The State and Local Implications of Federal Tax Reform

By Susan Gaffney and Barrie Tabin Berger

On November 1, the President’s Advisory Panel on Federal Tax Reform delivered its much-anticipated report to Treasury Secretary John Snow. President Bush created the Panel in January to recommend options for making the tax code simpler, fairer, and more conducive to economic growth. While the cornerstone of the Panel’s report is the repeal of the Alternative Minimum Tax, it also includes many provisions that would be harmful to state and local governments if the recommendations were to become law. The Panel reached consensus on two tax reform platforms — the Simplified Income Tax Plan and the Growth and Investment Tax Plan. Both plans recommend repeal of the AMT, a measure that will cost the U.S. Treasury more than $600 billion over a 10-year period; however, this lost revenue is fully offset by other recommendations. The difference between the plans lies mainly in the tax treatment of business and capital income. This article examines the Panel’s recommendations as they relate to state and local governments.

DEDUCTIBILITY OF STATE AND LOCAL TAXES

The most important element of the Panel’s report to state and local governments is the recommendation to eliminate the deductibility of state and local income, sales, and property taxes. The report states that “the deduction provides a federal subsidy for public services provided by state and local governments. Taxpayers who claim the state and local tax deduction pay for these services with tax-free dollars. These services, which are determined through the political process, represent a substantial personal benefit to the state and local residents who receive them — either by delivering the service directly or by supporting a better quality of life in their community. The Panel concluded that these expenditures should be treated like any other nondeductible personal expense, such as goods or clothing, and that the costs of those services should be borne by those who want them — not by every taxpayer in the country” (page 83).

GFOA and other state and local government organizations have long fought against the elimination of federal deductibility of state and local taxes. This was a long-fought battle in the 1986 tax reform bill, and came forward again in the 1990s. State and local governments have argued against this provision for many reasons, including the fact that it constituted federally mandated double taxation of income, property, and purchased goods. But just as importantly, eliminating the deductions would compromise the fiscal autonomy of state and local governments. Given that the federal government continues to impose unfunded mandates on and revoke responsibility to state and local governments, further deterioration of the ability to raise own-source revenues to pay for these mandates would jeopardize many of the services and infrastructure that citizens demand from their local and state governments.
The tax-exempt status of municipal bonds for businesses would be a major blow to both corporate investors and state and local governments. Without question, such action would drive down demand for municipal bonds and thus increase borrowing costs for issuers. In making this recommendation, the Panel cited the flexibility businesses have to deduct interest outside of purchasing tax-exempt bonds. A key point that GFOA and others will make is that the impact of this provision will likely not be felt by the businesses, but instead by thousands of state and local governments across the United States.

Another feature of the Growth and Investment Tax Plan would exempt all dividend, income and 75 percent of capital gains income from federal taxation. These provisions could further hurt demand for tax-exempt bonds.

Savings and Health Care Initiatives

The Panel's report recommends the consolidation of the current constellation of savings incentives and accounts into three plans: (1) Save at Work plans, (2) Save for Retirement accounts, and (3) Save for Family accounts.

Employer-provided Save at Work plans would combine current private and governmental plans such as 401(k); SIMPLE 401(k); Thrift 401(b); governmental 457; SARSEP, and SIMPLE IRA plans into a single type of plan that could be established by any employer. These accounts would be almost identical to the Employee Retirement Savings Accounts (ERSAs) that the president and many Republican members of Congress have tried to advance in recent years. GFOA and other associations representing the interests of state and local governments have consistently cautioned against a consolidation of these types of retirement accounts, maintaining that a "one size fits all" approach may not necessarily address the needs of the public sector's diverse workforce and legal framework, or increase retirement savings. State and local interests must ensure that these Save at Work plans do not increase complexity and confusion for public sector plan sponsors and plan members, and undermine the gains state and local governments have made in recent years in addressing the unique savings and retirement needs of the public sector.

Save for Retirement accounts would replace existing IRAs, Roth IRAs, Non-deductible IRAs, deferred executive compensation plans, and tax-deductible "inside build up" of the cash value of life insurance and annuities. Save for Family accounts would consolidate such vehicles as state-run Section 529 tuition plans, Health Savings Accounts, and Flexible Spending Accounts and could be used by taxpayers for retirement, health, education and training, or a down payment on a home. These two accounts would operate outside of the workplace and would allow every taxpayer to save $10,000 a year in each account. Contributions to each account would be made with after-tax dollars like current Roth IRAs, and earnings would grow tax-free.

Also addressed in the Panel's proposal are recommendations limiting the tax exclusion for employer-provided health coverage to the average cost of health care and allowing a deduction for the purchase of health insurance in the individual market. Specifically, the Panel
This booklet introduces the fundamentals of tax increment financing (TIF), a revenue-harboring technique for financing TIF projects, and the pros and cons associated with TIF usage. It also discusses the risks and risk management tools for helping to ensure successful TIF outcomes.

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