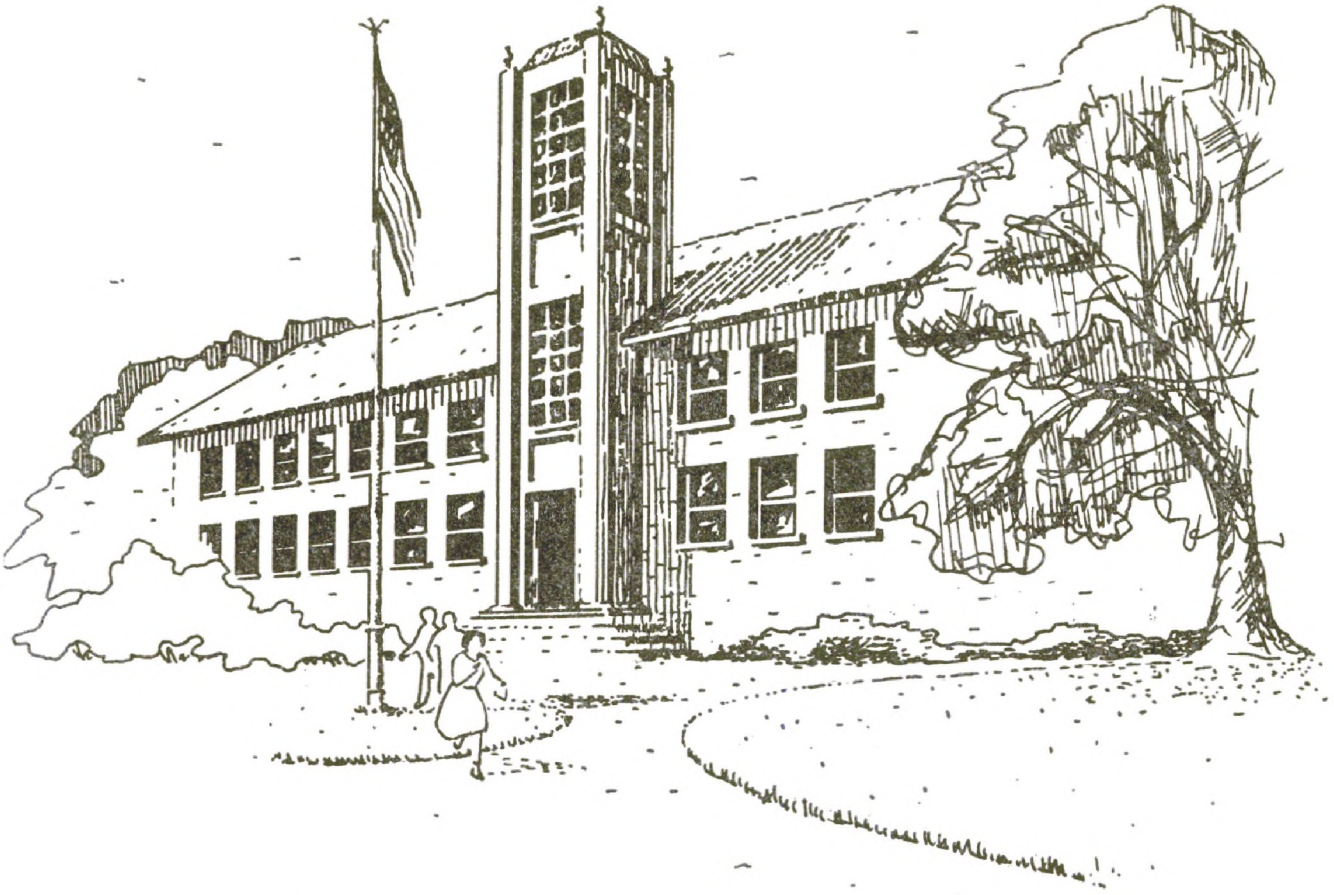


The Taxes That Won't Be Cut

THE taxpayer's joyous expectation of an $11 billion reduction in Federal taxes perhaps should be tempered by the realization that state and local taxes, in 1964 and in the years to come, will almost certainly continue their inexorable upward surge. The nation's demand for more schools, more highways, and more health and welfare services — all of which are predominantly financed through state and local governments—has more than doubled the state and local tax bill just within the past decade, and no relaxation in that demand is in sight.

The Johnson Administration has given explicit recognition to the state and local financial problem, by presenting the proposed tax cut as a device for releasing resources which can be utilized for meeting community needs as well as for meeting the individual needs of consumers and businessmen. But what are the dimensions of these community needs? How much must the state and local governments collect in increased taxes to satisfy those requirements, and how will their increasing tax bite interact with the Federal government's decreasing take?

Released resources

The funds scheduled to be released by the Federal tax cut, according to the House bill passed last year, would include almost $9 billion in individual tax reductions and more than $2 billion in corporate tax reductions. The $11 billion total tax cut would be the net result of some major cutbacks in the tax laws, partially offset by other changes which would increase the payments of some taxpayers.

The bulk of the tax saving would result from a change in the rate scale applied to individual incomes; the range would be pared from 20-91 percent to 14-70 percent. In addition, several provisions would reduce further the tax burden on low-income groups. The most important of these provisions, scheduled

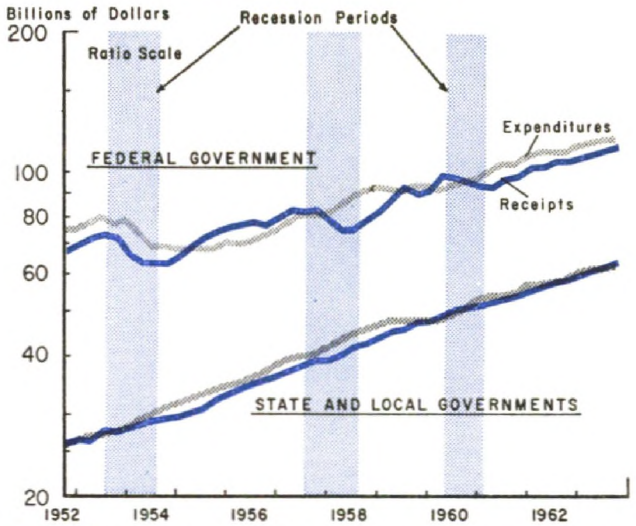
to reduce tax payments by about $320 million, would impose a minimum standard deduction of $300 for single persons and $400 for married couples filing joint returns; at present, the standard deduction is $1,000 or 10 percent of taxable income, whichever is the smaller of the two.

For corporations, the normal tax rate would be reduced but the surtax rate applied to taxable income over $25,000 would be increased; the net result would be a lowering of the combined rate from 52 to 50 percent in 1964 and to 48 percent in later years. (Again, the figures are from the 1963 House bill.) On the other hand, the Act also contains provisions for accelerating corporate tax payments. The present law permits corporations to pay half of their tax liability over $100,000 during the year it is incurred, and the other half during the first two quarters of the following year. The planned acceleration would shift the timetable for tax payments made by large (but not small) corporations, so that by 1970 all taxes on income over $100,000 would be paid in the current year.

The rising spiral

How would the resultant $11-billion reduction affect total collections from state-local taxes as well as Federal income taxes? In the first place, it may be assumed that the growing needs of state and local governments will cause their tax burden to increase, quite apart from any change in the Federal tax burden. In the second place, only $7 billion of the $11 billion Federal tax cut will take effect in 1964, even if the new law is retroactive to January 1. But specifically, the total take from Federal, state, and local governments was about $5-6 billion higher in 1963 than in the preceding year; in 1964, the total take probably would be increased almost as much as if there were no tax cut but would be reduced by $1-2 billion if a tax cut were made retroactive to January 1. The latter eventuality could develop partly because of rising incomes, which would permit a growing tax base to offset part of the reduction in Federal rates, but also because of the steady rise expected in state-local tax revenues.

Rapid growth of expenditures strains state-local tax resources

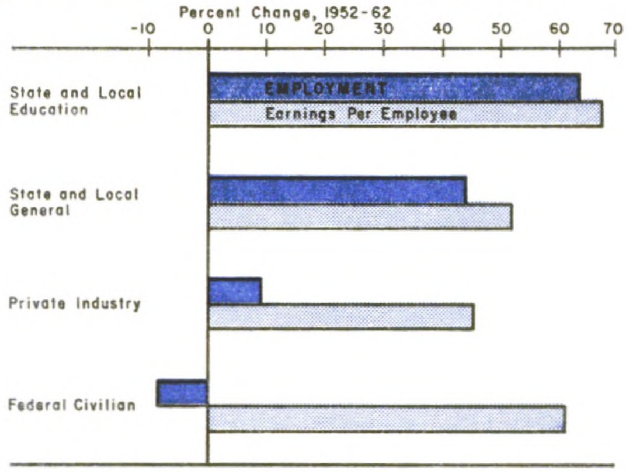


Source: U. S. Department of Commerce (national income basis).

In recent years, state-local revenues have been rising by $4-5 billion annually; the total in 1962 was $59 billion (including $8 billion in Federal grants-in-aid), and it reached about $64 billion in 1963. Yet even at this level, revenues have been hard put to match the ever-growing volume of expenditures. The 50 states and the multitude of local government units now spend about $63 billion annually, which works out to more than $300 a year for every resident of the United States. The most striking phenomenon about state and local expenditures, however, is their continued uptrend; these expenditures have expanded more rapidly than gross national product ever since the turn of the century, and their growth in relation to GNP has speeded up during the last decade.

Rapid increases in both employment and employee earnings have contributed to this much greater increase in state and local expenditures. In the last decade, the education sector recorded gains of over 50 percent in

Wages rise everywhere . . . job gains centered in state-local sector



Source: U. S. Department of Commerce.

both employment and average earnings, and the general administration sector did almost as well. Private industry and the Federal civilian sector also experienced substantial wage increases during this period, but their increases in total payrolls were smaller because of much smaller gains in employment.

The mushrooming of state-local expenditures can be explained partly by the rapid rise in the postwar demand for government services—a rise stimulated by substantial population growth, a shift in the population mix (with increased concentration in the youngest and oldest age brackets), and a heavy migration of people to urban and suburban areas (which provide an increasingly extensive, as well as expensive, range of services). But a major part of the spending increase has been due to a substantial increase in prices, which is related to the fact that this sector's disbursements are dominated by such increasingly expensive cost items as employee payrolls and construction.

From cradle to grave

The most noteworthy element in this upsurge of state and local spending has been the increasing demand for public education —now a $20 billion annual item. The nation's population has increased 20 percent in the last decade, and the school-age population has increased even faster. State and local governments, which provide more than 95 percent of the funds for education, have thus felt the constant pressure of this growth. They have also felt the pressure of demands for increased spending per pupil, created by the nation's increasing emphasis on higher teacher salaries and improved curricula and equipment. As one consequence of this dual drive for greater quantity and improved quality of education, state and local governments have doubled their school-construction bill (to $3 billion a year) just within the past decade.

Another major expense has been transportation facilities—a $10 billion item. During the past decade this item has more than doubled, because of the construction and improvement of highways, waterways, and air transport facilities. But the trend of these expenditures recently has tended to level off, and thus it may not represent so intense a worry to budget makers as some of the other expenditure items.

Other major spending categories—public assistance and relief, and public health and sanitation—have increased substantially during the past decade to around $12 billion.

These expenditures have not risen quite so rapidly as total expenditures, but their costs tend to increase with population growth and urbanization, so state and local governments seem destined to require ever-growing sums for such purposes.

California and the West provide the outstanding examples of expanding community needs and rising spending. To finance its rapidly growing activities, California increased its state-local tax take from $2 billion to more than $5 billion just within the the past decade, and thereby increased its share of the national total from 10.5 to 12.5 percent. Other District states as a group have grown less rapidly, but have continued to account for roughly 5 percent of total state-local tax revenues.

Where the money comes from

The pressure of expanding activities, rising prices, and higher salary scales has helped to create the widely-discussed fiscal "crisis" of state and local governments. To meet this situation these governments have called increasingly upon the resources of the capital market as well as upon the resources of the Federal government and their own taxpayers. Increased borrowing throughout the postwar period has pushed total state-local debt to about $85 billion, or to more than one-fourth of the level of the Federal debt. But while Federal government debt per capita has declined during the postwar period, state-local debt per capita has more than tripled, from $113 in 1946 to $436 in 1962.

The state-local fiscal "crisis" has also developed from the pressure to find adequate tax resources to meet the ever-rising trend of expenditures. The problem is related to the capacity of the state-local tax structure to siphon off its share of the increases in incomes and consumer expenditures that develop from the growth of the national economy. This tax structure, despite its many criticized features, however, has been successful in increasing total collections in the 1952-62 period from about $20 billion to about $43 billion, divided equally between the states and the myriad local government units.

States still rely mainly on sales taxes for their current revenue. To supplement this source, however, many states by now have turned increasingly to income taxes. Corporate tax payments to state governments have doubled since the early postwar period, and the increase in individual income tax payments has been even more striking; in fact, individuals have so far outdistanced corporations as a tax source that the latter, which used to pay more into state coffers than individuals, now contribute less than half as much. Even so, individual income taxes still provide only about one-eighth of state tax revenues, as opposed to the three-fifths share contributed by sales taxes.

At the local level, the principal tax remains the property tax. Today, as for years past, taxes on property account for nearly 90 percent of all the revenues collected by local governments; another 7 percent comes from sales and gross receipts taxes, and the remainder from income and miscellaneous taxes.

In general, then, the tax structure of state and local governments has not changed markedly over the past decade, despite increasing reliance on income and other taxes which cause revenues to grow as the economy grows. The states now obtain about 20 percent of their revenue from income taxes but still rely on sales taxes as the foundation of their tax systems; local governments obtain less than 2 percent of their revenue from income taxes and still depend overwhelmingly on property taxes.

Will the multiplier multiply?

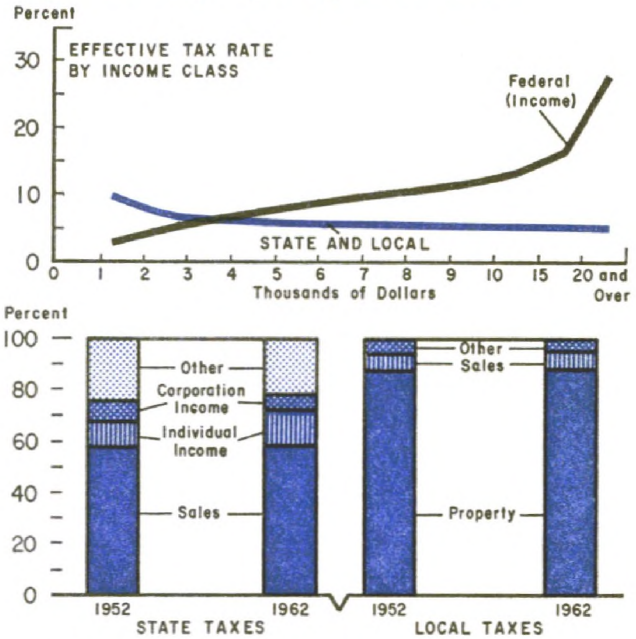
The proposed Federal tax cut is expected to ease this state-local tax problem, by stimulating business and consumer spending so that the present state-local tax structure yields

more than it did in past years. According to the official Administration argument, the tax cut should stimulate extra spending by consumers and business investors, and it should thus help to close the $30 billion gap between actual and "potential" GNP. This conclusion is based on the pragmatic assumption that a "multiplier" of roughly 2 can be applied to the initial spending increase, since the higher incomes generated by that initial increase will generate still further increases in incomes and spending in an endless (albeit diminishing) chain.

The strength of these secondary bursts of spending may depend, however, on which consumers and businessmen get more to spend. This presents, in other words, a question of tax incidence. People who pay less taxes, of course, will have more money left to use for other purposes, but the extent to which the reduced tax dollar is reflected in higher consumption spending or saving depends on the size of the reduction in each individual's tax burden. Since the percentage of income consumed typically declines as individuals move up the income scale, a reduction in taxes paid by people in the lower-income brackets should raise consumption more than an equal reduction of taxes contributed by people in the higher-income brackets.

The proposed cut in Federal tax is designed to achieve precisely that effect; for example, the average reduction in tax liability would be 38 percent for taxpayers in the $0-$3,000 bracket, 20 percent for those in the $5-10,000 bracket, and 15 percent for those in the $20-50,000 bracket. But will the spending urge created in these families through the courtesy of the noncollecting Federal tax collector be reduced by the dunning of the state-local tax collector? The answer may depend upon the extent of regressiveness in the state-local tax structure, that is, the extent to which lower income groups pay more tax in relation to income than do higher income groups. The answer may also depend upon the difference in impact between the type of tax that is scheduled to be reduced—the Federal income tax—and the type of tax that almost certainly will not be cut—the regressive group of state-local taxes.

Tax structure at state-local level depends on property, sales taxes



Source: Internal Revenue Service; Bureau of the Census.

Facts versus theories

The facts are rather clear about the continued regressiveness of the state-local tax structure, despite the slightly increased importance of (progressive) state and local income taxes. Most studies show that property and sales taxes have created a regressive state-local tax structure, as opposed to the progressive Federal structure created by the income tax. According to one basic study, in 1954 the tax-payment-to-income ratio, on the state-local level, ranged from 11 percent for the $0-2,000 bracket to 8 percent for the $10,000-and-over bracket, while on the Federal level the corresponding tax-to-income ratios were 16 and 33 percent respectively.[1]

[1] Richard A. Musgrave, "Incidence of the Tax Structure and Its Effects on Consumption," Papers Submitted by Panelists—*Federal Tax Policy for Economic Growth and Stability* (Washington: Government Printing Office, 1956).

An examination of a limited group of tax returns for 1960 reveals essentially the same regressive pattern as in earlier years, which is not surprising in view of the relatively stable nature of the state-local tax structure. This examination, limited to returns of individuals who listed their state-local tax payments as deductions on their Federal tax returns, shows a moderate regression in the state-local structure but, of course, a definite progression in the Federal income structure.

This 1960 analysis shows that the state-local tax burden was 9.9 percent for those in the $1,000-1,500 adjusted-gross-income bracket, 6.7 percent for those in the $2,500-3,000 bracket, and 5.7 percent for those with incomes of $5,000 or more. For those same categories, the Federal tax progression ranged from 2.5 to 5.2 to 14.6 percent. As a result of these contrasting patterns of incidence, taxpayers with incomes below $2,000 paid more taxes to state and local governments than they paid in Federal income tax.

So much for the difference in incidence between the two types of tax structure. But the more important question remains—will this difference reduce the stimulus to consumer and other spending expected as a result of the $11 billion Federal tax cut? The answer may well be — theoretically, yes; practically, no. Theoretically, the state-local tax structure may limit the ultimate expansion initiated by the Federal tax cut; practically, the increase in state-local tax revenues resulting from their regressive structure should be only a small offset to the expansive force created by the Federal tax cut.

The amount of goods and services that will be purchased by the average taxpayer (especially the lower-income taxpayer) may very well be restrained by the regressive state-local tax structure—but only on certain conditions. One qualification is fairly obvious: the individual burden may actually be lessened if the burgeoning demands of state and local governments are met through an enlarged tax base (such as could be created by a strong economic expansion) rather than through increased tax rates. The beneficent effects of an expansionary tax reduction at the Federal level thus could swamp the restraining effects of a regressive state-local tax structure.

State and local governments, of course, will continue to exert an expansionary influence of their own through a large and rising level of spending for community needs. On the restrictive side, meanwhile, these governments seem far more likely to restrict consumer and business spending through their rising tax take than through their regressive tax structure. (As was suggested earlier, the total effect this year of an expansionary tax base, a reduced Federal take, and a larger state-local bite may be only a modest, rather than a substantial, decline in total revenues.) All these considerations thus add weight to the official argument that economic expansion dictates a reduction in taxes at least at one major level of government in 1964.