't seem to trust governments to manage their finances. Perhaps we should not take the possible arbitrage seriously, except that I will note that any attempt discussed under 1) above to limit investment at r will also close down this channel. That, in my view, is another reason for favoring the Treasury's curbs, however imperfect they may be. And while as I said above I am not enamored of the large cuts in federal marginal rates dictated by the goal of revenue neutrality, I have to admit that cutting t will curb this channel as well.

3. The remaining possibility is to trade on the difference between s, which Netzer argues will not change, and $r(1-t)$. Wealthy individuals will want to borrow at $r(1-t)$ and invest at s, on their own account. If s is fixed, this form of arbitrage will be cut by lower marginal tax rates, but the arbitrage has minimal effect on states and localities. Poor communities will want to borrow at s, lower property taxes, and have their citizens earn $r(1-t)$ on the saved property taxes. Here the relevant t is for poor investors, and this subsidy for the poor is not changed much by the Treasury. Here again the structure of the rate cuts looks good because it limits the rich person's subsidy without touching the poor person's.

My general verdict on this part then is that what the Treasury is trying to do is good, though in part because of the cut in top marginal rates. I don't see why Netzer is so ambivalent about the Treasury proposals, though we both should be slightly more ambivalent if I had my way and marginal federal tax rates were not cut so much.