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Federal Support for State and Local Governments Through the Tax Code

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Contents

Chairman Baucus, Senator Hatch, and members of the Committee, thank you for the invitation to testify on federal support for state and local governments provided through the tax code and on some ways in which tax reform might affect that support. My testimony focuses on two particular aspects of current policy: (1) the use of tax-preferred bonds by state and local governments for subsidizing investment in capital-intensive projects for such things as highways, water resources, and school buildings and (2) the deductibility of state and local taxes.[1]

The federal government provides preferential tax treatment for bonds issued to finance activities of state and local governments. As a result, those governments are able to borrow more cheaply than they otherwise could. At the end of 2011, state and local governments owed roughly $3 trillion in the form of tax-preferred bonds.

The most common type of tax-preferred bond is one for which interest income is exempt from federal taxes. Another type of tax preference for a state or local bond, which until recently has not been much used, is to offer a federal tax credit in lieu of some or all of the interest income from the bond.

Although a large majority of tax-preferred bonds are traditional tax-exempt bonds, such bonds are a relatively inefficient mechanism for the federal government to transfer funds to state and local governments. Specifically, with tax-exempt bonds, the federal government forgoes more in tax revenues than state and local governments receive. Estimates suggest that the difference is about $6 billion per year—or about one-fifth of the approximately $30 billion in federal revenues lost through that tax preference. That sum accrues to investors who pay high marginal tax rates. In contrast, for tax-credit bonds, the revenues forgone by the federal government are captured entirely by state and local governments.

However, tax-credit bonds have not been especially well received in financial markets until a few years ago. Investors' lack of enthusiasm for such bonds probably stemmed from the limited size and temporary nature of most tax-credit bond programs and an absence of rules for separating tax credits from the associated bonds and reselling them. In contrast, "direct-pay" tax-credit bonds—for which the value of the tax credit takes the form of a payment from the Treasury to the state or local government issuing the bond—became a significant source of state and local financing in the years during which they were authorized, namely, 2009 and 2010.

The deductibility of state and local taxes provides another means of federal support for state and local governments. Taxpayers who itemize their deductions may claim a deduction for most state and local taxes. That "taxes-paid" deduction provides an indirect federal subsidy to state and local governments because it decreases the net cost to taxpayers of paying such deductible taxes. By lowering the net cost of those state and local taxes, the taxes-paid deduction encourages state and local governments to impose higher taxes and provide more services than they otherwise would and to use deductible taxes in place of some nondeductible taxes. According to an estimate by the staff of the Joint Committee on Taxation, the tax subsidy provided through this deduction was $67 billion in 2011.[2]

How much a given state or local government benefits from this deduction depends on the structure of its tax system and the characteristics of the taxpayers who provide revenues to it. For example, a state or local government that finances its spending by using a larger share of taxes that are deductible under the federal individual income tax receives a larger benefit through the deductibility provision than does an otherwise identical government that finances its spending by using a smaller share of taxes that are deductible. All else being equal, a state or local government whose taxpayers are more likely to itemize deductions also gains a greater benefit than does a government whose taxpayers tend to claim the standard deduction.

In 2009, slightly fewer than one-third of all tax filers claimed the deduction for state and local taxes paid. The amount of those taxes paid generally increased with income, as did the tax saving from the deduction and the

1. For previous analysis of these topics, see Congressional Budget Office and Joint Committee on Taxation, *Subsidizing Infrastructure Investment with Tax-Preferred Bonds* (October 2009); and Congressional Budget Office, *The Deductibility of State and Local Taxes* (February 2008).

2. Joint Committee on Taxation, *Estimates of Federal Tax Expenditures, 2011–2015*, JCS-1-12 (January 17, 2012).

likelihood that a taxpayer would claim the deduction. For example, approximately 25 percent of tax filers with income under $100,000 claimed the deduction in 2009, compared with over 85 percent of tax filers with income of $100,000 or more.

Over the next several years, scheduled changes to tax provisions and the interaction of the regular income tax and the alternative minimum tax (AMT) will change the number of taxpayers who claim the deduction and the associated loss of federal revenues because the AMT does not allow people to claim the taxes-paid deduction. Without further changes to tax law, the number of taxpayers subject to the AMT will rise in 2012 because temporarily higher AMT exemption levels expired at the end of last year; as a result, fewer people will be able to claim the taxes-paid deduction. Also, without further changes to tax law, tax provisions originally enacted in 2001 and 2003 will expire at the end of 2012, increasing regular income tax rates for many taxpayers. Those increases will raise the value of the taxes-paid deduction for those who claim it and increase the associated revenue loss for the federal government. In addition, with the higher tax rates, many taxpayers will shift from being subject to the AMT (even if the current lower AMT exemption levels remain in place) to being subject to only the regular income tax and will therefore be able to claim the deduction for state and local taxes paid.

If certain tax policies that have recently been in effect were extended rather than being allowed to expire, as under current law, the revenue effects of the taxes-paid deduction would be different. Specifically, if all tax provisions expiring after 2012 (including the lower regular income tax rates originally enacted in 2001 and 2003) were extended and the AMT exemption levels were increased for years after 2011, there would be two opposing effects on the taxes-paid deduction. First, the lower regular income tax rates would reduce the tax saving and associated revenue loss for the federal government for taxpayers claiming the deduction. Second, the higher AMT exemption levels would reduce the number of taxpayers subject to the AMT, thereby increasing the number of taxpayers who would claim the deduction.

Federal Financial Support to State and Local Governments

The federal government provides financial support to state and local governments in a variety of ways. The largest amount comes to state and local governments in the form of grants, but the federal government also delivers support through the federal tax code by provisions that make it less expensive for state and local governments to raise revenues through their own tax collections and to borrow money by issuing bonds. That federal financial support covers the gamut of state and local government activities—including ones involving education, assistance to individuals and families with limited resources, transportation systems, and other infrastructure projects.

Magnitude of Federal Financial Support

Federal outlays for grants to state and local governments totaled $607 billion in 2011, or roughly one-quarter of all state and local government expenditures (which in 2011 amounted to $2.5 trillion).[3] Health care programs accounted for nearly half of those grants, including $275 billion for Medicaid. Most of the remaining grants went to fund programs in income security; education, training, employment, and social services; and transportation. Such grants are funded through both annual appropriations and the authorizing legislation of some mandatory programs.[4]

Another type of federal financial support is in the form of tax subsidies that make it less costly for state and local governments to raise revenues through taxes or to borrow. In 2011, according to estimates by the staff of the Joint Committee on Taxation, the federal tax subsidy deriving from the deduction for state and local taxes was $67 billion, and the tax subsidy for bonds issued by state and local governments totaled about $30 billion. The tax subsidy for state and local taxes is one of the largest "tax expenditures" in the individual income tax, exceeded only by the exclusion of pension contributions and earnings, the exclusion of employers' contributions for health care,

3. *Budget of the United States Government, Fiscal Year 2013: Analytical Perspectives*, Table 18.1; and Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts, February 13, 2012, Table 3.3.

4. The federal government also offers loans and loan guarantees to state and local governments for a number of different purposes, including state unemployment programs, community development projects, and disaster aid.

the reduced tax rate for capital gains and dividends, and the deduction of mortgage interest.[5]

Tax Subsidies vs. Grants

The mechanisms by which the federal government gives financial support to state and local governments offer different degrees of federal control over the amount of the support, the uses of those federal funds, the distribution of that support across jurisdictions and individuals, and transparency in the federal budget process.

The amount of the federal tax subsidy for the state and local tax deduction and for tax-preferred state and local bonds depends on state and local governments' tax and spending policies and on the tax circumstances of the individuals who opt to take the deduction and the individuals and firms who purchase those government bonds. The amount of some federal grants to state and local governments is specified in the appropriating or authorizing legislation of the grant program. For other programs, including Medicaid, the authorizing legislation sets out how the spending is to be divided between the federal government and state and local governments but also gives those governments considerable decisionmaking power that helps to determine the amount of federal spending.

Control over the use of federal funds varies widely depending on the financing mechanism. For subsidies provided through the federal tax system, the federal government has no control over how state and local governments spend the funds as long as the subsidized tax revenues and bonds are used for a governmental purpose. For grants, the federal government may specify the purpose for which the funds are to be spent, impose other conditions on that spending, and require state and local governments to spend out of their own resources. However, the fungibility of those federal grant funds raises the possibility that state and local governments may reallocate their other spending as a result of the federal grants they receive.

The distribution of the federal tax subsidies that support state and local governments depends on the mix of state and local policies at play and the incomes of residents. Although specific individuals and firms may have smaller federal tax liabilities as a result of those tax subsidies, the benefits of those subsidies may extend to all residents to whom federally subsidized state and local government goods and services are provided. Federal grants are typically allocated among state and local governments by formulas or other rules set out in legislation. The participants in those grant programs may be the most direct beneficiaries, but others in their communities may receive spillover benefits.

The federal tax subsidies that support state and local governments do not appear as spending in the federal budget, making the amounts of support less evident, though the staff of the Joint Committee on Taxation provides annual estimates of those and other tax expenditures separately. In contrast, grants to state and local governments are specified in appropriating or authorizing legislation as either a dollar amount or a formula with a set of criteria for spending the funds. They appear in the federal budget as either discretionary or mandatory spending as determined by the specifics of each grant program. For discretionary programs, lawmakers make decisions about appropriation amounts annually.

Tax-Preferred Bonds

The federal government offers preferential tax treatment for bonds issued by state and local governments to finance governmental activities. Most tax-preferred bonds are used to finance schools, transportation infrastructure, utilities, and other capital-intensive projects. Although there are several ways in which the tax preference may be structured, in all cases state and local governments face lower borrowing costs than they would otherwise.

Types of Tax-Preferred Bonds

Borrowing by state and local governments benefits from several types of federal tax preferences. The most commonly used tax preference is the exclusion from federal income tax of interest paid on bonds issued to finance the activities of state and local governments. Such tax-exempt bonds—known as governmental bonds—enable state and

5. See Joint Committee on Taxation, *Estimates of Federal Tax Expenditures, 2011–2015*. Tax expenditures are defined under the Congressional Budget and Impoundment Control Act of 1974 as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." Tax expenditure estimates, unlike revenue estimates, do not take into account any changes in taxpayers' behavior in response to changes in the tax code.

local governments to borrow more cheaply than they could otherwise.

Another type of tax-exempt bond—qualified private activity bonds, or QPABs—is also issued by state and local governments. In contrast to governmental bonds, QPABs reduce the costs to the private sector of financing some projects that provide public benefits. Although the issuance of QPABs can be advantageous to state and local finances—for example, by encouraging the private sector to undertake projects whose public benefits would otherwise either have gone unrealized or required government investment to bring about—states and localities are not responsible for the interest and principal payments on such bonds. Consequently, QPABs are not the focus of this testimony (although the findings of some studies cited later in this section apply to them as well as to governmental bonds).[6]

A final type of tax preference for state and local borrowing takes the form of a tax credit to buyers of bonds issued to finance governmental activities. Such bonds have not generally proved popular with investors, however, and recently have been reconfigured to allow the state and local governments issuing them to claim the tax credits in the form of direct payments from the Treasury. Particularly in 2009 and 2010, when the American Recovery and Reinvestment Act of 2009 (Public Law 111-5) authorized Build America Bonds, for which those direct payments to issuers occurred, tax-credit bonds became a significant source of federal financial support for state and local borrowing. Greater use of such direct-pay tax-credit bonds and tax-credit bonds more generally offers the prospect of both increased efficiency in providing a federal financial subsidy to state and local governments and greater transparency in how that subsidy is delivered.

Uses of Tax-Preferred Bonds

With the exception of some types of tax-preferred bonds, states and localities can use tax-preferred debt to finance just about any government activity.[7] According to the data in the Flow of Funds reports published by the Federal Reserve, at the end of 2011 there was approximately $3 trillion in outstanding liabilities of state and local governments, almost all of which (98 percent) was in the form of long-term debt.[8] More than half of that debt was issued by localities. According to the latest available data from the Bureau of the Census, long-term outstanding debt obligations of local governments totaled $1.6 trillion at the end of the second quarter of 2009, and the corresponding figure for states was $1 trillion.[9] Most of those long-term governmental bonds, as well as Build America Bonds during the several years in which they were authorized, were issued to finance capital spending (or investment).

State and local governments vary in their amount of outstanding debt and the interest payments associated with it depending on the purpose for which the debt has been issued—reflecting the different focus of each level of government. For example, states have a larger amount of outstanding debt and interest payments from investments in highway infrastructure than do localities; states' annual capital spending for that purpose is several times larger than localities'. For investment in utilities infrastructure (such as water and gas facilities), the situation is reversed. State and local governments sometimes also use short-term governmental bonds (with a maturity of less than 13 months) to finance government operations, particularly during periods when revenues fall below expenses. But such bonds (known as revenue anticipation notes, or RANs) account for only about 2 percent of the debt owed by those governments.

To finance new capital spending by state and local governments, $216.4 billion in governmental and Build America Bonds was issued in 2009 (see Table 1).[10] About 60 percent of those proceeds financed investment in education, transportation, and utilities. The shares for

6. According to an estimate by the Federal Reserve, at the end of 2011 the amount of outstanding qualified private activity bonds was approximately $752 billion. See Federal Reserve, Flow of Funds (statistical release, March 8, 2012), www.federalreserve.gov/releases/z1/. For a comprehensive discussion of QPABs and other tax-preferred bonds, see Congressional Budget Office and Joint Committee on Taxation, *Subsidizing Infrastructure Investment with Tax-Preferred Bonds*.

7. However, issuing tax-preferred bonds to realize arbitrage gains (by investing bond proceeds to earn a higher, taxable rate of return) is prohibited.

8. See Federal Reserve, Flow of Funds (statistical release, March 8, 2012), www.federalreserve.gov/releases/z1/.

9. See Bureau of the Census, State and Local Government Finances by Level of Government and by State: 2008-09, www.census.gov/govs/estimate/.

10. That total omits $3.7 billion of other tax-credit bonds that were used primarily to finance school construction.

Table 1.

Governmental and Build America Bonds Issued, 2009

(Billions of dollars)

	Total		Bonds for New Capital Spending			
			Total		Amount, by Type	
Purpose of Bond	Amount	Percent	Amount	Percent	Governmental	Build America
Education	91.9	28	65.5	30	45.9	19.6
Transportation	50.1	15	38.4	18	20.1	18.3
Utilities	44.9	14	25.2	12	18.2	7.0
Environment	20.8	6	15.1	7	10.9	4.1
Public Safety	7.4	2	6.2	3	4.3	1.9
Health and Hospital	7.8	2	5.1	2	2.6	2.5
Housing	1.0	0	0.6	0	0.3	0.3
RANs and Other Bonds	2.0	1	1.7	1	1.6	0.1
Unspecified Purposes	101.9	31	58.7	27	47.1	11.6
Total	**327.8**	**100**	**216.4**	**100**	**151.1**	**65.3**

Source: Congressional Budget Office based on data from the Internal Revenue Service.

Notes: Governmental bonds have a maturity of at least 13 months.

Build America Bonds were authorized by the American Recovery and Reinvestment Act for issuance in 2009 and 2010. The Build America Bonds reported in this table were direct-pay tax-credit bonds.

The table omits $3.7 billion of other tax credit bonds that were used primarily to finance school construction.

Numbers may not add up totals because of rounding.

RAN = revenue anticipation note.

those various purposes are very similar to the average amounts since 1991.[11]

Build America Bonds accounted for 30 percent ($65.3 billion) of the total amount of such bonds issued in 2009. All of those Build America Bonds took the form of direct-pay tax-credit bonds. The amount almost doubled in 2010 (to about $115 billion). Their popularity stemmed from several factors. Because the interest rate subsidy of 35 percent that the federal government provided was considerably larger than the reduction in financing costs that state and local governments could obtain by issuing traditional tax-preferred bonds, those governments were eager to issue Build America Bonds. In addition, because the interest payment is fully taxable, pension funds and other investors with low or no income tax liability had an incentive to purchase them.

Impact of Tax-Preferred Bonds on State and Local Budgets

Federal tax exemptions for interest income from governmental bonds enable issuers of such debt to sell bonds that pay lower rates of interest than do taxable bonds with the same maturity, risk, and other characteristics. The lower the rate of interest that state and local governments must pay on their debt, the more funds they have available to provide government operations and the greater the amount of debt they can service and, therefore, the greater the amount of investment they can make.[12]

11. Note that over 30 percent of the proceeds from governmental bonds issued in 2009 were reported by their issuers as being for "other purposes," which means either that the specific purpose(s) listed on the reporting form did not apply or that the issuer did not allocate the bonds' proceeds among separate purposes. That share is also very close to its average from 1991 to 2009.

12. The interest rate subsidy from Build America Bonds and other tax-credit bonds has a similar impact on state and local budgets. Debt-service payments are made from current revenues and in many states are subject to requirements for a balanced budget, which constrain the funds available for government operations. In contrast, expenditures for capital investments—often from the proceeds from issuing tax-exempt bonds—are reported in a capital budget and are not subject to those requirements. For a detailed discussion of capital budgeting, see Congressional Budget Office, *Capital Budgeting* (May 2008).

The interest rate those governments pay is the rate that matches the supply of tax-exempt bonds with the demand for them, which is determined by the last buyer needed to equalize supply with demand and "clear" the market. That interest rate is therefore the yield that all issuers of comparable tax-exempt debt must pay. Because purchasers of tax-exempt bonds demand a return that is at least as high as the after-tax yield they could obtain from comparable taxable bonds, the amount by which the federal tax preference lowers the rate of interest on tax-exempt bonds—and thus the amount of savings in financing costs enjoyed by state and local governments—largely depends on the income tax rate of the market-clearing buyer of tax-exempt bonds.

Data on tax-exempt and taxable bond transactions allow a rough estimate of the marginal tax rate for the market-clearing buyer of tax-exempt bonds and, hence, the amount that states and localities save in financing costs by issuing such bonds. In 2009, the average yield on (taxable) high-grade corporate bonds was 5.3 percent, and the average yield on tax-exempt municipal bonds of similar creditworthiness was 4.6 percent—a difference of 0.7 percentage points, or approximately 13 percent of the taxable return. That 13 percent also represents the marginal tax rate at which an investor would be indifferent between purchasing a taxable bond yielding 5.3 percent and a tax-exempt bond yielding 4.6 percent.[13]

The implicit tax rate for market-clearing buyers of tax-exempt bonds from 2008 to 2010 ranged from 13 percent to 16 percent, considerably lower than the average of 21 percent during the prior two decades.[14] Investors' appetite for risk, the desired time horizon of their investments, and other features of the bonds can also influence the demand for taxable and tax-exempt debt. Turbulence in financial markets during the 2008–2010 period led investors to favor less risky debt—such as U.S. Treasury securities—over tax-exempt debt, thereby raising the (relative) yield on state and local bonds. For example, the yields on U.S. Treasury securities with 10- and 30-year maturities in 2009 were 3.3 percent and 4.1 percent, respectively, which are considerably lower than the contemporaneous yield of 4.6 percent on tax-exempt bonds—in spite of the fact that U.S. Treasury securities are subject to federal income tax.[15]

It is possible to use the implied savings in interest rate costs from a comparison of tax-exempt and taxable bond yields to roughly determine the impact of the tax exemption of governmental bonds on state and local budgets. For example, in 2007—the year immediately preceding the turmoil in financial markets and the exceptionally low implied reduction in financing costs through issuing tax-exempt bonds—state and local governments issued $200 billion in governmental bonds for new capital spending. The comparison of the yields on high-grade corporate bonds and tax-exempt bonds of comparable creditworthiness (5.6 percent and 4.4 percent, respectively) suggests that the tax exclusion for bond interest income shaved 1.2 percentage points off of the interest rate those governments would have paid if they had issued taxable debt. Thus, the tax exclusion provided states and localities a first-year interest subsidy of over $2 billion on the debt they issued in 2007 to fund their activities.[16]

13. The precision of the estimated tax rate depends heavily on the comparability of the tax-exempt and taxable bonds. In particular, depending upon how the "comparable" taxable bond is selected, different levels of cost savings can result. For example, if the tax-exempt bond is compared with a U.S. Treasury security, the estimated marginal income tax rate for the market-clearing bond buyer will be smaller than if it is compared with a corporate bond (as in the example in the text).

    Additionally, because the data on both tax-exempt and taxable interest rates used in this analysis are averages for bonds in each category that may still vary somewhat in terms of their risk, their time to maturity, the nature of their interest payments (fixed versus variable), and other features, the marginal tax rate implied for the market-clearing buyer of tax-exempt bonds may not be equal to the rate specified by the tax code. In 2009, for example, the marginal personal income tax rate for such buyers was either 10 percent or 15 percent.

14. See Joint Committee on Taxation, *Present Law and Issues Related to Infrastructure Finance*, JCX-83-08 (October 24, 2008), p. 28, www.house.gov/jct/x-83-08.pdf). The implied tax rates during that time ranged from 17 percent to 27 percent.

15. The bond yields cited in this testimony come from Council of Economic Advisers, *Economic Report of the President* (February 2012), Appendix B, Table B-73, p. 404, www.whitehouse.gov/administration/eop/cea/economic-report-of-the-President.

16. A similar calculation for 2009 suggests that the reduction in first-year financing costs for state and local governments amounted to roughly $1 billion. However, the tax exclusion for interest income from governmental bonds was not the only type of federal financing subsidy provided to those governments in that year. As described in more detail elsewhere in the testimony, issuers of Build America Bonds also received direct payments from the federal government that defrayed a substantial portion of the interest payable on that debt.

Increasing the Efficiency of Federal Tax Preferences for State and Local Borrowing

From the federal government's perspective, tax-exempt bonds are an inefficient means of providing a subsidy for debt financing. The amount of the tax preference provided is larger than the financing subsidy conveyed to state and local governments. As the issuers of tax-exempt debt expand the pool of bond purchasers until it is sufficiently large to exhaust the amount of debt they are offering, they draw in buyers from ever lower income tax brackets by raising the interest rate enough so that the yield on tax-exempt bonds is competitive with the after-tax rate of return on taxable investments available to those buyers. As a result, the market-clearing buyer of tax-exempt bonds will typically demand a tax-exempt yield that exceeds what an individual in a higher income tax bracket requires to purchase those bonds. Because there are multiple tax brackets and the market-clearing purchaser of municipal bonds will probably be in a lower bracket than many other bondholders, the loss of federal receipts is greater than the reduction in interest costs for the issuers of the tax-exempt bonds.

Several analysts suggest that about 80 percent of the tax expenditures from tax-exempt bonds translates into lower borrowing costs for states and localities, with the remaining 20 percent taking the form of a federal transfer to bondholders in higher tax brackets.[17] Consequently, a direct appropriation of funds to state and local governments would subsidize more spending per dollar of impact on the federal budget.

Tax expenditures for tax-exempt bonds are estimated as the product of forgone taxable income and the marginal income tax rate of the average holder of tax-exempt bonds—where forgone taxable income is estimated on the basis of the outstanding stock of tax-exempt debt and an estimate of the return that would be realized if those bond holdings were instead in the form of taxable investments (usually assumed to be taxable bonds of comparable risk and maturity). For 2011, according to estimates by the staff of the Joint Committee on Taxation, those tax expenditures by the federal government totaled $30.4 billion.[18] If 20 percent of the federal revenue loss from tax-exempt bonds accrued to bondholders in higher tax brackets without lowering borrowing costs, then the transfer to them was approximately $6 billion.

Using tax-exempt bonds to finance government activities is regressive, because the amount by which the benefits captured by investors in governmental bonds exceeds the issuers' cost savings increases with taxpayers' marginal tax rates. One study estimates that eliminating the tax exemption on state and local debt (including qualified private activity bonds) would reduce after-tax income primarily for taxpayers in the highest income quintile—and particularly for individuals in the top 1 percent of the income distribution.[19] Another study estimates that 53 percent of the outstanding stock of tax-exempt bonds in 2003 was held by households with marginal tax rates in excess of 30 percent, with the holdings of the remaining tax-exempt bonds distributed throughout most of the lower income tax brackets.[20]

Tax-Credit Bonds. Starting in the late 1990s, lawmakers turned to tax-credit bonds as a way to address the inefficiency of tax-exempt financing. Early forms of tax-credit bonds allowed bondholders to receive a credit against their federal income tax liability instead of the cash interest typically paid on the bonds. The amount of the tax credit equals the credit rate, which is set by the Secretary

17. See Dennis Zimmerman, *The Private Use of Tax-Exempt Bonds: Controlling Public Subsidy of Private Activity* (Washington, D.C.: Urban Institute Press, 1991), pp. 103–104; and James Poterba and Arturo Ramirez Verdugo, "Portfolio Substitution and the Revenue Cost of the Federal Income Tax Exemption for State and Local Government Bonds, *National Tax Journal*, vol. 64, no. 2 (June 2011), pp. 591–613. The latter authors estimate that in 2003, the marginal income tax rate for the average investor in tax-exempt bonds was 26.8 percent, and the tax rate for the market-clearing buyer of municipal bonds was between 13 percent and 22 percent. Their analysis is restricted to households and does not include corporations, which account for between one-quarter and one-third of the total tax expenditures from tax-exempt bonds estimated for the 2008–2012 period.

18. Joint Committee on Taxation, *Estimates of Federal Tax Expenditures, 2011–2015.*

19. The decrease in after-tax income that results from eliminating the tax exemption is estimated to be at or near zero for all but the top income quintile; after-tax income falls by 0.24 percent for that quintile and 0.50 percent for the top 1 percent. See Leonard Burman, Eric Toder, and Christopher Geissler, "How Big Are Total Individual Income Tax Expenditures, and Who Benefits from Them?" Discussion Paper No. 31 (Washington, D.C.: Urban Institute, December 2008), p. 11, www.urban.org/publications/1001234.html.

20. See James Poterba and Arturo Ramirez Verdugo, "Portfolio Substitution and the Revenue Cost of the Federal Income Tax Exemption for State and Local Government Bonds."

of the Treasury, multiplied by the face amount of the holder's bond. Because bondholders pay taxes on the amount of credit they claim, tax-credit bonds do not, in contrast to tax-exempt debt, provide a revenue transfer to investors in high marginal tax brackets. As a result, the tax preferences for tax-credit bonds reduce state and local borrowing costs dollar for dollar. Tax-credit bonds also allow the amount of federal subsidy to vary on the basis of the desirability, from the federal government's perspective, of the different types of projects being financed. Thus, tax-credit bonds offer the promise of increasing the efficiency with which federal resources are allocated to support infrastructure and other investments, as well as altering the distribution of those resources.

The early tax-credit bond programs were not particularly well received by financial markets for a number of reasons, including the limited size and temporary nature of the programs and the absence of rules for separating tax credits from the associated bonds and reselling them (which could have made such bonds advantageous to investors whose income tax liability did not allow them to immediately claim the full value of the credit).

Build America Bonds. The American Recovery and Reinvestment Act authorized Build America Bonds, a new type of tax-credit bond that was sold only in 2009 and 2010. State and local governments were authorized to issue Build America Bonds either as traditional tax-credit bonds or, if certain conditions were met, as direct-pay tax-credit bonds (known as qualified Build America Bonds). In contrast to earlier tax-credit bonds, Build America Bonds had an interest rate (or coupon) that was set by the issuers rather than by the Secretary of the Treasury. In the direct-pay scenario, a credit equal to 35 percent of each interest payment could be claimed by an issuer in lieu of a tax credit going to the bondholder. Because state and local governments issuing direct-pay Build America Bonds are not liable for taxes on that credit, they pay less interest than they would for Build America Bonds that provide the credits to bondholders. As a result, the direct-pay version of the bonds proved to be the one that issuers used, and the amount issued was substantial. Sales of those bonds totaled roughly $181 billion during the 2009–2010 period.

Direct-pay tax-credit bonds offer several advantages over other types of tax-preferred bonds. Making a payment directly to state and local governments to compensate them for the interest they pay on direct-pay tax-credit bonds is a more cost-effective way to provide a federal subsidy than offering a tax exemption on interest income. CBO has estimated that replacing the current tax exclusion on interest income from governmental bonds (and qualified private activity bonds) with direct-pay bonds at a 15 percent subsidy rate—roughly equal to the implicit subsidy rate discussed above for governmental bonds issued in 2009—would reduce budget deficits by $30.5 billion from 2012 to 2016 and by $142.7 billion from 2012 to 2021.[21]

Making subsidy payments to the issuers of bonds could improve federal budgeting practice. By paying state and local bond issuers a direct subsidy, the federal government would know the exact amount of financing subsidy it was providing in a given year. That information would allow for several types of evaluations. For example, policymakers could readily compare the cost of that subsidy with the cost of other types of assistance to state and local governments for similar purposes. In addition, policymakers could examine the distribution of the federal financing subsidy among states. The federal tax exemption redistributes funds to constituents in the states and localities that make especially heavy use of it, but the amounts by which individual states and localities benefit are not evident in the federal budget.

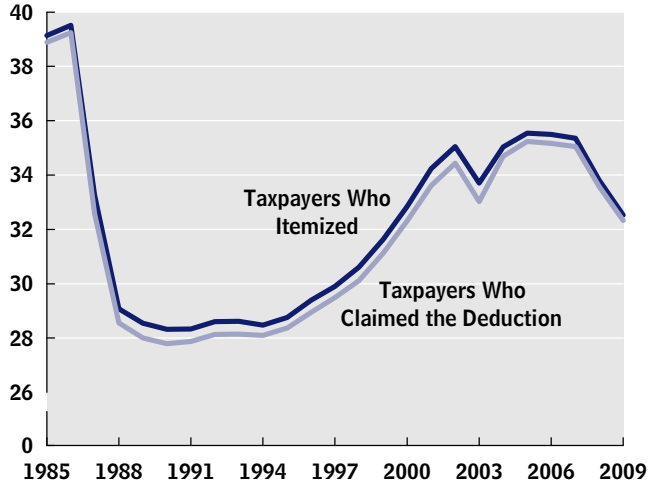
Making payments directly to bond issuers could also increase the federal government's control over the amount of its financial assistance. Under current practice, the federal government's control over the amount of the subsidy provided through the tax exemption is limited. The amount is not decided through the annual appropriation process—as is, for example, spending on infrastructure and other discretionary programs. Indeed, because the savings in interest costs enjoyed by state and local borrowers by issuing tax-exempt rather than taxable bonds depends largely upon the marginal income tax rate of the market-clearing bond buyer, the amount of subsidy delivered by that tax preference is mainly determined indirectly by the federal tax code (along with other factors that influence the demand for tax-exempt bonds).

21. See Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (March 2011), p. 163–164.

Figure 1.

Percentage of Taxpayers Who Itemized and Who Claimed the Taxes-Paid Deduction, 1985 to 2009

(Percent)



Source: Congressional Budget Office based on data from the Internal Revenue Service.

Note: The taxes-paid deduction allows taxpayers to deduct from their adjusted gross income some of the taxes they pay to state and local governments, including income, real estate, personal property, and other taxes. From 2004 to 2009, taxpayers had the option to deduct general sales taxes in lieu of income taxes.

Deductibility of State and Local Taxes

Taxpayers who itemize deductions on their federal income tax returns may, with some limitations, deduct payments for certain state and local taxes from their reported income. In particular, under the rules for determining tax liability for 2011, taxpayers who itemized their deductions could deduct from their adjusted gross income (AGI) state and local real estate taxes, personal property taxes, and either income taxes or general sales taxes. About one-third of tax filers opted to itemize deductions on their federal income tax returns in 2009 (the most recent year for which complete data are available), and nearly all of them claimed a deduction for state and local taxes paid (see Figure 1). State and local income taxes and real estate taxes made up the majority of the state and local tax deductions claimed, constituting 55 percent and 39 percent of the total, respectively. Deductions for sales taxes were about 4 percent of the total, and personal property taxes were just over 1 percent (see Figure 2).

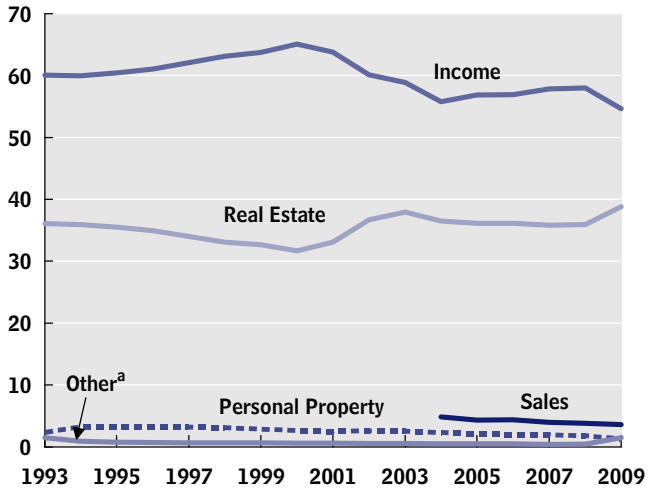
Over the next few years, scheduled changes to tax provisions and the interaction of the regular income tax and the alternative minimum tax will change the number of taxpayers who claim the deduction and the associated loss of federal revenues. (The AMT is a parallel income tax system with fewer exemptions, deductions, and tax rates than the regular income tax. Taxpayers potentially subject to the AMT must calculate their taxes under both the regular income tax and the AMT and pay the higher amount.)

Under current law, the amount of the loss of federal revenues is projected to diminish in 2012 because more taxpayers will pay the AMT, which does not allow people to claim the taxes-paid deduction. The number of taxpayers subject to the AMT will rise under current law because

Figure 2.

Types of Taxes Claimed Under the Taxes-Paid Deduction, 1993 to 2009

(Percentage of all taxes deducted)



Source: Congressional Budget Office based on data from the Internal Revenue Service.

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a. "Other" in 2009 includes the sales tax deduction for purchases of new vehicles.

temporarily higher AMT exemption amounts expired at the end of 2011. Without changes in the tax code—such as additional increases in the AMT exemption level like those enacted in recent years—more and more taxpayers will pay the AMT over time as their income grows.

The scheduled expiration after 2012 of tax provisions originally enacted in 2001 and 2003 will raise regular income tax rates for many taxpayers, boosting the value of the taxes-paid deduction for those who claim it and increasing the associated revenue loss for the federal government. With the higher tax rates for the regular income tax, many taxpayers will move from being subject to the AMT back to being subject only to the regular income tax—under which they are permitted to claim the deduction for state and local taxes. Those shifts will further increase the number of taxpayers claiming the taxes-paid deduction and the associated revenue loss.

Impact on State and Local Taxes and Spending

The taxes-paid deduction, which has been in place in some form since the inception of the modern federal income tax, benefits the taxpayers who claim it and provides an indirect federal subsidy to the state and local governments that levy deductible taxes—because it decreases the net cost to taxpayers of paying those taxes. By lowering the net cost of certain state and local taxes, the taxes-paid deduction encourages state and local governments to impose higher taxes and to provide more services than they otherwise would.

Two competing factors are the basis of the principal arguments in favor of and opposed to the deduction: on the one hand, the federal government's interest in assisting state and local governments in providing public services that have benefits beyond their borders and, on the other hand, the possibility that such assistance may generate an inefficiently large volume of services that are strictly local in nature.

If deductible taxes are simply charges that cover the value of services desired by taxpayers who have chosen to live in a particular state or local community, the rationale for subsidizing those services at the federal level is weak (unless localities face significant differences in the cost of providing services). For example, to better suit their preferences for street lights, parks, and even public safety, citizens may sort themselves into different communities that provide different amounts of those services. It is not evident why the federal government should subsidize those citizens who prefer to consume more of such services. In fact, the original legislation enacting the federal income tax explicitly labeled as nondeductible local taxes paid in return for local benefits.

Some deductible taxes, though, are clearly not charges for services that provide only local benefits but instead finance services, such as public assistance and education, that provide benefits that "spill over" to people in other states and localities. Such spillovers provide a rationale for federal support. Another rationale for federal support is that state income taxes are generally considered to have a redistributive function, although the extent to which they redistribute income varies widely and is small relative to the redistributive capacity of the federal income tax.

Three other points merit consideration. First, the taxes-paid deduction may simply encourage state and local governments to use deductible taxes in place of nondeductible taxes (levies such as selective—rather than general—sales taxes) without increasing spending for the desired activities. If so, the subsidy does not effectively encourage those governments to provide services that generate national benefits. A number of studies show that deductibility affects the mix of taxes that states and localities choose for financing their activities, but there is relatively little evidence that deductibility increases spending for services.[22]

Second, a common argument for allowing taxpayers to deduct state and local taxes is that such a deduction prevents double taxation of income. The contention is

22. Martin S. Feldstein and Gilbert E. Metcalf ("The Effect of Federal Tax Deductibility on State and Local Taxes and Spending," *Journal of Political Economy*, vol. 95, no. 4 [1987], pp. 710–736) find that among a cross-section of states, deductibility raises the share of revenues that subsidized taxes make up but has no consistent effect on spending. Douglas Holtz-Eakin and Harvey S. Rosen ("Tax Deductibility and Municipal Budget Structure," in Rosen, ed., *The Fiscal Behavior of State and Local Governments: Selected Papers of Harvey S. Rosen* [Lyme, N.H., Elgar, 1997], pp. 43–72) document a similar effect, smaller but more precisely measured. Gilbert E. Metcalf ("Tax Exporting, Federal Deductibility, and State Tax Structure," *Journal of Policy Analysis and Management*, vol. 12, no. 1 [1993], pp. 109–126), using data on the states from 1980 to 1988, finds that the income tax share of taxes is sensitive to the subsidy from deductibility but the sales tax share is not. Holtz-Eakin and Rosen ("Federal Deductibility and Local Property Tax Rates," *Journal of Urban Economics*, vol. 27, no. 3 [1990], pp. 269–284), using a sample of municipal governments from 1976 to 1980, find that deductibility increases local property tax rates.

that resources claimed as taxes by state and local governments are not truly available to taxpayers and thus should not be considered part of the basis for federal taxation. In fact, that argument involves some of the same issues just discussed. If state and local taxes are benefit charges and reflect the amount of state and local public services that taxpayers desire and receive from their governments, then such taxes are appropriate to include in the basis for a levy that rests on the concept of people's ability to pay. Alternatively, if state and local taxes finance services whose benefits spill over to other localities, then the federal subsidy may be justified regardless of the issue of double taxation.

Third, another argument for the taxes-paid deduction involves its effect on marginal tax rates (that is, the tax rate on the last dollar of income). By reducing the combined federal, state, and local marginal tax rate on income, the deduction lessens the deterrent to earning income that is inherent in high tax rates. But that reduction in the distortion to choices by individuals (choices between work and leisure) is achieved by an increase in the distortion to choices by state and local governments (choices between deductible and nondeductible taxes and choices about the kinds and amounts of services the governments provide). The overall effects and the extent to which choices are distorted by the various incentives depend on the behavior of individuals and governments.

Distribution of Benefits by State

How benefits from the taxes-paid deduction are distributed among states and localities depends on the structure of governments' tax systems and the characteristics of the taxpayers who provide revenues to those governments. For example, a state or local government that finances its spending by using a larger share of taxes that are deductible under the federal individual income tax receives a larger subsidy through the deductibility provision than does an otherwise identical government that finances its spending through a smaller share of deductible taxes. In addition, a state or local government whose taxpayers are more likely to itemize deductions also gains a greater benefit, all else being equal, than does a government whose taxpayers tend to claim the standard deduction.

How much of state and local governments' revenues drawn from their own sources are subsidized through the taxes-paid deduction? A starting point for estimating that subsidy is assessing the share of all revenues collected by state and local governments from taxes that the federal tax code labels as deductible. That measure exceeds the amount of the subsidy in two respects: Taxpayers do not claim all legally deductible taxes on their returns (because not all taxpayers itemize and because the deduction is limited for some taxpayers), and the subsidy does not equal the total amount deducted but is the resulting reduction in federal tax revenues.

In 2004, taxes made up about 50 percent of states' "own-source" revenues.[23] The potentially deductible portion of those taxes was about 17 percent of such revenues; shares ranged from a low near zero in Alaska to highs near 40 percent in Washington and Tennessee. Revenues from direct federal transfers—constituting just under 24 percent of revenues from all sources—made up a larger share of states' total revenues than did potentially deductible taxes.

State governments tend to raise most of their tax revenues from income and sales taxes, but local governments depend primarily on property taxes for revenues. In 2004, about 38 percent of localities' own-source revenues came from property taxes and another 2 percent came from income taxes, both of which are potentially deductible. Although the potentially deductible share of localities' own-source revenues therefore averaged 40 percent, shares varied widely across the country—ranging from about 15 percent for localities in Alabama and Arkansas to about 75 percent for those in New Hampshire and New Jersey.

Using the share of own-source revenues raised by potentially deductible taxes to assess the benefits that state and local governments receive from the deductibility provision does not account for differences in the percentage of residents' total income that different governments collect as own-source revenues. For example, a state government that collects in revenues a larger share of its residents' total income receives a larger federal subsidy than does a state government that has the same share of its revenues derived from potentially deductible taxes but that has a lower overall revenue burden. However, potentially deductible taxes as a share of state and local governments' own-source revenues and as a share of the total income of state residents are fairly well correlated. That correlation suggests that most of the variation among states in the subsidy attributable to the deductibility provision results

23. See Congressional Budget Office, *The Deductibility of State and Local Taxes*.

from differences in the mix of taxes that the governments choose rather than from differences in their overall tax burdens.

Considering the states on a regional basis reveals a few general patterns about the distribution of potentially deductible taxes. The share of own-source revenues represented by potentially deductible taxes and the share of taxpayers' total income represented by such taxes tends to be larger in the Northeastern states. States in the South and Southwest—with the exception of Florida and Texas in the years when the sales tax was a potentially deductible tax—tend to have smaller shares of potentially deductible taxes by either measure.

The amount of potentially deductible taxes that are ultimately deducted on individuals' tax returns depends on whether those taxpayers itemize their deductions or take the standard deduction. Taxpayers with higher income tend to have both more itemized deductions apart from that for state and local taxes and higher state and local taxes; they are therefore are more likely to have itemized deductions that exceed the standard deduction (which does not vary by income or state) and to choose to itemize. Thus, states with taxpayers whose average income is comparatively high will have a larger share of taxpayers who itemize deductions. The states in which taxpayers claim the largest shares of the deduction are states with large populations and, in particular, large populations of high-income itemizing taxpayers. The percentage of taxpayers who itemize is highest in New England, the Middle and South Atlantic regions, and the Mountain and Pacific regions (see Table 2). Taxpayers in the Middle Atlantic and Pacific regions claim the largest percentages of total deductions.

For taxpayers, one indicator of the benefit provided by the taxes-paid deduction is how much the deduction reduces their income subject to taxation—specifically, the percentage deduction from their AGI. CBO estimated such benefits by state for 2009 by dividing the total deductions taken by residents of a state by the total AGI in that state. CBO further divided those figures by the average of the share of the AGI deducted in all states; residents of states that have relative shares above 1 have a larger percentage deduction from AGI than the national average, and residents of states that have relative shares below 1 have a smaller percentage deduction than the national average. According to that measure, taxpayers in the Middle Atlantic region, southern New England, and the Far West benefit most from the deduction, a geographic distribution that corresponds more closely to the distribution of high-income taxpayers among the states than to the distribution of potentially deductible taxes among the states.

The interaction between taxpayers' incomes and state and local tax burdens also influences how the benefits from the taxes-paid deduction are distributed among the states. Although taxpayers in states that have a large percentage deduction from AGI tend to claim larger deductions at all income levels than do taxpayers in states that have a small percentage deduction, the difference in claimed deductions increases as income rises. That is, the difference between the claimed deductions of taxpayers in large-share states and small-share states is greatest for the highest-income taxpayers. That finding implies that the benefits from the deductibility provision depend on the progressivity of state and local taxes as well as their average level.

Distribution of Benefits by Income Groups

High-income households are more likely than low- or moderate-income households to benefit from the taxes-paid deduction. The probability that taxpayers will itemize, the amount of state and local taxes paid, and the reduction in federal income taxes for each dollar of state and local taxes deducted all increase with income.

Individuals who choose to itemize and deduct the state and local taxes they have paid decrease their federal tax liability by the amount of their deductible state and local taxes multiplied by their marginal tax rate under the individual income tax. Because the likelihood of itemizing and the marginal tax rate increase with income, taxpayers who benefit from the taxes-paid deduction in its current form are concentrated in the upper part of the income distribution.

Slightly less than one-third of all tax filers deducted state and local taxes in 2009, and the percentage claiming the deduction varied widely among income groups. Approximately 25 percent of tax filers with income less than $100,000 took the deduction, compared with about 87 percent of tax filers with income of $100,000 or more. The latter group, who made up roughly 12 percent of filers, accounted for 64 percent of the value of all state and local tax deductions claimed, with an average of about $18,300 in deductible taxes for each return on which the deduction was claimed.

The tax saving from each dollar of the taxes-paid deduction increases with income because of the progressivity of federal income tax rates. In general, under the individual income tax, the higher a taxpayer's income is, the higher will be his or her marginal tax rate and therefore the larger the reduction in federal tax liability gained from deducting an additional dollar of state or local tax. According to CBO's estimates, in 2009 approximately 73 percent of the tax benefit of the taxes-paid deduction accrued to taxpayers with income above $100,000. Among those with income above $100,000, taxpayers with income between $100,000 and $200,000 received just under 35 percent of the total benefit, and taxpayers with income of more than $1 million received slightly more than 20 percent of the benefit.

Policy Options

When policymakers discussed major tax reform in the 1980s, one of the many proposals they considered was the elimination of the deduction for state and local taxes paid. The Tax Reform Act of 1986, the outcome of those deliberations, repealed only the deduction for general sales taxes.

The Omnibus Budget Reconciliation Act of 1990 enacted a general limit on itemized deductions under which certain itemized deductions—including that for state and local taxes—were reduced by 3 percent of the amount by which a taxpayer's adjusted gross income exceeded an indexed threshold, with a maximum reduction of 80 percent of deductible expenses. However, that limit has since been rolled back. The Economic Growth and Tax Relief Reconciliation Act of 2001 gradually phased out the limit and completely eliminated it by 2010, and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the elimination of the general limit on itemized deductions through 2012. Without further changes in law, the general limit will again apply beginning in 2013.

In addition, the American Jobs Creation Act, enacted in 2004, reinstated the sales tax deduction that the Tax Reform Act of 1986 had eliminated. The 2004 law allowed taxpayers to deduct either income taxes or sales taxes—but not both—in 2004 and 2005. (Before the change enacted in 1986, taxpayers could deduct both income taxes and general sales taxes.) Subsequent legislation extended that provision to 2006 and 2007, and then through 2009, and then again through 2011.

In its 2011 report on options for reducing the deficit, CBO considered two options for changing the taxes-paid deduction: eliminating the deduction and limiting the deduction to 2 percent of adjusted gross income.[24]

The options would have the following estimated effects relative to the outcomes under current law:

- Eliminating the deduction would increase federal revenues by an estimated $862 billion from 2012 through 2021, and limiting the deduction to 2 percent of AGI would increase revenues by an estimated $629 billion over the same period.[25] Both options would have the greatest impact on higher-income taxpayers, particularly in 2013. In 2012, eliminating the taxes-paid deduction would increase taxes for 48 percent of tax filers with income of $100,000 or more (approximately 12 percent of all tax filers in 2012), but in 2013 it would have that effect for 76 percent of those tax filers (under an assumption that the tax rate reductions originally enacted in 2001 and 2003 expire as scheduled). By comparison, limiting the deduction to 2 percent of AGI would raise taxes for 44 percent of taxpayers with income between $50,000 and $100,000 in 2012 and for 49 percent of such taxpayers in 2013.

- Eliminating the taxes-paid deduction would produce the largest decrease in average income measured after individual income taxes (after-tax income) for taxpayers with income of $500,000 or more. For example, under that option, average after-tax income in 2012 would fall by 1.3 percent for taxpayers whose income was between $500,000 and $1 million and by 1.7 percent for taxpayers whose income was $1 million or more. After-tax income for those groups would fall even more in 2013, after the tax rate reductions originally enacted in 2001 and 2003 expired, by 2.9 percent and 2.7 percent, respectively.

24. See Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options*, pp. 148–149. The CBO report *The Deductibility of State and Local Taxes* considers additional options, including replacing the deduction with a 15 percent credit. The 2005 President's Advisory Panel on Federal Tax Reform recommended the complete elimination of the deduction.

25. Estimates of the options' effects on federal revenues were provided by the staff of the Joint Committee on Taxation.

Table 2.

Selected Measures of State and Local Tax Deductibility, 2009

	Percentage of Taxpayers Who Itemized	Percentage of Total Deductions Claimed	Average Taxes-Paid Deduction per Return Claiming the Deduction (Dollars)	Percentage of AGI Deducted	Ratio of Deduction Share to AGI Share
By State					
Alabama	29.4	1.0	5,117	3.2	0.84
Alaska	25.8	0.2	4,332	1.9	0.60
Arizona	35.6	1.9	6,282	4.4	1.10
Arkansas	24.6	0.5	7,240	3.9	0.78
California	37.2	16.6	12,486	7.6	1.30
Colorado	39.2	1.8	6,840	4.5	1.05
Connecticut	44.0	2.0	14,863	8.2	1.12
Delaware	36.3	0.3	7,170	4.6	0.96
District of Columbia	40.8	0.3	12,683	6.9	1.09
Florida	28.9	5.2	5,934	3.3	0.89
Georgia	37.1	3.0	7,333	5.6	1.12
Hawaii	32.5	0.5	7,116	4.5	1.12
Idaho	33.2	0.4	6,772	4.9	1.05
Illinois	34.4	4.1	9,269	5.4	0.92
Indiana	27.0	1.3	6,810	3.9	0.74
Iowa	30.6	0.7	7,779	4.7	0.80
Kansas	30.2	0.7	8,840	5.1	0.85
Kentucky	28.8	0.9	7,914	5.0	0.84
Louisiana	24.2	0.9	6,347	3.1	0.75
Maine	30.6	0.3	9,307	6.1	0.90
Maryland	49.1	3.3	11,097	8.1	1.39
Massachusetts	40.1	2.9	11,720	6.8	1.03
Michigan	32.2	2.5	7,876	5.3	0.91
Minnesota	39.6	2.0	9,286	6.4	1.05
Mississippi	24.0	0.5	5,569	3.2	0.80
Missouri	30.3	1.5	7,727	4.7	0.87
Montana	30.2	0.3	6,934	4.6	0.93
Nebraska	29.8	0.5	8,810	5.2	0.84
Nevada	33.4	0.9	5,071	3.1	1.06
New Hampshire	35.8	0.5	8,283	4.9	1.00
New Jersey	43.9	4.6	14,655	9.1	1.19
New Mexico	25.8	0.4	5,704	3.3	0.79
New York	36.6	8.8	16,897	9.3	1.14
North Carolina	34.8	2.7	8,124	5.8	1.05

Continued

- Eliminating the deduction would have a small effect on taxpayers with income between $50,000 and $100,000; their after-tax income would drop by about 0.7 percent in 2012 and 2013. The reduction in after-tax income for income groups below $50,000 would be 0.3 percent or less.
- Under both of the options, the change in after-tax income for taxpayers who pay the AMT would be quite different in 2012 from the change in 2013. For example, eliminating the taxes-paid deduction would decrease the average after-tax income of taxpayers whose income was between $200,000 and $500,000 by only 0.3 percent in 2012. Most taxpayers in that

Table 2. **Continued**

Selected Measures of State and Local Tax Deductibility, 2009

	Percentage of Taxpayers Who Itemized	Percentage of Total Deductions Claimed	Average Taxes-Paid Deduction per Return Claiming the Deduction (Dollars)	Percentage of AGI Deducted	Ratio of Deduction Share to AGI Share
By State (Continued)					
North Dakota	19.7	0.1	6,710	2.5	0.52
Ohio	30.8	2.8	8,565	5.5	0.85
Oklahoma	27.0	0.8	6,547	3.6	0.80
Oregon	39.8	1.4	9,095	7.2	1.28
Pennsylvania	30.5	3.5	9,237	5.2	0.84
Rhode Island	36.7	0.4	10,446	7.1	1.03
South Carolina	30.8	1.2	6,977	4.8	1.00
South Dakota	19.5	0.1	4,787	1.9	0.57
Tennessee	24.2	1.2	4,546	2.3	0.74
Texas	25.1	5.3	6,704	3.0	0.70
Utah	39.5	0.9	6,513	4.9	1.19
Vermont	29.7	0.2	9,667	5.9	0.98
Virginia	40.9	3.3	9,229	5.9	1.10
Washington	35.7	2.2	6,092	3.6	0.94
West Virginia	18.4	0.3	7,772	3.2	0.57
Wisconsin	35.7	1.8	9,918	6.9	0.99
Wyoming	24.7	0.1	4,729	1.9	0.65
All States	**35.2**	**100.0**	**6,767**	**5.4**	**1.00**
By Census Division					
New England	39.1	6.2	11,968	7.0	1.04
Middle Atlantic	36.3	16.9	14,293	8.2	1.07
South Atlantic	38.7	19.5	7,972	5.2	1.05
East north central	32.2	12.6	8,617	5.4	0.89
East south central	26.6	3.7	5,709	3.3	0.80
West north central	32.0	5.6	8,395	5.1	0.88
West south central	25.1	7.6	6,684	3.1	0.72
Mountain	35.0	6.8	9,439	4.2	1.04
Pacific	35.9	21.2	11,064	6.7	1.20

Source: Congressional Budget Office based on data from the Internal Revenue Service.

Notes: The taxes-paid deduction allows taxpayers to deduct from their adjusted gross income some of the taxes they pay to state and local governments, including income, real estate, personal property, and other taxes. In 2009, taxpayers had the option to deduct general sales taxes in lieu of income taxes.

AGI = adjusted gross income.

income range will pay the AMT this year under current law and thus will not be able to claim the taxes-paid deduction. In 2013, when tax reductions enacted in 2001 and 2003 are currently scheduled to have expired, many taxpayers with income between $200,000 and $500,000 will shift from being subject to the AMT to being subject to only the regular income tax—under which they may claim the deduction. Eliminating the taxes-paid deduction would reduce the average after-tax income of taxpayers in that income range by 1.4 percent in 2013.

The effects of any changes to the taxes-paid deduction would depend critically on any future changes to the

AMT. CBO analyzed each of the options under the assumption that current law would remain in place (that is, the AMT exemption amounts would revert to their pre-2001 levels in 2012 and would not be indexed for inflation). Because the deduction for state and local taxes is the largest item (for taxpayers considered altogether) that must be added back to income under the AMT, lawmakers' choices regarding the AMT would substantially affect the revenues derived from those options.

Under current law, the number of taxpayers who pay the AMT will grow each year because the exemption amounts and AMT tax brackets are not indexed for inflation. As the scope of the AMT expands, fewer people will benefit from the deduction for state and local taxes. However, policymakers have routinely increased the AMT exemption amount, and if that happened again in the future, fewer taxpayers would be subject to the AMT, and, consequently, more could claim the deduction for state and local taxes. In that case, the revenues gained from eliminating the deduction would be larger than those under current law.

In an analysis several years ago, CBO considered the combined effects under current law of permanently raising and indexing the AMT exemption levels and indexing the AMT while also eliminating the deduction for state and local taxes.[26] The results at that time indicated that the gain in revenues from eliminating the deduction would more than offset the loss in revenues from indexing the AMT. The gain from eliminating the deduction would be smaller, however, if the lower regular income tax rates originally enacted in 2001 and 2003 were permanently extended.

26. See Congressional Budget Office, *The Deductibility of State and Local Taxes* (February 2008). That report also considered the combined effects of indexing the AMT and additional options for limiting, rather than eliminating, the taxes-paid deduction.