UKnowledge

Kentucky Law Journal

Volume 51 | Issue 2 Article 5

1962

# Deductions and Credits for State Income Taxes

Walter W. Heller
*Council of Economic Advisors to the President*

# Deductions and Credits for[*] State Income Taxes

By Walter W Heller[†]

State income taxes stand in a class by themselves among the Federal income tax deductions that cannot quality as expenses of earning income. Deductibility of such taxes plays a unique and important role in Federal-State tax relationships in that (a) it prevents confiscatory combinations of Federal, State, and local income taxes and (b) it gives the States a helping hand in income taxation by reducing net burdens and interstate differentials. But deductibility does only part of the job that needs to be done to coordinate income taxes and strengthen hard-pressed State tax systems, and a disproportionate share of its benefits accrues to the higher incomes and wealthier States.

In this paper, I shall argue (a) that unlike deductions for other State and local taxes, there is a strong case for retaining income tax deductibility or some superior substitute in the Federal income tax structure; (b) that if deductibility is retained, it needs to be buttressed by a sliding-scale Federal credit; and (c) that the alternative of removing deductibility and substituting a Federal credit should be given serious consideration.

## A. The Role and Impact of State Income Tax Deductibility

Deductions for State and local taxes other than income taxes have little justification. The already regressive gross burden of general sales, property, and most selective excises becomes more regressive under the impact of Federal deductibility In the case of consumption taxes, the deduction means little (20 percent) or nothing (where the standard deduction is used) to those in the

---

* Chairman, Council of Economic Advisors to the President.

† Originally published in House Comm. on Ways and Means, 86th Cong., 1st Sess., Tax Revision Compendium: Compendium of Papers on Broadening the Tax Base, Vol. 1, at 419 (Comm. Print 1959).

low brackets, and up to 91 percent in the top bracket. In the case of property taxes, renters get no deduction, and homeowners benefit inversely to the size of their incomes. Apart from this perverse pattern of burden distribution, consumption tax deductions are difficult and expensive to verify, and the property tax deduction (together with deductions for mortgage interest) distorts resource allocations by drawing funds into home-ownership that would have yielded a higher return in rental housing or other forms of investment. In short, a determined attack on income tax erosion should wipe out these deductions. It is true that the net burden of State-local taxes would thereby be increased, especially for those in higher brackets. But if a Federal credit were adopted as suggested below, the increase in Federal revenues resulting from denial of these tax deductions would be plowed back into tax assistance for the States.

Federal deductibility of State income taxes can be differentiated and defended on several grounds. First, it protects taxpayers against confiscatory taxation. For example, New York's top rate of 10 percent, added to the Federal tax rate of 91 percent, equals, not 101 percent, but 92 percent after adjusting the Federal tax liability via deduction of the State tax. (In common with one-third of the income tax States, New York disallows the Federal tax as a deduction, while the other two-thirds allow it.) At present rates, either deductibility or a tax credit is essential to forestall confiscation. If tax reform were to reduce the top Federal rates to 70 or 60 percent, confiscation would become only a remote possibility Under these circumstances, the confiscation argument for deductibility would lose much of its force.

Second, deductibility strengthens State income tax systems in two important ways: (a) By giving the States access to income tax revenues at a net cost to taxpayers which, especially for taxpayers with high incomes, is significantly below the amount of tax they pay in to the State; (b) by reducing interstate differentials in net burdens of the income tax, which is most sensitive to the retarding fears of interstate migration of wealth and industry

Concrete illustrations of these effects are presented in tables 1 and 2. Table 1, which is based on tax distribution date derived

TABLE 1.—*Proportion of Minnesota individual income tax offset by present deductibility under Federal income tax and suggested 5-percent Federal credit, by income groups (as of 1956)*[1]

| Gross income group[2] | 1956 Minnesota income tax liability | Estimated State tax offset by deductibility under Federal tax[3] | | Estimated State tax that would be offset by a 5-percent Federal tax credit[4] | |
|---|---|---|---|---|---|
| | | Amount | Percent | Amount | Percent |
| 0 to $999 | $70,023 | $14,004 | 20.0 | $44,100 | 63.0 |
| $1,000 to $1,999 | 431,711 | 86,342 | 20.0 | 477,650 | 110.6 |
| $2,000 to $2,999 | 1,765,961 | 353,292 | 20.0 | 1,535,150 | 86.9 |
| $3,000 to $3,999 | 3,737,591 | 806,431 | 21.6 | 2,571,350 | 68.8 |
| $4,000 to $4,999 | 6,282,605 | 1,326,119 | 21.1 | 3,512,550 | 55.9 |
| $5,000 to $5,999 | 6,652,750 | 1,419,872 | 21.3 | 3,094,100 | 46.5 |
| $6,000 to $6,999 | 5,868,179 | 1,275,619 | 21.7 | 2,339,250 | 39.9 |
| $7,000 to $7,999 | 4,293,034 | 918,987 | 21.4 | 1,461,400 | 34.0 |
| $8,000 to $8,999 | 2,756,715 | 639,236 | 23.2 | 835,800 | 30.3 |
| $9,000 to $9,999 | 2,195,702 | 522,624 | 23.8 | 609,620 | 27.8 |
| $10,000 to $10,999 | 1,826,816 | 444,502 | 24.3 | 484,100 | 26.5 |
| $11,000 to $11,999 | 1,509,363 | 363,801 | 24.1 | 388,010 | 25.7 |
| $12,000 to $12,999 | 1,372,416 | 384,191 | 28.0 | 341,670 | 24.9 |
| $13,000 to $13,999 | 1,200,485 | 345,267 | 28.8 | 291,520 | 24.3 |
| $14,000 to $14,999 | 1,120,292 | 324,398 | 29.0 | 263,755 | 23.5 |
| $15,000 to $19,999 | 4,482,085 | 1,490,098 | 33.2 | 1,045,665 | 23.3 |
| $20,000 to $29,999 | 5,882,355 | 2,289,563 | 38.9 | 1,381,295 | 23.5 |
| $30,000 to $39,999 | 3,300,892 | 1,649,533 | 50.0 | 875,815 | 26.5 |
| $40,000 to $49,999 | 1,885,834 | 1,084,250 | 57.5 | 555,495 | 29.5 |
| $50,000 to $99,999 | 3,331,592 | 2,218,080 | 66.6 | 1,162,690 | 34.9 |
| $100,000 and over | 2,029,646 | 1,806,384 | 89.0 | [5] 1,205,790 | [5] 59.4 |
| Total | 61,996,047 | 19,762,593 | 31.9 | 24,476,775 | 39.5 |

1 This table compares (a) the estimated proportion of the Minnesota individual income tax that is, in effect, absorbed by the reduction in Federal income tax liabilities resulting from deduction of the State income tax from Federal taxable income with (b) the proportion that would be absorbed by allowing a credit of 5 percent of the Federal income tax liability for State income taxes paid. Source: data derived from Minnesota individual income tax returns for 1956 by Research and Planning Division, Minnesota Department of Taxation.

2 This is essentially the same income concept as "adjusted gross income" under the Federal income tax.

3 Computation: (a) The average Federal taxable incomes for the returns in each gross income group were estimated. (b) The gross Federal income tax for the returns was computed assuming no deductibility for the State income tax. (c) The top Federal rates applicable to the returns in each gross income group were applied to the State income taxes paid in each of these groups. The dollar values so determined represent the reduction in Federal income tax liability resulting from the deductibility of State income taxes paid. Computations were made separately for the single and the married taxpayers and the results combined to give the estimated total amount of offset. No adjustment was made for "wastage" of State income tax deductions by Federal taxpayers using the standard deduction.

4 Computed by applying a 5-percent credit to Federal tax deducted on Minnesota individual income tax returns. Total Federal tax deducted on State returns was $489,535,000, while the Internal Revenue Service, "Statistics of Income, 1956, Individual Income Tax Returns" (p. 60), reported $526,262,000 Federal income tax for Minnesota. The principal reasons for the difference in these two figures are (a) the Internal Revenue data are liabilities incurred while Minnesota data are deductions for taxes paid, and (b) some Federal tax liability is incurred by those not subject to Minnesota State income tax.

5 These figures overstate the amount of State tax offset under present law because, as illustrated in col. 9 of table 2, the 5-percent credit exceeds 100 percent of the Minnesota tax in the top brackets.

from Minnesota income tax returns, indicates that nearly one-third of the burden of Minnesota's income tax in 1956 was absorbed by reductions in Federal liability. Even if we allow for "wastage," by use of the standard deduction, of perhaps half of the State income taxes paid by those with incomes below $12,000 (and therefore subtract a little over $4 million from the nearly $20 million of tax offset), the absorption still approximates one-fourth of the State tax.

Table 2, column 5, shows the net cost of the State tax after taking account of Federal deductibility. Table 2 in the Appendix shows that nominal tax rates run from 2 to 10 percent in New York, and 1 to 10.5 percent (plus a 10-percent surtax) in Minnesota. Yet the peak net cost of the State tax after deductibility, in terms of effective rates, is below 3.5 percent in Minnesota and

TABLE 2.—*Net cost of State income taxes to taxpayers at selected income levels, and percent of State tax offset by Federal deductibility and 5 percent Federal tax credit (Minnesota and New York, married taxpayer with 2 dependents, income year 1959)*

| Net income before taxes [6] | Federal tax if no State tax levied | State tax [7] | Combined Federal and State tax [8] | Net cost of State tax to taxpayer | | State tax offset by deductibility under Federal income tax | | State tax that would be offset by a 5 percent Federal tax credit | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | Amount (col. 3 minus col. 1) | As a percent of net income before tax | Amount (col. 2 minus col. 4) | Percent of State tax | Amount (5 percent of col. 1) | Percent of State tax |
| | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) |
| Minnesota: [9] | | | | | | | | | |
| $2,000 | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| $4,000 | $320 | $50 | $360 | $40 | 1.00 | $10 | 20.0 | $16 | 32.0 |
| $6,000 | 720 | 148 | 838 | 118 | 1.97 | 30 | 20.3 | 36 | 24.3 |
| $10,000 | 1,592 | 392 | 1,898 | 306 | 3.06 | 86 | 21.9 | 79 | 20.2 |
| $30,000 | 8,348 | 1,826 | 9,389 | 1,041 | 3.47 | 785 | 43.0 | 417 | 22.8 |
| $100,000 | 51,912 | 5,224 | 53,375 | 1,463 | 1.46 | 3,761 | 72.0 | 2,596 | 49.7 |
| $500,000 | 402,456 | 11,735 | 403,512 | 1,056 | .21 | 10,679 | 91.0 | 20,123 | 171.5 |
| New York: [10] | | | | | | | | | |
| $2,000 | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| $4,000 | 320 | --- | 320 | --- | --- | --- | --- | 16 | --- |
| $6,000 | 720 | 34 | 747 | 27 | .45 | 7 | 20.6 | 36 | 105.9 |
| $10,000 | 1,592 | 200 | 1,748 | 156 | 1.56 | 44 | 22.0 | 79 | 39.5 |
| $30,000 | 8,348 | 1,965 | 9,468 | 1,120 | 3.73 | 845 | 43.0 | 417 | 21.2 |
| $100,000 | 51,912 | 8,965 | 54,422 | 2,510 | 2.51 | 6,455 | 72.0 | 2,596 | 34.5 |
| $500,000 | 402,456 | 40,005 | 406,866 | 4,410 | .88 | 44,595 | 91.0 | 20,123 | 41.1 |

[6] Net income after all deductions except for income taxes.

[7] Amount actually payable to the State.

[8] After taking account of deductibility of State income tax in computing taxable income for Federal tax.

[9] Federal income tax deductible in computing taxable income for State tax.

[10] Federal income tax not deductible.

3.8 percent in New York (both at the $30,000 income level) At $500,000, the net cost drops to 0.9 percent in New York under the impact of single deductibility and 0.2 percent in Minnesota under double deductibility

This overall cushioning effect of deductibility is its greatest strength. But its distribution is perhaps its greatest weakness. For the higher the income, the deeper the cushion. The higher a person s income or the wealthier the State, the greater the proportion of any given State income tax burden that is offset by savings in Federal tax liabilities. Deductibility relentlessly bends the upper-bracket end of the State income tax curve into regressive form. As between States, it runs counter to the goal we customarily seek of reducing interstate inequalities of income.

From tables 1 and 2 it can be seen that substituting a flat Federal credit for the existing deduction for State income taxes would markedly alter the distribution of benefits. Substantial relief would still be provided in the top brackets. Table 2, column 9, indicates that a Federal credit of 5 percent would offset about one-half of the burden of the Minnesota tax and one-third of the New York tax at the $100,000 level. At the same time, taxpayers in the lower brackets, who now get an offset ranging from zero (if they take the standard deduction) to 20 percent, would be relieved of all or a large part of the burden of the existing State tax (thus making room for additional State levies in these areas) This improved distribution of benefits is a secondary, but not unimportant, part of the case for a Federal tax credit which is examined below A strong inference is that if a credit is coupled with, instead of substituted for, deductibility, it should be put on a sliding scale, or negatively graduated, basis.

### B. THE CASE FOR A FEDERAL CREDIT

The case for a Federal credit for State income taxes paid does not rest on the removal of income tax deductibility Retention or removal will affect the form which the credit should take, but not the underlying case for it. That case rests on (1) the need for drawing on the superior taxing power of the Federal Government to undergird the strenuous State tax efforts required to meet the severe financial strains on State and local budgets today and in the years ahead; (2) the need to reduce interstate differentials in income taxation and thereby to allay the fears of interstate migration of industry and wealth which plague the States in their efforts to make full use of their tax potential; (3) the need for Federal fiscal support in a form that will reduce rather than increase income inequalities among the States.

1. *The fiscal strains on State-local budgets*

State-local spending and debt have multiplied fourfold in the postwar period, while Federal spending has risen 2½ times, and Federal debt, 10 percent. Projections for the next decade generally foresee rising surpluses for the Federal Government, rising deficits for State-local governments.[11] The relatively much greater strain on State-local budgets becomes more understandable primarily in terms of the pressures generated by rising prosperity and rapid population growth, complicated by inflation and longstanding deficiencies in public plant and equipment.

At the Federal level, we tend to think of economic growth as generating revenues faster than increased expenditure demands. But for State-local governments our growing affluence is proving to be a mixed blessing. Automatic revenue growth is substantial, but much more sluggish than in the progressive, income-tax oriented Federal tax system. Meanwhile, the collective wants associated with increasing economic well-being tend to fall largely within the traditional sphere of State-local functions and responsibility: improved schooling and higher education; better care for the mentally ill and the aged; expansion of recreational facilities; redevelopment of decaying urban areas and unsnarling of local transit and traffic problems; improved sanitation facilities, water sources, and pollution control. In the interplay of economic forces and political processes, economic growth seems to generate more expenditure demands than tax revenue for State and local governments.

At the same time vigorous population growth multiplies State-local fiscal problems. For the 20-year period from 1946 to 1965, U.S. population is increasing by 40 percent. School-age

[11] See, *e.g.*, the projections by Otto Eckstein in Committee for Economic Development, Trends in Public Expenditures in the Next Decade 6-10 (April 1959); and Netzer, *infra* note 24.

population (ages 5 to 17) is rising by 78 percent; the 65-and-over group is rising by 63 percent; but the 18-65 group is rising by only 21 percent. In other words, the most "expensive" age groups for State and local governments are growing three times as fast as the middle group from which the great bulk of State-local tax moneys is drawn. (In absolute terms, of course, the growth in the middle groups outpaces that in the other two groups.)

The population is not only growing fast, but moving fast. The flight to the suburbs generates irresistible demands for new roads, new schools, new sewer systems, new firehouses, new waterworks, new parks, and the like. Superimposed on the public works deficiencies of depression and war that have not yet been overcome, these new demands will increase State and local public construction outlays sharply for years to come. Projections by municipal bond consultants foresee a doubling of 1957's $11 billion by 1967

Inflation has worsened the relative position of State and local governments. Not only do their revenue systems respond much less actively to inflation than the Federal tax system, but price movements have been adverse to State-local purchases of goods and services. From 1947 to 1957 the Department of Commerce deflator for gross national product was 130; for Federal purchases, 135; for construction materials and labor, 143; and for State-local purchases, 154.

The Federal income tax credit would be an effective way of helping to redress the balance between Federal and State-local financial developments. For example, a 5-percent credit would make roughly $2 billion annually available to State-local government without cost to State income-tax payers. Not all of this would be a net addition to State revenues, but as will be shown below, an increase in the average size of the credit, or the use of a sliding scale concentrating the benefits of the credit in the lower income groups, would provide sizable additional revenues even to States whose average income tax liabilities exceed the average Federal credit. (A comparison of the figures for Minnesota in table 1, above, and table 3, below, illustrates the latter point.)

In short, as the Federal Government, barring a worsening of international tensions, develops leeway for tax reduction either through economic growth, or base-restoring income tax reform, it should give full consideration to the States as a claimant on the available funds. Apart from debt retirement, as necessary, to reduce inflationary pressures and facilitate inflation control, the pressing claims of the States for funds to finance their vital programs deserve at least equal priority with the claims of taxpayers for Federal tax reduction to facilitate private spending or the claims of Federal agencies for budget increases to expand Federal programs. (Evidence that the States are trying to do their share of the necessary financing job, rather than standing idly by, is contained in the appendix to this paper. Table 2 in the Appendix in particular, demonstrates the efforts in the income tax field.)

2. *The fear of interstate competition*

Another important cause of favorable action on a Federal tax credit is the impact that fears of driving out industry and wealth have in choking off the full use of State tax resources. Although every unbiased study of location factors ranks taxes well below such considerations as skill and productivity of the labor force, closeness to markets, availability of plentiful water and low-cost power, the fear of interstate competition continues to be a major, even a growing, influence in the politics of State taxation. And the State income tax movement bears the full brunt of taxpayer threats to seek haven in friendlier tax territory This process of playing off one State against another has the net effect of weakening the financial base of responsible self-government and striking hard at the tax which responds most readily to economic growth. As recessions and the potential revenue instability of State income taxes get smaller and as the economic growth trend gets stronger, the responsiveness of State individual income taxes to growth (for every 1 percent rise in the Nation's total output, State revenues from personal income taxes have been rising 1.7 percent, as against only 1 percent for the sales taxes) steadily increases the attractiveness of this revenue source as a means of matching the expanding responsibilities thrust on State-local government.

Congress should follow the precedent it established 35 years ago when it enacted a Federal estate tax credit to bring to an end the vicious competitive rate cutting which had threatened to run State death taxes into the ground. A Federal income tax credit averaging 5 or 10 percent would not remove the interstate competition threat entirely, but it would put a substantial noncompetitive floor under State income taxes and reduce the struggle for competitive advantage which has retarded the use of the outstanding growth tax in the State revenue system.

3. *Interstate equalization*

Either substitution of a Federal credit for deductibility, whether as a flat percentage of the Federal tax or on a sliding-scale basis, or supplementation of deductibility by a sliding-scale credit would serve to reduce somewhat the existing interstate inequalities of income. As already noted, the protective impact of deductibility is greater, the wealthier the State; the higher the brackets a State's taxpayers are in, on the average, the larger the percentage of the State income tax burden than can be "exported" to the Federal Government.

If deductibility is retained, and a flat Federal credit were added, the present imbalance would not be corrected. Thus, adding a flat 10-percent credit without removing deductibility would give taxpayers in the lowest bracket who use the standard deduction an offset worth only 2 percentage points (10 percent of the first-bracket rate of 20 percent), while those in the 90-percent bracket who are subject to a top State rate of 10 percent would get an offset worth 18 percentage points (10 percent of 90 percent plus 90 percent of 10 percent)

As tables 1 and 2 have already demonstrated, substitution of a flat credit would materially improve the distribution of benefits by income groups in the sense of sharing a larger portion of the benefits with the lower bracket taxpayers than they receive at present under deductibility Since use of the standard deduction is not taken into account in those tables, the increase in their relative position is considerably understated. A corresponding improvement in the interstate impact of the allowance for State income taxes would also take place with the substitution of the credit for the deduction. Proportionately, the residents of the poorer States would get a substantially larger part of any given benefit in the form of a tax credit than they now get in the form of a deduction from income. The net effect would be a shift in Federal support from the wealthier to the poorer States.

This shift could be magnified by the adoption of a sliding-scale credit of the type illustrated in table 3. Here, the credit would be 20 percent of first $200 of Federal income tax, 10 percent of the next $300, and 1 percent of the remainder. If Federal deductibility were retained, it would be imperative to put a Federal credit in this negatively graduated form in order to balance somewhat the bias of deductibility in favor of high incomes. Even if the deduction were eliminated, the desire to build a positive interstate equalizing effect into the credit for State income taxes might well lead to some form of the sliding scale.

Table 3 demonstrates the equalizing effect. The central column shows that State taxpayers in Mississippi and Montana would get almost twice as large an average credit against their Federal tax as those in Delaware, and about one-third more than those in New York, Michigan, and Illinois. Since the average credit allowed in each State depends on both the average size and the distribution of income, the suggested sliding-scale credit would not accomplish the perfect inverse correlation between size of credit and per capita income that might be desired. But its general effect would be the desired one: to provide more fiscal support to the poorer, and less fiscal support to the wealthier, States.

### C. CONCLUDING COMMENTS

Two main objections, apart from the loss of Federal revenue, are voiced against the Federal credit proposal: First, that relatively little support is provided for States whose income taxes already yield a higher percentage of Federal collections than the average proposed credit; second, that a large measure of Federal coercion is involved.

As to the Federal revenue loss, this would depend on the size of the credit and the action taken on other State and local tax deductions. Removal of all such deductions would make possible a Federal credit averaging 5 percent without any appreciable

TABLE 3.—*Allowable credit against Federal individual income tax for State income taxes under a sliding-scale credit plan: 20 percent against the first $200 of Federal tax, 10 percent against the next $300, and 1 percent against tax in excess of $500, selected States, 1956*[12]

[Dollar amounts in thousands]

| States | 1956 Federal individual income tax liability[13] | Total Federal tax credit allowable to residents of each State under sliding scale credit plan | | Actual State individual income tax collections, fiscal 1957 | |
|---|---|---|---|---|---|
| | | Amount[14] | As percent of Federal liability | Amount[15] | As percent of Federal liability[16] |
| Arkansas | $133,344 | $13,228 | 9.9 | $5,413 | 4.1 |
| California | 3,373,902 | 269,593 | 8.0 | 143,339 | 4.3 |
| Delaware | 161,748 | 8,600 | 5.3 | 14,471 | 8.9 |
| Florida | 644,329 | 51,198 | 7.9 | ---------- | ---------- |
| Georgia | 385,097 | 36,781 | 9.6 | 25,985 | 6.9 |
| Illinois | 2,611,643 | 203,751 | 7.8 | ---------- | ---------- |
| Kansas | 303,256 | 29,435 | 9.7 | 13,266 | 4.4 |
| Louisiana | 388,475 | 32,513 | 8.4 | (17) | 6.0 |
| Maryland | 646,807 | 57,981 | 9.0 | 51,355 | 7.9 |
| Michigan | 1,839,256 | 143,024 | 7.8 | ---------- | ---------- |
| Minnesota | 526,262 | 50,349 | 9.6 | 64,445 | 12.2 |
| Mississippi | 119,728 | 12,010 | 10.0 | 5,982 | 5.0 |
| Missouri | 746,046 | 65,349 | 8.8 | (17) | 3.0 |
| Montana | 97,412 | 9,790 | 10.1 | 7,550 | 7.7 |
| New York | 4,232,431 | 327,914 | 7.7 | 476,312 | 11.3 |
| Ohio | 2,149,144 | 181,794 | 8.5 | ---------- | ---------- |
| Pennsylvania | 2,373,040 | 207,911 | 8.8 | ---------- | ---------- |
| Rhode Island | 166,319 | 15,313 | 9.2 | ---------- | ---------- |
| Tennessee | 377,869 | 35,355 | 9.4 | 4,422 | 1.2 |
| Texas | 1,404,530 | 114,278 | 8.1 | ---------- | ---------- |
| Wisconsin | 686,386 | 63,210 | 9.2 | 110,256 | 16.1 |

[12] The amounts and percentages shown in cols. 2 and 3 are the credits that would have been available to the taxpayers in the listed States if these States had had individual income taxes in effect sufficient to absorb the full Federal credit. Col. 5 shows the actual State individual income tax collections in the fiscal year 1957 as a percentage of col. 1. The difference between cols. 3 and 5 does not necessarily measure the full benefit of the Federal credit; States with average liabilities already exceeding the Federal credit may have areas in their income tax scale where liabilities fall substantially below the level of credits allowable under the 20-10-1 percent sliding scale. (See table 1 for an illustration of this in terms of Minnesota, where the overall ratio of State collections is over 9.6 percent of the Federal but liabilities fall substantially below the 20-percent ratio in the lower brackets.)

[13] Liabilities for residents of the selected States, as shown in Internal Revenue Service, Statistics of Income, 1956, Individual Income Tax Returns, table 16, 59-62 (1957).

[14] Computed by allocating Federal tax payments to applicable brackets on basis of table 16, *op. cit. supra* note 13.

[15] U.S. Bureau of the Census, Compendium of State Government Finances in 1957, table 5, p. 11 (1958).

[16] These percentages overstate, on the average, the relative weight of State income taxes because the Federal liabilities shown in col. 1 are based on unaudited returns. Audit adjustments probably add relatively more to Federal liabilities in the high-income than the low-income States. Also, Federal liabilities are shown according to the States in which the returns are filed, while some of the income may be taxable in other States; this factor would tend to work in a compensating direction, i.e., overstating somewhat the Federal liabilities in high-income States and vice versa.

[17] Figures for corporate and individual income taxes not reported separately. Percentage shown is an approximation based on combined collections.

revenue loss.[18] A credit averaging 10 percent would cost, gross, $4 billion annually or, net of removal of State-local tax deductions, $2 billion.

Turning to the revenue support argument, one must acknowledge that the greatest revenue benefit would go to the 17 States that do not now have income taxes, and many of these are economically strong States. At the same time, both significant direct support and indirect support would go to the 33 States that already have individual income taxes.[19] Obviously, those whose income taxes fall short, in the aggregate, of the average level of the credit would benefit at least to the extent of the shortfall. But even those whose taxes exceed the level of the credit, on the average, would in most cases receive significant revenue support in selected areas of their income tax scale. Minnesota is a good case in point. Table 1 indicates that even with a 5-percent flat credit, the total State tax liabilities in some of the lower brackets would be nearly equaled, or even exceeded. A 10- or 20-percent credit in those brackets would clearly give Minnesota access to large additional revenues without additional burdens on its taxpayers, even though the overall ratio of Minnesota collections to Federal liabilities would exceed the allowable average credit. Beyond this, of course, the general lightening of State taxpayers' burdens via the tax credit would make it substantially easier to increase State income tax rates.

Finally, what of the coercion issue? The crediting device represents a paradoxical combination of freedom and coercion. Its most fundamental purpose is to protect the power of the purse underlying State sovereignty and local independence. Moreover, Federal credits, while certain to bring about greater uniformity not only in income tax burdens but also in the structure of income taxation at the State level, leave ample room for variations in State definitions of income, exemptions, and tax rates. At the same time, the credit would strongly induce if not force 17 States, with over one-third of the Nation's population, to adopt at least minimum, credit-absorbing personal income taxes.

---

18 See Pechman, *What Would a Comprehensive Income Tax Yield?* House Comm. on Ways and Means, 86th Cong., 1st Sess., Tax Revision Compendium: Compendium of apers on Broadening the Tax Base, Vol. 1, at 251 (Comm. Print 1959).

19 See Table 1 in the Appendix.

On balance, it seems fair to conclude that the Federal tax credit, particularly if substituted for the present deduction for State income taxes, offers the States a large gain in fiscal integrity and independence in exchange for a relatively small loss in freedom of tax action.

## APPENDIX

## THE PRESENT STATUS OF STATE INCOME TAXATION

### A. PRESENT USE OF THE STATE INCOME TAX

As shown in appendix table 1, 31 of the 50 States now have full-fledged individual income taxes, while 2 (New Hampshire and Tennessee) tax only income from interest and dividends. All of the States having individual income taxes, except New Hampshire, also have corporation income taxes. In addition, Connecticut, New Jersey, Rhode Island, and Pennsylvania, utilize corporation income taxes.

APPENDIX TABLE 1.—*States with income taxes as of July 1, 1959*[20]

| | Individual | Corporate | | Individual | Corporate |
|---|---|---|---|---|---|
| Alabama | X | X | Mississippi | X | X |
| Alaska | X | X | Missouri | X | X |
| Arizona | X | X | Montana | X | X |
| Arkansas | X | X | New Hampshire | ([21]) | ---------- |
| California | X | X | New Jersey | ---------- | X |
| Colorado | X | X | New Mexico | X | X |
| Connecticut | ---------- | X | New York | X | X |
| Delaware | X | X | North Carolina | X | X |
| District of Columbia | X | X | North Dakota | X | X |
| Georgia | X | X | Oklahoma | X | X |
| Hawaii | X | X | Oregon | X | X |
| Idaho | X | X | Pennsylvania | ---------- | X |
| Iowa | X | X | Rhode Island | ---------- | X |
| Kansas | X | X | South Carolina | X | X |
| Kentucky | X | X | Tennessee | ([21]) | X |
| Louisiana | X | X | Utah | X | X |
| Maryland | X | X | Vermont | X | X |
| Massachusetts | X | X | Virginia | X | X |
| Minnesota | X | X | Wisconsin | X | X |

[20] Source: Appendix Table 2 and Joint Economic Committee, The Federal Revenue System: Facts and Problems, 1959, 254-59 (1959). These sources provide information on rates and exemptions.

[21] New Hampshire and Tennessee have very limited income taxes, applying only to income from interest and dividends.

### B. RECENT ACTIVITY IN STATE INCOME TAXATION

Mounting budgetary pressures have generated brisk activity on the State income tax front in recent years. New Jersey entered the field in 1958 with a corporate income tax. Delaware rounded out its income tax structure by enacting a corporate income tax in 1957 Statehood for Alaska (which enacted corporate and individual income taxes, effective in 1949) and Hawaii (which completely revised its tax on individual incomes in 1957) added to the number of income tax States. Several non-income-tax States seriously considered this source of revenue in 1959, and Michigan's budget proposals included taxes on both corporate and personal income, but no new State income taxes were enacted.

Caught between steadily rising expenditures and the adverse revenue impact of the recession, many States raised rates and broadened the base of their income taxes in 1958-59. As appendix table 2 shows, by mid-1959, 17 States had enacted major income tax increases and/or adopted withholding and pay-as-you-go systems. For example, Colorado increased individual income tax liabilities by 40 to 50 percent and virtually doubled its corporate tax (by withdrawing Federal deductibility) Minnesota raised its individual income tax by roughly 12 percent and its corporate tax by 25 percent; Oregon, already the top income tax State, by 9 percent. Other States enacting sharp increases in individual income taxes included California, Idaho (whose new rate structure ranks near the top of the income tax States), Maryland, Montana, and South Carolina. Corporate tax increases were also enacted in California, Idaho, Iowa, Kansas, Montana, and Rhode Island. Six States adopted withholding, bringing the total number to 18.

"Fiscal measures adopted thus far during this year's (1959) legislative sessions promise to enlarge the tax take of the State governments by something like $1.5 to $2 billion during the year now underway This amount roughly measures the net effect of a host of changes in tax rates—and redefinitions of the bases to which the rates apply—and adoptions of some new taxes."[22] This was estimated to be a 12- to 13-percent increase for State taxes as a whole. The increases in income taxes, by comparison, were estimated to amount to 15 percent overall, consisting of a 19-percent increase in State individual income taxes (from $1.6

[22] *State Legislatures Boost Taxes,* Business Conditions, Monthly Review of the Federal Reserve Bank of Chicago, 4 (Sept. 1959).

APPENDIX TABLE 2 —*Major changes in State income taxation during 1958 and 1959*[26]

| State and year | Individual income tax: Exemptions | | Individual income tax: Rates | | | Individual income tax: Withholding and other changes[27] | Corporation income tax |
|---|---|---|---|---|---|---|---|
| | *Amount* | | | | | | |
| Alaska, 1958[28] (statehood): | | | | | | | |
| Single | | $600 | 14 percent of Federal liabilities | | | Withholding introduced in 1949 on basis of 10 percent of Federal Also current quarterly payments | 18 percent of Federal liabilities. In 1959 amended tax to get full coverage of out of-State corporations doing business in State |
| Married | | 1 200 | | | | | |
| Divorced | | 600 | | | | | |
| Arizona 1959 | | | | | | Discontinued optional use of withholding tables. Withholding now at flat 0 5 percent rate | |
| | | | | *Old*[29] *(per cent)* | *New (per cent)* | | |
| California 1959: | *Old* | *New* | | | | | |
| Single | $2,000 | $1 500 | 1st $2,500 | | 1 0 | Standard deduction increased from 6 percent to 10 percent; also adopted several provisions of Federal code relating to depreciation capital gains etc | Raised 4 percent rate to 5.5 percent and increased minimum tax to $100. Tax on financial institutions raised to 11 percent |
| Married | 3 500 | 3 000 | 2d $2 500 | | 2 0 | | |
| Divorced | 400 | 600 | 3d $2,500 | | 3 0 | | |
| | | | 4th $2 500 | | 4 0 | | |
| | | | 5th $2 500 | | 5 0 | | |
| | | | 6th $2,500 | | 6 0 | | |
| | | | Over $15,000 | | 7 0 | | |
| Colorado, 1959 | | | 1st $1,000 | 1 0 | 3 0 | Exemption for 2 percent surtax on intangibles income raised from $600 to $5,000. Capital gains holding period lengthened to 30 months. Raised withholding rate from 4 percent to 6 percent of Federal withholding (In 1958, broadened current collection system to require declarations of estimated tax for self-employed and corporations) | Removed deductibility of Federal income tax; no change in rates |
| | | | 2d $1 000 | 1 5 | 3 5 | | |
| | | | 3d $1,000 | 2 0 | 4 0 | | |
| | | | 4th $1 000 | 2 5 | 4 5 | | |
| | | | 5th $1 000 | 3 0 | 5 0 | | |
| | | | 6th $1 000 | 4 0 | 5 5 | | |
| | | | 7th $1 000 | 5 0 | 6 0 | | |
| | | | 8th $1 000 | 6 0 | 6 5 | | |
| | | | 9th $1,000 | 7 0 | 7 0 | | |
| | | | 10th $1 000 | 8 0 | 7 5 | | |
| | | | 11th $1,000 | 9 0 | 8 0 | | |
| | | | Over $11 000 | 10 0 | 9 0 | | |
| | *Amount* | | | | *Percent* | | |
| Hawaii,[30] 1959 (statehood): | | | | | | | |
| Single | | 400 | 1st $500 | | 3 0 | Adopted Federal code. Has full scale pay as you go system, using withholding tables | 1st $25,000, 5 percent; over $25,000, 5.5. Corporations pay ½ on estimated basis in September; other ½ in January. Federal income tax not deductible |
| Married | | 800 | Next $500 | | 3 5 | | |
| Divorced | | 400 | Next $1 000 | | 4 0 | | |
| | | | Next $3 000 | | 5 0 | | |
| | | | Next $5,000 | | 6 0 | | |
| | | | Next $10 000 | | 7.0 | | |
| | | | Next $10 000 | | 8 0 | | |
| | | | Over $30 000 | | 9 0 | | |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| | *Old* | *New* | | *Old (percent)* | *New (percent)* | | |
| Idaho, 1959: | | | 1st $1,000 | 2.0 | 3.0 | Adopted Federal code | Raised 8 percent rate to 9.5 percent. Replaced franchise tax with direct income tax—will get full coverage of interstate corporations |
| Single | $100 | $600 | 2d $1 000 | 4.0 | 5.0 | | |
| Married | 1,500 | 1,200 | 3d $1,000 | 5.0 | 6.5 | | |
| Divorced | 200 | 600 | 4th $1 000 | 6.0 | 7.5 | | |
| | (31) | (32) | 5th $1,000 | 7.0 | 8.5 | | |
| | | | Over $5,000 | 8.0 | 9.5 | | |
| | | | Enacted $10 minimum filing fee in 1959 | | | | |
| Iowa 1959 | | | | | | | Raised 2 percent rate to 3 percent |
| | | | | *Old (percent)* | *New (percent)* | | |
| Kansas, 1958 | | | 1st $2,000 | 1.0 | 1.5 | | Raised 3 percent rate to 3.5 percent |
| | | | Next $1 000 | 2.0 | 2.5 | | |
| | | | Next $2 000 | 2.5 | 3.0 | | |
| | | | Next $2 000 | 3.5 | 4.0 | | |
| | | | Over $7,000 | 5.0 | 5.5 | | |
| Kentucky, 1958: | | | | | | | |
| Single | 12 | 13 | | | | | |
| Married | 24 | 26 | | | | | |
| Divorced | 12 | 13 | | | | | |
| Maryland, 1958 | | | Raised 2 percent rate to 3 percent | | | | |
| Massachusetts, 1959 | | | | | | Adopted withholding (using tables) effective February 1959. Also current quarterly payments | |
| | | | | *Old (percent)* | *New (percent)* | | |
| Minnesota, 1959: | | | | | | | |
| Single | 10 | (33) | 1st $500 | 1.0 | 1.0 | Adopted Federal depreciation provisions | Raised rate from 7.3 percent to 9.3 per cent. |
| Married | 30 | (33) | 2d $500 | 1.0 | 1.5 | | |
| Divorced | 10 | 14 | 2d $1 000 | 2.0 | 2.5 | | |
| | | | 3d $1,000 | 3.0 | 3.5 | | |
| | | | 4th $1 000 | 4.0 | 4.5 | | |
| | | | 5th $1,000 | 5.0 | 5.5 | | |
| | | | Next $2 000 | 6.0 | 6.5 | | |
| | | | Next $2 000 | 7.0 | 7.5 | | |
| | | | Next $3 500 | 8.0 | 8.5 | | |
| | | | Next $7,500 | 9.0 | 9.5 | | |
| | | | Over $20,000 | 10.0 | 10.5 | | |
| | | | Plus 10 percent surtax in both cases. | | | | |
| Mississippi, 1958 | | | Allowed 14 percent surtax enacted in 1955 to expire | | | | |

See footnotes on page 278

APPENDIX TABLE 2 —*Major changes in State income taxation during 1958 and 1959*[36]—*Continued*

| State and year | Individual income tax: Exemptions — *Amount* | Rates | Old (*per-cent*) | New (*per-cent*) | Withholding and other changes[37] | Corporation income tax |
|---|---|---|---|---|---|---|
| Montana, 1959 | -- | 1st $1,000 | 1.0 | 1.0 | Broadened withholding on non-residents to include all income earned in State | Removed deductibility of Federal income tax and reduced corporate rate from 5 percent to 4.5 percent. |
| | | 2d $1 000 | 1.5 | 2.0 | | |
| | | 3d $1,000 | 2.0 | 3.0 | | |
| | | 4th $1 000 | 2.5 | 4.0 | | |
| | | 5th $1 000 | 3.0 | 4.0 | | |
| | | 6th $1 000 | 3.5 | 5.0 | | |
| | | 7th $1,000 | 4.0 | 5.0 | | |
| | | Over $7 000 | 5.0 | 7.0 | | |
| New Jersey, 1958 | -- | -- | -- | -- | -- | Enacted new corporation income tax at the rate of 1.75 percent. |
| New York, 1959: | | 1st $1,000 | 2.0 | 2.0 | Adopted withholding using tables and current quarterly payments, effective April 1959 (1958 taxes, except on capital gains, canceled) | |
| Single | 1,000 [34] 600 | Next $2 000 | 3.0 | 3.0 | | |
| Married | 2,500 [35] 1,200 | Next $2 000 | 4.0 | 4.0 | | |
| Divorced | 400 600 | Next $2 000 | 5.0 | 5.0 | | |
| | | Next $2 000 | 6.0 | 6.0 | | |
| | | Next $2 000 | 7.0 | 7.0 | | |
| | | Next $2 000 | 7.0 | 8.0 | | |
| | | Next $2,000 | 7.0 | 9.0 | | |
| | | Over $15 000 | 7.0 | 10.0 | | |
| North Carolina, 1959 | -- | -- | -- | -- | Adopted withholding (using tables) and current quarterly payments, effective January 1960. | |
| Oklahoma, 1959 | -- | -- | -- | -- | Adopted withholding at rate of 5 percent of Federal withholding.[38] | |
| Oregon, 1959 | -- | Removed Federal deductibility and lowered rates as follows: | Old[37] (*per-cent*) | New (*per-cent*) | Special rate applied to capital gains if reinvested in Oregon enterprises, 80 percent on assets held 1-2 years; 60 percent, 2-5 years; 50 percent, over 5 years. | |
| | | 1st $500 | -- | 2.5 | | |
| | | 2d $500 | -- | 3.0 | | |
| | | Next $1 000 | -- | 5.0 | | |
| | | Next $5 500 | -- | 6.0 | | |
| | | Next $7,500 | -- | 7.0 | | |
| | | Over $15 000 | -- | 7.5 | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Rhode Island, 1958. | | | | | | Raised bank tax from 4 to 5 percent. Imposed 10 percent temporary surtax on bank and corporation taxes. |
| South Carolina, 1959 | | 1st $2,000 | 2.0 | 2.0 | Adopted withholding using tables and current quarterly payments, effective January 1960. Eliminated Federal deductibility entirely (formerly limited to $500) | Raised tax on financial institutions to 8 percent. |
| | | 2d $2 000 | 3.0 | 3 0 | | |
| | | 3d $2,000. | 4.0 | 4.0 | | |
| | | 4th $2 000 | 5.0 | 5.0 | | |
| | | 5th $2,000 | 5.0 | 6.0 | | |
| | | Over $10 000 | 5.0 | 7 0 | | |
| Tennessee, 1959 | | | | | | Amended tax to reach out-of-State corporations. |
| Utah, 1959 | | | | | Adopted withholding, effective July 1959, at rate of 7 percent of Federal withholding | Amended tax to reach out-of-State corporations. |

See footnotes on page 278

billion to $1.9 billion) and a 10-percent increase in State corporation income taxes (from $1 billion to $1.1 billion)[23]

The renewed interest in income taxation has been spurred, first, by its responsive revenue performance in a growth economy Studies by Dick Netzer on the revenue elasticity of State-local taxes indicate that for every 1 percent growth in gross national product, the yield of State individual income taxes as a group automatically grows by 1.7 percent. Growth of State corporate income taxes is less, but above 1 percent. In contrast, the "GNP elasticity" of general sales taxes is only 1 percent.[24]

Second, the success of a few income tax States in building the individual income tax into a truly impressive revenue producer has also acted as a stimulant. Individual income tax collections average about 8 percent of Federal collections in the income tax States. Yet Oregon collects nearly 29 percent; Vermont, 22 percent; Wisconsin and Kentucky, 17 percent; and eight other States, above 10 percent.[25]

---

[23] *Id.* at 6.

[24] Dick Netzer, *Financial Needs and Resources Over the Next Decade: State and Local Governments,* a paper prepared for the Conference on Public Finances of the National Bureau of Economic Research, April 1959 (to be published in a conference volume by the National Bureau).

[25] L. L. Ecker-Racz & I. M. Labovitz, *Practical Solutions to Finance Problems Created by the Multilevel Political Structure,* a paper prepared for the Conference on Public Finances of the National Bureau of Economic Research, April 1959 (to be published in a conference volume by the National Bureau). The authors point out that for some individuals the liability for State taxes does not arise in the same State in which their Federal taxes are paid. Since only minor deviations are involved, the percentage of State to Federal collections is, by and large, an excellent basis for comparing the relative weight of individual income taxes. But it is not a reliable basis for comparing the relative weight of corporate income taxes because of large discrepancies between place of payment of the Federal tax and the place of liability for State tax.

FOOTNOTES FOR APPENDIX TABLE 2—

[26] Except for Alaska and Hawaii, where the "change" consists of statehood, this table represents the results of State legislative action between Jan. 1, 1958, and July 1, 1959.

Sources for Table 2: Varied sources, including news reports, interviews, and Commerce Clearing House State Tax Review.

[27] These actions bring to 18 the total number of States with income tax withholding.

[28] Alaska introduced its income taxes in 1949, at rates of 10 percent of Federal liabilities for both corporations and individuals.

[29] Former California rates: 1 percent on 1st $5,000; 2 percent on 2d; 3 percent on 3d; 4 percent on 4th; 5 percent on 5th, and 6 percent on income over $25,000.

[30] Provisions shown were enacted in 1957, when Hawaii completely revised its income taxes. Hawaii introduced its income taxes in 1901.

[31] Plus $5 dependency credit.

[32] Repealed $5 dependency credit.

[33] Dollar credits unchanged but income equivalents reduced, via rate increases, to $833 for single person and $1,700 for married couple.

(Continued on next page)

Third, one may attribute part of the relatively strong emphasis on income taxation in recent State tax programs to the demonstrated improvements in income tax administration, especially with the aid of withholding and Federal cooperation.

---

(Footnote continued from preceding page)

[34] Plus $10 tax credit.

[35] Plus $25 tax credit.

[36] Forced to referendum by petition prior to October 1959, effective date.

[37] Old rates 3 percent on 1st $500; 4 percent on 2d $500; 5 percent on 3d $500; 6 percent on 4th $500; 7 percent on next $2,000; 9 percent on next $2,000; 9.5 percent on income over $8,000. Combined changes effect an increase of roughly 9 percent in individual income tax liabilities.