A COMMISSION REPORT

Federal-State Coordination of Personal Income Taxes

ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS

OCTOBER 1965

A—27

ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS
(As of the date of adoption of this report)

A COMMISSION REPORT

FEDERAL-STATE COORDINATION

of

PERSONAL INCOME TAXES

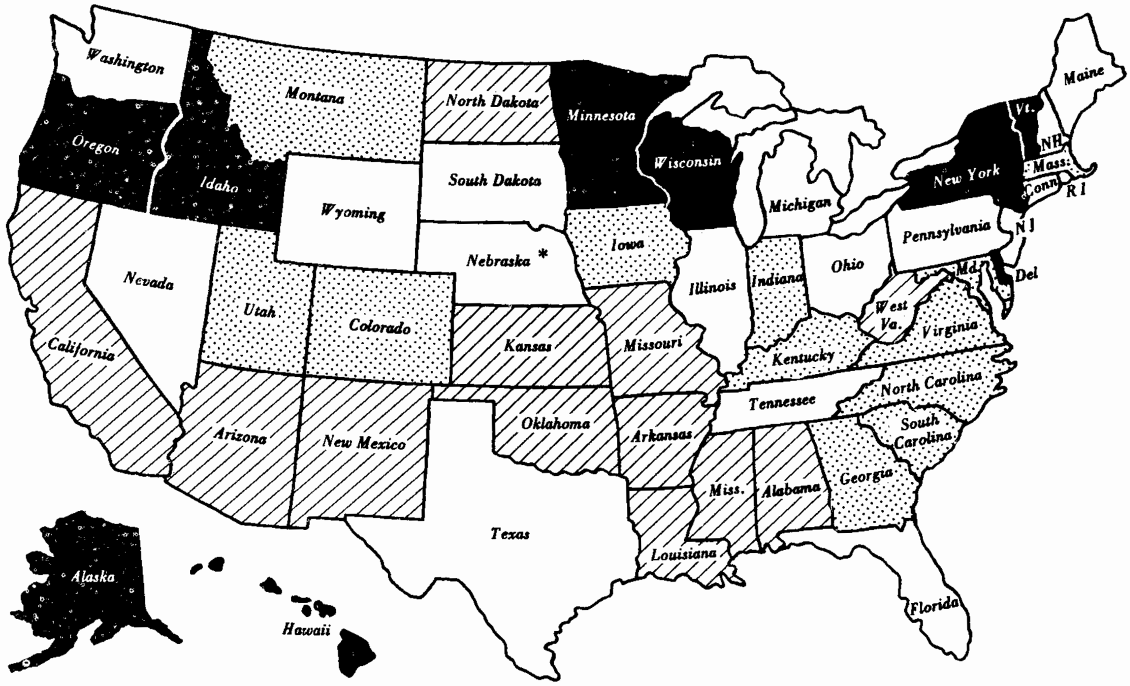
ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS

October 1965

A-27

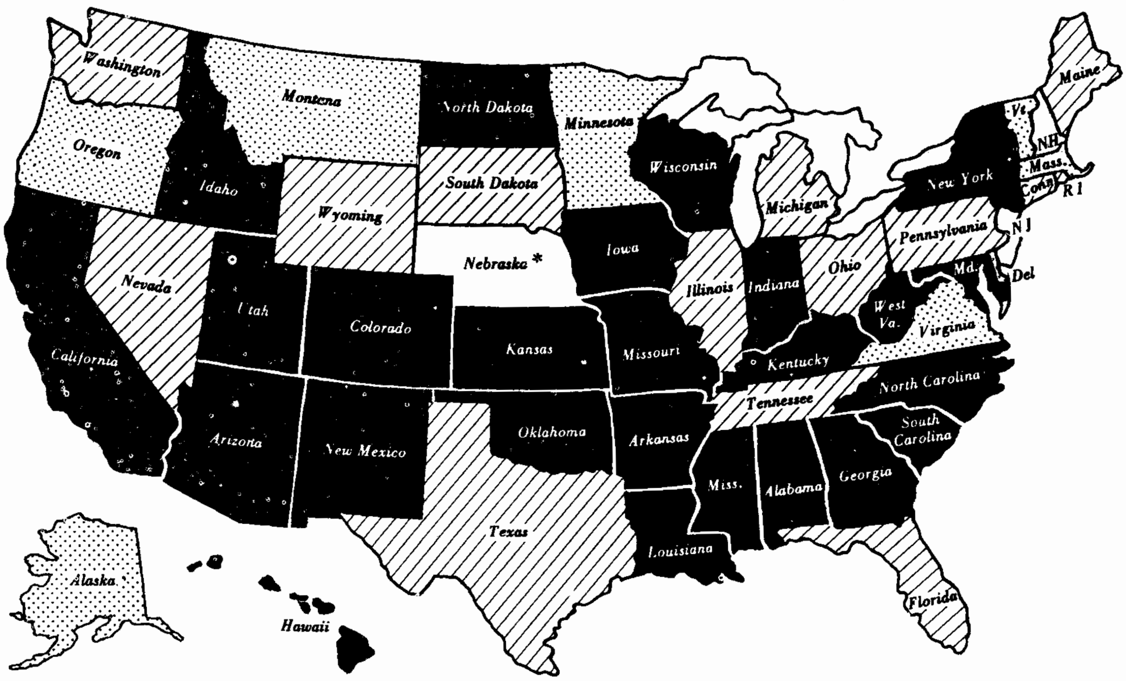
STATES WITH BROAD-BASED PERSONAL INCOME TAXES (JAN. 1, 1966)

No Tax | Low Tax | Moderate Tax | High Tax



USE OF PERSONAL INCOME AND GENERAL SALES TAXES BY STATES (JAN. 1, 1966)

Neither Tax | Sales Tax Only | Income Tax Only | Sales and Income Tax



* Footnote for Nebraska: Personal income tax effective Jan. 1, 1967, subject to referendum

PREFACE

In this report the Commission turns its attention once again to improving the fiscal strength of State and local government, a problem that demands continuing study. Strong State and local government responsive to the needs of its citizens is the foundation of an enduring federal form of government and financial capability circumscribes governmental strength.

The personal income tax, the specific object of our present inquiry, has now been used by the Federal Government and by some States for a half century. Its appearance in local tax systems is more recent. The annual revenue contribution of this tax has now reached $50 billion at the Federal and $4 billion at the State and local level.

An examination of the intergovernmental aspects of this major revenue producer is now very timely. Continuing economic prosperity and national policies to sustain that prosperity are focusing public attention on the revenue responsiveness of this tax to economic growth at a time when political leadership in all parts of the country is preoccupied with acceptable ways to relieve the persistent revenue pressure on State and local governments. Simultaneously, reductions in Federal tax rates at least open up the possibility that the States' elbow room in the income tax field is being enlarged.

In this context, the Commission addresses itself to several interrelated questions:

1. What should be the role of the personal income tax in State tax systems and what part, if any, should the Federal Government play in facilitating that role?

2. What should be the relationship between the structure and administration of State and Federal taxes?

3. How can income tax relationships among the States and between State and local governments be improved?

Public Law 86-380 directs this Commission to point the way to the most desirable allocation of governmental revenues among the several levels of government, more orderly and less competitive fiscal relationships between governments, and reduced tax compliance burdens. Changes in personal income taxation, as our recommendations make clear, afford a prime opportunity to advance toward these goals.

This report was adopted by the Commission on October 17-18, 1965.

Frank Bane
Chairman

ACKNOWLEDGMENTS

Responsibility for the staff work on this report was shared by John Shannon, who also coordinated the project, with Jacob M. Jaffe and Robert Rafuse, Jr., with the assistance of Frank Tippett. Technical Paper 1 was completed by Stuart Urbach before his untimely death last August. The detailed tabulations of deductions and exclusions for Technical Paper 2 were reviewed and augmented by the income tax officials of the respective States.

The Commission and its staff benefited from an informal review of a draft of the report by a number of individuals, including Gerard M. Brannon, B. W. Brown, Samuel B. Chase, Jr., Gerhard Colm, Charles F. Conlon, John Davidson, Douglas Eldridge, Delphis C. Goldberg, Richard Goode, William G. Herzel, Ernest H. Johnson, Lawrence R. Kegan, William Kingsley, I. M. Labovitz, George Lent, Emanuel Melichar, Anita Wells Merriam, Carl S. Shoup, William H. Smith, James L. Sundquist, David B. Walker, and Ronald B. Welch.

The Commission records its appreciation for the contribution of these individuals to this report. Responsibility for content and accuracy rests, of course, with the Commission and its staff.

Wm. G. Colman
Executive Director

L. L. Ecker-Racz
Assistant Director

WORKING PROCEDURES OF THE COMMISSION

This statement of the procedures followed by the Advisory Commission on Intergovernmental Relations is intended to assist the reader's consideration of this report. The Commission, made up of busy public officials and private persons occupying positions of major responsibility, must deal with diverse and specialized subjects. It is important, therefore, in evaluating reports and recommendations of the Commission to know the processes of consultation, criticism, and review to which particular reports are subjected.

The duty of the Advisory Commission, under Public Law 86-380, is to give continuing attention to intergovernmental problems in Federal-State, Federal-local, and State-local, as well as interstate and inter-local relations. The Commission's approach to this broad area of responsibility is to select specific, discrete intergovernmental problems for analysis and policy recommendation. In some cases, matters proposed for study are introduced by individual members of the Commission; in other cases, public officials, professional organizations, or scholars propose projects. In still others, possible subjects are suggested by the staff. Frequently, two or more subjects compete for a single "slot" on the Commission's work program. In such instances selection is by majority vote.

Once a subject is placed on the work program, a staff member is assigned to it. In limited instances the study is contracted for with an expert in the field or a research organization. The staff's job is to assemble and analyze the facts, identify the differing points of view involved, and develop a range of possible, frequently alternative, policy considerations and recommendations which the Commission might wish to consider. This is all developed and set forth in a preliminary draft report containing (a) historical and factual background, (b) analysis of the issues, and (c) alternative solutions.

The preliminary draft is reviewed within the staff of the Commission and after revision is placed before an informal group of "critics" for searching review and criticism. In assembling these reviewers, care is taken to provide (a) expert knowledge and (b) a diversity of substantive and philosophical viewpoints. Additionally, representatives of the American Municipal Association, Council of State Governments, National Association of Counties, U. S. Conference of Mayors, U. S. Bureau of the Budget and any Federal agencies directly concerned with the subject matter participate, along with the other "critics" in reviewing the draft. It should be emphasized that participation by an individual or organization in the review process does not imply in any way endorsement of the draft report. Criticisms and suggestions are presented; some may be adopted, others rejected by the Commission staff.

The draft report is then revised by the staff in light of criticisms and comments received and transmitted to the members of the Commission at least two weeks in advance of the meeting at which it is to be considered.

In its formal consideration of the draft report, the Commission registers any general opinion it may have as to further staff work or other considerations which it believes warranted. However, most of the time available is devoted to a specific and detailed examination of conclusions and possible recommendations. Differences of opinion are aired, suggested revisions discussed, amendments considered and voted upon, and finally a recommendation adopted (or modified or diluted as the case may be) with individual dissents registered. The report is then revised in the light of Commission decisions and sent to the printer, with footnotes of dissent by individual members, if any, recorded as appropriate in the copy.

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Chapter 1

FINDINGS AND RECOMMENDATIONS

The times are auspicious for reexamining intergovernmental relations in personal income taxation. Changes in both Federal and State income tax policies and viewpoints are affecting interrelationships with significant implications for "the conventional wisdom" on how best to accommodate them to one another, how best to coordinate them.

FACTORS AFFECTING INTERGOVERNMENTAL RELATIONS IN PERSONAL INCOME TAXATION

The Problem of Tax Overlapping

Some Americans have lived with overlapping Federal and State taxation of their personal incomes for half a century; nearly two-thirds of them for a quarter century. An additional number have now had years of experience with Federal-local duplication.

Since its introduction with modest tax rates and generous personal exemptions, the personal income tax has become the National Government's major tax source. It is presently producing at an annual rate of approximately $50 billion. Some States experimented with income taxes as long as a hundred years ago, but the modern State personal income tax is largely a contemporary of the Federal tax. The 33 States that now collect this tax raise over $3½ billion from it.[1/] About half of them, however, do not use the tax effectively. This circumstance and the uneven distribution of personal incomes among the States explain the fact that 10 States collectively account for 80 percent of all State collections.

1/ Since we limit our discussion to "broad-based personal income taxes now in operation, our count of 33 State taxes excludes (a) the New Jersey "commuters'" income tax, which applies only to New York residents working in New Jersey, (b) the New Hampshire and Tennessee taxes, which are limited to income from interest and dividends, and (c) the newly enacted Nebraska personal income tax which becomes effective on January 1, 1967, and then only if approved by referendum. Some of the subsequent discussion, particularly that relating to legislative developments, necessarily includes the Nebraska tax.

Over the years, overlapping income taxation has acquired the status of an accepted institution. The reconciliation to dual taxation has come more quickly in the income tax area than in some of the others. The succession of study groups, commissions, and tax experts who had labored since the turn of the century in behalf of a separation of the major tax sources, assigning each tax to one or another level of government, gradually abandoned their favorite remedy when they prescribed for income taxation. The record is inconclusive and we can only surmise their reasons for excluding the income tax from programs of revenue separation.

One likely factor was general appreciation that the deductibility of State taxes for Federal income tax purposes affords some relief from the dual tax burden and that the degree of relief increases the higher the tax rate otherwise applicable to the taxpayer. This particularly impressed those troubled by the possibility that the addition of State to Federal tax rates might pre-empt substantially all income in the upper brackets.

It is relevant, too, that much of the support for the separation of State and Federal revenue sources stemmed from preoccupation with the States' problems. The States were believed to be at a tactical disadvantage, as compared with the Federal Government. Revenue separation was viewed as a device by which the National Government would relinquish tax sources to the States, not vice versa. The inappropriateness of this prescription for income taxation became progressively clearer as the Federal Government's revenue requirements and the degree of its reliance on income taxation increased. The States' stake in the income tax, in any event, did not appear to be large. Only a few States derived significant revenue from it; most of the industrialized States did not use it at all.

Perhaps more important than any of these considerations was the spread of techniques for alleviating the double compliance burdens of taxpayers and keeping down the cost of dual tax enforcement. The tendency of States to adopt some Federal Revenue Code definitions, their ready access to Federal tax returns, their opportunity to exchange audit results with the Internal Revenue Service, and the development of tax withholding to ease the payment and collection of taxes on wages and salaries, all helped to allay concern over compliance burdens and enforcement costs. The fact that the employment of tax practitioners for preparing tax returns became general, particularly among large income recipients--those most likely to be affected by the more complex provisions of duplicating revenue laws--also may have played a part in the acceptance of tax overlapping.

While the familiar checklist of the different kinds of taxes used by the several categories of government designed to dramatize the extent of overlapping for years has had two, three, or more checkmarks opposite most taxes, the discerning have long recognized that a large degree of tax separation does in fact exist in the American system. The perceptive knew that the National Government obtained about 80 percent of its tax revenues from personal and corporate income taxes; that local governments derive over 85 percent of theirs from property taxes; that States depend for nearly two-thirds of theirs on consumption taxes; and that tax overlapping, in the aggregate, involves not more than a sixth of all tax collections.

Those concerned with the pattern of tax burden distribution were consoled by the fact that the Federal Government, which relied so largely on the graduated income tax, was the major and the growing tax collector. Similarly, those preoccupied with the relationship between tax policy and stable economic growth reckoned primarily with Federal policies, believing that budgetary constraints necessarily immobilized State and local government--that these governments, preoccupied with the need for stable revenues, lacked the income flexibility required to practice fiscal policies other than "budget balancing."

The changed role of government in American life since the Second World War, particularly in the parts played by the Federal Government on the one hand and State and local governments on the other, has had important consequences for income tax relationships, including the problem of income tax overlapping.

The Fiscal Plight of State and Local Governments

The overriding fiscal need of State governments (including their local governments) is more tax revenue, particularly a tax source with a strong revenue growth potential in a growing economy. This immediately focuses attention on the personal income tax because, in a majority of the States, it is either the least effectively used major tax source or not used at all, and because it responds to economic growth more than any other tax.

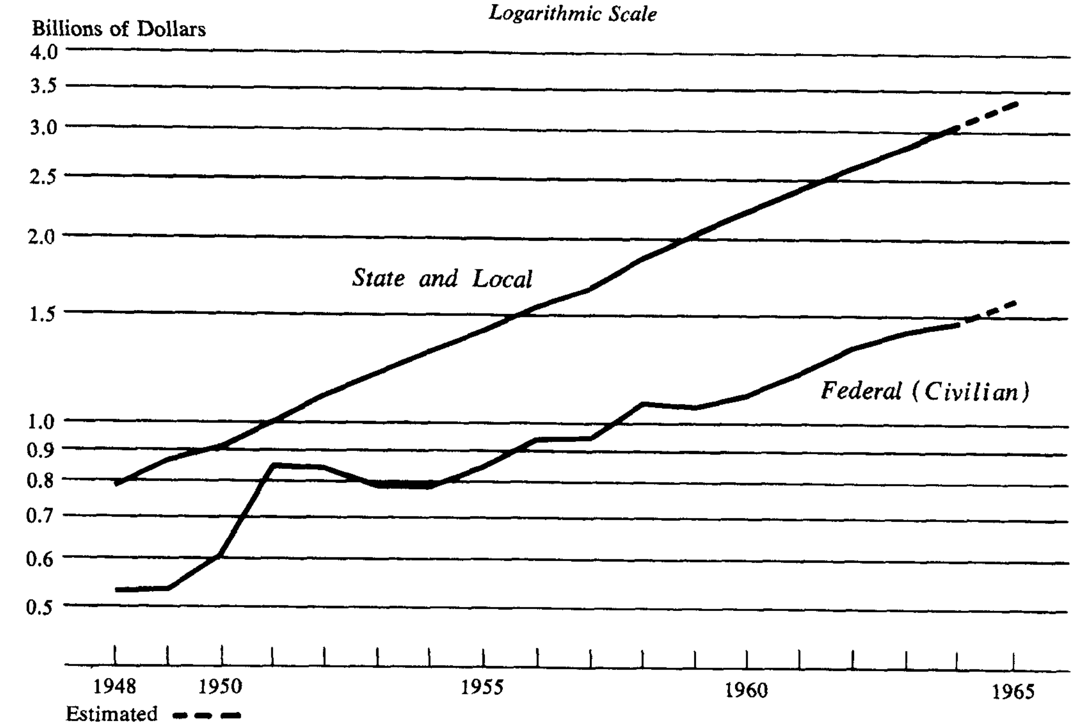
As we point out in the immediately following chapter, State and local spending has been rising at an unprecedented annual rate of 8 percent to 9 percent a year, strikingly faster than the Nation's output of goods and services (GNP). A 145 percent post-war increase in GNP has been accompanied by nearly a 300 percent increase in State-local general government expenditures.

The Nation's growing economic affluence generates more than a proportionately increased demand for more, better, and costlier governmental services, and the impact of this rising demand falls primarily on the States and their local governments because the provision of most governmental services is primarily their responsibility. This feature of our system of government explains the facts that between 1948 and 1964 the annual level of State and local governments' spending for general government purposes increased by $52 billion compared with a $14 billion increase in Federal general expenditures for civilian domestic purposes; that the number of their employees increased by 90 percent compared with 22 percent (Federal civilian); and that their per capita debt increased $355 while Federal per capita debt actually declined by $91.

Moreover, the recent rate of increase in State and local spending can be expected to persist at least for some years because the forces that produced it continue to be operative and additional ones are developing. The total population and the proportion of it consisting of older prople and of those living in the relatively costlier urban areas will continue to rise. Also, as the people's prosperity continues to improve, their demand for improved community amenities will grow apace. The National Government's emphasis on social programs to speed the realization of "great society" goals will operate in the same direction.

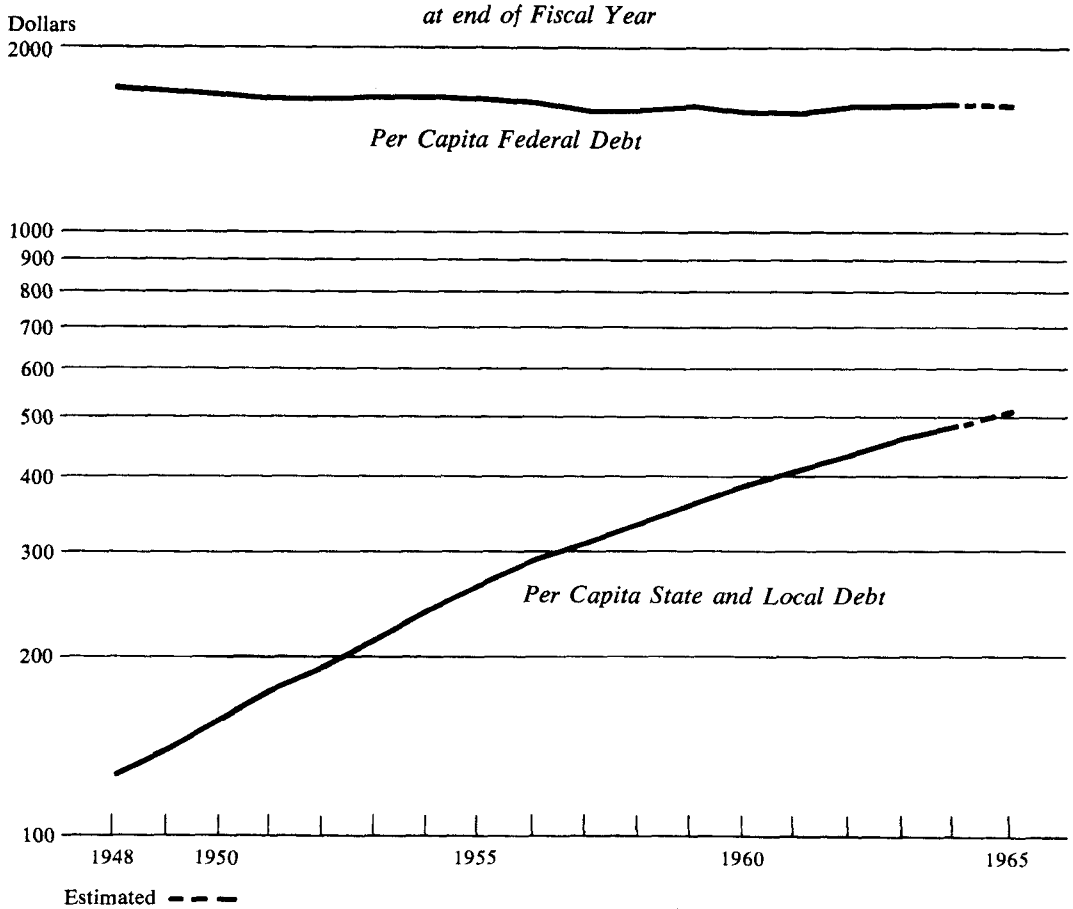
FEDERAL AND STATE-LOCAL MONTHLY PAYROLLS, 1948 TO 1965

Logarithmic Scale



FEDERAL AND STATE-LOCAL DEBT, 1948 TO 1965

at end of Fiscal Year



We have in mind also the need to correct the accumulated deficiencies in public facilities and services in the many parts of the country bypassed by recent improvements. The publicized improvements in such national averages as per pupil expenditures for public education, per case expenditures for general relief, and per capita public health expenditures obscure the fact that the level of program support in some States is barely half, in some only a third, of that found in the leader States.

In contemplating the future, we must reckon also with the fact that as time goes on, the scope of services provided by State and local governments will tend to increase because programs now known only to a few pioneering communities will tend to become the accepted norm. The educational and welfare cost implications of a national undertaking to rectify the educational and employment handicaps of the underprivileged, for example, can easily add several billion dollars to the annual level of spending within the next several years.

The ability of State and local governments to meet their growing revenue needs is becoming an increasing intergovernmental concern. On the one hand, the economic, social, and international policy objectives of the Federal Government create part of the increasing demands being made on State and local governments. On the other hand, these same national objectives are jeopardized when inadequate revenues oblige these governments to leave critical needs unmet. Congressional recognition of this Federal-State-local interdependency is being demonstrated with increasing frequency by the enactment of grant programs in functional areas hitherto left to State and local initiative.

While State and local governments' revenue needs continue to rise significantly faster than the economy, the revenue yield of their tax systems, apart from the contribution of new enactments and rate increases, does well to keep pace with economic growth. This results from the kind of taxes they employ. Consumer and property taxes account for over three-fourths of all State and local tax revenues. As we point out in Chapter 2, an increase in the GNP of say 10 percent raises total consumer tax receipts by less than 10 percent because, as people's incomes rise, they tend to devote a declining share to some categories of consumer expenditures. The response of the property tax to economic growth also has tended to be less than proportional although the more recent evidence suggests that, for the present at least, property tax revenues (with benefit of new construction and rising property values) keep pace and possibly somewhat outpace the economic growth rate. In contrast, the personal income tax has a very striking growth potential, as the Federal income tax has made clear for some years. As income levels rise, single persons and families with very low incomes move into taxable brackets and those in the lower brackets into the adjoining higher tax rate brackets. However, since the personal income tax, even after its recent rapid growth, provides only about 14 percent of State and only 8 percent of combined State and local tax revenues, its present influence on total State and local tax systems is quite diluted.

The income tax is of timely interest also because State activity in this field--new enactments as well as rate adjustments--is on the increase. Also, States are beginning to experiment with using the income tax to blunt the burden of the two major local and State taxes (real property and retail sales) on the very low income groups.

In Chapter 3, where we trace the income tax movement in the States, we point out that after the frenzied legislative activity during the Depression, the income tax movement came to an abrupt halt on the eve of World War II. After 1937, nearly a quarter century went by without a single State joining the States that had an income tax by that time. 1/ More recently, State income tax activity has resumed. In 1961 West Virginia, in 1963 Indiana, and in 1965 Nebraska adopted this tax. Several other States are actively debating its adoption. Moreover, during 1965, 8 States increased their personal income tax rates.

Recently, four States have embarked on using their income taxes to free the low income groups of excessive sales and property tax burdens. Wisconsin uses the vehicle of its income tax to rebate to elderly people a portion of their property tax bill in excess of a prescribed percentage of their income. Indiana, Colorado, and Hawaii use the income tax to relieve taxpayers of sales taxes paid on specified amounts of food purchases. In each instance, the relief is provided in the form of a credit against income tax liability with cash refunds (negative tax credit) to those whose income tax liability is insufficient to exhaust the credit.

In an earlier report we described the spreading competition among States and communities for commerce and industry. 2/ For some, the primary motivation is to provide employment and increased business; for others, the prospect of added tax revenue without tax rate increases. Whatever the motivation, the ability to attract new business firms and to hold on to old ones is rapidly becoming a symbol of political leadership.

The level of tax rates is--or at least is believed to be--a factor in this competition. Political leadership sensitive to this issue places a premium on spreading the tax load among as many different kinds of taxes as possible (and in making the base of each tax as broad as possible) so that tax rate levels required to produce the necessary amount of revenue can be minimized. This line of reasoning fosters interest in the income tax in States now without this tax and in those with relatively ineffective income taxes.

State interest in income taxation is enhanced also by the improved stability of its yield. The few States that had relatively well-developed income taxes by the 1930's were hard hit by the impact of the Depression on

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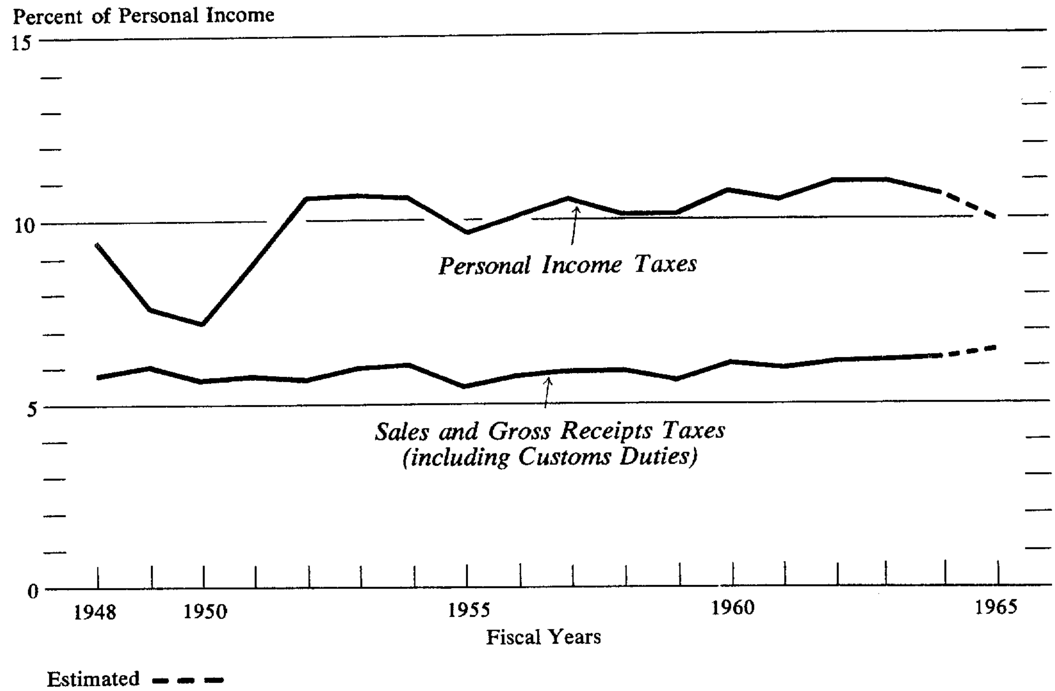
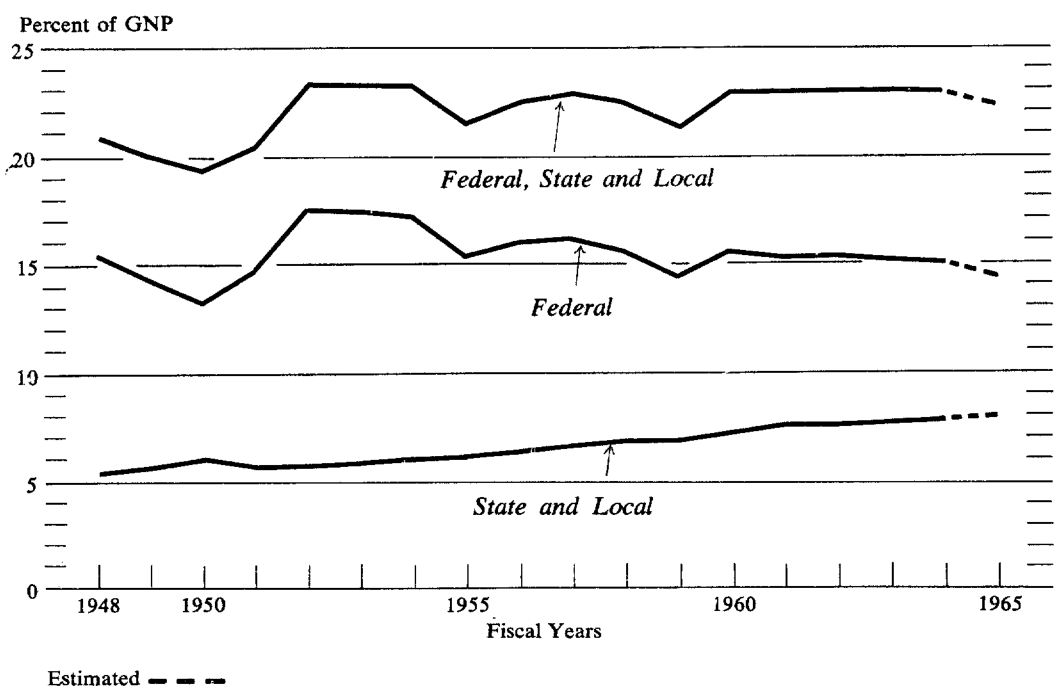
1/ Alaska adopted its tax in 1949, when it was still a territory.

2/ Industrial Development Bond Financing (A-18), June 1963.

PERSONAL INCOME TAXES AND CONSUMER TAXES AS PERCENTAGE OF PERSONAL INCOME, 1948 TO 1965



TAXES AS PERCENTAGE OF THE GROSS NATIONAL PRODUCT, 1948 TO 1965



their collections, all the more damaging because States lack the statutory authority to use deficit financing for operating costs. In the ensuing emphasis on States' need for depression-proof taxes, the income tax was understandably downgraded. Increasing public confidence in the ability of national economic policy to sustain stable economic growth and to prevent the recurrence of serious economic recessions is gradually offsetting this "unstable revenue yield" association with income taxes.

At the same time, national preoccupation with social and economic policies to improve the lot of the economically underprivileged groups in the population is focusing attention on the pattern of State tax burdens and more particularly on the potential usefulness of the income tax in reshaping the distribution of State tax burdens to harmonize better with national social policy objectives.

Rising State and local consumer and property tax rates are increasing the weight of regressive and business cost taxes at a time when Federal fiscal policies are reducing the progressiveness of the Federal income tax. The increasing regressivity of the Nation's total tax structure undercuts the Administration's efforts to wage war on poverty through direct expenditure programs and Federal tax revision.

In a very real sense, the growing weight of regressive State and local taxes tends to frustrate these governments' own revenue objectives. It is obliging them to mandate costly, inefficient, and clumsy tax exemptions, thus aggravating their revenue shortages. Exemption of food from sales taxes is the outstanding example. Exemption of the aged and veterans from property taxes, discussed in one of our earlier reports, is another. 1/ The search for more economical ways to mitigate the burden of consumer and property taxes on the low income groups is also contributing to the revival of State interest in personal income taxation.

The Role of the Federal Government

We have already noted that although both the Federal Government and the States have been active in income taxation for about 50 years, the field has been dominated by the Federal Government, particularly since World War II. The virtual halt in the State income tax movement noted above is at least partially traceable to the "pre-emptive" high Federal tax rates. For more than three decades, as the Federal Government pursued its objective of placing more and more relative dependence on income taxes, it was generally assumed that increasingly higher Federal tax rates was the wave of the future, diminishing the scope for State participation in this tax area.

Now, for the first time since the 1920's, the National Government is embarked on an economic policy, initiated with the 1964 income tax reductions,

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1/ The Role of the States in Strengthening the Property Tax (A-17), June 1963, Vol. 1, Chap. 8.

that holds out the prospect of successive future tax rate reductions. This is taking place against a background of increasing acceptance of the theory that by reducing the fiscal drag, tax reductions can contribute to stable economic growth so that revenue productivity can be preserved and increased despite lower tax rates. Presumably, this enlarges somewhat the potential of State income taxation, both by leaving the States more "elbow room" and by enhancing the revenue productivity of their taxes at any rate level.

Mention should be made also of the increasing public emphasis placed on the States' needs for more revenue by the leadership of the National Administration in recognition of the key role of State and local governments in the attainment of national economic and social policies. Finally, a recently developed interest in proposals that the Federal Government share some of its Federal income tax revenue with the States is throwing the spotlight on the varying effectiveness with which the States are utilizing their own powers to tax personal incomes.

The Need for Reexamination

It is clear, then, that both national and State developments combine to make this a propitious time to reexamine intergovernmental income tax relations, in the interest of augmenting the fiscal resources of the States, lending support to the policy objectives of the National Government, and exploring new opportunities for reducing the compliance burdens of taxpayers and improving the efficiency of tax administrations.

In short, the problem we pose for ourselves in this report is how best to adapt State income taxation and more particularly Federal-State income tax relationships to the emerging economic, fiscal, and political environment. As the foregoing discussion and more particularly the detailed discussion in subsequent chapters makes clear, our consideration of this problem is influenced by a number of objectives we deem to be of timely importance:

The need to improve the revenue producing strength of State and local tax systems;

The need to increase the revenue responsiveness (elasticity) of State and local tax systems to economic growth;

The need to minimize the level of tax rates, to offset each State's fear of competition for commerce and industry from the other States;

The need to enable the States to retain maximum control over the structure of their tax systems;

The need to minimize jurisdictional conflict between States;

The need for conforming the tax burden distribution of State and local tax systems (particularly on those with small incomes) to national social policy objectives;

The need to preserve the Federal Government's freedom of income tax action for future national crises; and

The need to minimize the compliance burdens of taxpayers, improve the operating efficiency of tax administrations, and foster tax simplification.

We turn now to an examination of the issues we believe to be controlling in the accommodation of State and Federal personal income taxes in the light of these requirements. More specifically, we address ourselves to these questions:

1. What should be the role of the personal income tax in State tax systems?

2. What part, if any, should the Federal Government play in facilitating that role?

3. What should be the relationship between the structure of State and Federal income taxes?

4. How can Federal-State administrative cooperation be enhanced?

5. How can income tax relationships among States be improved?

6. How can State-local income tax relationships be improved?

These problems are here examined in the order enumerated.

It will be noted that we deliberately exclude from our present considerations the range of issues associated with proposals that the Federal Government relinquish some of its revenues to State and local governments. These proposals have taken various forms. In recent months considerable public attention has focused on the suggestion that when it again becomes opportune for the Federal Government to reduce income taxes, it consider the alternative of diverting part of its surplus revenues to relieve the fiscal pressures on State and local governments. We do not here consider this group of proposals. It is subject enough for a separate report. It is in any event tangential to our present concern with the need to strengthen the Federal system by helping the States to help themselves out of their own resources. We have undertaken to examine the personal income tax in this context because a majority of the States are presently not using it at all or use it only ineffectively and this interstate variation contributes significantly to the wide divergence in the comparative tax efforts made by the fifty States.

The Role of the Income Tax in State Tax Systems

The personal income tax presently supplies about 14 percent of the States' and about 8 percent of State and local governments' aggregate tax revenues. Its relative role in individual States varies widely not only because of differences in the level of personal incomes but also because of different degrees of taxation.

One-third of the States do not tax personal incomes at all and another third tax them at relatively low effective rates. In contrast, the National Government obtains more than half of its tax revenue from this source. Of the American people's annual tax payments on their personal incomes, 93 percent is to the Federal Government, only 7 percent to State and local governments. The Federal payments, aggregating now about $50 billion, come from about 51 million families and single persons in all parts of the country; the $4 billion State and local payments probably come from about 25 million taxpayers living in about two-thirds of the States, which exclude some of the most industrialized high-income sections of the country.

The question before us is whether State and local governments should be encouraged to place greater reliance on this kind of tax. The case for doing so rests principally on these considerations:

1. The overriding fiscal problem of the States is their need for additional revenue and especially for a tax source that responds more than proportionately to economic growth. The personal income tax has a greater capability for producing an accelerating amount of revenue in response to rising economic activity than any other tax now in use.

2. Increased use of the income tax would permit lesser reliance on other taxes and enable State and local governments to spread their tax take among more taxes, thus permitting all tax rate levels to be minimized to reduce State vulnerability to and political leaders' concern with tax competition from other States.

3. Since the burden distribution of the income tax, unlike that of most taxes, can be predetermined, increased income tax use would enable political leadership to guide the distribution of a larger share of the State tax burden to accord with their voters' preferences.

4. The personal income tax provides the most effective way for exempting the disadvantaged members in American society--the poor--from some of the burden of State and local taxation. This fact takes on increasing importance as national policy objectives encompassed in the anti-poverty program gain dominance, as the significance of the State and local

sector in the total government operations increases and as the weight of national payroll taxes to finance social security programs grows heavier.

5. A greater reliance on the personal income tax would contribute to improving the fairness of State and local taxation also by permitting a larger share of the tax burden to be adjusted to the size of the family through an exemption system--a criterion typically disregarded by the property tax and violated by the sales tax. The unique ability of the income tax to treat individuals and households with equal income equally grows in importance as the margin between people's incomes and their consumer expenditures widens and as family homesteads become less and less indicative of taxpaying ability.

A case, however, can be made for the contrary position, in favor of the proposition that State income taxation should be kept at present relatively nominal levels. The arguments in favor of this position are these:

1. The National Government's freedom of tax action, especially important in times of emergency, should not be reduced by increased State dependence on income taxation. It will be recalled that Canada and Australia found it necessary "to buy out" their States' stake in the income tax to finance World War II.

2. States in quest of more rapid economic development may want to rely on indirect (consumer) taxes rather than direct taxes on personal incomes which tend to dull incentives. States concerned with revenue stability may have similar preferences.

3. Since the personal income tax is suited best to highly industrialized State economies, it cannot produce significant amounts of revenue efficiently for some States.

4. The States' freedom to pursue different tax policies is one of the cherished features of this federal system and should be fostered.

5. The more limited State taxation of income, the less the degree of State-Federal tax overlapping, and overlapping is incompatible with the people's preference for tax simplicity, for a clear separation of revenue sources among government levels.

In our judgment, the argument is in favor of expanding the role of personal income taxes in State-local tax systems. In arriving at this conclusion we have sought diligently to avoid the sales tax <u>vs</u>. income tax issue. We decline to express ourselves on that pointless controversy. We hold this to be a fruitless debate from the longer run viewpoint because, as time progresses, States will be left with less and less freedom to choose between taxes; increasingly they will be obliged to use all of them.

Income and sales taxes, to be sure, have very different attributes. However, the States' need for revenue is so compelling as to overshadow even such significant differences among taxes as the pattern of their burden distribution. We have identified a variety of national policy objectives that can be realized only to the extent that the States (including their local governments) have the revenue to finance their share of them. Since many of these programs concentrate on improving the well-being of the less prosperous groups in the population, the benefits these groups stand to forego, if State and local governments default on these programs for lack of funds, loom large even in relation to the low-income group's stake in the difference between the tax burden patterns of different kinds of taxes.

We have noted with interest also that sales tax and income tax advocates are beginning to find some bases of reconciliation now that the usefulness and practicability of income tax credits for relieving the burden of sales taxes on low-income groups has been demonstrated (Indiana, Colorado, and Hawaii).

We appreciate also that the aversion to income taxation at the State level is in some ways associated with forebodings about its potential misuse for "soak the rich" and other non-revenue objectives. It would appear, however, that the restraining influence exerted on State political leadership by the hard facts of interstate tax competition, limited State taxing jurisdiction, and mobility of business firms and people--factors of increasing influence since World War II--will tend to quiet public apprehensions about the possible misuse of personal income taxation by State legislators.

Recommendation No. 1. The Commission recognizes that the proper role of the personal income tax in a State's tax system must be determined by the State, for itself, on the basis of its revenue needs, resources, and its people's preference among types of taxes. The Commission, however, recommends for reasons states in this report, that in formulating their tax policies, States without the personal income tax give early and careful consideration to incorporating it into their tax system and that those presently employing a relatively ineffective income tax strengthen it.[1/]

The Federal Role in the State Income Tax Movement

Since the Federal Government's personal income tax collections are approximately 11 times greater than those of State and local governments, its income tax policies are critically important to any assessment of the future of the States' income taxes.

1/ Senator Ervin, Senator Mundt, Governor Dempsey, and Congresswoman Dwyer dissent from this recommendation and state:

"We strongly disagree with the action which the Commission has taken here. It is up to each State to determine the degree to which, if any, it wishes to use the income tax as a source of revenue for the State government. Some States with good reason may decide not to use it at all; others with equally good reason may decide to use it extensively. In our view, the Commission majority is wrong on two points. First, one cannot generalize regarding whether a tax is good or bad for the Nation as a whole. For example, some States, taking into account the very heavy burden imposed by the Federal income tax, have chosen to try to lend some balance to the equation by an emphasis on consumption and property taxes.

"In the second place, we believe it is inappropriate for the Commission to presume upon the independence of State governments in suggesting the types of taxes which they employ. In our opinion, this recommendation which the majority of the Commission has chosen to adopt is not compatible with the Commission's tradition of objectivity and neutrality in the examination of questions of intergovernmental relations."

Congressman Fountain also dissents and states:

"I favor effective State use of the personal income tax as a productive source of revenue for strengthening State government. However, I am disassociating myself from this recommendation as stated because I believe it is likely to be misconstrued.

"Tax systems and conditions differ among the States and, as the Commission has observed, each State is best able to judge for itself which taxes are most appropriate for it. Accordingly, this recommendation could be viewed as gratuitous advice to those States which have chosen not to use the income tax, or to use it only lightly, due to local conditions and the Federal tax structure. I believe that the proper way to encourage greater State use of the personal income tax is by Federal tax incentives rather than exhortation."

The historical evidence marshalled in Chapter 3 supports the finding that heavy Federal use of the personal income tax, especially since 1940, has been the single most important deterrent to its expanded use by the States. It has enabled the opponents of State income taxation to win the day with the argument that the Federal Government has effectively "pre-empted" this tax; that, therefore, State and local governments must necessarily depend primarily on consumer, business, and property taxes.

We believe it to be significant that not a single State adopted a personal income tax between 1937 and 1960, when 12 States adopted general sales taxes. Although 3 new State income taxes have been added since 1960, approximately 95 percent of the nearly $4 billion currently collected from this source goes to jurisdictions that enacted it before 1938--over a quarter century ago. In contrast, only 68 percent of general sales tax revenue is collected by States that adopted this tax prior to 1938.

The Commission concludes that extensive use of the personal income tax by the Federal Government since 1940 has deterred the State personal income tax movement.

This finding, together with our conclusion that the national interest would be served by expanded (or continued) State use of the personal income tax, as expressed in our first recommendation, brings us logically to the question whether the Federal Government should alter its tax treatment of State income tax payments so as to neutralize the deterrent effect of its heavy income tax on State use of this revenue source. The Federal Government now allows income taxpayers either to claim a 10 percent standard deduction (with minimum and maximum dollar limitations) or to itemize their State and local income tax payments as one of their allowable personal expense deductions.

A change in the Federal tax treatment of State income taxes would differentiate them from property, sales, and gasoline taxes on the ground that the National Government makes very intensive use of the income tax but taxes consumer expenditures only lightly and property not at all and that this deters State taxation of incomes. Since differentiation in tax treatment would give legislative recognition to the hypothesis that once the presently nonneutral effect of the Federal income tax on State tax policy is removed, State legislators would look with favor on the income tax because (a) it represents the last major source of untapped revenue, (b) it has unique revenue growth potential, and (c) it enjoys important advantages from the standpoint of tax fairness.

The analysis of alternative approaches to neutralizing the influence of Federal income tax policies on the taxing freedom of the States presented in Chapter 6 suggests that the most feasible method for achieving this end is to allow a tax credit against Federal liability; that a tax credit of somewhere between 25 and 50 percent of income taxes paid to State and local governments would be required. A tax credit equal to about 40 percent of State income taxes would represent a middle course between overcompensation (90-100 percent credit) and undercompensation (the present rules). The standard deduction would not be changed.

Because of its high visibility, even a partial credit has great psychological value. Under the present deductibility system, the State income tax payment merely shows up as one itemized component of the State and local tax payments (alongside property, sales, and gasoline tax payments), which are subtracted from income (together with other personal expense items) in calculating the amount of taxable income subject to the tax rates. A tax credit, available to all taxpayers whether or not they itemize, would be identified as a separate item to be subtracted by all from the amount of tax otherwise payable. This would make State tax policymakers mindful of its special Federal tax-reduction value.

The income tax credit device is familiar to many taxpayers since it has been long employed for the handling of foreign taxes paid on income derived abroad and more recently, in the treatment of dividend and retirement income and to encourage plant investment. A Federal tax credit for income taxes paid to States, moreover, has been proposed from time to time for furthering various policy objectives. In the course of our current investigation we have explored the advantages and disadvantages of the credit device in considerable detail. We here summarize both sides of the question to clarify the basis of our conclusions.

Clearly, a Federal credit for State income taxes would involve a continuing revenue cost to the U. S. Treasury, its amount depending upon its terms and upon the response of State legislatures. The range of probable costs can be estimated, however, within reasonably narrow limits.

Since the Federal Government already sustains a heavy revenue loss under the present deductibility system--every dollar of income tax collected by the States results in about a 24 cents reduction in Federal income tax liability--the <u>initial</u> cost of an optional credit plan would be less than is generally presumed. It is estimated that in terms of revenue foregone by the U. S. Treasury the cost of the present system of itemizing State income tax payments will reach about $1.1 billion by fiscal year 1967. The comparable revenue cost of an optional 40 percent credit for the same year would be about $1.8 billion. Thus, the additional 1967 cost attributable to the credit would be approximately $700 million. The comparable estimate for a 33 percent tax credit is about $500 million.

On the basis of a very liberal assumption about the effect of a 40 percent tax credit on State legislation, i.e., that all States would immediately enact individual income taxes with a yield equivalent to 2 percent of Federal AGI less personal exemptions (the corresponding equivalent in 1963 was 1.2 percent), the additional cost in terms of Federal revenue foregone would approach $2 billion in fiscal year 1968. This Federal cost would be associated with approximately $7.5 billion of State income tax collections. In the absence of such a credit, State collections can be expected to rise to $4.8 billion. Thus, a $2 billion Federal revenue loss would be matched with a $2.7 billion State revenue gain.

In a sense, the introduction of a Federal credit for State income taxes would discriminate in favor of Federal taxpayers residing in income tax States and against those in the States that rely upon other revenue sources. It would have this result if most of the non-income tax States continued to refrain from income taxation; if the credit did not achieve its end. However, the very threat of such discrimination would tend to make it short lived. By making the effective date of the credit provision prospective, say two to four years after the date of enactment, Congress would afford legislatures (and the electorate) in the non-income tax States an opportunity to enact a personal income tax, to safeguard their constituents against discriminatory Federal tax treatment. Similarly, legislatures in States with operating income taxes would have ample opportunity to consider rate increases to absorb all or part of the prospective Federal tax credit. We are confident that this is the course State legislatures would elect because the pressure for added revenue is unrelenting. Indeed, it is for this reason that we believe it unnecessary to couple such a credit with a requirement for corresponding increases in State income taxes, a revenue maintenance provision of the kind we proposed in connection with increasing the Federal estate tax credit.

Some are of the opinion that it is unnecessary for the Federal Government to incur a revenue cost for the purpose of encouraging greater State use of the personal income tax because the growing fiscal crisis at the State level will eventually force most States to use this last major source of untapped revenue anyhow; that the recent Federal tax reductions will speed this development. We are not so confident. Many of the non-income tax States will continue to be hobbled by their relatively inelastic tax structure in the foreseeable future unless income taxation is accorded some additional support. Since political leadership tends to regard any decision to impose a new general tax on the public as a last resort, non-income tax States can be expected to exploit less controversial revenue sources before adopting a personal income tax. Three years have elapsed since Federal tax reduction to stimulate the economy was first injected into public discussion on a large scale. During that period legislatures in many States faced tax increases. Significantly, none was urged to increase income taxes on the ground that Federal taxes were being reduced.

We have considered also the view that preferential tax treatment for State personal income tax payments would violate the concept of Federal neutrality as the general public understands it and would undermine State autonomy in decision-making on taxes. Such departure from neutrality, however, would be more apparent than real, since in a sense the present system, dating from 1913, lost its neutral character when the Federal Government turned to primary reliance on the individual income tax during World War II.

The possibility can not be overlooked that preferential treatment of State income taxes would trigger demands upon the Congress for comparable treatment of sales and property taxes. The basic objective of the plan to encourage State income taxes would be nullified, of course, if Congress heeded these demands. Congress need not do so, however, for as we have already noted, the income tax can be distinguished from the others on the ground that while the Federal Government pre-empts a large share of personal incomes, it taxes neither general sales nor property.

It will be noted that we leave open the percentage rate at which State income tax payments should be credited against Federal tax liability, believing this to be a matter for congressional consideration on the basis of public hearings. Some will hold that political and economic circumstances vary so widely among the States that preferential tax treatment of State income taxes pegged at any reasonable level will overcompensate for the deterrent effects of the heavy Federal income tax in some States and undercompensate for it in others. Admittedly, the science of public finance is not sufficiently exact to tell us the precise amount of inducement that will just be sufficient to compensate for the deterrent effect of heavy Federal taxes. Reasonable inferences can be drawn, however, from historical experience. Clearly, a 90 to 100 percent credit would tip the scales completely in favor of State income taxation. No State could refrain from financing most of its needs by writing drafts on the U. S. Treasury. It is equally clear that the present deductibility system (equal, on the average to a 24 percent Federal credit for all deductible taxes) makes inadequate compensation for the high Federal rates and that, as a consequence, Federal tax policy tips the scales in favor of State and local consumption and property taxes. This suggests that a partial credit in the 25 to 50 percent range would come close to steering a middle course between undercompensation (the present situation) and overcompensation (a 100 percent or full credit). The precise rate required is appropriately an issue for legislative resolution.

We have considered the possibility of postponing consideration of the States' need for more effective income taxes pending completion of a comprehensive study of the whole State and local fiscal system and of the alternatives available to the Federal Government for relieving the financial burdens of State and local governments and concluded against counseling delay. It is clear to us that no comprehensive study of the ways in which the Federal Government can use its resources in aiding State and local governments can override the hard logic that the States should be encouraged to exploit their own tax resources before Congress considers the introduction of large scale general purpose aid programs.

These are the principal considerations underlying our conclusion in favor of the Federal income tax credit. We believe that such a credit would facilitate more effective State use of personal income taxation and, by improving the States' ability to solve their fiscal problems with their own resources, would help to reinforce their independence and thereby strengthen this federal system.

<u>Recommendation No. 2.</u> <u>The Commission concludes that extensive use of the Federal personal income tax since 1940 has retarded the State personal income tax movement and that this deterrent effect should be neutralized in order to enable the States to help themselves before Congress is asked to consider other general forms of Federal financial aid. The Commission recommends, therefore, that the Congress amend the Internal Revenue Code on a prospective basis</u>

to give Federal income taxpayers an option to either (a) continue itemizing their income tax payments to State and local governments or (b) claim a substantial percentage of such payments as a credit against their Federal income tax liability. [1/]

The Conformity Issue

The proposition that revenue sources should be clearly separated by an arrangement which would reserve the income tax for the Federal Government, sales taxes for the States, and the property tax for local governments has long had widespread support. Confronted with the hard fact of tax overlapping in the income tax field, however, many have tended to support the view that State personal income tax laws should conform as closely as possible to the Federal Internal Revenue Code, in order to minimize inconvenience to taxpayers and administrative costs. If taxpayer convenience and administrative efficiency can not be secured by separation of revenue sources, then a policy of conformity is acceptable as a "second-best" method.

Two basic questions are involved in the conformity issue:

> Should the States be encouraged to conform their tax laws more closely to the Federal income tax?
>
> If more extensive conformity is desirable, how much farther down the path to conformity should the States go?

Although considerations of taxpayer convenience and administrative efficiency support a substantial degree of conformity to the Federal income tax, several other factors must also be weighed in the balance. Conformity involves a limited delegation of State sovereignty, the effects on State revenues can

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1/ Secretary Fowler expresses the following reservation:

> "I have not voted on this recommendation. At the present time I am clear I cannot vote in favor of it. But since important issues are involved, I do not desire to vote against it. I would prefer that the matter be given wider study and discussion. It represents in effect a method of providing Federal financial assistance to State and local governments. Alternative methods to this end have been suggested by others. All of these alternatives involve a very substantial commitment of Federal funds and for that reason require careful public discussion."

Governor Dempsey abstains from this recommendation.

not be overlooked, and conformity builds into the State law the bad features of the Federal income tax along with the good.

It is our judgment that an attempt to exercise independence with respect to the definition of net income derived from business and professional activity would be misguided, because the basic questions in this area are best resolved in accord with the rules of good business practice, which presumably do not vary significantly from State to State. The major issue is what should be allowed as a cost for doing business, and the rules of sound accounting practices must necessarily prevail. The definition of net income from business operations is, in fact, largely an exercise in articulating the rules of accountancy.

<u>The Commission concludes that State personal income tax laws should provide for the deduction of the "ordinary and necessary" expenses of earning income as they are defined in the Federal Internal Revenue Code, and that the expenses of employees should be deductible in the same way as the expenses of those carrying on a trade or business.</u>

We turn next to consideration of the extent to which State laws should conform to the Federal income tax. Apart from the rather theoretical possibility of pursuing a totally independent course (the first of listed alternatives) a State can follow one of five basic alternatives:

Rank Order	Degree of conformity	Description	Form 1040 correspondence
1.	None	Complete independence from Federal provisions	None
2.	Minimum	Conformity with respect to particular exclusion and deduction provisions	Selected line items
3.	Moderate	Conformity to Federal adjusted gross income (total income after "cost" adjustments) and before personal exemptions and deductions	Line 9
4.	Extensive	Conformity to Federal net income before personal exemptions	Line 11b
5.	Very extensive	Conformity to Federal taxable income	Line 11d
6.	Complete	The State tax base is the Federal tax liability	Line 16

FORM 1040 U.S. Treasury Department Internal Revenue Service

U.S. INDIVIDUAL INCOME TAX RETURN—1964

or taxable year beginning ...., 1964, ending ...., 19....

Your social security number (Husband's if joint return)

Please Print or Type

First name and initial (If joint return, use first names and middle initials of both) | Last name | Occupation

Home address (Number and street or rural route) | Wife's number, if joint return

City, town or post office, and State | Postal ZIP code | Occupation

Enter the name and address used on your return for 1963 (if the same as above, write "Same"). If none filed, give reason.

NOTE.—Married taxpayers: If you are changing from filing separate returns to a joint return or from a joint return to separate returns, enter names and addresses from the 1963 joint or separate returns.

See instructions before completing your return.

FILING STATUS—check one:

1a. ☐ Single

b. ☐ Married filing joint return (even if only one had income)

c. ☐ Married filing separately. If your husband or wife is also filing a return give his or her first name and social security number.

d. ☐ Unmarried Head of Household

e. ☐ Surviving widow(er) with dependent child

EXEMPTIONS

2a. Regular . . . . . . ☐ Yourself ☐ Wife

b. Age 65 or over . . ☐ Yourself ☐ Wife

c. Blind . . . . ☐ Yourself ☐ Wife

Enter number of boxes checked →

3a. Number of your dependent children *who lived with you*

b. Number of other dependents (from line 3, Part I, page 2)

4. Total exemptions claimed →

● Attach Copy B of Form W-2 Here ●

INCOME—If joint return, include all income of both husband and wife

5. Wages, salaries, tips, etc. If not shown on attached Forms W-2 attach explanation • $

6. Other income (from line 9, Part II, page 2) •

7. Total (add lines 5 and 6)

8. Adjustments (from line 5, Part III, page 2) •

9. Total income (subtract line 8 from line 7) •

FIGURE TAX BY USING EITHER 10 OR 11

TAX COMPUTATION

10. Tax Table—*If you do not itemize deductions and line 9 is less than $5,000, find your tax from tables* in instructions. Do not use lines 11 a, b, c, or d. Enter tax on line 12.

11. Tax Rate Schedule—

a. If you itemize deductions, enter total from Part IV, page 2
If you do not itemize deductions, and line 9 is $5,000 or more enter the larger of:
(1) 10 percent of line 9 or;
(2) $200 ($100 if married and filing separate return) plus $100 for each exemption claimed on line 4, above.
The deduction computed under (1) or (2) is limited to $1,000 ($500 if married and filing separate return). •

b. Subtract line 11a from line 9

c. Multiply total number of exemptions on line 4, above, by $600

d. Subtract line 11c from line 11b. (Figure your tax on this amount by using tax rate schedule on page 10 of instructions. Enter tax on line 12.)

TAX—CREDITS—PAYMENTS

● Attach Check or Money Order Here ●

12. Tax (from either Tax Table, line 10, or Tax Rate Schedule, line 11) •

13. Total credits (from line 5, Part V, page 2) •

14. Income tax (subtract line 13 from line 12)

15. Self-employment tax (Schedule C-3 or F-1) •

16. Total tax (add lines 14 and 15) •
If either you or your wife worked for more than one employer, see page 5 of instructions.

17a. Total Federal income tax withheld (attach Forms W-2) •

b. 1964 Estimated tax payments .... •
(Include 1963 overpayment allowed as a credit) **(Office where paid)**

c. Total (add lines 17a and 17b)

TAX DUE OR REFUND

18. If payments (line 17c) are less than tax (line 16), enter **Balance Due.** Pay in full with this return. →

19. If payments (line 17c) are larger than tax (line 16), enter **Overpayment** →

20. Amount of line 19 you wish credited to 1965 Estimated Tax

21. Subtract line 20 from 19. Apply to: ☐ U.S. Savings Bonds, with excess refunded; or ☐ Refund only

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete. If prepared by a person other than taxpayer, his declaration is based on all information of which he has any knowledge.

SIGN HERE → .... If joint return, BOTH HUSBAND AND WIFE MUST SIGN even if only one had income. .... Date

Sign here .... Signature of preparer other than taxpayer .... Address .... Date

16—78363a—1

PART I.—EXEMPTIONS—Complete only for dependents claimed on line 3b, page 1

(a) NAME (If more space is needed attach schedule)	(b) Relationship	(c) Months lived in your home. If born or died during year write "B" or "D"	(d) Did dependent have income of $600 or more?	(e) Amount YOU furnished for dependent's support. If 100% write "ALL"	(f) Amount furnished by OTHERS including dependent
1.				$	$
2.					

3. Total number of dependents listed above. Enter here and on line 3b, page 1 . . . . →

PART II.—INCOME FROM ALL SOURCES OTHER THAN WAGES, SALARIES, ETC.

Dividends and Other Distributions

A. Gross amount . . . .

B. Nontaxable and capital gain distributions . .

C. Subtract item B from item A. Give details in lines 1a through 1d .

Explanation of Item C (Write (H), (W), (J) for stock held by husband, wife, or jointly)

1a. Qualifying dividends (Name of payer)

Total . . .

b. Subtract $100. If joint return see instructions .

c. Balance . . . .

d. Nonqualifying dividends (Name of payer)

Total . . .

2. Total (add lines 1c and 1d) . . . →

3. Interest (Name of payer)

Total interest income . . . →

4. Pensions and annuities, rents and royalties, partnerships, and estates or trusts (Schedule B) .

5. Business income (Schedule C) . . . . . .

6. Sale or exchange of property (Schedule D) . .

7. Farm income (Schedule F) . . . .

8. Other sources (state nature)

Total other sources . . . →

9. Add lines 2 through 8. Enter here and on line 6, page 1 . . . . →

PART III.—ADJUSTMENTS

1. "Sick pay" if included in line 5, page 1 (Attach Form 2440 or other required statement) . .
2. Moving expenses (attach Form 3903) . . . .
3. Employee business expense (attach Form 2106 or other statement) . . . .
4. Payments by self-employed persons to retirement plans, etc. (Attach Form 2950SE) . . .
5. **Total adjustments** (lines 1 through 4). Enter here and on line 8, page 1 . . . .

EXPENSE ACCOUNT INFORMATION—If you had an expense allowance or charged expenses to your employer, check here ☐ and see page 7 of instructions.

PART IV.—ITEMIZED DEDUCTIONS—Use only if you do not use tax table or standard deduction.

Medical and dental expense.—Attach itemized list. Do not enter any expense compensated by insurance or otherwise. NOTE: If you or your wife are 65 or over, or if either has a dependent parent 65 or over, see page 8 of instructions for possible larger deduction.

1. Enter excess, if any, of medicine and drugs over 1% of line 9, page 1 . . . .
2. Other medical, dental expenses (include hospital insurance premiums) . . . .
3. Total (add lines 1 and 2) . . . .
4. Enter 3% of line 9, page 1 (see note above) .
5. Subtract line 4 from line 3; see page 8 of instructions for maximum limitation . . . . .

Contributions.—If other than money, attach required statement—see instructions.

Total (see instructions for limitations) →

Interest: Home mortgage

Other (Specify)

Total interest expense →

Taxes—Real estate

State and local gasoline

General sales

State and local income

Personal property

Total taxes →

Other deductions (see page 9 of instructions)

Total other deductions →

TOTAL DEDUCTIONS (For line 11a, page 1) →

PART V.—CREDITS

1. Dividends received credit: Enter smallest of (a) 2% of line 1c, Part II, (b) tax shown on line 12, page 1, less foreign tax credit, or (c) 2% of taxable income (see instructions).
2. Retirement income credit (Schedule B) . . .
3. Investment credit (Form 3468) . . . . . .

4a. Foreign tax credit (Form 1116)

b. Tax-free covenant bonds credit

5. **Total credits** (add lines 1 through 4b). Enter here and on line 13, page 1 . . . .

☆☆ U.S. GOVERNMENT PRINTING OFFICE: 1964—O-725-541

A detailed discussion of the relative advantages of the alternative conformity policies appears in Chapter 7. The Commission believes that the following criteria are relevant to a choice among them:

1. The policy should maximize taxpayer convenience and minimize administrative costs;

2. It should enable a State to collect substantial revenues with relatively low tax rates and therefore should employ the broadest possible tax base;

3. Taxpayers with equal abilities to pay taxes should be treated equally; in technical terms, the definition of taxable income should be "horizontally equitable";

4. The approach should not restrict a State's freedom to establish its own rate structure and personal exemptions; and

5. The approach should minimize the likelihood of adverse effects on State tax revenues resulting from foreseeable changes in Federal tax policy.

The first criterion alone is sufficient to rule out the first two listed alternatives. Some meaningful gains in taxpayer convenience could be obtained by an extension of conformity with respect to particular exclusions and deductions, but only alternatives 3 through 6, those embraced in the range from moderate to complete conformity, are relevant if a real breakthrough in taxpayer convenience and administrative economy is desired. As far as taxpayer convenience and administrative costs are concerned, alternatives 3 through 6 all are quite satisfactory. A single figure from his Federal tax return would be enough to complete most of a taxpayer's State return under any one of the approaches.

If the largest possible State tax base is sought, the highest rating must be given to the adjusted gross income base (alternative 3). Federal adjusted gross income is over 75 percent larger than Federal taxable income. Even Federal adjusted gross income could be substantially increased by the inclusion of such classes of income as unemployment compensation, sick pay, and the 50 percent of long-term capital gains that is excluded by the Federal Code. Many States presently include these items in taxable income. Modification of Federal adjusted gross income by requiring the addition of such classes of income could increase the Federal figure by as much as 10 or 15 percent.

The Internal Revenue Code has come under increasing criticism in recent years for its special provisions that impair the equal treatment of taxpayers with equal incomes. Most of these inequities result from personal deduction provisions, which discriminate against renters and those who pay cash for their television sets and washing machines--to cite two examples. Since many of the inequities could be avoided by not conforming to Federal taxable income, the criterion of equity also provides a basis for preferring adjusted gross income (alternative 3). Indeed, a regard for tax fairness reinforces the revenue case for raising the Federal figure by including in the State tax base certain classes of income that are excluded from Federal adjusted gross income. To the extent that Federal personal deduction provisions are designed to serve social policy objectives--such as encouraging charitable contributions--it is doubtful that State tax considerations will have an effect on individuals' plans that begins to match the cost to the State in lost tax base. Only alternative 6, that is, when the Federal tax is the base for the State tax, would preclude a State from enacting exceptions to any of the Federal definitions whenever considerations of equity or social policy appear to that State to be worth the revenue loss.

Under any of the four alternatives--3 through 6--a State is free to set its own tax rates, but only under alternatives 3 and 4 does a State reserve the right to define its own personal exemptions. Theoretically, adoption of the Federal tax liability as the State tax base--alternative 6--leaves a State free to establish a rate structure that yields a progressive, regressive, or proportional distribution of the State tax burden. Given that Federal tax liabilities are progressively distributed, however, a flat-rate State tax defines a degree of progressivity that parallels the Federal. Since State rates that appear to decline as a taxpayer's Federal income tax rises are unlikely to have much political appeal, adoption of alternative 6 probably would tend to commit a State to a flat percentage relationship to Federal tax liability and to a burden distribution that parallels the progressiveness of the Federal tax.

Recommendation No. 3. The Commission recommends that the States endeavor to bring their income tax laws into harmony with the Federal definition of adjusted gross income, modified to allow the deduction of individuals' income earnings expenses and for such additions to the tax base as considerations of base-broadening and equity make feasible. 1/

Federal-State Administrative Cooperation

Americans take justifiable pride in the opportunity their federal system affords for experimentation at the State level with alternative approaches to the solution of governmental problems. The diffusion of political responsibility affords the opportunity to test new ideas in limited geographic areas. The personal income tax, which preoccupies us in this report, was first pioneered in its modern version, it should be remembered, by a State (Wisconsin), not the Federal Government.

Now that 20 to 25 million families and single persons pay both Federal and State income taxes and even a larger number file two tax returns, a first

1/ Governor Dempsey abstains from this recommendation.

rate opportunity exists to advance taxpayer convenience and administrative simplification, provided that both Federal and State tax policymakers can create an environment hospitable to administrative innovation and experimentation. The potential benefits of Federal-State administrative cooperation will become even greater as more States move into income taxation.

Since World War II, and more particularly after 1950, considerable progress has been made in administrative cooperation, as exemplified by the conclusion of formal agreements between the Federal Government and the States for cooperative exchange of tax information, by the availability of Federal statistical services to the States, and by the provision of machinery to enable State tax enforcement personnel to participate in training programs conducted by the Internal Revenue Service (Chapter 7). These arrangements are only beginning to be utilized and their use will undoubtedly be expanded as their potential benefits come to be more widely appreciated.

However promising these efforts in Federal-State cooperation, we regard them at best to be tentative first steps toward maximizing taxpayer convenience and administrative efficiency. To date, the progress has been chiefly in the direction of strengthening the enforcement arm of the State. To the extent that the taxpayer's filing process has been made more convenient, it stems less from intergovernmental cooperation than from State legislatures' efforts to conform their personal income tax laws to Federal Revenue Code definitions.

The ultimate objective of Federal-State income tax comity--one contemplated by some planners as early as the 1930's--is a condition that would enable the taxpayer to satisfy both State and Federal filing requirements with a single tax return. We are not unmindful of the differences between the State and Federal constitutional taxing powers with respect to some sources of income, but such differences as are essential can be handled in the relatively few cases affected by adjustments within a combined Federal-State return. Conceivably, both governments' taxes could ultimately be collected by the Federal Internal Revenue Service. The realization of such a goal, however, is unlikely without State and Federal authority to experiment on a limited geographic basis.

Federal collection of State personal income taxes could be implemented at any one of four successive stages of tax administration:

1. Withholding of income tax at the source;

2. The taxpayer's declaration of estimated income;

3. Initial arithmetic verification of the taxpayer's return by the Internal Revenue Service; or

4. Audit of the taxpayer's return by the Internal Revenue Service.

Joint handling of both State and Federal tax returns up to the arithmetic verification (3) or the audit (4) stage would ease taxpayers' compliance burdens materially because a single annual return with the Internal Revenue Service would discharge both the Federal and State obligations. Employers would benefit from a substantial reduction in paper work if withheld State and Federal taxes could be handled in a single remittance. State tax agencies would gain in improved taxpayer compliance and in substantial administrative economies.

Obviously, it would be fairly simple for the Internal Revenue Service to collect State income taxes if they were all tied uniformly to the Federal tax base and the rules of State taxing jurisdiction were simplified and standardized. Still, the versatility afforded by comprehensive and sophisticated data processing systems will facilitate handling many kinds of interstate variations. However, the electronic computer can function only on the basis of information fed into it. It cannot resolve the kind of legal, administrative, and political problems inherent in the construction of a combined Federal-State collection system. We have in mind, for example, the absence of a uniform definition of residency, the multistate origin of income, the mobility of taxpayers, and the varying concepts of State taxing jurisdiction.

Serious political problems are also raised by a proposal to "farm out" the collection of State income taxes to the Internal Revenue Service. On general principles, many persons would take the view that the benefits to be derived in the form of greater taxpayer convenience and administrative efficiency would be far outweighed by the loss of absolute State control over the collection process and the consequent aggrandizement of the Federal bureaucracy.

If Federal collection were applied at the withholding (1), the declaration (2), or the arithmetic verification (3) stage, the Internal Revenue Service would be acting only in an administrative capacity. States would not necessarily be required to change their tax structures significantly. Presumably, their tax sovereignty would not be jeopardized because they would retain the ultimate administrative and political responsibility, both for determining the amount of the tax and for final adjudication of taxpayer liabilities. Only if the combined State-Federal administration carried all the way through the audit (4) stage would a State actually "farm out" final determination of taxpayer liability to the Internal Revenue Service.

Because of the political ramifications and administrative problems involved in Federal collection of State income taxes, any experimentation in this field would of necessity have to be on an optional basis. State political leaders would have to weigh the benefits to be derived--greater taxpayer convenience, administrative simplification, improved compliance--against the loss of States' control over their collection system. By the same token, the Internal Revenue Service would want to retain its freedom to prescribe the conditions necessary to enable it to undertake such an activity.

The crucial point to be underscored is this: Both the States and the Internal Revenue Service should be given the legal authorization to enter into tax collection agreements because without it experimentation with Federal collection of State income taxes is effectively prevented. It is our expectation that, armed with this kind of authority, a State considering the adoption of a personal income tax for the first time might well be receptive to the idea of utilizing the Federal collection apparatus at the withholding stage or even to the point of mathematical verification, and would therefore be willing to construct its laws so as to meet the reasonable requirements of the Internal Revenue Service for this kind of undertaking.

Recommendation No. 4. The Commission recommends that in order to encourage experimentation with Federal collection of State income taxes, the Congress authorize the Internal Revenue Service, and that the legislatures of States using personal income taxes authorize their governors, to enter into mutually acceptable agreements for Federal collection of State income taxes.1/

State Taxing Jurisdiction

It is a well-established principle of income tax jurisdiction that a State can tax all the income of its residents, wherever derived, as well as that portion of a nonresident's income that originates within its borders. The objective of holding a resident accountable for all of his income wherever derived has logic in its favor in that the income tax is a personal tax and liability under it should properly reflect the taxpayer's total personal income. The taxation of nonresident income recipients, on the other hand, recognizes that the State of employment incurs various public costs in providing and developing employment opportunities. Since many individuals obtain at least part of their income from out-of-State sources, the simultaneous use of both jurisdictional rules can result in double taxation except to the extent that it is prevented by a system of tax credits.

In the usual situation, an individual who resides in one income tax State and derives income from another is granted a tax credit by his own State for the income tax he pays to the other State. For example, if he earns all of his income in the other State, and his tax liability to his own State is equal to or less than his liability to the other State, he will pay a tax only to the other State; if his own State imposes a heavier income tax than the other, he will pay the difference between the two tax liabilities to his State of residence (having paid the other State the amount he owes it under its rate structure).

Thirteen States use a different approach. In addition to allowing a credit to residents who are required to pay income taxes to another State, they either allow a credit to nonresidents or exempt them from the income tax, provided their own State reciprocates. In these circumstances, a resident of one such reciprocating State deriving income from another is relieved of any nonresident tax where the reciprocating States exempt nonresident income (that is, his total tax is paid to his own State). Where the reciprocal agreement is in the form of a nonresident credit and the State in which the taxpayer earns his income levies a higher tax than does his own State, he pays

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1/ Governor Dempsey abstains from this recommendation.

only the difference between the two tax liabilities to the former (having paid his own State the amount he owes it under its rate structure).

While both crediting devices prevent double taxation, they have opposite effects on the distribution of tax revenue derived from interstate income. When a State grants a credit to its residents and not to nonresidents, it is voluntarily shifting all or part of its residents' tax liability on out-of-State income to the State where that income is earned, while retaining the tax on nonresidents' income derived within its borders. States reciprocally crediting nonresidents with taxes they pay to their own States or exempting nonresidents' income from taxation shift the nonresidents' tax back to their State of residence, while retaining the whole tax of their residents no matter where their income is derived.

There are a number of arguments in favor of the prevailing system of allowing resident credits for income taxes paid to other States:

1. The resident credit ties into withholding systems operating in virtually all States, for it recognizes the fact that an employer can be required to withhold taxes for the State in which his business is located while he cannot be required to do so by another State, unless he also operates in that State. With a nonresident credit or exemption of nonresidents' income from taxation, the tax liability is to the State of residence which cannot enforce withholding of its tax from the income of its residents in another State. The resident State can, of course, require its taxpayers to make a declaration of estimated income, but it loses the administrative advantage of withholding at the source. It is for this reason that a number of States have relinquished their nonresident credit since adopting withholding.

2. Our Recommendation No. 4, that the Internal Revenue Service be authorized to experiment with Federal collection of State personal income taxes, reflects our expectation that it should be possible ultimately to move toward a combined Federal-State system of personal income tax administration. Since withholding at the source is the backbone of both Federal and State tax enforcement, that objective can be attained only if withholding can be applied at the source of income, regardless of the taxpayer's State of residence.

3. When a State provides a nonresident credit, it tempts bordering non-income tax States to shift part of its personal income tax revenue to themselves. Until 1961, New York was among those States that allowed a nonresident credit. This credit entailed very little revenue cost to New York at that time since its major bedroom communities were in New Jersey and Connecticut, neither of which levied an income tax. New Jersey tried to capitalize on this situation by levying a "commuters' income tax" which would have drawn

about \$30 million from the New York income tax paid by New Jersey residents. To avoid that loss, New York dropped its nonresident credit.

4. At one time, when industry was concentrated in a few States, the resident credit device favored the industrial States. With many more in-commuters than out-commuters, it was to their advantage to tax nonresidents, leaving it up to those individuals' States to adjust for double taxation by allowing them a resident credit. The progressive industrialization of more and more States and the greater incidence of interstate commuting is rapidly changing this picture. As the number of commuters moving in both directions across State lines is better balanced, the revenue advantage of taxing nonresidents will be minimized.

The disadvantage of the credit system (whether it is applied to residents or nonresidents) is the burden it places on the taxpayer. Under a credit system, the taxpayer with out-of-State income must file tax returns in two States--his own and the one in which he derives his income--if both levy a personal income tax. In many instances, such a taxpayer owes taxes to both States. Since his employer will have withheld the nonresident State's tax, the taxpayer may well have to apply for a refund from that State at the same time that he pays some amount to his own State. A half-dozen States have moved to eliminate this source of taxpayer irritation by exempting a nonresident's income from their taxes if his State accords their residents like treatment. In these instances, the employer is also relieved of withholding the tax, since the residence State cannot enforce withholding upon the employer in the nonresidence State. As a result, the State of residence has to rely on obtaining a declaration of estimated income from the taxpayer, making enforcement more difficult. It is sometimes possible to arrange for voluntary withholding, as was done in the Maryland-D.C.-Virginia area with the cooperation of Federal agencies. In general, however, unless a firm operates in all States that enter such an agreement, it is hardly likely that this arrangement can be applied to a private employer.

The advantage of eliminating double filing inherent in the credit system by exempting the income of a nonresident from a State's personal income tax is outweighed, in our view, by the administrative advantages to be derived from a uniform system of resident credits to avoid double taxation.

<u>Recommendation No. 5.</u> <u>The Commission recommends, therefore, that all States continue to allow credits to their residents for personal income taxes they pay to other States and that those States that now allow a nonresident credit repeal such nonresident provision.</u> [1/]

1/ Governor Dempsey abstains from this recommendation.

Definition of "Residence"

Although the present system of credits minimizes double taxation, there are some gaps because States define a "resident" in different ways. Thus, an individual could be considered a resident of two States during the same period of time as a result of conflicting legal definitions or conflicting interpretations of those definitions. Conversely, it is possible to evade State income taxation by deft manipulation of residence definitions.

Some States define "residence" as "domicile" or "permanent place of abode," without specifying a time period during which an individual is required to be in such status to be considered a resident. Others set forth detailed specifications, including different time periods. These variations result in time-consuming administrative annoyances to State tax officials.

Several States, like California and Arizona, consider an individual is a resident of the State if he "is in this State for other than a temporary or transitory purpose" or if he "is domiciled in this State" but "is outside the State for a temporary or transitory purpose." New York uses a somewhat more precise definition in that it provides for a minimum length of time an individual must have spent in the State during a taxable year to be considered a resident (the specified time period depending upon whether or not he maintained a "permanent place of abode.") This Commission believes that some such definition (either the California or the New York type) applied uniformly by all the States, would avoid some of the problems now faced by State tax administrators. Admittedly, some problems would still remain, as in the case of individuals who maintain "permanent" residences in two or three States. By and large, however, a taxpayer could only be considered a resident of one State during any period of time under such a definition.

The absence of a uniform definition of "residence" brings to mind the problems associated with the divergent State rules for the allocation of income from interstate commerce. Because the States have not been able to agree on a single, uniform allocation formula, the Congress has been petitioned to prescribe such rules for them. We regret the need for such Federal action, as do State tax administrators but, in the absence of vigorous action on the part of the States, see no logical basis for questioning it.

The "residence" problem in the personal income tax field is a much simpler one and the States should be able to cooperate in arriving at an acceptable solution.

Recommendation No. 6. The Commission recommends that the States adopt the following definition of "residence":

> "A resident individual means an individual: (a) who is domiciled in this State, unless he maintains no permanent place of abode in this State, maintains a

permanent place of abode elsewhere, and spends in the aggregate not more than thirty days of the taxable year in this State; or (b) who is not domiciled in this State but maintains a permanent place of abode in this State and spends in the aggregate more than one hundred eighty-three days of the taxable year in this State."

The Commission recommends further that the State tax agency be authorized to enter into reciprocal agreements to eliminate potential double taxation that might result from conflict in interpretation of the residence rule.1/

State-Local Relationships

Local governments in six States (Alabama, Kentucky, Missouri, Michigan, Ohio, and Pennsylvania) impose income taxes (Chapter 4). The first three-mentioned States levy also State personal income taxes at low to moderate rates, but the number of their localities using income taxes is quite limited.

Michigan, Ohio, and Pennsylvania, none of which levies a State personal income tax, have permitted local income taxation to proliferate. This is particularly true in Pennsylvania, where almost 2000 cities, boroughs, townships, and school districts have enacted local income taxes, and in Ohio where about 100 city income tax ordinances are in force. Although only few Michigan cities now use income taxes, the 1964 legislation authorizing uniform city income taxes will undoubtedly spur many more local enactments. About $350 million is now being produced annually from the local income taxes in the three States: $200 million in Pennsylvania, $100 million in Ohio, and $40 to $50 million in Michigan.

Any proposal for a State personal income tax inevitably raises the question of sharing the proceeds with local governments. That issue will be particularly controversial in States where local governments already collect income taxes. Should the State allow the local taxes to continue and adopt a third overlapping income tax? Or should the authority for local income taxes be replaced somehow from the proceeds of the new State tax?

This Commission has already gone on record with regard to the uncoordinated proliferation of local nonproperty taxes. In the report, State Constitutional and Statutory Restrictions on Local Taxing Powers, we urged the States

1/ Governor Dempsey abstains from this recommendation.

to adhere to the following basic principle in granting nonproperty taxing powers to their local governments:

> Most local governments are smaller than the economic area in which they participate and therefore are handicapped in individually making use of income, sales, excise, and similar nonproperty taxes. Accordingly, local governments should be enabled to use these taxes only where required in the interest of the desired distribution of the combined State-local tax burden among the several bases of taxation (property, income, consumption, and business activity), and more specifically, only where increasing demands for local services cannot be reasonably met from available property tax sources or where property already bears an inordinate share of the local tax burden. Where these conditions necessitate the use of nonproperty taxes by local governments, it is incumbent upon the State to help those local governments to overcome the handicaps which necessarily attach to independently administered nonproperty taxes.

Basically, insofar as the personal income tax is concerned, our preference is for a State, rather than a locally imposed, tax. Nevertheless, we recognize that political philosophies differ among States, and each will make its decision according to that philosophy. No matter what the decision, however, it should take advantage of the coordinating possibilities that a State income tax will open up.

Obviously, the most effective way to coordinate State and local personal income taxes is to impose and administer such a tax at the State level. The State can then distribute a portion of the tax to its local governments by: (1) returning to each locality a specific percentage of the amount collected within its jurisdiction; (2) using a portion of the tax revenue as an equalizing grant to be used by local governments as they see fit (including the reduction of property taxes); or (3) increasing the amounts distributed under grant-in-aid programs for particular purposes. In a strict construction sense, each of these devices can be said to impair somewhat local independence, for the State legislature can change the percentage it is willing to share, it can change an equalization formula, and it can impose conditions as to the local use of the funds. There is no "best" way for distributing State funds to local governments and the Commission offers none at this time. The resolution of that problem is subject enough for a separate study of State-local fiscal relationships.

If States like Michigan, Ohio, and Pennsylvania decide to continue local income taxation in conjunction with a State personal income tax, they should adhere to the following guidelines, generally applicable to local nonproperty taxes, which we have already set forth in the aforementioned report: (1) provisions relating to the use of nonproperty taxes should be statutory rather than constitutional, and they should be specific as to the kinds of taxes authorized, the particular local governments authorized to use them, their structure (tax base, exemptions, etc.), and administration; (2) the electorate should always have the authority to initiate by petition a vote on proposals for new nonproperty taxes; (3) the case for most nonproperty taxes is strongest in the large urban places; and (4) where a particular tax, such as the sales or income tax, is in widespread use by local governments and is simultaneously used also by the State, the most promising coordinating device is the local tax supplement to the State tax.

The Michigan "Uniform City Income Tax Act," which adheres closely to the first three guidelines, could be adapted very readily to the piggy-back idea contemplated by the fourth guideline should a State decide to adopt a statewide personal income tax. It also mitigates some of the regressive sting and inequitable features to be found in most of the existing local income taxes by allowing personal and dependency exemptions and by including in the base of the tax interest, dividends, and capital gains income. The Michigan approach to local income taxation holds some useful lessons for States that find it necessary to sanction local taxation of income.

Recommendation No. 7. The Commission recommends taxation of personal income at the State rather than the local level, but if local income taxes are also levied, they should be authorized only in the form of a supplement ("piggy-back") to be administered with the State tax.

States electing to relinquish the personal income tax to their local governments are urged (a) to limit them to as large taxing areas as possible, ideally coinciding with the boundaries of trading and economic areas, (b) to prescribe rules governing taxpayers, tax base, rates, etc., uniformly applicable to all local taxing jurisdictions, and (c) to provide technical assistance in the administering and enforcement of local income taxes. 1/

1/ Representative Crank dissents in part from this recommendation and states that:

> "Personal income taxes should not be utilized below the State level. Their attempted use by local governments promotes inter-local economic competition and results in unequal taxation of individuals with comparable income derived within and partly without the jurisdiction in which they reside."

Governor Dempsey abstains from this recommendation.

Chapter 2

THE FISCAL PROBLEM OF THE STATES

The fiscal problem of State (including local) governments is the failure of their revenue systems to generate yields that grow--without rate increases or new taxes--as rapidly as expenditure requirements. In this chapter we examine the dimensions of this problem; first expenditures, then revenues. Since the focus of our analysis is the State personal income tax, the primary emphasis is on State government.

EXPENDITURES

State and local governments today are responsible for slightly more than half (52 percent) of all government spending for civilian-domestic purposes. Exclusive of trust fund and business enterprise activities, the States and local governments account for over three-fourths of civilian general expenditures. In fiscal year 1964, the latest year for which State-local data are available, the Federal Government spent about $23 billion for non-military general expenditure purposes. State and local governments' direct general expenditures were $69 billion. The States' share of this total was $24 billion, or approximately 26 percent of all civilian-domestic general government expenditures (table 1).

During the past decade the gross national product rose at an average annual rate of 5.5 percent. (This figure slightly overstates the true growth rate of the economy because 1954 was a recession year, and 1964 a year of prosperity.) The same period saw State and local direct general expenditures rise steadily by 8.5 percent per year. The States' expenditures rose even more rapidly at 9.2 percent every year, while Federal spending increased at a rate--6.0 percent--that barely exceeded the rate of GNP rise.

The accomplishments of the years since World War II notwithstanding, the pressures for growing expenditures are not likely to abate in the near future. Most of the factors responsible for expenditure growth in the immediate past will continue to be operative: the total population, the relative importance of the dependent age groups and of those living in the relatively costlier urban areas, will continue to rise; growing economic affluence will continue to generate demand for improving community amenities.

Some of the factors operating to raise State and local expenditure needs are less widely appreciated. As the business community's methods become more

TABLE 1.--CIVILIAN-DOMESTIC DIRECT GENERAL EXPENDITURES BY GOVERNMENTS, 1948, 1954, AND 1964

(Dollar amounts in millions)

Government	Civilian-domestic direct general expenditures					
	1948		1954		1964	
	Amount	Percent of total	Amount	Percent of total	Amount	Percent of total
Federal 1/	$ 8,713	33.0	$12,792	29.4	$22,838	24.8
State and local	17,684	67.0	30,701	70.6	69,302	75.2
State only	6,186	23.4	10,109	23.2	24,275	26.3
All governments	26,397	100.0	43,493	100.0	92,140	100.0

1/ Total direct general expenditures less expenditures for defense and international relations, space research and technology, interest on general debt, and veterans' services.

Sources: U. S. Bureau of the Census, Census of Governments: 1962, Vol. VI, No. 4, Historical Statistics on Governmental Finances and Employment, 1964, pp. 36, 39, 42; Governmental Finances in 1963-64, 1965, pp. 19, 25.

sophisticated, its management insists on a better educated labor force, on improved public facilities (water, sewage, roads, airports), and on better environmental conditions for its employees. The National Government's aspirations for a Great Society and its economic growth and foreign policy objectives, as well as rapidly changing technology and increased population mobility, operate in the same direction, both directly and by stimulating the social consciousness of the people. The impact of national policies on State and local budgets is inescapable because the public services and facilities prerequisite for the environment in which the Federal policies can be realized by the individual, the business firm, and the community are largely local and State responsibilities.

It needs to be recognized, too, that while the postwar expenditure increases have improved the quality of governmental services, the improvement has been very uneven. Some States and some communities within most of the States have been bypassed. Regrettably, expenditure levels tend to be least adequate in the very areas where needs are greatest--where the economically underprivileged predominate. Even among States, disparities in spending levels remain wide. In 1964 public school expenditures per pupil ranged from $241 in Mississippi to $705 in New York. Average monthly old-age assistance payments ranged from less than $40 in Mississippi to $108 in California; general assistance payments per recipient from less than $4 in Arkansas to $64 in Maryland. Average monthly earnings of full-time municipal employees ranged from $255 in Mississippi to $607 in California. Since these are State averages, the needs in many places within particular States are even more acute.

We make no attempt here to develop firm, quantitative projections of future State and local spending levels. The economic, technological, and social transformation in process is too rapid to warrant confidence in the continued validity of past trends. Ten, possibly even five years ago, few would have anticipated a 1965 State-local expenditure level of nearly $90 billion, and understandably so. Services known only to residents of a few pioneering communities in one decade become commonplace in the next. Consider, for example, the implications for State and local budgets of a national undertaking to rectify the educational and health deficiencies or the employment handicaps of the economically and socially disadvantaged. Man's aspirations for goods and services always lead current availabilities. These considerations suggest that the rate of State and local expenditure growth experienced in the immediate past will continue for the near future. 1/ However, the growth need not continue at the 8.5 percent annual rate of the last decade to produce spending levels in excess of $100 billion by 1970. In the absence of untoward international and defense developments, State and local expenditures can readily outdistance total Federal spending within a decade.

REVENUES

The expenditure growth examined in the preceding section has been financed from three general sources: State and local taxes, fees, and user charges; Federal grants-in-aid; and State and local borrowing (table 2). General revenues raised by State and local governments from their own sources increased 124 percent during a decade in which the GNP rose only 71 percent; those raised by State governments alone increased 126 percent. Even these spectacular rates of growth were modest in comparison with the increase in Federal aid. It more than tripled in the 10 year period and, with $9 out of every $10 going to the States, accounted for nearly 30 percent of the rise in total State general revenue. Moreover, about 45 percent of the aid was earmarked for highways and another 25 percent for public welfare (primarily public assistance payments to the aged, dependent children, the blind, and the disabled).

Of the $28 billion in general revenue collected by the States from their own sources in 1964, 86 percent--$24 billion--came from taxes. State tax systems are dominated by consumer taxes (table 3), in contrast to the

1/ It obviously can not continue indefinitely at a rate faster than the growth in the GNP.

TABLE 2.--SOURCES OF STATE AND LOCAL GENERAL REVENUE IN 1954 AND 1964

(Dollar amounts in millions)

Source	Amount 1954	Amount 1964	Percent increase 1954-64	Amount of increase 1954-64	Percent of total increase 1954-64
Total State-local general revenue	$29,012	$68,443	135.9	$39,431	100.0
Federal grants	2,966	10,002	237.2	7,036	17.8
Revenue from State-local sources	26,046	58,440	124.4	32,394	82.2
Total State general revenue	15,299	37,648	146.1	22,349	100.0
Federal grants	2,668	9,046	239.1	6,378	28.5
Revenue from State sources 1/	12,631	28,602	126.4	15,971	71.5

1/ Including a small amount of revenue from local governments.

Sources: U. S. Bureau of the Census, Census of Governments: 1962, Vol. VI, No. 4, Historical Statistics on Governmental Finances and Employment, 1964, pp. 39, 42; Governmental Finances in 1963-64, 1965, p. 22.

Federal system, which relies primarily upon income taxes, and to local systems, which obtain most of their revenue from property taxes. The most important single source of State revenue in 1965 was the general sales tax. Individual income taxes came in a poor third after motor fuel levies. It should be noted, however, that, while the relative contribution of consumer taxes to total State tax yield has been virtually constant since World War II, the role of income and general sales taxes has increased significantly, largely at the expense of selective sales and miscellaneous license and privilege taxes.

State and local debt outstanding increased from $39 billion in 1954 to $92 billion in 1964, a rise of 137 percent. State debt grew even more dramatically--161 percent--during a period in which the debt of the Federal Government rose only 15 percent.

Our discussion of State general revenue must be pursued in substantially greater depth before the true dimensions of the States' fiscal problem are clearly established. The points made in the following discussion apply equally to fees, charges, and other general revenue, but to simplify the terminology we refer only to taxes. The important issues will be easier to handle if we establish a simple conceptual distinction. On the one hand,

TABLE 3. --STATE TAX COLLECTIONS, BY MAJOR SOURCE, SELECTED YEARS, 1902 to 1965

Year	Total, excluding employment taxes	Individual income	Corporation income	Sales and gross receipts				All other
				Total	General	Motor fuel	Other	
			AMOUNT (In millions of dollars)					
1902	156	--	--	28	--	--	28	128
1913	301	--	--	55	--	--	55	246
1922	947	43	58	134	--	13	121	712
1927	1,608	70	92	445	--	259	186	1,001
1932	1,890	74	79	726	7	527	192	1,011
1934	1,979	80	49	978	173	565	240	872
1936	2,618	153	113	1,394	364	687	343	958
1938	3,132	218	165	1,674	447	777	450	1,075
1940	3,313	206	155	1,852	499	839	514	1,100
1942	3,903	249	269	2,218	632	940	645	1,167
1944	4,071	316	446	2,153	720	684	749	1,157
1946	4,937	389	442	2,803	899	886	1,019	1,304
1948	6,743	499	585	4,042	1,478	1,259	1,304	1,616
1950	7,930	724	586	4,670	1,670	1,544	1,455	1,950
1952	9,857	913	838	5,730	2,229	1,870	1,631	2,376
1953	10,552	969	810	6,209	2,433	2,019	1,757	2,564
1954	11,089	1,004	772	6,573	2,540	2,218	1,816	2,740
1955	11,597	1,094	737	6,864	2,637	2,353	1,874	2,902
1956	13,375	1,374	890	7,801	3,036	2,687	2,078	3,310
1957	14,531	1,563	984	8,436	3,373	2,828	2,234	3,548
1958	14,919	1,544	1,018	8,750	3,507	2,919	2,324	3,606
1959	15,848	1,764	1,001	9,287	3,697	3,058	2,531	3,798
1960	18,036	2,209	1,180	10,510	4,302	3,335	2,873	4,137
1961	19,057	2,355	1,266	11,031	4,510	3,431	3,090	4,405
1962	20,561	2,728	1,308	12,038	5,111	3,665	3,263	4,487
1963	22,117	2,956	1,505	12,873	5,539	3,851	3,482	4,783
1964	24,243	3,415	1,695	13,957	6,084	4,059	3,814	5,176
1965	26,104	3,642	1,931	15,052	6,710	4,295	4,047	5,479
			PERCENTAGE DISTRIBUTION					
1902	100.0	--	--	17.9	--	--	17.9	82.1
1913	100.0	--	--	18.3	--	--	18.3	81.7
1922	100.0	4.5	6.1	14.1	--	1.4	12.8	75.2
1927	100.0	4.4	5.7	27.7	--	16.1	11.6	62.3
1932	100.0	3.9	4.2	38.4	.4	27.9	10.2	53.5
1934	100.0	4.0	2.5	49.4	8.7	28.5	12.1	44.1
1936	100.0	5.8	4.3	53.2	13.9	26.2	13.1	36.6
1938	100.0	7.0	5.3	53.4	14.3	24.8	14.4	34.3
1940	100.0	6.2	4.7	55.9	15.1	25.3	15.5	33.2
1942	100.0	6.4	6.9	56.8	16.2	24.1	16.5	29.9
1944	100.0	7.8	11.0	52.9	17.7	16.8	18.4	28.4
1946	100.0	7.9	9.0	56.8	18.2	17.9	20.6	26.4
1948	100.0	7.4	8.7	59.9	21.9	18.7	19.3	24.0
1950	100.0	9.1	7.4	58.9	21.1	19.5	18.3	24.6
1952	100.0	9.3	8.5	58.1	22.6	19.0	16.5	24.1
1953	100.0	9.2	7.7	58.8	23.1	19.1	16.7	24.3
1954	100.0	9.1	7.0	59.3	22.9	20.0	16.4	24.7
1955	100.0	9.4	5.4	59.2	22.7	20.3	16.2	25.0
1956	100.0	10.3	6.7	58.3	22.7	20.1	15.5	24.7
1957	100.0	10.8	6.8	58.1	23.2	19.5	15.4	24.4
1958	100.0	10.3	6.8	58.7	23.5	19.6	15.6	24.2
1959	100.0	11.1	6.3	58.6	23.3	19.3	16.0	24.0
1960	100.0	12.2	6.5	58.3	23.9	18.5	15.9	22.9
1961	100.0	12.4	6.6	57.9	23.7	18.0	16.2	23.1
1962	100.0	13.3	6.4	58.5	24.9	17.8	15.9	21.8
1963	100.0	13.4	6.8	58.2	25.0	17.4	15.7	21.6
1964	100.0	14.1	7.0	57.6	25.1	16.7	15.7	21.4
1965	100.0	14.0	7.4	57.7	25.7	16.5	15.5	21.0

Note: Detail may not add to total because of rounding.

Sources: U.S. Bureau of the Census, Census of Governments: 1962, Vol. VI. No. 4, Historical Statistics on Governmental Finances and Employment, 1964; Compendium of State Government Finances in 1964, 1965; State Tax Collections in 1965.

the most obvious fact about State revenue systems is that in any particular fiscal year different taxes yield different amounts of revenue. Thus our discussion begins with the factors that determine the absolute amounts of tax yields. Only slightly less obvious, on the other hand, is the fact that the yields of different taxes grow at widely varying rates, and that these rates appear to bear no relationship to the relative importance of the taxes in total revenues. Our discussion of the factors that account for different rates of growth will take us directly to the heart of the States' fiscal problem.

The amount of revenue yielded by a given tax in a particular fiscal year depends directly upon two basic factors: the size of the tax base and the average effective tax rate. A general sales tax that excludes food from its definition of taxable sales (the tax "base") for example, will yield less revenue than the same tax rate applied to a base that includes food. 1/ The quality of tax administration is an important enough variable to deserve mention as a third determinant of total yield. The introduction of income tax withholding, for example, has brought forth very substantial increases in yields without rate increases or "base-broadening."

Increases in tax collections from one year to the next involve an additional set of considerations. Other things being equal, of course, the yield of a given tax will be higher next year than in the present fiscal year if the legislature increases the average rate, or if it broadens the definition of the base, or if it appropriates more money for tax enforcement. Similarly, the yield of a State's revenue system as a whole will increase if entirely new taxes or fees are adopted. We will see that a very large proportion of the actual increases in State general revenues since World War II have resulted from these types of "structural" changes in State systems. It is by no means true, however, that the tax with the broadest base and/or the highest average rate will have the most rapidly growing yield.

Income Elasticity

The discussion of the next few pages focuses on an aspect of the growth of State general revenue that is, from the point of view of defining the dimensions of the States' fiscal problem, more important than any other--the portion of changes in receipts that may be called automatic.

Tax collections rise automatically whenever the gross national product increases, and when the GNP declines during a recession the yield of almost every tax suffers. This relationship exists because individuals' incomes and consumption expenditures, which are the sources of nearly all tax revenues, move in the same direction as the GNP. Apart from the influence of tax enforcement, the amount of tax collections, of course, depends upon the size of the base (consumer expenditures or income) and the tax rate: rate times base equals yield.

1/ The exclusion of food from the base can result in the loss of a quarter or more of the potential yield.

The yield of each tax responds differently to changes in the GNP, and the concept that measures the degree of automatic responsiveness is called income elasticity. If an increase of 10 percent in the GNP is accompanied by a 10 percent rise in the proceeds of a particular tax (with no change in rate), the tax is said to have an income elasticity of 1. If the percentage change in yield is less than the percentage change in the GNP, the tax is inelastic (the ratio of the percentage changes has a value of less than 1). If the reverse is true the tax is elastic (income elasticity is greater than 1).

The income elasticity of every tax is determined primarily by the responsiveness of its base to changes in the gross national product. During 1964, for example, the GNP increased 6.6 percent, gasoline sales increased approximately 4 percent, and consumer spending for goods and services rose 6.5 percent. 1/ On the basis of this information we would expect the income elasticity of a gasoline tax to be considerably less than that of a general sales tax, and this is, in fact, the case. 2/ When the behavior of its tax base has been defined, the income elasticity of a consumption tax is explained.

The elasticity of an income tax is a considerably more complicated matter, and a detailed consideration of the question appears in Chapter 5. Suffice it to say here that the elasticity of an income tax is primarily a function of the responsiveness of its base--taxable income--to changes in the GNP, so the above discussion of the elasticity of consumption taxes should be sufficient for the purposes of this discussion.

A number of studies of State finances have come up with estimates of the GNP elasticities of the major categories of State general revenues. Table 4 is based on the results of several of these studies. Note that three elasticity estimates are provided for each category. It is necessary to be somewhat less than specific about the elasticities for two basic reasons. First, there is no consensus among economists regarding the proper average elasticities. Secondly, the evidence suggests that the elasticities of all, or nearly all, categories of receipts vary over time. The best we can do, then, is to specify the ranges within which we may reasonably expect the elasticities to fall during any particular period. For these reasons, references in this report to receipts elasticities generally will be to ranges rather than to precise figures.

1/ U. S. Department of Commerce, Survey of Current Business, February 1965, p. 16. Gasoline sales estimated by the American Petroleum Institute, reported in Federation of Tax Administrators Tax Administrators News, January 1965, p. 6.

2/ Studies have determined that the GNP elasticity of the typical gasoline tax is approximately 0.5, while the elasticity of general sales taxes approaches 1.0.

TABLE 4. --GROSS NATIONAL PRODUCT ELASTICITIES OF THE MAJOR CATEGORIES OF STATE GENERAL REVENUE

Revenue source		Elasticity estimates		
		Low	Medium	High
Property taxes		0.7	0.9	1.1
Income taxes:	individual	1.5	1.65	1.8
	corporate	1.1	1.2	1.3
Sales taxes:	general	0.9	0.97	1.05
	motor fuel	0.4	0.5	0.6
	alcoholic beverages	0.4	0.5	0.6
	tobacco	0.3	0.35	0.4
	public utilities	0.9	0.95	1.0
	other	0.9	1.0	1.1
Auto license and registration		0.2	0.3	0.4
Death and gift taxes		1.0	1.1	1.2
All other taxes		0.6	0.65	0.7
Higher education fees		1.6	1.7	1.8
Hospital fees		1.3	1.4	1.5
Natural resources fees		0.9	1.0	1.1
Interest earnings		0.6	0.7	0.8
Miscellaneous fees and charges		0.6	0.7	0.8

Sources: Benjamin Bridges, Jr., "The Elasticity of the Property Tax Base: Some Cross Section Estimates," Land Economics, Vol. 40, November 1964, pp. 449-51; Jesse Burkhead, State and Local Taxes for Public Education, The Economics and Politics of Public Education Series, No. 7 (Syracuse University Press, Syracuse: 1963), p. 67; David George Davies, "The Sensitivity of Consumption Taxes to Fluctuations in Income," National Tax Journal, Vol. 15, September 1962, pp. 281-90; James S. Duesenberry, Otto Eckstein, and Gary Fromm, "A Simulation of the United States Economy in Recession," Econometrica, Vol. 28, October 1960, pp. 749-809; Harold M. Groves and C. Harry Kahn, "The Stability of State and Local Tax Yields," American Economic Review, Vol. 42, March 1952, pp. 87-102; Robert Harris and Selma Mushkin, "The Revenue Outlook in 1970: A Further Report on Project '70," unpublished paper prepared for the National Association of Tax Administrators' 1964 Conference on Revenue Estimating, October 1964, p. 16; Ernest Kurnow, "On the Elasticity of the Real Property Tax," Journal of Finance, Vol. 18, March 1963, pp. 56-8; Eugene P. McLoone, "Effects of Tax Elasticities on the Financial Support of Education," unpublished Ph.D. dissertation (College of Education, University of Illinois, Urbana: 1961); Dick Netzer, "Financial Needs and Resources Over the Next Decade: State and Local Governments," in Public Finances: Needs, Sources, and Utilization, a Report of the National Bureau of Economic Research (Princeton University Press, Princeton: 1961), pp. 23-65; Robert W. Rafuse, Jr., "The Cyclical Behavior of State-Local Finances," in Richard A. Musgrave, Editor, Essays in Multi-Level Finance, Studies of Government Finance, The Brookings Institution, Washington, D.C., 1965; Lee Soltow, "The Historic Rise in the Number of Taxpayers in a State with a Constant Tax Law," National Tax Journal, Vol. 8, December 1955, pp. 379-81.

These crude estimates of the GNP elasticities of the major categories of State government suggest a number of interesting conclusions. Estimates of the GNP elasticity of total State general revenues at any particular point in time are given by weighted averages of the elasticities of the several revenue sources, using actual collections in the year in question as the weights. 1/ Thus, it is possible to say that the GNP elasticity of total State general revenue in fiscal year 1964 was approximately 0.92--the result yielded by using the medium elasticity hypotheses. The low and high estimates for 1964 are 0.82 and 1.01, as shown in the following table:

Fiscal year	Elasticity estimate Low	Medium	High
1947	0.74	0.83	0.93
1954	.75	.85	.94
1964	.82	.92	1.01
1970	.89	.99	1.09

As time passes and economic growth results in an increasing GNP, the yields of the receipts categories with higher elasticities automatically grow more rapidly, by definition, than collections from categories with lower elasticities. Thus, unless rate increases and new adoptions are relatively more frequent in the cases of the low elasticity receipts categories, the overall elasticity of State general revenue will increase every year that the GNP increases. By 1970, if the GNP increases according to the estimates of the Inter-Agency Study of Economic Growth, that is, by approximately 60 percent above 1964, and if there are no increases in tax rates or adoptions of new sources, 2/ this process will automatically raise the elasticity of general revenues to 0.89, or 0.99, or 1.09 (low, medium, and high elasticity hypotheses, respectively). The elasticity of State general revenues has in fact been rising gradually since the end of World War II. Using actual yields in 1947 and 1954 as weights, the medium elasticity estimate for 1947 is 0.83. By 1954 the elasticity (medium estimate) had increased slightly to 0.85. Clearly, the process of elasticity-rise has proceeded somewhat more rapidly since 1954.

1/ The average elasticities discussed here are for total State general revenue. Since the importance of a particular category of receipts will vary from State to State--yielding averages that will vary depending on the State--these estimates of system elasticities should not be interpreted as applying to any particular State.

2/ Or if there are such increases or adoptions, we assume only that they are evenly distributed among the categories.

The set of elasticity estimates for the major categories of State general revenue also provide the necessary raw material for determining the approximate relative importance of rate increases and adoptions of new taxes --changes that may be referred to as "structural," to distinguish them from the automatic changes that are handled by the elasticity concept--in raising State general revenues in the postwar period. Accordingly, we have prepared estimates of the percentage of the actual increase in State revenues that was accounted for by structural changes in State revenue systems (rate increases and new sources) during the periods 1947-64 and 1954-64. 1/

Between 1947 and 1964 the medium elasticities imply that 58 percent of the total increase in State general revenues is attributable to taxes and rate increases enacted since 1947. 2/ For the period since 1954 our calculations indicate that roughly 55 percent of the rise in State receipts is attributable to structural changes, 3/ and only 45 percent to the automatic responsiveness of collections to the growing GNP. These findings suggest that State legislative activity in the revenue field was only slightly less vigorous between 1954 and 1964 than it had been during the earlier years of the postwar period.

If these estimates of the revenue increases attributable to structural changes in State systems seem high, a moment's reflection on the record of new adoptions and rate increases during the past 17 or 18 years should prove convincing. In 1946, 23 State revenue systems included a general sales tax. By the end of 1965, 15 more States (not including Hawaii) had adopted the tax, 19 of the original 23 States had raised their rates, and still others had broadened their tax bases. At the beginning of the postwar period 30 States taxed personal incomes, and by 1964 three more States had been added to the list. 4/ Seventeen States increased their income tax rates between 1950 and 1964. Five States have adopted corporation income taxes since

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1/ Each of the sets (low, medium, and high) of elasticity hypotheses is used to estimate the automatic increase in the yield of each revenue category that would have accompanied the increase in the GNP for the period in question. Presumably, then, the differences between the predicted automatic increases and the increases that actually occurred represent the revenue impact of new taxes and rate changes.

2/ The corresponding low and high elasticity estimates are, respectively, 63 percent and 53 percent.

3/ The low and high elasticities yield estimates of 60 and 50 percent, respectively.

4/ These figures do not include New Hampshire and Tennessee, which have taxed income from intangibles since before World War II; New Jersey, which enacted its "commuters'" (personal income) tax in 1961; and Nebraska, which adopted a personal and a corporation income tax in 1965 that will go into effect on January 1, 1967, if it is not voted down in referendum.

1947. Thirty-eight States raised their gasoline tax rates between 1950 and 1964. Fifteen States enacted cigarette taxes between 1947 and 1964, and by 1964, 42 had increased their rates. The experience of the past two years is excellent evidence of the States' quest for new revenues through structural changes in their tax systems (table 5).

REVIEW OF THE OVERALL SITUATION

Since reserves accumulated during World War II disappeared about the time the Korean War began, many States have been confronted by continuous fiscal crisis. They have been able to struggle through the past 15 years only by resorting to one expedient after another. They have doubled and redoubled cigarette taxes, they have pushed sales tax rates as high as 5 percent, they have asked for and received massive aid from the Federal Government, they have experimented with an ingenious arsenal of budgetary legerdemain, and they have even resorted to the operation of lotteries. And still yields fall short of needs. Things will be no better 5 years from now unless States make progress toward a solution of their basic fiscal problem, the inability of most of their revenue systems to generate yields that grow--without rate increases or new taxes--as rapidly as expenditure requirements. In technical terms, as discussed in the preceding pages, the income elasticity of State revenue systems is too low.

We have determined that the GNP elasticity of State general revenues today is approximately 0.9, or, alternatively, that it lies somewhere in the range of 0.82 to 1.01. We have also seen that the elasticity figure has increased slightly since the end of World War II, when it was around 0.8, and that the gradual process of elasticity increase can be counted upon, in the absence of offsetting structural changes, to carry the figure to approximately 1.0 by 1970.

The rate of growth of State general expenditures, on the other hand, has been nearly twice the rate of GNP rise during the postwar period. During the past decade the rates were, respectively, 9.2 percent and 5.5 percent. Strictly speaking the concept of GNP elasticity in its rigorous, scientific sense should not be applied to the expenditure side of the budget, but we do no great violence to the concept by employing the terminology to simplify this discussion. 1/ For the period since 1954, therefore, we may say that the GNP elasticity of State general expenditures has averaged approximately 1.7, and we have argued that there are no persuasive reasons why we should not anticipate an "elasticity" this large in the near future.

1/ Technically, the concept of elasticity relates only automatic changes in receipts to changes in the GNP. As we have seen, the behavior of government receipts cannot really be understood without distinguishing between automatic and structurally induced changes in revenue yields. On the expenditure side, however, there are very few cases of automatic (footnote continued on next page)

TABLE 5.--STATES INCREASING TAX RATES AND ENACTING NEW TAXES, SELECTED TAXES, JANUARY 1, 1959-68*

State	Sales	Personal income	Corporation income	Motor fuel	Cigarette	Alcoholic beverage
Alabama......	x	....	x	....	xxx	x
Alaska.......	....	x	....	xx	x	x
Arizona......	x	xx	xx	xx	x	x
Arkansas.....	....	....	....	x	x	....
California...	x	xx	xx	x	Nx1/	xx
Colorado.....	x	x	x	x	Nx	x
Connecticut..	x	....	x	....	xxx	x
Delaware.....	....	x	....	xx	xx	x
Florida......	....	....	....	....	x	xx
Georgia......	....	....	x	....	x	x
Hawaii.......	x	x	x	....	x	x
Idaho........	N	xx	xx	x	xxx	xxx
Illinois.....	xxx	....	....	x	xxx	x
Indiana......	N2/	N2/	N2/	....	xx	....
Iowa.........	x	xx	xx	x	xxxx	xx
Kansas.......	x	x	x	....	xx	xx
Kentucky.....	N	....	....	....	....	....
Louisiana....	....	....	....	....	....	....
Maine........	xx	....	....	....	xxxx	x
Maryland.....	....	x	x	x	x	....
Massachusetts	N	x	x	x	x	x
Michigan.....	x	N	N	x	x	x
Minnesota....	N	xxx	xxx	xx	xxx	x
Mississippi..	x	....	....	x4/	xx	N
Missouri.....	x	....	....	x	x	x

State	Sales	Personal income	Corporation income	Motor fuel	Cigarette	Alcoholic beverage
Montana......	....	xxx	xx	x	....	x
Nebraska.....	N	N	N	x	xx	x
Nevada.......	x	....	....	....	x	x
N. Hampshire.	....	....	....	x	xx	....
New Jersey...	N	N3/	x	x	xxx	x
N. Mexico....	x	x	x	xx	x	xx
New York.....	N	x	....	x	xx	x
N. Carolina..	....	....	....	....	....	x
N. Dakota....	xx	....	....	....	x	x
Ohio.........	x	....	....	x	xx	x
Oklahoma.....	....	....	....	....	xx	N
Oregon.......	....	....	....	x	N	....
Pennsylvania.	xxx	....	x	x	xxx	x
Rhode Island.	xxx	....	x	x	xx	....
S. Carolina..	....	x	....	....	x	x
S. Dakota....	x	....	....	....	xxx	x
Tennessee....	....	....	xx	x4/	xx	xxx
Texas........	N	....	....	....	xx	x
Utah.........	xx	x	x	....	x	....
Vermont......	....	....	....	....	xxx	....
Virginia.....	N	....	....	x	N	x
Washington...	xxx	....	....	xxx	xxx	x
W. Virginia..	x	N	N	x	x	....
Wisconsin....	N	xxxx		x	xxx	xxx
Wyoming......	xx	....	....	x	xx	x5/
Dist. of Col.	x	x	....	x	x	xx

Note: Each x indicates a tax increase enactment, and each N indicates a new tax; 1967 enactments are underlined.

1/ California enacted a two-step cigarette tax increase, from 3¢ to 7¢ a package eff. 8/1/67 and a further increase from 7¢ to 10¢ eff. 10/1/67.

2/ Partly replaces the gross income tax.

3/ "Commuter Income" tax.

4/ Increase in diesel fuel tax rate only.

5/ Beer tax increase declared unconstitutional (1963).

* Updated for this reprint.

An expenditure elasticity of 1.7 and a revenue elasticity of 0.9 or 1.0 leave a financing gap that is the perennial fiscal problem of the States. At the Federal level the situation is entirely different. The GNP elasticity of Federal expenditures appears to be considerably less than that of State expenditures. The elasticity of Federal receipts by all indications appears to be in the same neighborhood as the elasticity of expenditures--1.1 or 1.2. Indeed, recent discussions of the Federal budgetary outlook have centered on the remarkable prospect that the automatic growth of Federal receipts in the next few years may actually outdistance foreseeable expenditure increases, thus creating the phenomenon referred to as "fiscal drag." This line of thinking is responsible for the attention that has been given recently to proposals for further tax cuts and unrestricted grants to the States.

In the past the gap between the high elasticity of expenditures and the low elasticity of receipts has been closed by legislation that, in nearly every State, contributed very little to a real solution to the underlying problem. In any particular fiscal year the gap between revenues and expenditures can be bridged, of course, by the yield of a doubled cigarette tax, or the yield of an increase in gasoline tax rates, to cite two examples. But such measures are no more than palliatives. They contribute nothing to a solution of the real problem; indeed, increases in the rates of cigarette and gasoline taxes will only aggravate the long-run situation, since they will tend to depress the GNP elasticity of the State's tax system. In the following fiscal year spending will again rise faster than the GNP, revenue will again rise at approximately the same rate as the GNP, and the gap will reappear to haunt the unhappy political leadership. That this treadmill can be negotiated for an extended period of time is one of the most surprising lessons of the postwar period. That it is not without its pitfalls is testified to by a long list of ex-governors, who have been toppled from power by the political hazards inherent in a policy that requires a new round of tax increases every few years.

Even with the imposition of rigorous expenditure controls, the only real solution to the States' fiscal problem lies in the adoption of measures that raise the GNP elasticity of State revenue systems. In essence, this

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changes that result from the ebb and flow of the GNP. Unemployment compensation payments are perhaps the only pure example of a counterpart on the expenditure side to automatic receipts behavior. Such payments, of course, move contrary to cyclical changes in the GNP--increasing during recession and declining during boom--and their GNP elasticity, for this reason, is negative. This is by no means to suggest that economic growth and decline have no effects on spending levels. It is to say that the relationships are indirect rather than direct. Since significant changes in expenditure levels tend to require legislative action, they are more analogous to structural revisions of a revenue system than they are to the automatic changes in receipts that invariably accompany swings in the level of economic activity.

approach amounts to nothing more than increasing the emphasis on high elasticity sources and de-emphasizing sources that have low elasticities. More specifically, this means increasing reliance on income and general sales taxes.

Chapter 3

THE INCOME TAX MOVEMENT IN THE STATES

Viewed against the historical backdrop of State tax activity summarized in table 6, the slow and sporadic increase in the number of States adopting income taxes (both personal and corporation) stands out in sharp contrast to the steady or rapid adoption rates for the other major State taxes. In the light of its shorter history, the adoption record of even the general sales tax appears somewhat more impressive than that of the income taxes.

The central aim of this chapter is to identify the primary factors responsible for the sporadic expansion of the State personal income taxes in the past in order to make a more accurate assessment of the fiscal role which this revenue instrument can be expected to play in the future. In this analysis, the issue of Federal-State tax overlapping in the personal income tax field assumes significance because of the widespread belief that the high Federal income tax rate structure was the principal if not the sole factor restricting State income tax adoptions after the late 1930's.[1/]

FAIRLY STEADY GROWTH: 1911-1929

Wisconsin's enactment in 1911 marks the beginning of effective State use of the modern income tax. Earlier State experiments had proved unsuccessful because the laws contained a basic administrative defect--the delegation of responsibility for enforcing State income tax laws to local property tax officials. The success of Wisconsin's income tax has been attributed to two administrative innovations: (1) centralized administration in which local assessors of income were selected on a merit basis

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1/ John Due, for example, in an article on the income tax for the Encyclopedia Britannica (Chicago, 1965, Vol. 12, p. 19) notes in two specific references to the State income tax movement that high Federal rates "retarded" and "restricted" expanded State use of income taxes after 1940. He cites no other inhibiting factor.

TABLE 6 .--DATES OF ADOPTION OF MAJOR STATE TAXES, FREQUENCY DISTRIBUTION 1/ *

Year	Individual income	Corporation income	Death	Gift	General sales	Distilled spirits	Cigarettes	Gasoline	Automobile registration
Pre-1901...	......	......	23	.....	......	....	....	....	....
1901.......	1	1	4	.....	......	....	....	....	1
1902.......	......	......	.....	.....	......	....	....	....	....
1903.......	......	......	4	.....	......	....	....	....	6
1904.......	......	......	.....	.....	......	....	....	....	4
1905.......	......	......	2	.....	......	....	....	....	12
1906.......	......	......	1	.....	......	....	....	....	2
1907.......	......	......	3	.....	......	....	....	....	3
1908.......	......	......	.....	.....	......	....	....	....	....
1909.......	......	......	1	.....	......	....	....	....	2
1910.......	......	......	.....	.....	......	....	....	....	3
1911.......	1	1	.....	.....	......	....	....	....	5
1912.......	1	......	1	.....	......	....	....	....	3
1913.......	......	......	2	.....	......	....	....	....	6
1914.......	......	......	.....	.....	......	....	....	....	1
1915.......	1	2	.....	.....	......	....	....	....	1
1916.......	2	......	1	.....	......	....	....	....	....
1917.......	2	3	.....	.....	......	....	....	....	....
1918.......	......	......	1	.....	......	....	....	....	....
1919.......	2	2	2	.....	......	....	....	4	....
1920.......	......	......	.....	.....	......	....	....	1	....
1921.......	1	2	1	.....	......	....	1	10	....
1922.......	1	1	1	.....	......	....	....	4	....
1923.......	......	1	.....	.....	......	....	3	16	....
1924.......	......	......	.....	.....	......	....	....	....	....
1925.......	......	......	.....	.....	......	....	1	9	....
1926.......	......	......	.....	.....	......	....	....	....	....
1927.......	......	......	.....	.....	......	....	2	2	....
1928.......	......	......	.....	.....	......	....	....	....	....
1929.......	2	4	.....	.....	......	....	1	2	....
1930.......	......	......	.....	.....	......	....	....	....	....
1931.......	4	4	2	.....	......	....	2	....	....
1932.......	......	......	.....	.....	1	....	2	1	....
1933.......	6	5	.....	2	13	9	1	....	....
1934.......	2	2	.....	1	2	7	....	....	....
1935.......	1	1	.....	.....	5	8	4	....	....
1936.......	1	1	.....	.....	1	1	1	....	....
1937.......	2	2	.....	2	1	2	3	....	....
1938.......	......	......	.....	.....	1	....	....	....	....
1939.......	......	......	.....	3	......	2	6	....	....
1940.......	......	......	.....	1	......	....	....	....	....
1941.......	......	......	.....	2	......	....	2	....	....
1942.......	......	......	.....	1	......	....	....	....	....
1943.......	......	......	.....	.....	......	....	3	....	....
1944.......	......	......	.....	.....	......	....	....	....	....
1945.......	......	......	.....	.....	......	1	1	....	....
1946.......	......	......	.....	.....	......	....	....	1	....
1947.......	......	1	.....	.....	4	....	7	....	....
1948.......	......	......	.....	.....	......	1	1	....	....
1949.......	1	1	.....	.....	1	....	1	....	....
1950.......	......	......	.....	.....	......	....	....	....	....
1951.......	......	......	.....	.....	3	....	1	....	....
1952.......	......	......	.....	.....	......	....	....	....	....
1953.......	......	......	.....	.....	1	....	....	....	....
1954.......	......	......	.....	.....	......	....	....	....	....
1955.......	......	......	.....	.....	1	....	1	....	....
1956.......	......	......	.....	.....	......	....	....	....	....
1957.......	......	1	.....	.....	......	....	....	....	....
1958.......	......	1	.....	.....	......	....	1	....	....
1959.......	......	......	.....	.....	......	1	1	....	....
1960.......	......	......	.....	.....	1	....	1	....	....
1961.......	1	......	.....	.....	2	....	....	....	....
1962.......	......	......	.....	.....	......	....	....	....	....
1963.......	1	1	.....	.....	......	....	....	....	....
1964.......	......	......	.....	.....	......	....	1	....	....
1965.......	......	......	.....	.....	2	....	1	....	....
1966.......	......	......	.....	.....	3	1	....	....	....
1967.......	2	3	.....	.....	2	....	....	....	....
Total...	2/ 35	3/ 40	49	12	44	4/ 33	49	50	49

See footnotes on following page.

TABLE 6.--DATES OF ADOPTION OF MAJOR STATE TAXES, FREQUENCY DISTRIBUTION[1/]*

(Concluded)

1/ Includes only States that used the tax as of January 1, 1968.

2/ Exclusive of New Jersey "Commuters'" tax and the New Hampshire and Tennessee taxes on interest and dividends.

3/ Exclusive of South Dakota's tax applicable to financial institutions.

4/ Exclusive of the excises levied by the 16 States that own and operate liquor stores, and the North Carolina county stores system operated under State supervision.

* Updated for this reprint.

and placed under the direct control of the Wisconsin State Tax Commission, and (2) the requirement and use of information-at-source returns on salaries and dividends.[1]

The Wisconsin advocates of the income tax were guided not so much by any great enthusiasm for this form of taxation as by a desire to shake loose from the "inequitous" personal property tax in general and the intangible tax in particular.[2] In order to realize this objective, the legislature abolished the personal property tax on intangibles and allowed the taxpayer to credit against his income tax any remaining personal property tax paid. To reimburse local governments for the loss of revenue, companion legislation provided that 70 percent of the income tax would be returned to the town in which the taxpayer resided and 20 percent to his county, leaving only 10 percent to be retained by the State.

Although State taxation of income did not "spread like wildfire" as predicted by the Wisconsin Tax Commission, 12 States had followed Wisconsin's lead by 1930.[3]

Individual Income Tax Adoptions: 1911-1929[4]

Year	State
1911	Wisconsin
1912	Mississippi
1915	Oklahoma
1916	Massachusetts, Virginia (revised)
1917	Delaware, Missouri
1919	New York, North Dakota
1921	North Carolina
1922	South Carolina
1929	Arkansas, Georgia

1/ Clara Penniman and Walter W. Heller, State Income Tax Administration (Chicago: Public Administration Service, 1959), p. 6.

2/ Kossuth Kent Keenan, "The Wisconsin Tax," Quarterly Journal of Economics, November 1912, Vol. 26, p. 171.

3/ This listing excludes New Hampshire's tax on income from stocks and bonds, imposed in 1923, since it is not a bona fide income tax by contemporary terminology, although it, too, reflects in part, an effort to to replace property taxes on intangibles.

4/ As a territory, Hawaii adopted a tax on personal income in 1901.

Factors Promoting the State Income Tax Movement

Several motives appear to have influenced State legislatures in the adoption of income taxes:1/

1. To tap a new revenue source;
2. To equalize the burden between property-owning and non-property-owning classes having taxpaying ability;
3. To introduce a more accurate method of ascertaining taxpaying ability;
4. To reach incomes from intangibles escaping property taxes; and
5. To introduce a convenient progressive element into the tax system.

Public expenditure commitments brought on by wartime expenses, rising price and salary levels, and partial assumption of certain local financial responsibilities also forced many States to search for new sources of revenue.2/ When Delaware adopted the personal income tax in 1917, the proceeds were earmarked for the local school system.

While two factors--property tax replacement and the need to develop a more equitable revenue source--stand out as the decisive forces behind the State income tax movement throughout this early period, the dramatic success of the Wisconsin and the Federal income taxes certainly encouraged the States to venture forth along the progressive income tax path. The Federal Government's entry into the income tax field in 1913 was of special significance in winning favor for a State income tax, if only because it compelled taxpayers to file a Federal return and time and effort could be saved if the State made use of similar tax.3/

Rural influence in many State legislative bodies also worked in favor of income tax adoption. Farmers considering themselves burdened by heavy real and personal property tax loads, looked upon an income tax as an equalizer--the means for insuring that the wealthy "city people" made a contribution to the State treasury. Most of the States adopting the income tax between 1913-1929 could be classified as "farm" States.

Most of the early States' income tax laws applied the tax to the entire net income of residents and to that part of the net income of non-residents which was derived from property and business or occupation within the State.

1/ National Industrial Conference Board, State Income Taxes (New York: 1930) Vol. II, p. 171.

2/ Emanuel Melichar, State Individual Income Taxes (Storrs: The University of Connecticut, July 1963), Monograph 2.

3/ National Industrial Conference Board, op. cit., Vol. I, p. 8.

In 1929 the average exemption for a family of four was approximately \$2,700, and the typical rate schedules were mildly progressive, ranging usually between 1 and 5 percent.[1]

While the 14 State individual income tax laws (including New Hampshire's) produced only 6.7 percent of the \$1.8 billion collected from all tax sources by the 48 States in 1929, revenue from this source was an important fiscal consideration for several States. In relation to total State tax collections, personal income tax receipts amounted to 57 percent in Massachusetts, 35 percent in New York, and 20 percent in Wisconsin.[2]

Factors Checking the Spread of State Income Taxes

Three factors combined to brake the State income tax movement prior to the Depression. First, most States were able to meet their expenditure requirements by placing increasing reliance on consumer taxes and by financing capital projects with long-term debt issues. Encouraged by easy borrowing conditions, State debt increased fivefold between 1913 and 1927, from \$379 million to almost \$2 billion. During the same period, consumption-type tax collections rose from \$55 million to \$445 million while motor vehicle and operators license revenue soared from \$5 million to \$301 million.

Second, it was difficult to muster sufficient political support for a progressive income tax in States confronted by neither a fiscal crisis nor a strong demand for property tax relief. Because the graduated tax on income represented a substantial departure from the regressive (and proportional) incidence of the existing tax structures, it precipitated strong opposition. To some persons, the adoption of a graduated tax on net income represented the first step down the path to Marxian Socialism. There was also the contention that graduated income tax rates might drive the relatively mobile wealthy to non-income tax States, and that companion legislation taxing the net income of corporations would place these firms at a competitive disadvantage.

Third, constitutional restrictions on the power of State legislatures to impose taxes also retarded the State income tax movement. Many State constitutions required that all taxes imposed on property be uniform in character. One school of thought took the position that a tax on income was in fact a tax on property and concluded that a progressive income tax would be unconstitutional. Because of these legal restrictions, proponents of income taxation were often required to muster a high degree of political support in order to amend State constitutions.[3]

1/ National Industrial Conference Board, op. cit., Volumes I and II.

2/ Emanuel Melichar, op. cit., p. 32.

3/ Most States levying an income tax did amend their constitutions specifically to authorize its use (see table 31, p. 155).

Federal-State Overlapping

Although there was a limited degree of Federal-State overlapping in the personal income tax field during the Civil War period, the adoption of a Federal income tax in 1913 marked the real beginning of multiple taxation of income by Federal and State governments. As in the case of State income taxes, Federal individual income tax rates of 1913 were relatively moderate--a 1 percent normal tax rate with a 1 to 6 percent surtax. High personal exemptions restricted the reach of this tax to a small percentage of the population and quickly earned it the designation of "the rich man's tax."

Table 7 illustrates the accordian-like effect of congressional decisions to expand and to contract the revenue capabilities of the individual income tax during the 1913-1929 period. World War I triggered a series of dramatic rate increases and some reductions in personal exemptions, culminating in the Revenue Bill of 1918 with a 65 percent maximum surtax rate. Immediately thereafter tax rates were lowered and exemptions raised; in fact, tax rates were reduced on six different occasions and exemptions increased twice between 1919 and 1928.

TABLE 7. --FEDERAL INDIVIDUAL INCOME TAX RATES AND EXEMPTIONS FOR SELECTED YEARS

Item	1913	1919	1929
Exemptions:			
Married couple	$4,000	$2,000	$3,500
Single	3,000	1,000	1,500
Dependent	---	200	400
Normal tax rates:			
1st $2,000	1%	6%	1/2%
2nd 2,000	1%	6%	1/2%
Next 4,000	1%	12%	2%
Over 8,000	1%	12%	4%
Surtax rates:			
Minimum rate	1% 1/	1% 1/	1% 1/
Maximum rate	6% 2/	65% 2/	20% 2/

Source: U.S. Treasury Dept., Annual Report of the Secretary, 1940 pp. 466-469.

1/ Minimum rate applied to that portion of surtax net income from $20,000 - $50,000 in 1913; $5,000 - $6,000 in 1919; and $10,000 - $14,000 in 1929.

2/ Maximum rate applied to that portion of surtax net income over $500,000 in 1913; $1,000,000 in 1919; and over $100,000 in 1929.

Despite the Federal income tax reductions and the increase in the number of income tax States, the Federal Government maintained such a large collection lead over the States throughout the 1913-1929 period as to make intergovernmental tax duplication in the field appear almost inconsequential. In fiscal year 1929, State individual income tax receipts amounted to $133 million as compared to Federal collections of $1,164 million for the preceding calendar year (table 8).

In the light of present levels, both the Federal and State income taxes of the Twenties were quite insignificant in their impact on the general public. In 1927, the Bureau of Internal Revenue processed 2.5 million taxable and 1.7 million nontaxable returns; State tax officials handled an estimated 1.5 million returns. Less than 4 percent of the population was directly involved in the Federal filing process and less than half of these, concentrated in Massachusetts, New York, and Wisconsin, fell into the dual filer category.

CONVULSIVE EXPANSION: 1930-1937

The Great Depression made the need for additional State tax revenue critical; the demand for property tax relief became strident. The convulsive expansion of both the personal income tax and the general retail sales tax is clearly reflected in the unprecedented volume of tax adoptions between 1930 and 1938.

Individual Income Tax Adoptions:1/ 1930-1938

Year	State
1930	Oregon
1931	Idaho, Utah*, Vermont
1932	Illinois* (unconstitutional)2/
1933	Alabama*, Arizona*, Kansas*, Minnesota, New Mexico*
1934	Iowa*, Louisiana*
1935	California*, South Dakota*,3/ West Virginia*4/
1936	Kentucky
1937	Colorado*, Maryland

* Denotes that a general sales tax was also adopted between 1930-1938.
1/ This listing excludes the Tennessee on income from stocks and bonds only, adopted in 1931.
2/ Declared unconstitutional in 1932.
3/ Repealed in 1943.
4/ Repealed in 1943; re-enacted in 1961.

TABLE 8.--FEDERAL AND STATE INDIVIDUAL INCOME TAX COLLECTIONS: 1912-1929

(Dollar amounts in thousands)

Year	Number of States using income tax	State collections (fiscal year)	Federal collections (calendar year)	State as percent of preceding year's Federal
1912	2	$ 636	--	--
1913	3	651	$ 28,254	--
1914	3	677	41,046	2.2
1915	4	916	67,944	2.2
1916	4	1,394	173,387	2.1
1917	5	14,717	694,131	8.5
1918	8	18,785	1,127,722	2.7
1919	7	18,715	1,269,630	1.7
1920	9	58,534	1,075,054	4.6
1921	9	59,278	719,387	5.5
1922	11	51,258	861,057	7.1
1923	11	59,114	661,666	6.9
1924	12	54,299	704,265	8.2
1925	12	60,429	734,555	8.6
1926	12	76,933	732,471	10.5
1927	12	89,997	830,639	12.3
1928	12	106,293	1,164,254	12.8
1929	14	133,269	1,001,938	11.4

Sources: Federal data from the U. S. Treasury Dept., Internal Revenue Service; Statistics of Income, Individual Income Tax Returns; State data from Emanuel Melichar, *op. cit.*, pp. 41 and 264.

Because the Depression generated considerable public support for proposals calling for a radical redistribution of personal income, it created a political environment receptive to expanded use of progressive income taxation. The growing popularity of various "share the wealth" schemes undoubtedly suggested to both Federal and State political leadership and even to the more conservatively inclined the advisability of supporting at least moderate forms of income taxation.1/

While the Depression was creating both the fiscal and political demand fo: greater use of the income tax, it came close to wiping out its tax base. State personal income tax collections fell from $133 million in 1929 to $59 million by 1933 (table 9). The massive erosion of the national income base is also reflected in the radical drop in Federal individual income tax collections, from $1 billion in 1929 to $246 million in 1931. The combination of rising personal income and three tax increases in 1932, 1934, and 1935 (recognized only subsequently to be incompatible with economic recovery policy) brought Federal persona income tax collections back to the pre-Depression level by 1936.

A PERIOD OF INACTIVITY: 1937-1960

The forward motion of the State income tax movement came to an abrupt halt in 1937. Significantly, not a single new State individual income tax was enacted between 1937 and 1960.2/

In explaining the halt of the individual income tax movement after 1937, particular importance must be attached to the "last resort" character of any decision to impose a new general tax on the public. In the absence of a fiscal crisis, State tax policymakers can be expected first to exploit less controversia revenue raising devices to meet rising expenditure requirements. This phenomenor rests on the fact that a State must reach a crisis situation before sufficient consensus can be mobilized in favor of a major revision of its revenue structure.

Because national economic growth has produced steadily increasing revenue yields during the years after the Depression, many of the non-income tax States were able to stave off a fiscal crisis by relying increasingly on consumer-type taxes. The enactment of the general retail sales tax by many non-income tax States during the Depression placed these jurisdictions in a good position to exploit this form of taxation (by making upward adjustments in their sales tax rates) when expenditure requirements out-stripped the normal growth in the tax collections.

1/ For a description of this political effect at the Federal level, see The Federal Income Tax (Roy G. Blakey, Longmans, Green and Co. New York: 1940) pp. 366-369. See also, State and Local Taxes in California, a Comparative Analysis (Sacramento: Report of the Senate Interim Committee on State and local Taxation, 1951) Part 3, p. 92.

2/ Alaska adopted an individual income tax in 1949 when it was still a territory

TABLE 9 .--FEDERAL AND STATE INDIVIDUAL INCOME TAX COLLECTIONS: 1929-1940

(Dollar amounts in thousands)

Year	Number of States using income tax	State collections (fiscal year)	Federal collections (calendar year)	State as percent of preceding year's Federal
1929	14	$133,269	$1,001,938	11.4
1930	15	133,944	476,715	13.4
1931	16	81,497	246,127	17.1
1932	19	70,465	329,962	28.6
1933	19	58,795	374,120	17.8
1934	25	79,614	511,400	21.3
1935	27	102,421	657,439	20.0
1936	31	147,126	1,214,017	22.4
1937	32	217,355	1,141,569	17.9
1938	34	230,560	765,218	20.2
1939	34	201,957	928,394	26.4
1940	35	214,503	1,495,930	23.1

Sources: Federal data from the U. S. Treasury Dept., Internal Revenue Service; Statistics of Income, Individual Income Tax Returns; State data from Emanuel Melichar, *op. cit.*, p. 39.

When it became necessary for several States to choose between an income tax and a general sales tax after World War II, a combination of political, fiscal, and constitutional factors tipped the scales in favor of the sales tax.

The decision of Congress to make intensive use of the personal income tax during World War II stands out as a major factor working against State income adoptions after 1940. World War II financing brought the introduction of withholding, which, together with drastically reduced exemptions and sharply increased tax rates, converted the income tax into a major revenue producer that affected for the first time the majority of income recipients in the country. Between 1939 and 1944 the number of taxable returns rose from 4 million to 42 million and tax collections from $1 billion to $16 billion. After reaching a peak in 1944, the wartime tax loads were reduced, first in 1945 and again in 1948. However, as a result of increased defense requirements associated with hostilities in Korea, rates were again increased in 1950 and 1951. The Korean legislation left personal exemptions unchanged but increased rates. The Revenue Act of 1951 increased the rate applicable to 1952 and 1953 incomes to 22.2 percent on the first $2,000 of taxable income and up to 92 percent on the amount of taxable income in excess of $200,000. The overall limitation on an individual's total tax was raised to 88 percent of net income. In 1954, in accordance with the provisions of the Revenue Act of 1951, the first-bracket rate reverted to 20 percent, the top rate to 91 percent, and the maximum to 87 percent, where they remained until the 1964 tax rate reductions

The pre-eminent position of the Federal Government with respect to personal income taxation not only retarded the State individual income tax movement, but it facilitated sales tax adoptions (table 6). It was argued that while, viewed in isolation, the sales tax had a regressive effect, this characteristic (the chief argument against the sales tax) loses much of its seriousness when viewed in terms of the country's total tax structure. In short, the heavy and progressive burdens imposed by the Federal income tax far overshadowed the lighter and regressive burdens imposed by a State sales tax.

During the late 1930's and immediately after World War II, heavy emphasis was placed on creating a more stable revenue system for the States. In support of their case, sales tax supporters pointed to the radical decline in personal income tax receipts during the Depression and to the relatively stable collection record chalked up by the consumption taxes. It should be noted, however, that as fears of another major depression receded, this earlier emphasis on stable revenue sources has given way to recommendations that States make greater use of unstable or highly elastic taxes such as the personal income tax.

State constitutional limitations on the taxing authority of State legislatures continued to work against the adoption of a personal income tax in several States. The Florida legislature is prohibited by the State Constitution from imposing any type of a tax on income. Court decisions and legal interpretations appeared to prohibit the levying of income taxes with graduated rates in other States.[1/] Particularly after World War II, the formidable task of mustering sufficient political support to amend a State Constitution was

1/ See Technical Paper 1, p.161.

enough to dampen the enthusiasm of the most ardent champion of progressive State income taxation.

It should also be noted that in certain non-income tax States the perennial sales-income tax issue tended to polarize the political community, and this polarization effect militated against personal income tax and sales tax adoptions in some States. Liberal spokesmen denounced the regressive sales tax and championed the cause of progressive taxation. Conservatives rushed to the defense of the sales tax and marshalled arguments in opposition to a graduated tax on personal income. Although the liberals lacked the requisite legislative strength to enact an income tax, their opposition to regressive taxes is probably reflected in the fact that six of the eight non-income tax States that adopted a general sales tax after World War II exempted food items from the tax base.

Finally, the growing intensity of interstate competition for industry also placed a damper on the individual income tax movement--due at least in part to the fact that the adoption of a personal income tax is said to dampen incentives and often forebodes a corporate income tax enactment. (Strangely, the latter influence is less operative in the opposite direction.) Opponents of income taxation often argued that State adoption of progressive income tax policies tends to create a tax climate somewhat hostile to the location and expansion of industry. These warnings undoubtedly carried weight, particularly in certain Northeastern State legislative bodies, many of whose members were keenly concerned about the emigration of industrial firms to the Middle Atlantic and Southern States.

The halt of the State income tax movement between 1937 and 1960 appears to have been the product of a group of interrelated political, economic, and fiscal factors. While the heavy Federal income tax can not be tagged with sole responsibility, the evidence suggests that after 1937 and especially after 1943, Federal income tax policies played a major role in halting the State income tax movement and in tipping the scales in favor of increased State reliance on consumption-type taxes (table 10).

REVIVAL AND EXPERIMENTATION: 1961-1965

In retrospect the adoption of an individual income tax by West Virginia in 1961 may have marked the beginning of a new era for the State income tax movement--one characterized by revival and experimentation. It is perhaps of special significance that West Virginia (one of two States that had abandoned this revenue source during the 1940's) became the first State to give the adoption movement a forward push since Maryland enacted the income tax in 1937.1/

1/ As a territory, Alaska adopted the personal income tax in 1949.

TABLE 10. --FEDERAL AND STATE INDIVIDUAL INCOME TAX COLLECTIONS: 1941-1965

(Dollar amounts in thousands)

Year	Number of States using income tax	State collections (fiscal year)	Federal collections (calendar year)	State as percent of preceding year's Federal
1941	35	$ 236,318	$ 3,905,625	15.8
1942	35	258,468	8,926,712	6.6
1943	35	223,171	14,587,669	2.5
1944	33	324,058	16,034,025	2.2
1945	33	368,721	17,005,431	2.2
1946	33	398,679	16,062,353	2.3
1947	33	432,618	18,084,485	2.6
1948	33	507,270	15,459,810	2.8
1949	33	586,022	14,580,808	3.7
1950	33	715,734	18,389,534	4.9
1951	33	795,598	24,268,092	4.3
1952	33	901,663	27,889,716	3.7
1953	34	963,681	29,447,266	3.4
1954	34	1,002,335	26,707,201	3.4
1955	34	1,095,390	29,653,960	4.1
1956	34	1,368,951	32,706,061	4.6
1957	34	1,559,647	34,382,205	4.7
1958	34	1,595,124	34,350,979	4.6
1959	34	1,807,073	38,653,002	5.2
1960	34	2,209,294	39,545,386	5.7
1961	34	2,354,622	42,271,001	6.0
1962	35	2,727,984	44,892,879	6.5
1963	35	2,955,996	48,119,476	6.6
1964	36	3,415,035	47,100,000 est.	7.1
1965	36 1/	3,642,167	--	7.7

1/ Despite their highly limited coverage, New Hampshire, New Jersey, and Tennessee are included in this table. Nebraska (effective 1/1/67 if approved by electorate) is excluded.

Sources: Federal data from the U.S. Treasury Dept., Internal Revenue Service, Statistics of Income, Individual Income Tax Returns. State data (1941-1960), Emanuel Melichar, op. cit., p. 39; State data (1960-1965), U.S. Bureau of the Census, Compendium of State Government Finances and State tax collections in 1965.

The 1961-65 income tax adoptions stand in sharp contrast to the total absence of adoption activity during the preceding quarter of a century.

Individual Income Tax Adoptions:[1] 1961-65

Year	State
1961	West Virginia
1963	Indiana
1965	Nebraska[2]

Deviations from the Pre-World War II Model

The typical pre-World War II State income tax manifested a high degree of substantive conformity to Federal income tax policy but a rather low degree of formal or statutory agreement with Federal Code provisions. For example, most States followed the Federal policy pattern by graduating their rate schedule (albeit much more mildly) and allowing for the familiar non-business (personal expense) deductions. However, most State legislatures pursued an independent statutory approach by defining the income tax base without specific reference to the Federal Code.

In striking contrast, new State income tax enactments during the 1960's have tended to reverse this picture--a rather high degree of formal or statutory conformity to the Federal Code but a surprising degree of independence or deviation from the Federal pattern on such critical policy matters as graduated rates and the treatment of personal deductions. In an effort to maximize taxpayer convenience and administrative efficiency, West Virginia and Nebraska define their tax base by reference to the Federal treatment of net taxable income, while Indiana uses as its tax base the Federal definition of adjusted gross income. This high degree of formal or statutory agreement with the Federal income tax clearly reflects the post-World War II pre-eminence of the Federal income tax and State legislative accommodation to this fiscal fact of life.

The new pattern of conformity, however, is far more apparent than real because both Indiana and Nebraska have abandonded the graduated tax rate concept in favor of the flat percentage approach. Even more significantly, Indiana has jettisoned one of the most cherished and questionable features of the Federal income tax--allowance of non-business expenses, i.e., State and local consumer and property tax payments; religious, educational and charitable contributions; interest payments on personal loans and mortgages; and medical expenses.

1/ This listing excludes the New Jersey tax in effect limited to New York residents who derive income from New Jersey sources, adopted in 1961.

2/ Enacted in 1965 but will not become effective until January 1, 1967, and only if approved in a referendum.

The recent enactments of flat rate income taxes suggest that there is now greater public support (or less opposition) at the State level to a flat rate net income tax that takes the ability to pay concept into account only by adjusting tax loads according to differences in the size of family by providing for personal exemptions rather than the conventional income tax characterized by personal expense deductions <u>and</u> graduated rates.

Setting this finding in its intergovernmental context, the emergence of the steeply progressive Federal income tax since 1937 has perhaps narrowed the political choice for most of the non-income tax States to flat rate net income or on income tax--at least for those States with conservative political leanings.

<u>State Experimentation with Positive and Negative Personal Income Tax Credits</u>

Of special significance is the emerging trend to employ State personal income tax credits in lieu of blanket exemptions for releiving the regressiveness of heavy State and local consumption and property taxes. Because sales and property taxes bear down severely on the poor, some States exempt foods and drugs from their general retail sales tax and others have mandated partial homestead property tax exemptions.

While blanket tax exemptions can minimize regressivity, such a solution is costly. In the case of the food exemptions, for example, it can cut the sales tax base by as much as 25 percent or more. By the same token, blanket homestead tax exemptions severely erode the local property tax base and thereby increase the tax burdens of other property owners without relieving those who live in rented lodgings. Moreover, the exemption approach fairly bristles with administrative problems.

In order to avoid the revenue losses and administrative difficulties that flow from the blanket exemptions, the majority of the States tax food and drug purchases under their general retail sales tax and provide no homestead exemption from the local property tax. As sales and property tax loads increase, pressures for some type of tax relief for the poor also increases.

The income tax credit-reimbursement approach stands out as a practicable alternative. It calls for the elimination of food and homestead exemptions and provision for the reimbursement of sales or property tax payments or both. Thus, a person pays the sales tax on food purchases and is subsequently reimbursed for the taxes paid on a specified amount of food purchases in the form of a credit against his personal income tax liability. If the sales taxpayer has no income tax liability or if his tax liability is insufficient to absorb the entire credit (a negative tax credit situation), he qualifies for a cash refund by submitting a prescribed income statement.

While the idea of reconciling the sales tax with the ability to pay via the income tax credit was discussed in academic and Federal circles in World War II days, Indiana pioneered it at the State level, as did Wisconsin for local property taxes.

As part of its new income tax adopted in 1963, Indiana promoted a personal income tax credit for food and drug tax payments with cash refunds for those persons with incomes either too low to take full advantage of the tax credit or with incomes below the filing requirement. Under the Indiana system each person is granted a $6 sales tax credit. This assures annual food purchases of $300 per capita subjected to Indiana's 2 percent sales tax. The credit entitlement of a family of 4 is $24, deductible from the Indiana individual income tax or claimable as a cash refund.

Colorado and Hawaii adopted this approach to the sales tax regressivity problem in 1965 and Michigan and Massachusetts are reported to be considering it (table 11).

Wisconsin adopted a similar income tax credit and cash refund system in 1963 to provide homestead tax relief for elderly persons. The relief is available to both homeowners and rentors. Subject to certain limitations, elderly persons are reimbursed by the State of Wisconsin through the income tax machinery for property tax payments on their homesteads in excess of 5 percent of their total household income. An elderly rentor also may qualify for property tax relief because his property tax liability is assumed to be 25 percent of his gross annual rent bill. In effect, the Wisconsin legislature has taken the position that if a low income elderly person is required to turn over more than 5 percent of total household income to the property tax collector, he is carrying an extraordinary tax load and is entitled to tax relief.

As in the case of the Indiana, Colorado, and Hawaii tax credit arrangements, the beneficiary of the Wisconsin property tax relief plan files a State individual income tax return and claims either a credit against his Wisconsin income tax or the appropriate cash refund.

For financially hard-pressed State and local governments, the income tax credit solution to the regressivity problem has several advantages over the traditional blanket exemptions. The credit for sales tax payments can serve as an acceptable compromise on which opposing sales and income tax advocates can come to terms. Liberals troubled over the regressiveness of the sales tax may be comforted by the relief afforded the poor, while those fearful of income tax progression may find a flat rate income tax with personal exemptions tolerable.

Second, through the income tax credit device, the sales tax can be converted into an equitable and effective revenue instrument. It can provide far greater equity than can be realized under a general sales tax with no food exemption because the burden on low income families can be avoided by the tax credit or cash refund. Because an income tax credit system can be devised with sufficient precision to remove the main elements of regressivity from sales taxation, this approach can produce greater tax equity than an arrangement which merely exempts everybody's total food purchases from the general retail sales tax. In fact, construction of a system of diminishing tax credits as income rises (the Hawaii method) can make the sales tax

TABLE 11. --STATE USE OF PERSONAL INCOME TAX CREDITS OR CASH REBATES TO MINIMIZE OR OFFEST THE REGRESSIVITY OF SALES AND PROPERTY TAXES 1/*

State	Type of credit	Year adopted	Amount of credit	Law	Administrative procedure
Colorado	For sales tax paid on food	1965	$7 per personal exemption (exclusive of age and blindness)	Chap. 138, Art. 1, (secs. 138-1-18 & 138-1-19 added by H. B. 1119, laws 1965, effective 6/1/65)	Credit to be claimed on income tax returns. For resident individuals without taxable income a refund will be granted on such forms or returns for refund as prescribed by the Director of Revenue.
Hawaii	For consumer-type taxes	1965	Varies, based on income 2/	Chap. 121 (Secs. 121-12-1 & 121-12-2 added by Act 155 laws 1965)	The Director of Taxation shall prepare and prescribe the appropriate form or forms to be used by taxpayers in filing claims for tax credits. The form shall be made an integral part of the individual net income tax return. In the event the sales tax credits exceed the amount of the income tax payments due, the excess of credits over payments due shall be refunded to the taxpayer.
Indiana	For sales tax paid on food	1963	$8 per personal exemption (exclusive of age and blindness)	Chap. 50 (Chap. 30, Sec. 6d added by H. B. 1226, laws 1963, 1st sp. sess., effective 4/20/63)	Credit to be claimed on income tax returns. If an individual is not otherwise required to file a return, he may obtain a refund by filing a return, completing such return insofar as may be applicable, and claiming such refund.
Iowa	For sales taxes paid	1967	Varies, based on income 3/	Ch. 422 (sec. 18 added by H.B. 702, laws 1967)	Tax credit or refund to be claimed on income tax return. If an individual is not otherwise required to file a return, he may obtain a refund by furnishing the Department of Revenue with proof of his taxable income and the number of his personal exemptions.
Massachusetts	For consumer-type taxes	1966	$4 for taxpayer, $4 for spouse, if any, and $8 for each qualified dependent 4/	Chap. 62 (Sec. 6b added by ch. 14, Acts 1966)	Same as Indiana.
Minnesota	For senior citizen homestead relief	1967 5/	Varies with income from 75% to 10% of property tax or equivalent rent not to exceed $300 (Max. credit $225)	Chap. 32 (H.B. 27) Article VI	Tax credit or refund to be claimed on income tax return. Department of Taxation shall make available a separate schedule for information necessary to administration of this section and the schedule shall be attached and filed with the income tax return. Cash refund granted if property tax credit exceeds State personal income tax liability.
	Tax relief for renters.	1967 6/	3.75% of the total amount paid by claimant as rent, not to exceed $45 7/	Chap. 32 (H.B. 27) Article XVII	Same as above.

See footnotes at the end of table.

TABLE 11.--STATE USE OF PERSONAL INCOME TAX CREDITS OR CASH REBATES TO MINIMIZE OR OFFSET THE REGRESSIVITY OF SALES AND PROPERTY TAXES 1/* (Concl'd)

State	Type of credit	Year adopted	Amount of credit	Law	Administrative procedure
Nebraska	For sales tax paid on food	1967 8/	$7 per personal exemption (exclusive of age and blindness)	H. B. 377, laws 1967	Credit to be claimed on income tax returns. Refund will be allowed to the extent that credit exceeds income tax payable but no refund will be made for less than $2.
Wisconsin	For senior citizen homestead tax relief	1963	Varies, based on income and amount of property tax or rental payment	Chap. 71 (Sec. 7109 (7) added by ch. 566 (A.B. 301) eff. 6/10/64. Ch. 580 (A.B. 907) repealed & re-created Sec. 71. 09(7) effective Dec. 19, 1964	Tax credit or refund to be claimed on income tax return. The Department of Taxation shall make available a separate schedule which shall call for the information necessary to administering this section and such schedule shall be attached to and filed with the Wisconsin income tax form. Cash refund granted if property tax credit exceeds State personal income tax due.

1/ If a taxpayer has no State personal income tax liability or a tax liability insufficient to absorb the entire credit (a negative tax credit situation) he is entitled to the appropriate cash refund. If the taxpayer's State personal liability is equal to or greater than the tax credit, his personal income tax liability is reduced by the amount of the credit (a positive tax credit situation).

2/ The credits for consumer-type taxes are based on "modified adjusted gross income" (regular taxable income plus exempt income such as social security benefits, life insurance proceeds, etc.) and range from $20 per qualified exemption for taxpayers having a modified adjusted gross income of less than $1,000 to $1 per exemption where such income is between $5,000 and $6,999.

3/ Ranges from $12 per qualified exemption for taxpayers having taxable income under $1,000 to $0 where such income is over $7,000.

4/ Credits are only allowed if total taxable income of taxpayer and spouse, if any, does not exceed $5,000 for the taxable year.

5/ Applicable to property taxes accrued in 1967 and aubsequent years. Credit may be claimed on 1967 income tax return and thereafter.

6/ Applicable to rent paid in 1968 and thereafter. Credit may be claimed on 1968 income tax return and thereafter.

7/ Elderly may choose this relief or senior citizen relief but not both.

8/ Applicable to taxes due on 1968 income and thereafter.

* Updated for this reprint.

compatible with progressive taxation.[1]

Third, the income tax credit for sales tax payments solves more administrative problems for the sales tax than it creates for the income tax. For example, the manager of a supermarket is not required to maintain separate sales records for tax exempt and taxable items and State tax administrators are freed from the tedious task of auditing retail sales transactions for possible violations of the exemption provisions. According to all reports, the administration of this reimbursement approach via the tax credit-refund route is causing no major difficulties in Indiana, the only State which has employed this system long enough to permit a limited evaluation.[2]

These pioneering State efforts with the personal income tax credit illustrate the benefits that can flow from State and local experimentation with new ideas. Because the personal income tax credit system can considerably lighten the relatively heavy State and local tax load now borne by the poor, it can contribute to the effectiveness of the general sales tax and perhaps the property tax as sources of State and local revenue. Or to put the issue more affirmatively, a better reconciliation of consumption and property taxes with the ability to pay principle by means of income tax credits can help State and local tax policymakers cut the Gordian fiscal knot tied by two opposing pressures--the demand for tax relief for the poor and the need for additional revenue.

Summary

The events of the last two or three years, in the wake of no income tax adoptions in the preceding quarter of a century, do not provide a very firm basis for predicting the future of the State income tax movement. While many of the political factors which contributed to the inactivity during the 1940's and the 1950's remain, fresh history may be in the making. However dim the view of the immediate future, those preoccupied with updating intergovernmental relations in the income tax field need at least take note of the possibility that the State income tax may be accumulating some momentum.

1/ "An Analysis of Alternative Sales Tax Exemption Plans," prepared for the Indiana Senate Finance Committee by Charles F. Bonser, Resident Director, Commission on State Tax and Financing Policy, January 18, 1965.

2/ Statement of William L. Fortune, Indiana Commissioner of Revenue, to the National Association of Tax Administrators, June 8, 1965.

Chapter 4

THE LOCAL INCOME TAX MOVEMENT

Personal income taxes are a significant source of local tax revenue in five States (Kentucky, Michigan, Missouri, Ohio, and Pennsylvania) and in one Alabama city. They are now producing about $400 million for municipalities and school districts in these States, and account for about 10 percent of total State and local personal income tax collections.

Ten of the 43 largest cities (with population of over 300,000) use this source of revenue.[1/] Thirty-two cities with populations of 50,000 and over (including the District of Columbia) impose income taxes. Eleven of these cities are located in Ohio, 11 in Pennslyvania, 3 in Kentucky, 3 in Michigan, 2 in Missouri, and 1 in Alabama (table 12).

Philadelphia imposed the first municipal income tax in 1939. Under Pennsylvania's blanket authorization of 1947, which permitted local governments to use sources of revenue not employed by the State, with certain exceptions, even the smallest taxing jurisdictions can levy individual income taxes. Approximately 40 cities and 390 boroughs do so, as do about 330 townships and over 1,000 school districts. Frequently the tax is imposed by coterminous units, and in such cases the combined rate is limited to one percent. Where school districts, for example, are coterminous with the cities, boroughs, and townships, the proceeds are shared among them on the basis of their respective revenue needs as determined by mutual agreement.

The first local income tax in Ohio was imposed by Toledo in 1946. At last count about 95 Ohio municipalities were levying income taxes at rates ranging from 0.4 to 1 percent.

The present St. Louis income tax was enacted in 1954. Earlier income taxes had been enacted in 1948 and 1952 for temporary periods. Kansas City was authorized to levy an income tax in 1963 and did so, effective January 1, 1964.

1/ Detroit, Philadelphia, Pittsburgh, St. Louis, Kansas City (Mo.), Cincinnati, Columbus, Toledo, Louisville, and Washington, D.C.

TABLE 12.--LOCAL INCOME TAXES, RATES AND COLLECTIONS *

(Dollar amounts in thousands)

State and local government	Rate December 31, 1967 (percent)	Municipal tax collections, 1965-66 (Cities with over 50,000 population in 1960)		
		Total tax collections	Income tax collections	
			Amount	As a percent of total collections
Alabama:				
Gadsden	2.0	$4,004	$2,139	53.4
Kentucky:				
Berea	1.0	xxx	xxx	xxx
Bowling Green	1.0	xxx	xxx	xxx
Catlettsburg	1.0	xxx	xxx	xxx
Covington	1.75	2,831	792	28.0
Flemingsburg	0.5	xxx	xxx	xxx
Frankfort	1.0	xxx	xxx	xxx
Glasgow	1.0	xxx	xxx	xxx
Hopkinsville	1.0	xxx	xxx	xxx
Lexington	1.5	6,993	3,596	51.4
Louisville	1.25	26,882	13,912	51.8
Jefferson County 1/	1.75	xxx	xxx	xxx
Ludlow	1.0	xxx	xxx	xxx
Mayfield	0.67	xxx	xxx	xxx
Maysville	1.0	xxx	xxx	xxx
Middlesboro	1.0	xxx	xxx	xxx
Newport	2.0	xxx	xxx	xxx
Owensboro	1.0	xxx	xxx	xxx
Paducah	1.25	xxx	xxx	xxx
Pikeville	1.0	xxx	xxx	xxx
Princeton	1.0	xxx	xxx	xxx
Richmond	1.0	xxx	xxx	xxx
Maryland:	% of State Tax			
Baltimore City	50%	144.451	2/	2/
12 counties 3/	20%	xxx	xxx	xxx
1 county	25%	xxx	xxx	xxx
1 county	30%	xxx	xxx	xxx
3 counties	35%	xxx	xxx	xxx
1 county	45%	xxx	xxx	xxx
4 counties	50%	xxx	xxx	xxx
Michigan:				
Battle Creek	4/	xxx	xxx	xxx
Detroit	4/	158,246	45,176	28.5
Flint	4/	16,465	2,292	13.9
Grand Rapids	4/	8,312	2/	2/
Hamtramck	4/	xxx	xxx	xxx
Highland Park	4/	xxx	xxx	xxx
Lapeer	4/	xxx	xxx	xxx
Pontiac	4/	5,668	2/	2/
Saginaw	4/	5,572	904	16.2
St. Johns 5/	4/	xxx	xxx	xxx
Missouri:				
Kansas City	0.5	42,128	10,157	24.1
St. Louis	1.0	80,709	27,265	33.8
New York:				
New York City	0.4-2.0 6/	2,302,939	2/	2/
Ohio:				
Akron	1.0	18,519	9,936	53.7
Canton	1.0	5,374	4,015	74.7
Cincinnati	1.0	44,061	17,313	39.3
Cleveland	0.5	54,300	2/	2/
Cleveland Heights	0.5	2,962	2/	2/
Columbus	1.0	22,247	15,720	70.7
Dayton	1.0	21,467	11,689	54.5
Euclid	0.5	3,762	2/	2/
Hamilton	1.0	2,723	1,441	52.9

See footnotes at the end of table.

TABLE 12. --LOCAL INCOME TAXES, RATES AND COLLECTIONS *

(Dollar amounts in thousands)

State and local government	Rate December 31, 1967 (percent)	Municipal tax collections, 1965-66 (Cities with over 50,000 population in 1960)		
		Total tax collections	Income tax collections	
			Amount	As a percent of total collections
Ohio: (Cont'd)				
Lakewood	0.5	$2,866	2/	2/
Lima	1.0	1,779	$1,125	63.2
Lorain	0.5	2,423	2/	2/
Parma	0.5	3,202	2/	2/
Springfield	1.0	3,669	2,480	67.6
Toledo	1.5	18,763	10,735	57.2
Warren	1.0	3,164	2,024	64.0
Youngstown	1.0	8,354	4,590	54.9
143 cities and villages (with less than 50,000 population)	0.25-1.0	xxx	xxx	xxx
Pennsylvania:				
Cities, 50,000 population and over--				
Abington Township	1.0 7/	11,969	2/	2/
Allentown	1.0 7/	5,140	1,170	22.8
Altoona	1.0 8/	2,320	494	21.3
Bethlehem	1.0 7/	3,810	979	25.7
Chester	1.0 9/	2,229	2/	2/
Erie	1.0 7/	6,679	1,162	17.4
Harrisburg	1.0 7/	3,884	2/	2/
Johnstown	1.0 8/	2,211	403	18.2
Lancaster	0.5 10/	2,117	528	24.9
Penn Hill Township	1.0 8/	1,533	608	39.7
Philadelphia	2.0 9/	217,919	90,867	41.7
Pittsburgh	1.0 8/	50,130	10,273	20.5
Scranton	0.5 11/	4,555	690	15.1
Wilkes Barre	1.0 7/	2,426	2/	2/
York	1.0 7/	1,971	162	8.2
Approx. 3,000 other local jurisdictions (including over 1,000 school districts)	0.25-1.0	xxx	xxx	xxx

Note: Excludes Washington, D. C. which has a graduated net income tax that is more closely akin to a State tax than to the municipal income taxes (see table 10).

"xxx" Signifies cities under 50,000 population.

1/ A taxpayer subject to the 1.25 percent tax imposed by the City of Louisville may credit this tax against the 1.75 percent levied by Jefferson County.

2/ Tax went into effect after reporting period.

3/ Excludes Montgomery County, which levied a tax at the rate of 20 percent for calendar year 1967. As of January 1, 1968, the County Council had not set a rate for 1968.

4/ Under the Michigan "Uniform City Income Tax Act," the prescribed rates are 1.0 percent for residents and 0.5 percent for nonresidents. A resident is allowed credit for taxes paid to another city as a nonresident.

5/ St.Johns adopted the uniform income tax ordinance on November 7, 1967. Petitions for referendum have been filed and an election will be held on February 20, 1968.

6/ New York City residents' rate ranges from 0.4 percent on taxable income of less than $1,000 to 2.0 percent on taxable income in excess of $30,000. An earnings tax of 0.25 percent of wages or 3/8 of 1 percent on net earnings from self-employment, not to exceed that which would be due if taxpayer were a resident, is levied against nonresidents.

7/ The school district rate is the same as the municipal rate.

8/ The school district rate is 0.5 percent.

9/ There is no school district income tax.

10/ The school district rate is 1.0 percent.

11/ Combined city and school district rate may not exceed 2.0 percent.

* Updated for this reprint.

In Kentucky the city income taxes are levied as "occupational license taxes."[1] This form of tax was first adopted by Louisville in 1948. Fifteen other Kentucky cities and Jefferson County (in which the City of Louisville is located) have enacted similar measures. The Jefferson County tax is imposed at the same rate as the Louisville tax and allows taxpayers subject to the Louisville tax a credit for that tax.[2] Gadsden, Alabama also levies its tax as an "occupational license tax."

Detroit and Hamtramck, Michigan adopted income taxes in 1962 under a State statutory provision that grants charter cities the authority to levy "rents, tolls, and excises." In 1964, Michigan granted cities specific authority to levy a "uniform city income tax." Detroit and Hamtramck re-enacted their income tax ordinances to meet the requirements of that Act, and Flint and Saginaw have enacted identical income tax ordinances. Five more Michigan cities adopted uniform income tax ordinances which, however, failed to gain the approval of their electorates.

It is apparent from the foregoing discussion that the most extensive use of local income taxes has occurred in three highly industrialized States--Michigan, Ohio, and Pennsylvania--none of which levies a State personal income tax. Pennsylvania local governments derive almost $200 million, Ohio cities about $100 million, and the 4 Michigan cities between $40 and $50 million annually from their income taxes. The other three States with local income taxes had State personal income taxes before their localities entered the field. Missouri, which has had a State personal income tax since 1917, limits local income taxing authority to St. Louis and Kansas City. Alabama, with a State personal income tax that dates back to 1933, and Kentucky, which enacted its tax in 1936, never gave their municipalities specific authority to levy income taxes. It should be noted, however, that all three State personal income taxes are levied at low to moderate effective rates.

All of the local income taxes in Michigan, Ohio, and Pennsylvania are administered locally, with little interlocal coordination, except for credit provisions to avoid double taxation. In Pennsylvania, place of

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1/ The tax is levied in this form in view of the uncertainty whether Kentucky's Constitution permits the State to delegate the authority to levy an income tax to its subdivisions. The Constitution enumerates the taxes that can be delegated but does not include the income tax among them. Authority to delegate licensing powers to municipalities is explicit.

2/ However, Jefferson County was authorized to levy an additional 1/2 percent for school purposes, effective December 16, 1965.

residence is given priority: school districts are permitted to tax residents only; municipalities, which can tax both residents and nonresidents allow a credit to nonresidents for income taxes they pay to their place of residence.[1] Michigan and Ohio cities favor the place of employment: they grant a credit to their residents for income taxes they pay to another city.

The enabling acts of both Ohio and Pennsylvania specify a one percent maximum local rate, but in Ohio the maximum may be exceeded with voter approval. Local income tax rates range from 0.4 to 1 percent in Ohio (no city has obtained voter approval to exceed 1 percent) and from 1/4 to 1 percent in Pennsylvania (the Philadelphia rate is 1 5/8 percent by special legislation). As already noted, local rates in Michigan are set uniformly at 1 percent for residents and 1/2 percent for nonresidents.

THE MICHIGAN APPROACH

The Michigan "Uniform City Income Tax Act"[2] is unique in four respects. First, all cities are limited to the local income tax ordinance prescribed in the Act. That ordinance specifies the nature of the tax base (for both individuals and corporations), the rate, exemptions, and details as to administration (including withholding provisions) and appeal procedures. Thus, all city income taxes operate under identical rules.

Secondly, the base of the Michigan local income tax is much broader than in the other States. The traditional local tax on personal income is substantially a payroll tax; that is, it is imposed only on salaries and wages and on the net income from professional and unincorporated business activities. "Unearned" income from dividends, interest, and capital gains is excluded from the tax base. Such income is taxable in Michigan.

The third unique feature of the Michigan enabling act is its rate structure. As noted above, the Act specifies a 1 percent rate for residents (on all earnings) and a 1/2 percent rate for nonresidents on earnings within the city, with the city of residence allowing a credit for income taxes paid to another city. An individual living in one income tax city and employed in another thus pays half of his local income tax to each.

Fourth, the Michigan local income taxes differ from those in the other States in that they allow $600 per capita personal and dependency exemptions. Except as to rate, then, Michigan local income taxes are similar in structure to some of the State personal income taxes.

1/ Philadelphia is an exception: a nonresident gets no credit against the Philadelphia tax for a tax paid to the jurisdiction in which he resides.

2/ Public Act No. 284, Laws of 1964.

The Michigan approach offers a number of advantages lacking in the local income taxes of the other States. While, as in Pennsylvania and Ohio, the Michigan taxes are administered locally, they must all follow the same rules. Taxpayer appeals may be taken to the State Department of Revenue under rules and regulations issued by that agency. By legislative action the entire local income tax apparatus could be turned over to the State tax agency with little or no interruption, in the event that local income taxation becomes widespread. The system could also be modified to provide for county-wide income taxes.

At least as important as the administrative advantages of the Michigan approach is the fact that the local income taxes in that State dampen the inequitable effects of a payroll tax as applied in the other States. Even though the Michigan tax is levied at a flat rate, the personal exemptions make it somewhat progressive. And the inclusion of dividends, interest, and capital gains in the base assures that individuals with large "unearned" incomes are not given favorable treatment relative to salary and wage earners.

The provision that a commuter's tax should be shared between his place of residence and his place of employment reflects legislative concern with central city-suburb fiscal disparities, explained in an earlier report of this Commission, where it is recommended that States consider this kind of sharing device.[1/] Data in that report indicate that central cities have three times as many in-commuters as out-commuters, and that in many standard metropolitan statistical areas the suburbs typically have more ability to finance a comparable level of governmental services than do the central cities in which suburbanites earn their livelihood.

STATE-LOCAL RELATIONSHIPS

Inevitably, a proposal for the enactment of a State personal income tax raises the question: to what extent, if any, should local governments participate in the proceeds? Property tax rates are pressing against economic and legal ceilings in many communities, and the quest for new sources of local revenue continues apace as the demand for more and better quality educational, protective, health, and welfare services intensifies. The clamor for additional local nonproperty tax revenue has produced a rash of local sales taxes in some States, income taxes in others, and a miscellany of other kinds of taxes and service charges in still others. Despite these local tax developments and significant increases in State grants-in-aid and revenue

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1/ Advisory Commission on Intergovernmental Relations, Metropolitan Social and Economic Disparities: Implications for Intergovernmental Relations in Central Cities and Suburbs (A-25), January 1965, p. 123.

sharing, the revenue potential of a State personal income tax can be expected to evoke a demand on the part of local governments for their share.

Michigan, Ohio, and Pennsylvania, having allowed their local governments to enter the income tax field, will be faced with a particularly difficult problem, akin to that faced recently by New York when its newly enacted State sales tax had to be accommodated to a number of existing local taxes with varying rates. Should they add a third overlapping layer to the income tax or should they somehow absorb the local taxes into the State tax with appropriate adjustment in local revenues? This a political decision each State will have to resolve in its own way on the basis of its own philosophy of State-local relationships.

This Commission has already gone on record with regard to local nonproperty taxes, particularly sales and income taxes.[1/] If there is a choice between State or local imposition of consumption and income taxes, the preference is for a State-level tax for the reason that the impact of such taxes is broader than the economic area in which most local governments exercise taxing jurisdiction. Furthermore, such taxes can be administered more efficiently by a State than by a local government.

In enacting a State personal income tax, where local taxes are already prevalent (for example, Michigan, Ohio, and Pennsylvania), States could take one of three paths with regard to the local income taxes: (1) they could allow the local taxes to stand, possibly with some modification; (2) they could repeal the authority for local income taxes and share the State tax with them; or (3) they could repeal the authority for local income taxes and either increase grant payments to them, or take over some of their financing responsibilities.

Since tax sharing and grant-in-aid programs are generally designed to benefit all local governments (or all in a particular class) either device would probably be most appealing to local governments. The number of localities are few indeed that could not use additional funds, either to expand and improve their public services or to provide some property tax relief. Both a shared tax and a grant-in-aid can be designed to take account of differing local government needs and resources in their distribution formulas, and both have the advantage over independent local taxes of a single centralized administration with the benefit of superior enforcement facilities.

1/ Advisory Commission on Intergovernmental Relations, Local Nonproperty Taxes and the Coordinating Role of the States (A-9), 1961; and State Constitutional and Statutory Restrictions on Local Taxing Powers (A-14), 1962.

Nevertheless, to the extent that State aids are used to "buy out" local governments from the income tax, they do impair local fiscal independence somewhat, since the localities would not have the option to determine their own rates and bases, or even to refuse to accept the tax. At least in Michigan and Ohio, where local income taxes are now authorized for cities only (in contrast to Pennsylvania, where even school districts use them), tax sharing or a grant-in-aid would absorb a larger portion of a State personal income tax than would be collected by the limited number of localities imposing local income taxes at the time the State tax is adopted. Any sharing or grant program would have to assure the localities with income taxes that they would not lose revenue from the shift and the share available to the remaining communities would have to be large enough to assure them that they would be better off financially by accepting State aid than by levying their own tax.

After weighing the pros and cons of a tax sharing or grant-in-aid plan, the States may decide to continue the authorization for local income taxes. With a State income tax, they would have the opportunity to coordinate locally imposed income taxes by using the "piggy back" device employed so successfully in the general sales tax field by eight States. The Michigan approach to local income taxes, described above, is particularly suited for conversion as a local supplement to the State tax, since Michigan cities are already required to follow uniform rules.

While the scope and content of State enabling legislation governing local use of income taxation can contribute significantly to the effectiveness of local income taxes, the fact remains that local income taxation, under the best of conditions, is a poor alternative to taxation at the State level. Limitations on the taxing jurisdiction of local governments and on the resources they can commit to tax enforcement, local governments' increasing sensitivity to tax competition form jurisdictions within their immediate trading area and beyond, together with the rising number of local residents who derive income from other geographic areas and from income sources not amenable to withholding, are some of the important considerations that make income taxation at the State level preferable to taxation at the local level.

Chapter 5

REVENUE ASPECTS OF PERSONAL INCOME TAXES

On the basis of the analysis in Chapter 2 we concluded that the only hope for genuine progress toward a solution to the perennial fiscal problem of the States--short of drastic curtailment of expenditure growth or steadily increasing reliance on Federal financial aid--is heavier State reliance upon high-elasticity sources of revenue. The tax with the most potential for raising the automatic rate of growth of State revenue is the personal income tax. What use is made of this tax at the three levels of government at the present time? How important are existing income taxes in the revenue systems of the various States? What factors determine the productivity of the tax--why, for example, do the income tax States have such widely varying success with it? Why is the gross national product elasticity of an income tax higher than that of any major tax? What would a truly broad-based and low-rate individual income tax yield in each State, and would widespread adoption of the tax really be enough to shore-up the fiscal foundations of State governments? These are the questions considered in this chapter.

The taxation of personal income is the primary instrument for financing government in the United States. In the most recent year for which data are available, fiscal 1964, individual income taxes accounted for 38 percent of the tax collections of all levels of government--$52.5 billion of a $138.3 billion total. This amounted to a tax of $274.33 per inhabitant. The next most productive tax, on the income of corporations, yielded only slightly more than $25 billion (table 13).

The Federal Government clearly dominates the individual income tax field. Despite the fact that 33 States, 1/ the District of Columbia, and numerous local governments in a half-dozen States levied personal income taxes in 1964, these governments accounted for only 7.2 percent of all collections from this source. By far the largest share--92.8 percent--was Federal, gathered from more than 51 million taxpayers.

Not until World War II did the pre-eminence of the individual income tax at the Federal level become firmly established. Except for a brief interval during the First World War, the tax produced only about 20 percent

1/ Not including the special cases of New Hampshire, New Jersey, and Tennessee. Nebraska's new tax does not take effect until January 1, 1967, and also is not counted here.

TABLE 13.--FEDERAL, STATE, AND LOCAL TAX COLLECTIONS, BY SOURCE, 1964

Source	All governments	Federal government	State and local governments: Total	State and local governments: State	State and local governments: Local
	AMOUNT (in millions)				
Individual income	$ 52,488	$48,697	$ 3,791	$ 3,415	$ 376 1/
Corporation income	25,188	23,493	1,695	1,695	1/
Sales and gross receipts	30,538	14,776	15,762	13,957	1,806
Customs duties	1,252	1,252	---	---	---
General sales and gross receipts	7,254	---	7,254	6,084	1,170
Selective sales and gross receipts	22,032	13,524	8,508	7,873	635
Motor fuel	6,788	2,696	4,092	4,059	33
Alcoholic beverages	4,371	3,478	893	864	29
Tobacco products	3,328	2,048	1,280	1,196	84
Public utilities	1,864	1,016	848	498	350
Other	5,680	4,285	1,395	1,256	139
Property	21,241	---	21,241	722	20,519
Inheritance, estate and gift	3,052	2,394	658	658	2/
Motor vehicle and operators' licenses	2,048	---	2,048	1,917	131
All other taxes	3,737	1,148	2,589	1,879	710
Total	138,292	90,507	47,785	24,243	23,542
	DISTRIBUTION AMONG SOURCES (percent)				
Individual income	38.0	53.8	7.9	14.1	1.6 1/
Corporation income	18.2	26.0	3.5	7.0	1/
Sales and gross receipts	22.1	16.3	33.0	57.6	7.7
Customs duties	0.9	1.4	---	---	---
General sales and gross receipts	5.2	---	15.2	25.1	5.0
Selective sales and gross receipts	15.9	14.9	17.8	32.5	2.7
Motor fuel	4.9	3.0	8.6	16.7	0.1
Alcoholic beverages	3.2	3.8	1.9	3.6	0.1
Tobacco products	2.4	2.3	2.7	4.9	0.4
Public utilities	1.3	1.1	1.8	2.1	1.5
Other	4.1	4.7	2.9	5.2	0.6
Property	15.4	---	44.5	3.0	87.2
Inheritance, estate and gift	2.2	2.6	1.4	2.7	2/
Motor vehicle and operators' licenses	1.5	---	4.3	7.9	0.6
All other taxes	2.7	1.3	5.4	7.8	3.0
Total	100.0	100.0	100.0	100.0	100.0
	DISTRIBUTION AMONG GOVERNMENTS (percent)				
Individual income	100.0	92.8	7.2	6.5	0.7 1/
Corporation income	100.0	93.3	6.7	6.7	1/
Sales and gross receipts	100.0	48.4	51.6	45.7	5.9
Customs duties	100.0	100.0	---	---	---
General sales and gross receipts	100.0	---	100.0	83.9	16.1
Selective sales and gross receipts	100.0	61.4	38.6	35.7	2.9
Motor fuel	100.0	39.7	60.3	59.8	0.5
Alcoholic beverages	100.0	79.6	20.4	19.8	0.7
Tobacco products	100.0	61.5	38.5	35.9	2.5
Public utilities	100.0	54.5	45.5	26.7	18.8
Other	100.0	75.4	24.6	22.1	2.4
Property	100.0	---	100.0	3.4	96.6
Inheritance, estate and gift	100.0	78.4	21.6	21.6	2/
Motor vehicle and operators' licenses	100.0	---	100.0	93.6	6.4
All other taxes	100.0	30.7	69.3	50.3	19.0
Total	100.0	65.4	34.6	17.5	17.0

Note: Detail may not add to totals because of rounding.

1/ Minor amount of corporation income taxes included in individual income tax figures.

2/ Minor amount included in "all other taxes."

Source: U. S. Bureau of the Census, Governmental Finances in 1963-64.

of Federal budget receipts until 1942. The yield of the individual income tax rose steadily from $3.2 billion, or $23.77 per capita, in 1942 to $48.7 billion in 1964, when its per capita yield was $254.51, and when it accounted for 54 percent of Federal tax collections. The President's budget for fiscal year 1966 estimates the yield in that year at $48.2 billion--allowing for the effects of the dramatic tax cut that took effect during 1964 and 1965. 1/

The evolution of the individual income tax into the mainstay of the Federal tax system has been traced in Chapter 3. From the "rich man's tax," enacted in 1913 after the 16th Amendment was ratified, has developed a revenue producer that affects most income recipients in the country. Almost 64 million returns, covering 1963 income, were filed with the Internal Revenue Service in 1964. More than 51 million of these returns reported tax liabilities.

The 1964 Revenue Act cut tax rates across-the-board and made significant structural changes in the Federal tax, not the least of which resulted in substantial restrictions in the deductibility of State and local taxes. The new marginal rates, effective in two installments (1964 and 1965), begin at 14 percent and rise to 70 percent. The old rates, which had been in effect since 1954, ranged from 20 to 91 percent. The new basic rate applies only to the first of the four brackets into which the old $2,000 tax bracket ($4,000 for joint return) has been split.

Table 13 illustrates the importance--relative and absolute--of income taxes in the revenue systems of the three levels of government in the United States. Table 14 shows the relative significance of income taxes in the tax systems of each State in 1965.

DETERMINANTS OF INCOME TAX YIELD

We have seen in Chapter 2 that the behavior of tax yield can be considered logically in two stages, because the yield of a tax is determined by the size of the tax base and the level of the tax rates. In this section the same procedure is followed with respect specifically to income taxes. We consider first the determinants of the absolute amount of collections during a particular fiscal year. Then we examine the factors that account for the responsiveness of the yield of an individual income tax to changes in the gross national product--the question of elasticity.

The yield of a State income tax depends upon two basic factors that are like the blades of a pair of scissors: the size of the tax base (the

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1/ Total individual and business Federal tax liabilities will be approximately $14 billion lower in fiscal year 1966 than they would have been without the tax cut. "Budget Message of the President," The Budget of the United States Government, Fiscal Year Ending June 30, 1966, January 1965, p. 13.

TABLE 14.--STATE TAX COLLECTIONS, TOTAL AND PERSONAL INCOME TAXES, BY STATES, 1965

(Dollar amounts in thousands)

State	Total	Personal income tax	
		Amount	Percent of total
Alabama	$ 414,370	$ 46,216	11.2
Alaska	44,019	16,123	36.6
Arizona	236,965	14,562	6.1
Arkansas	217,861	17,922	8.2
California	3,132,171	410,486	13.1
Colorado	268,175	59,946	22.4
Connecticut	390,537	--	--
Delaware	120,946	42,183	34.9
Florida	762,402	--	--
Georgia	548,388	64,270	11.7
Hawaii	154,804	38,550	24.9
Idaho	92,213	28,862	31.3
Illinois	1,218,689	--	--
Indiana	648,646	123,253	19.0
Iowa	331,286	57,554	17.4
Kansas	265,261	33,084	12.5
Kentucky	391,496	56,827	14.5
Louisiana	581,272	23,515	4.0
Maine	117,735	--	--
Maryland	527,531	140,281	26.6
Massachusetts	674,981	219,751	32.6
Michigan	1,328,571	--	--
Minnesota	519,469	173,901	33.5
Mississippi	266,301	8,912	3.3
Missouri	503,804	57,117	11.3
Montana	79,560	16,657	20.9
Nebraska	115,222	--	--
Nevada	75,193	--	--
New Hampshire	54,044	2,128 1/	3.9
New Jersey	543,550	8,361 2/	1.5
New Mexico	188,445	16,219 3/	8.6
New York	2,862,288	1,131,731	39.5
North Carolina	687,992	136,351	19.8
North Dakota	82,080	7,956	9.7
Ohio	1,035,887	--	--

See footnotes at end of table.

TABLE 14.--STATE TAX COLLECTIONS, TOTAL AND PERSONAL INCOME TAXES, BY STATES, 1965 (Concl'd)

(Dollar amounts in thousands)

State	Total	Personal income tax	
		Amount	Percent of total
Oklahoma	$ 357,571	$ 26,484	7.4
Oregon	278,800	135,890	48.7
Pennsylvania	1,554,546	--	--
Rhode Island	124,622	--	--
South Carolina	309,492	43,359	14.0
South Dakota	64,182	--	--
Tennessee	433,872	6,862 1/	1.6
Texas	1,187,247	--	--
Utah	147,520	22,511	15.3
Vermont	63,205	18,724	29.6
Virginia	477,605	142,064	29.7
Washington	601,586	--	--
West Virginia	241,360	20,706	8.6
Wisconsin	732,354	272,849	37.3
Wyoming	47,920	--	--
U.S. total	26,104,036	3,642,167	14.0
Total for 33 States with broad-based personal income taxes	16,448,231	3,624,816	22.0

1/ Tax on income from dividends and interest only.

2/ "Commuters' tax;" applies only to income earned in New Jersey by residents of New York.

3/ Includes an unsegregable amount from corporation income taxes.

Source: U. S. Bureau of the Census, State Tax Collections in 1965.

amount of "taxable income") and the level of tax rates. If one blade is dull, scissors will not cut well. If taxable income is narrowly-defined it matters little that the rates are very high--yields will be poor. Alternatively, if the base is broad but rates are too low, the tax will be unproductive until the dull blade is sharpened. The quality of administration and the honesty of taxpayers, especially in the case of a tax that relies so heavily upon voluntary self-assessment, are also important determinants of the yield of an income tax. However, we exclude consideration of these factors in this context. 1/

Statutory Rate Schedules

Table 15 summarizes the rate schedules of State income taxes as they were on December 31, 1965. Except for New York and New Jersey, no two rate schedules are exactly alike. 2/ All but four States (Indiana, Maryland, Massachusetts, and Nebraska) have graduated rates. The graduated schedules range from 0.75-3.2 percent for the lowest taxable income bracket to a high of 2-14.56 percent at the top end of the income scale. However, the apparent progressivity of the statutory rate schedules is very substantially mitigated, if not completely offset, for taxpayers in 18 of the 30 States with graduated schedules by the fact that they are permitted to deduct Federal income taxes in arriving at taxable income. This point is explained in detail in an appendix to this chapter. Note that a tax with steeply graduated rates may yield less than a flat-rate tax that has what appears to be a very low rate. Graduation--that is, surtax rates that rise above the basic tax rate--in fact has relatively little revenue significance. 3/

1/ But see Clara Penniman and Walter W. Heller, State Income Tax Administration, Public Administration Service, Chicago, 1959.

2/ Since the New Jersey tax is intended to take full advantage of New York's provision for a credit to its residents who must pay income taxes to States in which they work, the New Jersey "commuters' income tax" was deliberately drafted to mirror the New York tax. The peculiar New Jersey tax is not considered further in this chapter.

3/ We have not been able to develop reliable estimates of the revenue significance of the surtax rates of the existing State income taxes. It is worth noting, however, that only 16 percent of the yield of the Federal individual income tax in 1963 (when marginal rates ranged up to 91 percent--the tax cut of 1964-65 reduced the top rate to 70 percent) was attributable to surtax rates above the (then) basic rate of 20 percent. In other words, the entire yield of the steeply-graduated Federal Tax in 1963 could have been produced by a flat rate of 23.1 percent. (Internal Revenue Service, Statistics of Income, 1963 [preliminary], June 1965, p. 14).

TABLE 15.--STATE INDIVIDUAL INCOME TAXES: RATES, DECEMBER 31, 1967 *

State	Net income after personal exemption	Rate (percent)	Federal tax deductible	Special rates or features
Alabama.........	First $1,000......	1.5	x	....
	$1,001-$3,000.....	3		
	$3,001-$5,000.....	4.5		
	Over $5,000.......	5		
Alaska..........	16 percent of the total Federal income tax that would be payable for the same taxable year at the Federal tax rates in effect on December 31, 1963.			....
Arizona[1].......	First $1,000......	2	x	....
	$1,001-$2,000.....	3		
	$2,001-$3,000.....	4		
	$3,001-$4,000.....	5		
	$4,001-$5,000.....	6		
	$5,001-$6,000.....	7		
	Over $6,000.......	8		
Arkansas........	First $3,000......	1	....	....
	$3,001-$6,000.....	2		
	$6,001-$11,000....	3		
	$11,001-$25,000...	4		
	Over $25,000......	5		
California[1]....	First $2,000......	1	....	The following rates apply to heads of households: First $3,000......... 1% $3,001-$4,500........ 2 $4,501-$6,000........ 3 $6,001-$7,500........ 4 $7,501-$9,000........ 5 $9,001-$10,500....... 6 $10,501-$12,000...... 7 $12,001-$13,500...... 8 $13,501-$15,000...... 9 Over $15,000.........10
	$2,001-$3,500.....	2		
	$3,501-$5,000.....	3		
	$5,001-$6,500.....	4		
	$6,501-$8,000.....	5		
	$8,001-$9,500.....	6		
	$9,501-$11,000....	7		
	$11,001-$12,500...	8		
	$12,501-$14,000...	9		
	Over $14,000......	10		
Colorado........	First $1,000......	3	x	Surtax on income from intangibles in excess of $5,000, 2 percent. Taxpayers are allowed a credit equal to 1/2 of 1 percent of net taxable income on the first $9,000 of taxable income. A $7 tax credit is allowed each taxpayer and each dependent for sales tax paid on food. If there is no income tax liability the taxpayer can apply for a refund. See table 11.
	$1,001-$2,000.....	3.5		
	$2,001-$3,000.....	4		
	$3,001-$4,000.....	4.5		
	$4,001-$5,000.....	5		
	$5,001-$6,000.....	5.5		
	$6,001-$7,000.....	6		
	$7,001-$8,000.....	6.5		
	$8,001-$9,000.....	7		
	$9,001-$10,000....	7.5		
	Over $10,000......	8		
Delaware........	First $1,000......	1.5	x[2]	....
	$1,001-$2,000.....	2		
	$2,001-$3,000.....	3		
	$3,001-$4,000.....	4		
	$4,001-$5,000.....	5		
	$5,001-$6,000.....	6		
	$6,001-$8,000.....	7		
	$8,001-$30,000....	8		
	$30,001-$50,000...	9		
	$50,001-$100,000..	10		
	Over $100,000.....	11		

See footnotes at the end of table.

TABLE 15.--STATE INDIVIDUAL INCOME TAXES: RATES, DECEMBER 31, 1967* (Cont'd)

State	Net income after personal exemption	Rate (percent)	Federal tax deductible	Special rates or features
Georgia.........	First $1,000......	1	....	....
	$1,001-$3,000.....	2		
	$3,001-$5,000.....	3		
	$5,001-$7,000.....	4		
	$7,001-$10,000....	5		
	Over $10,000......	6		
Hawaii[3/]........	First $500........	2.25	....	Alternative tax on capital gains: Deduct 50 percent of capital gains and pay an additional 4 percent on such gains. The income classes reported are for individuals. For joint returns the rates shown apply to income classes twice as large. Special tax rates are provided for heads of households ranging from 2.25% on taxable income not over $500 to 11% on taxable income in excess of $60,000. A sales tax credit based on modified adjusted gross income brackets is provided, ranging from $1 to $20 per qualified exemption. Taxpayers are also provided credits for students attending institutions of higher learning ($5 to $50) and dependent children attending school in grades kindergarten to twelve ($2 to $20). The amount of credit is based on size of A.G.I. If a taxpayer's credits exceed his tax, a refund will be made. See table 11.
	$501-$1,000.......	3.25		
	$1,001-$1,500.....	4.50		
	$1,501-$2,000.....	5.00		
	$2,001-$3,000.....	6.50		
	$3,001-$5,000.....	7.50		
	$5,001-$10,000....	8.50		
	$10,001-$14,000...	9.50		
	$14,001-$20,000...	10.00		
	$20,001-$30,000...	10.50		
	Over $30,000......	11.00		
Idaho[1/].........	First $1,000......	2.5	x	A $10 filing fee is imposed on each return. A $10 tax credit is allowed for each personal exemption.
	$1,001-$2,000.....	5.0		
	$2,001-$3,000.....	6.0		
	$3,001-$4,000.....	7.0		
	$4,001-$5,000.....	8.0		
	Over $5,000.......	9.0		
Indiana.........	Adjusted gross income............	2	....	A $8 tax credit is allowed each taxpayer and each dependent for sales tax paid on food. If there is no income tax liability, the taxpayer can apply for a refund. See table 11.
Iowa............	First $1,000......	0.75	x	A credit is allowed for sales taxes paid. If there is no income tax liability, the taxpayer can apply for a refund. See table 11.
	$1,001-$2,000.....	1.5		
	$2,001-$3,000.....	2.25		
	$3,001-$4,000.....	3		
	$4,001-$7,000.....	3.75		
	$7,001-$9,000.....	4.5		
	Over $9,000.......	5.25		
Kansas..........	First $2,000......	2	x	The income classes reported are for individuals and heads of households. For joint returns the rates shown apply to income classes twice as large.
	$2,001-$3,000.....	3.5		
	$3,001-$5,000.....	4		
	$5,001-$7,000.....	5		
	Over $7,000.......	6.5		

See footnotes at the end of table.

State	Net income after personal exemption	Rate (percent)	Federal tax deductible	Special rates or features
Kentucky........	First $3,000......	2	x	....
	$3,001-$4,000.....	3		
	$4,001-$5,000.....	4		
	$5,001-$8,000.....	5		
	Over $8,000.......	6		
Louisiana[1].....	First $10,000.....	2	x	....
	$10,001-$50,000...	4		
	Over $50,000......	6		
Maryland........	First $1,000......	2	....	....
	$1,001-$2,000.....	3		
	$2,001-$3,000.....	4		
	Over $3,000.......	5		
Massachusetts[3].	Earned income and business income...	3.075	x	A consumer tax credit is allowed of $4 each for the taxpayer and his spouse and $8 for each qualified dependent. If there is no income tax liability the taxpayer can apply for a refund. See table 11.
	Interest and dividends, capital gains on intangibles	7.38		
	Annuities.........	1.845		
Michigan........	All taxable income	2.6	....	The following credits are allowed (not to exceed the taxpayer's State income tax liability):

City income tax	Credit
Not over $100....	20% of city tax
$101-$150........	$20 + 15% of excess over $100
$151-$200........	$27.50 + 10% of excess over $150
Over $200........	$32.50 + 5% of excess over $200
	Maximum credit $10,000

Property tax	Credit
Not over $100....	20% of property tax
$101-$150........	$20 + 15% of excess over $100
$151-$200........	$27.50 + 10% of excess over $150
$201-$10,000.....	$32.50 + 5% of excess over $200
Over $10,000.....	4% of property tax

A lessee of a homestead is allowed a similar credit. In such a case 20% of the gross rent paid by the lessee is deemed to be property tax.

State	Net income after personal exemption	Rate (percent)	Federal tax deductible	Special rates or features
Minnesota.......	First $500........	1.5	x	A property tax credit is allowed for senior citizen homestead relief. Cash refund granted if property tax credit exceeds income tax due. See table 11.
	$501-$1,000.......	2.0		
	$1,001-$2,000.....	3.0		
	$2,001-$3,000.....	5.0		
	$3,001-$4,000.....	6.0		
	$4,001-$5,000.....	7.0		
	$5,001-$7,000.....	8.0		
	$7,001-$9,000.....	9.0		
	$9,001-$12,500....	10.0		
	$12,501-$20,000...	11.0		
	Over $20,000......	12.0		
Mississippi.....	First $5,000......	2	....	....
	Over $5,000.......	3		

See footnotes at the end of table.

TABLE 15.--STATE INDIVIDUAL INCOME TAXES: RATES, DECEMBER 31, 1967* (Cont'd)

State	Net income after personal exemption	Rate (percent)	Federal tax deductible	Special rates or features
Missouri........	First $1,000...... $1,001-$2,000..... $2,001-$3,000..... $3,001-$5,000..... $5,001-$7,000..... $7,001-$9,000..... Over $9,000.......	1 1.5 2 2.5 3 3.5 4	x	The rates apply to total income, not merely to the proportion of income falling within a given bracket, but as a result of the following tax credits, the schedule in effect is a bracket rate schedule: $1,001-$2,000..... $ 5 $2,001-$3,000..... $ 15 $3,001-$5,000..... $ 30 $5,000-$7,000..... $ 55 $7,001-$9,000..... $ 90 Over $9,000....... $135
Montana.........	First $1,000...... $1,001-$2,000..... $2,001-$4,000..... $4,001-$6,000..... $6,001-$8,000..... $8,001-$10,000.... $10,001-$25,000... Over $25,000......	2 3 4 5 6 7 8 10	x	After computing their tax, taxpayers may subtract 5% of the tax due.
Nebraska[3/]......	The tax is imposed on the taxpayer's Federal income tax liability before credits, with limited adjustments. The rate for 1968 is 10% and is to be set as a flat percentage by the State Board of Equalization and Assessment on or before November 15 annually for the taxable year beginning during the subsequent calendar year.			A $7 tax credit is allowed each taxpayer and each dependent for sales tax paid on food. If there is no income tax liability the taxpayer can apply for a refund. See table 11.
New Hampshire...	Interest and dividends (excluding interest on savings deposits).........	4.25	....	....
New Jersey......	First $1,000...... $1,001-$3,000..... $3,001-$5,000..... $5,001-$7,000..... $7,001-$9,000..... $9,001-$11,000.... $11,001-$13,000... $13,001-$15,000... Over $15,000......	2 3 4 5 6 7 8 9 10	....	Tax applies to commuters only, New Jersey-New York area.
New Mexico[1/3/]..	First $10,000..... $10,001-$20,000... $20,001-$100,000.. Over $100,000.....	1.5 3.0 4.5 6	x	Net income (of married taxpayer filing joint return and single taxpayer with one or more dependents) under $1,500 nontaxable.
New York........	First $1,000...... $1,001-$3,000..... $3,001-$5,000..... $5,001-$7,000..... $7,001-$9,000..... $9,001-$11,000.... $11,001-$13,000... $13,001-$15,000... Over $15,000......	2 3 4 5 6 7 8 9 10	....	Capital gains treatment is similar to that provided under Federal law. Income from unincorporated business is taxed at 4 percent. The following credit is allowed: If tax is-- credit is-- $100 or less... full amount of tax. $100-$200...... difference between $200 and amount of tax. $200 or more... no credit.

See footnotes at the end of table.

TABLE 15.--STATE INDIVIDUAL INCOME TAXES: RATES, DECEMBER 31, 1967* (Cont'd)

State	Net income after personal exemption	Rate (percent)	Federal tax deductible	Special rates or features
North Carolina..	First $2,000......	3	....	....
	$2,001-$4,000.....	4		
	$4,001-$6,000.....	5		
	$6,001-$10,000....	6		
	Over $10,000......	7		
North Dakota....	First $3,000......	1	x	....
	$3,001-$4,000.....	2		
	$4,001-$5,000.....	3		
	$5,001-$6,000.....	5		
	$6,001-$8,000.....	7.5		
	$8,001-$15,000....	10		
	Over $15,000......	11		
Oklahoma 3/......	First $1,500......	1	x	The income classes reported are for individuals and heads of households. For joint returns the rates shown apply to income classes twice as large.
	$1,501-$3,000.....	2		
	$3,001-$4,500.....	3		
	$4,501-$6,000.....	4		
	$6,001-$7,500.....	5		
	Over $7,500.......	6		
Oregon..........	First $500........	3	x 4/	The income classes reported are for individuals and heads of households. For joint returns the rates shown apply to income classes twice as large.
	$501-$1,000.......	4		
	$1,001-$1,500.....	5		
	$1,501-$2,000.....	6		
	$2,001-$4,000.....	7		
	$4,001-$8,000.....	9		
	Over $8,000.......	9.5		
South Carolina..	First $2,000......	2	x 5/	....
	$2,001-$4,000.....	3		
	$4,001-$6,000.....	4		
	$6,001-$8,000.....	5		
	$8,001-$10,000....	6		
	Over $10,000......	7		
Tennessee.......	Interest and dividends.........	6	....	Dividends from corporations having at least 75 percent of their property subject to the Tennessee ad valorem tax are taxed at 4 percent.
Utah............	First $1,000......	2	x	....
	$1,001-$2,000.....	3		
	$2,001-$3,000.....	4		
	$3,001-$4,000.....	5		
	$4,001-$5,000.....	6		
	Over $5,000.......	6.5		
Vermont 3/.......	The tax is imposed at a rate of 25% of the Federal income tax liability of the taxpayer for the taxable year (after the allowance of retirement income credit, investment credit, foreign tax credit and tax-free covenant bonds credit, but before the allowance of any other credit against that liability or the addition of any surtax upon that liability granted or imposed under Federal law), reduced by a percentage equal to the percentage of the taxpayer's adjusted gross income for the taxable year which is not Vermont income.			A credit is provided on the succeeding year's tax for 106% of the amount of the excess of tax liability over what such liability would have been had the Federal base used in arriving at the Vermont tax liability been determined in accordance with the Federal Internal Revenue Code in effect on January 1, 1967, instead of the Federal statute in effect for the year for which the return is being filed. Resident taxpayers who are full-time students for at least five months in the year are allowed a $10 credit.

See footnotes at the end of table.

TABLE 15.--STATE INDIVIDUAL INCOME TAXES: RATES, DECEMBER 31, 1967* (Concl'd)

State	Net income after personal exemption	Rate (percent)	Federal tax deductible	Special rates or features
Virginia........	First $3,000......	2	....	....
	$3,001-$5,000.....	3		
	Over $5,000.......	5		
W. Virginia.....	First $2,000......	1.2	....	The income classes reported are for individuals and heads of households. For joint returns the rates shown apply to income classes twice as large.
	$2,001-$4,000.....	1.3		
	$4,001-$6,000.....	1.6		
	$6,001-$8,000.....	1.8		
	$8,001-$10,000....	2.0		
	$10,001-$12,000...	2.3		
	$12,001-$14,000...	2.6		
	$14,001-$16,000...	2.8		
	$16,001-$18,000...	3.0		
	$18,001-$20,000...	3.1		
	$20,001-$22,000...	3.4		
	$22,001-$26,000...	3.5		
	$26,001-$32,000...	3.7		
	$32,001-$38,000...	3.9		
	$38,001-$44,000...	4.1		
	$44,001-$50,000...	4.3		
	$50,001-$60,000...	4.5		
	$60,001-$70,000...	4.7		
	$70,001-$80,000...	4.9		
	$80,001-$90,000...	5.0		
	$90,001-$100,000..	5.2		
	$100,001-$150,000.	5.3		
	$150,001-$200,000.	5.4		
	Over $200,000.....	5.5		
Wisconsin3/.....	First $1,000......	2.7	....	A property tax credit is allowed for senior citizen homestead relief. Cash refund granted if property tax credit exceeds income tax due. See table 11.
	$1,001-$2,000.....	2.95		
	$2,001-$3,000.....	3.2		
	$3,001-$4,000.....	4.2		
	$4,001-$5,000.....	4.7		
	$5,001-$6,000.....	5.2		
	$6,001-$7,000.....	5.7		
	$7,001-$8,000.....	6.7		
	$8,001-$9,000.....	7.2		
	$9,001-$10,000....	7.7		
	$10,001-$11,000...	8.2		
	$11,001-$12,000...	8.7		
	$12,001-$13,000...	9.2		
	$13,001-$14,000...	9.7		
	Over $14,000......	10.0		
Washington, D.C.	First $2,000......	2.5	....	Income from unincorporated business is taxed at 5 percent.
	$2,001-$4,000.....	3		
	$4,001-$6,000.....	3.5		
	$6,001-$8,000.....	4		
	$8,001-$10,000....	4.5		
	Over $10,000......	5		

1/ Community property State in which, in general, 1/2 the community income is taxable to each spouse.

2/ Limited to $300 for single persons and $600 for married persons filing joint returns.

3/ Allows deduction of State individual income tax itself in computing State tax liability.

4/ Any Federal tax paid due to an increase in rates effective after November 1, 1967, will not be deductible for Oregon personal income tax purposes. The limitation is effective for tax years beginning on and after 1/1/68, and ending not later than 11/30/70.

5/ Limited to $500 per taxpayer.

* Updated for this reprint.

Tax Base

The amount of taxable income in a particular State--the other blade of the scissors--is itself a function of two factors. The first is the potential tax base, which may be approximated by the State's personal income. 1/ The second is the extent to which that potential tax base is exploited, that is, the proportion of personal income that finally appears as taxable income.

The latest available personal income figures are shown in table 16. They underscore the enormous range of potential income tax bases among the States, from less than $1 billion personal income in Alaska and Wyoming to almost $57 billion in New York. The total income figures probably are more deceptive than enlightening: they do not take into account the great variation in the size of the States. For this reason, a more appropriate measure of the interstate variation in potential income tax bases is per capita personal income. These data are shown in table 16 as absolutes and as percentages of the national average per capita income. Very large disparities among the States appear in these figures as well, but they are on the order of 2-1 rather than 57-1 as in the total income figures. The point is obvious, however. The identical income tax will yield more than twice as much revenue per capita in Delaware as in Mississippi. These disparities must be recognized as a major determinant of yield, even though there is very little a tax administrator or a revenue committee can do to overcome them.

What a State does with its potential tax base, however, is an entirely different matter. One overriding fact is abundantly clear. Few income taxes in the United States include a very significant proportion of personal income in their tax bases, and the Federal tax is no exception. In addition to non-money forms of income, such as the value of home-grown food and the imputed rental value of owner-occupied homes, there are essentially three sorts of leakage 'twixt the cup of personal income and the lip of taxable income. The first is the classes of personal income that are excluded from adjusted gross income (to use the terminology of the Federal Internal Revenue Code). Among the most common exclusions are unemployment compensation payments, sick pay, social security benefits, and interest on tax-exempt government bonds. Business and personal deductions constitute the second major

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1/ Personal income is a highly imperfect measure of the potential base of a State income tax. The estimates, as prepared by the Department of Commerce, include certain types of non-money income that are not amenable to accurate assessment and candid reporting. For this reason the potential income tax base of the farm States is overstated by personal income estimates. Moreover, a State legally may tax all income earned within its borders, but the personal income estimates attempt to allocate income on the basis of residence. As a result, personal income estimates understate the potential tax base of a State to the extent that there is a net flow of commuters into the State--for example, New York.

TABLE 16.--ABSOLUTE AND RELATIVE POTENTIAL INDIVIDUAL INCOME TAX BASE, BY STATES, CALENDAR YEAR 1964

State	Absolute base (personal income, in billions)	Relative base (per capita personal income)	
		Amount	As percentage of national average
Alabama	$ 6.0	$1,749	68
Alaska	.8	3,116	121
Arizona	3.5	2,233	87
Arkansas	3.2	1,655	64
California	56.1	3,103	121
Colorado	5.0	2,566	100
Connecticut	9.1	3,281	128
Delaware	1.7	3,460	135
Dist. of Columbia	2.9	3,544	138
Florida	12.8	2,251	88
Georgia	8.3	1,943	76
Hawaii	1.8	2,622	102
Idaho	1.4	2,020	79
Illinois	31.9	3,041	119
Indiana	12.3	2,544	99
Iowa	6.5	2,376	93
Kansas	5.2	2,346	91
Kentucky	5.8	1,830	71
Louisiana	6.5	1,877	73
Maine	2.1	2,132	83
Maryland	9.8	2,867	112
Massachusetts	15.8	2,965	116
Michigan	22.3	2,755	107
Minnesota	8.4	2,375	93
Mississippi	3.3	1,438	56
Missouri	11.5	2,600	101
Montana	1.6	2,252	88
Nebraska	3.5	2,349	92
Nevada	1.3	3,248	127
New Hampshire	1.6	2,377	93
New Jersey	20.1	3,005	117
New Mexico	2.1	2,041	80
New York	56.6	3,162	123
North Carolina	9.3	1,913	75
North Dakota	1.4	2,133	83
Ohio	26.7	2,646	103
Oklahoma	5.1	2,083	81
Oregon	4.9	2,606	102
Pennsylvania	29.8	2,601	101
Rhode Island	2.3	2,514	98
South Carolina	4.2	1,655	64
South Dakota	1.3	1,879	73
Tennessee	7.1	1,859	72
Texas	22.7	2,188	85
Utah	2.1	2,156	84
Vermont	.9	2,119	83
Virginia	9.8	2,239	87
Washington	7.9	2,635	103
West Virginia	3.5	1,965	77
Wisconsin	10.2	2,490	97
Wyoming	.8	2,441	95
United States	491.0	2,566	100

Source: Department of Commerce, Office of Business Economics, Survey of Current Business, July 1965 pp. 10-11.

source of discrepancy between taxable and personal income. The expenses of earning income, casualty losses, and medical expenses are examples of these deductions. 1/ Finally, personal exemptions account for a large proportion of the difference between personal income and the tax base. 2/

Data problems preclude a detailed analysis of the relative importance of these factors in the case of each State income tax. Some figures for the Federal individual income tax may help, however, to put the various factors into perspective, since the similarities between the Federal and State taxes are quite extensive. Table 17 illustrates the relationships among these income concepts. The base of the Federal income tax in 1963 was considerably less than half the size of personal income. One-fifth of personal income is never reported on tax returns; 13 percent disappears through standard and itemized personal deductions; and a quarter of the potential Federal base is accounted for by personal exemptions.

Personal Exemptions

Every State individual income tax provides for personal exemptions (table 18). With the exception of Mississippi, which has the highest personal exemption, every State provides exemptions for dependents. Most of the State personal income taxes allow additional exemptions for old age and blindness. Exemptions generally take the form of deductions from adjusted gross income, but five States (Arkansas, Iowa, Kentucky, Minnesota, and Wisconsin) provide for tax credits. Several supplement their exemptions with credits, which are related to personal and dependency exemptions. Thus, New York allows a credit of $10 for a single individual and $25 for a head of household and for a married couple. Indiana provides a $6 credit for each taxpayer and dependent, which is intended to provide an approximate refund of sales taxes paid on food. 3/ Idaho amended its income tax law, effective January 1, 1965, to allow a $10 credit for each taxpayer and dependent. 4/

1/ Most expenses of earning income--trade and business expenses--are classified formally in the Internal Revenue Code as "deductions from gross income," and thus actually are excluded from adjusted gross income. What are referred to above as exclusions from adjusted gross income are formally classified as "exclusions from gross income," but the distinction has little practical significance, and it is ignored in this report except where otherwise indicated.

2/ See Technical Paper 2 (p.167,ff.) for discussion of the exclusion and deduction provisions of the Federal and State income tax laws.

3/ The credit is allowed without regard to the taxpayer's income tax liability, if any. If he has no liability, the taxpayer may apply for a refund. Similar credits are allowed by Colorado and Hawaii; and Wisconsin allows a comparable credit to elderly persons for the purpose of property tax relief. See Chapter 3.

4/ This was designed as a general cut in personal income tax rates, as part of a package that included a new 3 percent general sales tax.

TABLE 17.--PERSONAL INCOME, ADJUSTED GROSS INCOME, AND TAXABLE INCOME, FEDERAL INDIVIDUAL INCOME TAX, 1963

(In billions)

Item	Amount	Percentage of personal income
Personal income	$464.1	100.0
Less: Net exclusions 1/	95.3	20.5
Adjusted gross income	368.8	79.5
Less: Personal deductions	59.2	12.8
Personal exemptions	109.4	23.6
Adjustments 2/	- 8.9	- 1.9
Taxable income	209.1	45.1

1/ Items excluded from AGI less items not included in personal income (prizes, gambling profits, etc.). Approximately 35 percent of this amount represents non-monetary income, the taxation of which would be extremely difficult (percentage estimated for 1960 by Richard Goode, The Individual Income Tax, Studies of Government Finance, The Brookings Institution, Washington, 1964, p. 322).

2/ Primarily accounted for by the fact that personal deductions and exemptions exceed AGI on certain non-taxable returns.

Sources: U. S. Treasury Department, Internal Revenue Service, Statistics of Income, 1963, Individual Income Tax Returns, (Preliminary), June 1965, pp. 4, 14. Council of Economic Advisers, Economic Report of the President, 1965, January 1965, p. 205.

The size and nature of personal exemptions have an extremely important bearing on the productivity and incidence of an individual income tax. Since the personal exemptions in use today do not vary with size of income, they contribute to the progressivity of the tax. A flat-rate income tax with personal exemptions is "progressive" as that concept is usually defined, because with such a tax the yield-income ratio rises as income rises. 1/

1/ A regressive tax is identified by a yield-income ratio that falls when income rises. A tax is proportional if the ratio is the same for taxpayers in every income bracket.

TABLE 18. --STATE INDIVIDUAL INCOME TAXES: PERSONAL EXEMPTIONS, DECEMBER 31, 1967*

State	Personal exemption		Additional exemption on account of--		
	Single	Married (joint return)	Dependents	Age 1/	Blindness 1/
Alabama	$1,500	$3,000	$300	....	....
Alaska	600	1,200	600	$600	$600
Arizona	1,000	2,000	600	1,000	500
Arkansas 2/	17.50(1,750)	35(3,250)	6(333)	....	....
California 2/	25(2,250)	50(4,500)	8(400)	....	8(400)
Colorado 3/	750	1,500	750	750	750
Delaware	600	1,200	600	600	600
Georgia	1,500	3,000	600 4/	600	600
Hawaii 3/	600	1,200	600	600 5/	5,000
Idaho 6/	600	1,200	600	600	600
Indiana 3/	1,000	2,000 7/	500	500	500
Iowa 2/ 3/	15(1,500)	30(2,333)	10(467)	15 8/	15 8/
Kansas	600	1,200	600 9/	600	600
Kentucky 2/	20(1,000)	40(2,000)	20(1,111)	20(1,000)	20(1,000)
Louisiana 10/	2,500(50)	5,000(100)	400(8) 9/	....	1,000(20) 11/
Maryland	800	1,600	800 12/	800 12/	800
Massachusetts 13/ 3/	2,000	2,500-4,000	400 9/	500	2,000
Michigan	1,200	2,400	1,200 9/	1,200	1,200
Minnesota 2/ 3/	19(1,050)	38(1,683)	19(541)	14/	14/
Mississippi	5,000	7,000	....	....	....
Missouri	1,200	2,400	400	....	....
Montana	600	1,200	600 9/	600	600
Nebraska 3/	600	1,200	600 9/	600	600
New Hampshire 15/	600	600 16/	....	....	....
New Jersey 17/	600	1,200	600 9/	600	600
New Mexico	600	1,200	600 9/	600	600
New York 17/	600	1,200	600 9/	600	600
North Carolina	1,000	2,000 18/	600 19/	1,000	1,000
North Dakota	600	1,500	600	600	600
Oklahoma	1,000	2,000	500	....	....
Oregon	600	1,200	600 20/	21/	600 21/
South Carolina	800	1,600	800 22/	800	800
Tennessee 15/	....	....	....	....	....
Utah	600	1,200	600 9/	200 23/	600
Vermont	600	1,200	600 9/	600	600
Virginia	1,000	2,000	300 24/	600	600
West Virginia	600	1,200	600 9/	600	600
Wisconsin 2/ 3/	10(370)	20(740)	10(402)	5 25/	....
Dist. of Columbia	1,000	2,000	500	500	500

1/ In most States an identical exemption is allowed for a spouse if she meets the age and blindness conditions. In Massachusetts the deduction for blindness is allowed against business income only. In Hawaii the $5,000 blindness deduction is allowed in lieu of the personal exemption.

2/ Personal exemptions and credits for dependents are allowed in the form of tax credits which are deductible from an amount of tax. With respect to personal exemptions, the sum in parentheses is the exemption equivalent of the tax credit assuming that the exemption is deducted from the lowest brackets. With respect to the dependency exemptions; the sum in parentheses is the amount by which the first dependent raises the level at which a married person or head of family becomes taxable.

(Footnotes continued on the following page)

3/ In addition to the personal exemption deductions, a sales tax credit or cash rebate (in the case of Minnesota and Wisconsin a property tax credit or cash rebate) is provided. See table 15.

4/ The exemption is allowed for students regardless of age or income. For students beyond the high school level, $1,200 per dependent and $600 if the taxpayer is a student.

5/ Individuals establishing residence in Hawaii after the age of 65 are subject to tax on income from Hawaii sources only (the tax is imposed on the entire taxable income of resident individuals, estates, and trusts).

6/ In addition to the personal exemption deductions, a $10 tax credit is allowed for each personal exemption.

7/ Each spouse is entitled to the lesser of $1,000 or adjusted gross income. (Minimum $500.)

8/ Single person, $833; married couple, $1,167.

9/ The exemption is allowed for students regardless of age or income.

10/ The exemptions and credits for dependents are deductible from the lowest income bracket and are equivalent to the tax credits shown in parentheses.

11/ An identical exemption is allowed for a spouse or for a dependent.

12/ The exemption is allowed for students regardless of age or income. An additional exemption of $800 is allowed for each dependent 65 years of age or over.

13/ The exemptions shown are those allowed against business income, including salaries and wages: a specific exemption of $2,000 for each taxpayer. In addition, a dependency exemption of $500 is allowed for a dependent spouse who has income from all sources of less than $2,000. In the case of a joint return, the exemption is the smaller of (1) $4,000 or (2) $2,000, plus the income of the spouse having the smaller income. For nonbusiness income (annuities, interest, and dividends) the exemption is the smaller of (1) $1,000 or (2) the unused portion of the exemption applicable to business income. Married persons must file a joint return in order to obtain any nonbusiness income exemption. If a single person, or either party to a joint return, is 65 years of age, the maximum is increased from $1,000 to $1,500. No exemption is allowed against nonbusiness income if income from all sources for a single person exceeds $5,000 and for a married person exceeds $7,500.

14/ An additional tax credit of $20 is allowed for each taxpayer or spouse who has reached the age of 65. Additional tax credits for the blind: unmarried, $20; married, $25 for each spouse.

15/ The tax applies only to interest and dividends.

16/ An additional exemption of $600 is allowed a married woman with separate income; joint returns are not permitted.

17/ In addition to the personal exemptions, the following tax credits are granted: Single persons, $10; married taxpayers and heads of households, $25.

18/ An additional exemption of $1,000 is allowed a married woman with separate income; joint returns are not permitted.

19/ Plus an additional $600 for each dependent who is a full-time student at an accredited university or college.

20/ A credit of $1 is allowed for each $100 actually contributed by the taxpayer as partial support of a person who could qualify (except for the chief support requirement) as a dependent. The credit shall not exceed $6.

21/ A tax credit of $12 is allowed for each taxpayer or spouse who has reached the age of 65. A blind taxpayer and his spouse (if also blind) are allowed an additional $600 exemption plus a tax credit of $18 each.

(Footnotes continued on the following page.)

22/ The exemption is extended to dependents over the age of 21 if they are students in an accredited school or college.

23/ Increased to $400 for 1969, and $600 for 1970 and thereafter.

24/ Exemption for one dependent of unmarried person is $1,000, if dependent is father, mother, son, daughter, sister or brother.

25/ Single person, $185; married couple $402.

* Updated for this reprint.

Table 19 illustrates this principle. The 5 percent flat-rate income tax shown in the example is (diminishingly) progressive because the tax-income ratio (the "effective rate") starts at zero and approaches (but never quite reaches) 5 percent as income rises.

TABLE 19.--EFFECT OF A 5 PERCENT FLAT-RATE INCOME TAX WITH A $1,000 PERSONAL EXEMPTION ON THE TAX OWED BY A SINGLE TAXPAYER AT SELECTED INCOME LEVELS

Income	Personal exemption	Taxable income	Tax rate	Tax owed	$\frac{\text{Tax}}{\text{income}}$ ratio
$ 900	$1,000	$ -100 (or 0)	5%	$ 0	0.0000
2,000	1,000	1,000	5	50	.0250
3,000	1,000	2,000	5	100	.0333
5,000	1,000	4,000	5	200	.0400
10,000	1,000	9,000	5	450	.0450
20,000	1,000	19,000	5	950	.0475
100,000	1,000	99,000	5	4,950	.0495

Thus, even the flat-rate State income taxes are progressive because of their personal exemptions. Twelve of the income tax States use the Federal per capita exemption system of $600 for a single individual, $1,200 for a married couple, $600 for each dependent. Only Vermont and Wisconsin allow lower exemptions. The lower the exemption level the broader is the tax base, and the higher the potential income tax yield. On the basis of the estimates in table 17 , then, it is not unreasonable to conclude that the twelve States that follow the Federal exemption provisions devote roughly a quarter of their potential tax base to this end. With the exceptions of Vermont and Wisconsin, we may also conclude that the exemption provisions of the remaining State taxes, since they are more liberal than those of the Internal Revenue Code, absorb considerably more than 25 percent of their potential tax bases.

THE EFFECT OF STATE PERSONAL INCOME TAXES ON INDIVIDUAL TAXPAYERS

The foregoing discussion points up the fact that there is considerable variation in State personal income tax rate and base structures. The average effect of these variations on the individual taxpayer can be demonstrated by relating each State's personal income tax collections to its Federal adjusted gross income (a rough measure of the average effective rate) and to the amount of Federal personal income taxes collected in each State (table 20). In 1964 the 33 States with broad-based income taxes tapped only 1.6 percent of their taxpayers' 1963 Federal adjusted gross income, while the Federal tax in those same States claimed 13.1 percent. On the average, in other words, the 33 States collected $12.20 in State personal income taxes for every hundred dollars of Federal collections.

The averages, however, conceal a considerable interstate range in the burden of State personal income taxes relative to the Federal tax. An approximate allocation of Federal personal income taxes to the States of origin, indicates the following percentage relationship between State and Federal personal income tax collections: 1/

State collections as a percentage of Federal collections	No. of States
Under 8 percent	12
8-14 percent	10
14-20 percent	6
20 percent and over	5
Total	33

The range extended from 3.2 percent in Louisiana to 27.2 percent in Wisconsin. The collections of only four additional States amounted to 20 percent or more of Federal collections (Alaska, Idaho, Oregon and Vermont). The average for the 33 States listed in table 20 is 12.2 percent.

1/ Federal individual income tax collections for fiscal 1964 were allocated to the States of origin in proportion to the amount of "income tax after credits," as tabulated from unaudited individual income tax returns for 1963. This procedure does not provide a totally satisfactory distribution by State of origin because taxpayers may file their Federal returns in States where they are employed and not necessarily where they reside. As a result, taxes reported for Federal purposes do not always conform to liability for State taxes, and are probably somewhat overstated for the more industrialized States and understated for the less industrialized States. Despite these limitations there is a sufficiently wide interstate variation in the level of State individual income tax collections to make some valid comparisons of percentage relationships between State and Federal income tax collections.

TABLE 20.--STATE AND FEDERAL PERSONAL INCOME TAX COLLECTIONS IN 1964 AS A PERCENT OF FEDERAL ADJUSTED GROSS INCOME IN 1963, BY STATES

State	Collections as percent of Federal adjusted gross income		
	State	Federal 1/	State as percent of Federal
Alabama	.9	11.3	8.0
Alaska	2.8	14.0	20.0
Arizona	.5	12.3	4.1
Arkansas	.7	11.0	6.4
California	.9	13.7	6.6
Colorado	1.4	12.7	11.0
Delaware	3.1	17.3	17.9
Georgia	1.0	12.1	8.3
Hawaii	2.5	13.0	19.2
Idaho	2.4	11.2	21.4
Indiana	1.4	13.1	10.7
Iowa	1.0	11.7	8.5
Kansas	.7	12.2	5.7
Kentucky	1.1	11.7	3.6
Louisiana	.4	12.5	3.2
Maryland	1.5	13.5	11.1
Massachusetts	1.7	13.5	12.6
Minnesota	2.4	12.2	19.7
Mississippi	.4	10.7	3.7
Missouri	.8	13.4	6.0
Montana	1.3	11.7	11.1
New Mexico	.6	11.7	5.1
New York	2.6	14.3	18.2
North Carolina	1.8	11.2	16.1
North Dakota	.8	10.2	7.8
Oklahoma	.6	12.0	5.0
Oregon	3.3	12.7	26.0
South Carolina	1.2	10.7	11.2
Utah	1.1	11.3	9.7
Vermont	2.3	11.4	20.2
Virginia	1.8	12.4	14.5
West Virginia	.7	11.9	5.9
Wisconsin	3.4	12.5	27.2
33 States	1.6	13.1	12.2

1/ Distributed on basis of 1963 Statistics of Income. See text.
Source: U.S. Treasury Dept., Internal Revenue Service, Statistics of Income, 1963 (Preliminary); and U.S. Bureau of the Census, Compendium of State Government Finances in 1964.

These relationships reflect the variation in average effective rates of the State personal income taxes, which (in terms of collections as a percentage of Federal adjusted gross income) ranged from less than $\frac{1}{2}$ of 1 percent in Mississippi and Louisiana to almost $3\frac{1}{2}$ percent in Wisconsin.

The 33 States (excluding Nebraska) with broad-based personal income taxes can be divided into three almost equal groups--low impact, medium impact, and high impact personal income tax States. This classification is based upon the rough approximation of average effective rates shown in table 20 . The 12 States in Group I are those with an average effective rate of less than 1 percent; Group II (12 States), a rate of 1 to 2 percent; and Group III (9 States), a rate of over 2 percent (table 21).

No particular geographic pattern emerges from this grouping, but the States in each group tend to have similar economic characteristics. Thus, the States in Group I are mainly low-income States, with the notable exception of California. Group II States cluster around the U. S. average income, but with a smattering of both high and low-income States. Group III tends toward the middle and upper bands of the income spectrum, but also includes a few low-income States.

Graduated rate schedules, personal exemptions, and other structural features of the State personal income taxes tend to make them moderately progressive. Over limited income ranges some State taxes are more progressive than the Federal tax.

The progressivity of the State personal income taxes is illustrated in table 22 , which reports the computed 1965 effective rates at various income levels (up to $25,000) for a married couple with two dependents. 1/ With only a few exceptions, the State taxes, like the Federal, do not begin to affect this family until it earns about $3,500. At that income level, the State effective rates vary from a low of 2/100 of a percent in Missouri and Oklahoma to a high of 1.5 percent in Wisconsin. At the $25,000 level, the range is from a little less than 1 percent in Louisiana and New Mexico to over $5\frac{1}{2}$ percent in Hawaii, Minnesota, and Wisconsin.

An innovation introduced by Indiana in 1963 and picked up by Colorado and Hawaii in 1965 results in negative effective rates at the lowest income levels. This comes about from the per capita credits allowed by those States, which credits are intended to approximate a refund of sales taxes paid on food. If the credit exceeds the income tax liability, the taxpayer may apply for a refund. In an attempt to provide tax relief for elderly persons with low incomes, in 1963, Wisconsin adopted a similar credit system for residential property tax payments.

1/ For this purpose, "effective rate" is defined as the ratio of tax liability to Federal adjusted gross income. Federal income tax returns with adjusted gross income of $25,000 or less account for more than 90 percent of all reported Federal adjusted gross income.

TABLE 21.--AVERAGE EFFECTIVE RATES OF STATE PERSONAL INCOME TAXES, PER CAPITA INCOME, AND DISTRIBUTION OF FEDERAL ADJUSTED GROSS INCOME, BY STATES

State	State personal income taxes, 1964		Per capita income, 1964	Percent distribution of Federal adjusted gross income, 1961		
	Average effective rate 1/ (percent)	As percent of Federal personal income tax		Under $6,000	$ 6,000 to $15,000	$15,000 and over
	I. STATES WITH LOW EFFECTIVE RATES (low impact)					
Alabama	0.9	8.0	$1,749	44.8	44.4	10.7
Arizona	.5	4.1	2,233	34.4	50.0	15.6
Arkansas	.7	6.4	1,655	54.3	34.6	11.1
California	.9	6.6	3,103	27.0	54.3	18.7
Kansas	.7	5.7	2,346	40.5	46.6	13.0
Louisiana	.4	3.2	1,877	42.8	42.9	14.4
Mississippi	.4	3.7	1,438	53.6	34.4	12.1
Missouri	.8	6.0	2,600	38.9	46.0	15.2
New Mexico	.6	5.1	2,041	36.3	50.7	13.1
North Dakota	.8	7.8	2,133	55.6	35.9	8.6
Oklahoma	.6	5.0	2,083	42.2	43.9	13.9
W. Virginia	.7	5.9	1,965	43.6	47.4	8.9
	II. STATES WITH MODERATE EFFECTIVE RATES (medium impact)					
Colorado	1.4	11.0	2,566	33.0	51.2	16.0
Georgia	1.0	8.3	1,943	47.2	39.2	13.8
Indiana	1.4	10.7	2,544	38.4	50.1	11.4
Iowa	1.0	8.5	2,376	44.7	43.2	12.1
Kentucky	1.1	3.6	1,830	47.9	40.3	11.9
Maryland	1.5	11.1	2,867	35.3 2/	48.4 2/	16.4 2/
Massachusetts	1.7	12.6	2,965	37.0	47.4	15.7
Montana	1.3	11.1	2,252	44.5	43.7	11.8
North Carolina	1.8	16.1	1,913	51.5	36.0	12.5
South Carolina	1.2	11.2	1,655	51.0	39.7	9.2
Utah	1.1	9.7	2,156	32.2	57.0	10.8
Virginia	1.8	14.5	2,239	41.8	44.5	13.7
	III. STATES WITH HIGH EFFECTIVE RATES (high impact)					
Alaska	2.8	20.0	3,116	23.8	60.1	16.1
Delaware	3.1	17.9	3,460	31.9	41.9	26.2
Hawaii	2.5	19.2	2,622	33.7	46.3	19.9
Idaho	2.4	21.4	2,020	46.2	43.1	10.8
Minnesota	2.4	19.7	2,375	39.1	46.8	14.2
New York	2.6	18.2	3,162	31.9	45.6	22.5
Oregon	3.3	26.0	2,606	36.3	50.6	13.0
Vermont	2.3	20.2	2,119	48.8	42.1	9.1
Wisconsin	3.4	27.2	2,490	39.5	48.2	12.3
U.S.	1.6	12.2	2,566	35.8 3/	48.1 3/	16.1 3/

1/ State personal income tax collections as percent of Federal adjusted gross income in 1963. 2/ Includes District of Columbia. 3/ All States, including those without personal income taxes.

Sources: U.S. Dept. of Commerce, Office of Business Economics, Survey of Current ~~Business, July 1965; Bureau of the Census, Compendium of State Government~~ Finances in 1964; and U.S. Treasury Dept., Bureau of Internal Revenue, Statistics of Income, Individual Income Tax Returns, 1961 and 1963 (Preliminary).

TABLE 22.--EFFECTIVE RATES OF STATE PERSONAL INCOME TAXES FOR SELECTED ADJUSTED GROSS INCOME LEVELS, MARRIED COUPLE WITH TWO DEPENDENTS, BY STATE, DECEMBER 31, 1965

State	Adjusted gross income classes						
	$2,500	$3,500	$5,500	$7,500	$10,000	$17,500	$25,000
Alabama	--	--	.3	.8	1.4	2.1	4.4
Alaska	--	.7	1.5	1.9	2.2	2.6	3.2
Arizona	--	--	.3	.6	.9	1.4	1.9
Arkansas	--	--	.4	.9	1.3	2.0	2.5
California	--	--	.1	.3	.5	1.0	1.6
Colorado 1/	-1.1	-.7	.3	.9	1.5	2.4	3.2
Delaware	--	.3	.8	1.3	2.2	3.8	4.8
Georgia	--	--	.1	.5	1.0	2.2	3.1
Hawaii 1/	-3.2	-1.0	1.9	3.1	4.2	4.9	5.8
Idaho	--	--	.6	1.4	2.2	3.2	4.0
Indiana 1/	-1.0	-.1	.7	1.0	1.3	1.6	1.7
Iowa	--	--	.9	1.5	2.1	2.2	2.4
Kansas	--	.5	1.0	1.2	1.8	1.9	2.4
Kentucky	--	--	.8	1.7	2.3	2.7	3.1
Louisiana	--	--	--	.1	.4	.8	.9
Maryland	--	--	1.0	1.4	1.9	2.0	2.2
Massachusetts	--	--	.9	1.3	1.7	1.6	1.7
Minnesota	.4	.8	2.3	3.3	4.1	4.8	5.6
Mississippi	--	--	--	--	.5	1.1	1.6
Missouri	--	*	.4	.7	1.0	1.4	1.7
Montana	--	.2	.7	1.3	1.9	2.9	3.6
New Mexico	--	.3	.6	.7	.8	.9	.9
New York	--	--	.8	1.5	2.2	3.5	5.0
North Carolina	--	.5	1.3	2.0	2.9	3.6	4.4
North Dakota	--	.2	.4	.6	1.2	2.7	3.8
Oklahoma	--	*	.3	.4	.7	1.1	1.6
Oregon	--	.7	1.7	2.5	3.3	3.7	4.4
South Carolina	--	--	.5	1.0	1.5	2.7	3.8
Utah	--	.4	1.1	1.7	2.4	3.1	3.4
Vermont	.2	.7	1.8	2.7	3.7	4.3	4.9
Virginia	--	.5	1.0	1.5	2.3	2.8	3.3
W. Virginia	--	.3	.6	.7	.8	1.0	1.2
Wisconsin	.8	1.5	2.3	2.9	3.7	4.5	5.6
Federal tax	--	2.0	6.7	9.2	11.1	13.3	16.1

Note: In computing income taxes, it was assumed that all income was from wages and salaries and earned by one spouse. For State tax computations the optional standard deduction was used except for the $17,500 and $25,000 income classes where it was assumed that deductions are itemized. For Federal tax computations (other than the $17,500 and $25,000 A.G.I. classes) the following percentages of A.G.I. were used for estimated deductions: 16% through the $7,500 A.G.I. class and 14% for the $10,000 class. In computing the State tax at the $17,500 income level, itemized deductions were assumed to be $2,640, excluding the State personal income tax. For those States that allow deduction of the Federal income tax, the itemized deductions were assumed to be $2,850 in computing the Federal tax liability, (addition of estimated State income tax less certain deductions not allowed for the Federal tax); except that where the State individual income tax is itself deductible for State income tax purposes, the actual State tax liability was added to the $2,640 for both Federal and State tax computations. The comparable State and Federal estimated itemized deductions used in computing the tax at the $25,000 level are $3,475 and $3,843, respectively. New Hampshire and Tennessee are excluded since their personal income taxes apply only to interest and dividend income; also excluded is the New Jersey "commuters' income tax." Data for Nebraska are not available. "Effective rates" are computed as the ratio of tax liability to adjusted gross income (i.e., income after business deductions but before personal exemptions and other allowable deductions).

* Less than .05 percent.

1/ Negative rates result from credits allowed for sales taxes paid on food (Hawaii also allows a credit for each dependent who is a student). If the credit exceeds the tax liability, the taxpayer can apply for a refund.

The responsiveness of the yield of an income tax to changes in the GNP is a more complicated question than the elasticity of a consumption tax, which we considered in Chapter 2. The complications result from the fact that the effective rate of an income tax can not be counted upon to remain constant when the size of the tax base changes. Typically, the ratio of tax paid to income rises when an individual's income rises. For example, if the GNP increases 10 percent, and an individual's income rises by the same percentage, the tax he owes will probably rise by more than 10 percent. The base of an income tax, as we have seen, is taxable income, which is "total income" minus certain exclusions, deductions, and exemptions.

The total income of many individuals is less than the sum of their exclusions, deductions, and exemptions, with the result that taxable income is negative though it is treated as zero. We had to adjust for this fact in table 17. If the total income of such persons rises, the income tax base may or may not change, depending on whether their taxable income rises above zero. As this phenomenon works out in practice, the incomes of a great many people move above the break-even point during periods when the GNP is increasing. Conversely, if the GNP fails to rise or falls even a little, the population continues to increase (and with it the number of personal exemptions), so the incomes of many persons fall below the line. This effect is much more powerful than one might expect. Careful studies have found that taxable income changes by as much as 12-14 percent every time there is a 10 percent change in the gross national product. 1/

We began by saying that the income tax elasticity question is complicated because the ratio of tax to total income typically rises as income rises. As we saw in table 19, if there are personal exemptions, the ratio rises with income even if the statutory tax rate does not change.

If tax rates rise when taxable income increases, as they do in the case of the Federal and most State income taxes, the income elasticity of the tax is even higher. When individuals' incomes rise with GNP, not only does a larger proportion of total income enter the tax base, but some

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1/ During the period 1949-62, Federal taxable income (adjusted to compensate for the 1954 amendments to the Internal Revenue Code) changed an average of 12.2 percent for each change of 10 percent in the GNP. That is, the income elasticity of the Federal personal income tax base was approximately 1.22. A recent study of the responsiveness of State individual income tax bases to changes in State personal income concludes that the average income elasticity of taxable income in New York, North Carolina, and Virginia between 1946 and 1960 was about 1.39 (Robert W. Rafuse, Jr., "The Cyclical Behavior of State-Local Finances," in Richard A. Musgrave, editor, Essays in Fiscal Federalism, Studies of Government Finance, The Brookings Institution, Washington, 1965).

taxpayers move into higher rate brackets. Though it may seem surprising, in view of the significance attached to graduated rate structures in most public discussions, this effect is far less important than the movement of income into and out of the first rate bracket in causing the elasticity of income taxes to be very high. 1/

Potential Yield of Broad-Based State Income Taxes

In Chapter 7 we consider some of the advantages and disadvantages of State use of the Federal definition of taxable income or adjusted gross income as the base of a State individual income tax. It is clear that the case for State use of either definition is overwhelming as far as administrative efficiency and ease of taxpayer compliance are concerned. We will see that from the viewpoint of tax fairness a State income tax base should be at least as broad as Federal adjusted gross income. The issue is at least as clear-cut when revenue aspects of the choice are taken into account.

For State and local governments, low tax rates are always preferable to high rates, especially if the same amount of revenue is forthcoming in either case. We need look no further than the widespread concern about the effects of taxes on the location of industry--whether the effects are real or merely imagined is not important--for a major reason why the lowest possible marginal tax rates are desired. The simple arithmetic of taxation, then, indicates why tax rate considerations will lead State officials to prefer Federal adjusted gross income (AGI) to taxable income. By adopting AGI as much as 80 percent of personal income would be included in the tax base, only 20 percent would be lost. If the Federal personal exemption provisions were also adopted, another one-fourth of the potential base would be lost, but this would still represent a tax base one-fourth larger than Federal taxable income (see table 17). An opportunity to set rates at, say, 3 percent rather than 4 percent is not to be underestimated.

1/ The evidence suggests that the behavior of the tax base accounts for at least 90 percent of the income elasticity of the average State income tax in use today. The narrower the income brackets, and the larger the percentage increases in the statutory rates from one bracket to the next, the more important a factor is the rate structure in raising the income elasticity of an income tax. For example, of the following two taxes--identical in all other respects--the rate factor would cause tax B to have the higher income elasticity:

Tax A		Tax B	
Taxable income bracket	Marginal tax rate	Taxable income bracket	Marginal tax rate
First $5,000	20%	First $2,000	1%
Next 5,000	22	Next 2,000	2
Next 5,000	23	Next 2,000	3

What would be the yield of such a broad-based but low-rate type of State income tax, and by how much would such a tax raise the growth potential of State taxes?

Table 23 presents some crude estimates for each State of the yield (in fiscal year 1964) of a flat-rate income tax if the rate had been 2 percent of Federal adjusted gross income less Federal personal exemptions. A tax of this sort is approximately equivalent to the one that was adopted in 1963 by Indiana. 1/ In 1964 actual State income tax collections were just under $3\frac{1}{2}$ billion, and they accounted for 14.1 percent of total State collections. If every State had levied an income tax of 2 percent of Federal adjusted gross income (less Federal personal exemptions) in that year, the total yield would have been $5.2 billion, or 20 percent of (the increased) total State tax collections.

Table 24 illustrates the approximate amounts of yield that would have resulted in 1964 from several alternative tax rates applied to the Federal AGI base. If every State had adopted a tax with a flat rate of 4.6 percent (equivalent to the rate in Oregon, the highest actual rate in 1964), total State income tax collections would have exceeded $12 billion, and income taxes would have accounted for 36.5 percent of all State collections--when the actual percentage was only 14.1. 2/ Note that actual Federal collections in fiscal year 1964 would have required a rate of only 18.3 percent for a comparable definition of the tax base.

In Chapter 2 we found that the GNP elasticity of total State general revenue in fiscal year 1964 was approximately 0.92 (within a range of 0.82-1.01). 3/ The more rapid automatic growth of income tax yields will--in the absence of off-setting adoptions and rate increases in low-elasticity revenue sources--raise the contribution of income taxes to total State

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1/ The income elasticity of this tax would be toward the low end of the 1.5-1.8 range given in table 4 (p. 42), since there would be no contribution from a progressive rate factor. The elasticity of such a very broad-based tax could be expected to exceed the 1.4 elasticity mentioned earlier for the New York, North Carolina, and Virginia taxes (excluding the effects of their progressive rate structures). James A. Papke estimates that the elasticity of the Indiana tax will "approach 1.5," but his estimate may be conservative. ("Indiana Tax Policy: Revision, Reform, Reconstruction," National Tax Journal, Vol. 17, June 1962, p. 127).

2/ These percentages are based on the highly questionable assumption that other tax collections would not have been lower if every State had made such extensive use of the personal income tax. A more realistic assumption would result in substantial increases in the ratios of income tax yields to total tax collections.

3/ The estimate is an average of the elasticities in table 4 , weighted by actual collections in fiscal year 1964.

TABLE 23.--YIELD OF A TWO PERCENT STATE PERSONAL INCOME TAX, BY STATES, 1964
(Base data in millions; yield data in thousands)

State	Federal (1963)		"Taxable income"	2% yield	Actual yield F.Y. 1964	Actual as % of:	
	A.G.I.	Regular exemptions				2% yield	"Taxable income"
Alabama	$ 4,242	$ 1,568	$ 2,674	$ 53,480	$ 36,591	68.4	1.4
Alaska	501	136	365	7,300	13,931	190.8	3.8
Arizona	2,641	826	1,815	36,300	14,053	38.7	0.8
Arkansas	2,138	858	1,280	25,600	15,616	61.0	1.2
California	42,382	10,452	31,930	638,600	391,853	61.4	1.2
Colorado	3,783	1,120	2,663	53,260	52,521	98.6	2.0
Connecticut	7,099	1,647	5,452	109,040	--	--	--
Delaware	1,138	271	867	17,340	35,354	203.9	4.1
Dist. of Columbia	1,903	448	1,455	29,100	32,315	111.0	2.2
Florida	9,017	2,837	6,180	123,600	--	--	--
Georgia	5,808	1,971	3,837	76,740	56,018	73.0	1.5
Hawaii	1,382	409	973	19,460	34,680	178.2	3.6
Idaho	1,072	405	667	13,340	25,292	189.6	3.8
Illinois	24,161	6,111	18,050	361,000	--	--	--
Indiana	9,239	2,750	6,489	129,780	126,346	97.4	1.9
Iowa	4,685	1,600	3,085	61,700	48,524	78.6	1.6
Kansas	4,038	1,293	2,745	54,900	29,433	53.6	1.1
Kentucky	4,083	1,490	2,593	51,860	46,067	88.8	1.8
Louisiana	4,549	1,581	2,968	59,360	18,697	31.5	0.6
Maine	1,496	533	963	19,260	--	--	--
Maryland	8,081	2,223	5,858	117,160	123,266	105.2	2.1
Massachusetts	11,893	3,079	8,814	176,280	202,541	114.9	2.3
Michigan	17,033	4,700	12,333	246,660	--	--	--
Minnesota	6,337	2,016	4,321	86,420	149,505	173.0	3.5
Mississippi	2,060	824	1,236	24,720	7,962	32.2	0.6
Missouri	8,229	2,399	5,830	116,600	63,726	54.7	1.1
Montana	1,133	402	731	14,620	14,691	100.5	2.0
Nebraska	2,527	860	1,667	33,340	--	--	--
Nevada	1,001	236	765	15,300	--	--	--
New Hampshire	1,275	394	881	17,620	1,893	10.7	0.2
New Jersey	15,811	3,872	11,939	238,780	6,962	2.9	0.1
New Mexico	1,496	534	962	19,240	9,197 1/	47.8	1.0
New York	43,324	10,384	32,940	658,800	1,136,263	172.5	3.4
North Carolina	6,399	2,409	3,990	79,800	115,920	145.3	2.9
North Dakota	937	366	571	11,420	7,263	63.6	1.3
Ohio	20,672	5,856	14,816	296,320	--	--	--
Oklahoma	3,698	1,281	2,417	48,340	21,773	45.0	0.9
Oregon	3,743	1,079	2,664	53,280	122,876	230.6	4.6
Pennsylvania	22,873	6,513	16,360	327,200	--	--	--
Rhode Island	1,774	498	1,276	25,520	--	--	--
South Carolina	2,935	1,155	1,780	35,600	35,083	98.5	2.0
South Dakota	944	383	561	11,220	--	--	--
Tennessee	5,150	1,860	3,290	65,800	6,541	9.9	0.2
Texas	16,321	5,396	10,925	218,500	--	--	--
Utah	1,749	577	1,172	23,440	20,055	85.6	1.7
Vermont	632	231	401	8,020	14,539	181.3	3.6
Virginia	7,129	2,280	4,849	96,980	128,460	132.5	2.6
Washington	6,303	1,707	4,596	91,920	--	--	--
West Virginia	2,570	919	1,651	33,020	18,061	54.7	1.1
Wisconsin	7,730	2,393	5,337	106,740	259,541 2/	243.2	4.9
Wyoming	630	199	431	8,620	--	--	--
U.S. total	367,746	105,331	262,415	5,248,300	3,443,409	65.6	1.3
Total for 33 States & D.C. with broad-based personal income taxes	213,659	61,729	151,930	3,038,600	3,428,013	112.8	2.3

1/ Combined personal and corporation income taxes are reported to, and published by the Census Bureau. Amount shown is an estimate for personal income taxes only, based on percentages furnished by the Director of the N.M. Income Tax Division. 2/Amount recorded by the State of Wisconsin as 1964 F.Y. revenue. Changes in accounting methods cause this amount to reflect transactions of more than a 12-month period.

Sources: U.S. Treasury Dept., Internal Revenue Service, Statistics of Income, 1963 Individual Income Tax Returns; and U.S. Bureau of the Census, Compendium of State Government Finances in 1964, 1965.

TABLE 24.--ESTIMATED YIELD OF BROAD-BASED PERSONAL INCOME TAXES, AT SELECTED RATES, TOTAL FOR ALL STATES, FISCAL YEAR 1964

(Base data in millions; yield data in thousands)

Tax base 1/ (calendar year 1963)	Tax rate	Yield (total for all States)	Total State tax collections	Yield as percentage of total State collections
$ 262,415	1.3%	$ 3,443,409 2/	$ 24,459,391 2/	14.1%
262,415	2.0	5,248,300	26,264,282	20.0
262,415	2.3 3/	6,035,545	27,051,527	22.3
262,415	4/	6,172,834	27,188,816	22.7
262,415	2.5	6,560,375	27,576,357	23.8
262,415	3.0	7,872,450	28,888,432	27.3
262,415	3.5	9,184,525	30,200,507	30.4
262,415	4.0	10,496,600	31,512,582	33.3
262,415	4.5	11,808,675	32,824,657	36.0
262,415	4.6 5/	12,071,090	33,087,072	36.5
	Reference Data: Federal Base and Collections			
262,932 6/	18.3	48,200,445 7/	--	--

1/ "Taxable income" from table 23.

2/ Actual for all States (including D.C.)

3/ Actual average rate for the 33 States (and D.C.) using broad-based income taxes.

4/ A rate is defined only implicitly for this case, for which total collections are the sum of the yields of 2 percent taxes in the States without income taxes or with "rates" below 2 percent, and the actual collections of the 14 States (and D.C.) with ratios over 2 percent.

5/ Actual average rate for the State with the highest ratio of actual yield to "taxable income" (Oregon). The Wisconsin rate was slightly higher, but was based on inflated collection. See footnote 2, table 23.

6/ Total Federal adjusted gross income minus personal exemptions other than for age and blindness. This figure differs from the sum of the "tax bases" estimated for individual States primarily because the Federal total includes data for taxpayers residing abroad.

7/ Actual Federal collections after credits.

general revenue (own sources) from 12 percent in 1964 to 16 percent in 1970. This would represent a doubling of State income tax yields, from $3.4 billion in 1964 to $6.8 billion in 1970, without a single new income tax and without a single increase in the rates of existing taxes. These automatic changes would also raise the elasticity of total State general revenue to 0.99 (range of 0.89 to 1.09) by 1970.

If every State had levied an income tax of at least 2 percent of Federal AGI (less personal exemptions) in 1964, 1/ the GNP elasticity of the average State revenue system would have been 0.98 (in a range of 0.88-1.08), or approximately 7 percent higher than the actual--0.92. If every State had levied an income tax at the 4.6 percent rate "used" by Oregon in 1964, the income elasticity of total State revenue would have been 1.09 (or a range of 0.98 to 1.20). This 20 percent increase in the elasticity of State general revenue would involve income tax collections of about $12 billion. 2/

Does High Income Elasticity Have Its Dangers?

An important by-product of the Great Depression was the persistent memory of the virtual disintegration of State and local revenue systems in the early years of the decade. Until sometime in the 1950's, economists and those directly responsible for the State-local systems paid tribute to that memory by arguing that income inelasticity is a desirable and necessary characteristic of State and local tax structures: the more inelastic the system the less revenues will decline during a depression. Between 1929 and 1932, for example, when the GNP declined 44 percent, State income tax collections fell 47 percent, but State gasoline tax collections dropped only 4 percent between 1931 and 1932, and they actually rose between 1929 and 1931. 3/

1/ See footnote 4, table 24.

2/ The elasticity estimates in this paragraph are conservative. The crude method used to derive them does not reduce 1964 general revenue from other sources when income tax collections are raised (see footnote 2, p.102). Accordingly, the percentage of total revenue represented by income tax yield is understated and the GNP elasticity of the modified State revenue system is correspondingly underestimated. Though we can be fairly sure that total revenue would not have been larger by the full amount of the increased income tax collections, we have not been able to devise a reasonable procedure for taking this fact into account.

3/ Department of Commerce, U. S. Income and Output, 1958, p. 118; Emanuel Melichar, State Individual Income Taxes, (Storrs: The University of Connecticut, Agricultural Experiment Station, 1963) Monograph 2, p. 39; Public Roads Administration, Federal Works Agency, Highway Statistics, Summary to 1945, 1947, p. 36.

But inelasticity has other consequences, as we have seen. By the mid-Nineteen Fifties fears of a serious depression were receding, and as the decade wore on it became more apparent that the real problem was the failure of State (and local) revenues to grow rapidly enough, and this, of course, is the problem with which we are concerned in this report.

What if the States take steps to increase the elasticity of their revenue structures? Would such a policy carry with it an appreciable risk of disaster worse than that of the 1930's? A serious depression would indeed take the wind out of the sails of a high elasticity tax structure, and if a depression were a real possibility the States might well hold that the risks are too great. But a repeal of the Thirties is highly improbable. The private economy is far less susceptible to crisis, and the solid foundation provided by deposit insurance, unemployment compensation, and social security, and the built-in stability implicit in the far larger volume of government expenditures and taxes than prevailed in 1929, all are likely to prevent a recession from getting out of hand. Perhaps most important of all, the National Government's current and immensely-successful experiment with discretionary fiscal policy--the tax cut of 1964-65--and the consensus that has developed during the past 30 years in support of such counter-cyclical fiscal policy, assure that the Federal Government will never again fail to take the necessary steps to prevent a minor recession from developing into a major depression.

Indeed, an increase in the income elasticity of State revenue systems would represent a significant contribution to the built-in stability of the economy. Other things being equal, the more elastic a tax or a revenue system the more powerful it is as a built-in stabilizer. 1/ Thus, more elastic State revenue systems would in themselves make a major depression less probable.

1/ While a Federal individual income tax credit of the sort discussed in Chapter 6 would reduce the effectiveness of the Federal tax as a built-in stabilizer, the presumed increase in combined Federal and State collections would improve the total tax systems' built-in stability. However, to the extent that an increase in the elasticity of State revenues is brought about by a Federal credit, the net improvement in the stability of the economy would be less than it would have been had the same increase come about without the Federal credit.

Appendix to Chapter 5

EFFECTS OF THE DEDUCTIBILITY OF TAXES ON INCOME TAX RETURNS

The Federal Internal Revenue Code provides that State income taxes may be deducted in computing net income for Federal income tax purposes. Nineteen of the State income tax laws allow income taxes paid to the Federal Government to be deducted from income for State tax purposes, and six States permit the taxpayer to deduct the State individual income tax itself.

The most obvious effect of deductibility is to reduce the combined Federal and State income tax burden on the individual taxpayer. Moreover, because of the graduated statutory rates that are found in the Federal and in most State income tax structures, the benefits of deductibility rise with the income of the taxpayer. If the State personal income tax allows the Federal tax as a deduction, the benefit is even more pronounced as the taxpayer moves up the income scale, and the progressivity of the State tax is reduced.

The effect of unilateral and reciprocal deductibility on the tax owed by an unmarried individual with no dependents is illustrated in table 25. For income earned in 1965 the Federal rate on an additional dollar of taxable income is 50 percent, if the Federal taxable income is $25,000. With no State income tax the Federal rate results in a tax bill of 50 cents for each additional dollar of income. Since the Internal Revenue Code provides that State income taxes are deductible, the addition to Federal taxable income if there is a State tax is the rise in income less the applicable State tax. If deduction of the Federal tax is not allowed, a marginal State rate of 10 percent means that the single taxpayer pays 10 cents of the additional dollar of income to the State government. Federal taxable income rises by only 90 cents, and the Federal tax is 45 cents. The total marginal tax rate is the sum of the Federal and State taxes divided by the additional income, or 55 percent: a 10 percent marginal State tax rate adds only 5 percentage points to the combined Federal-State marginal rate. The revenue loss is borne by the Federal Treasury. For taxpayers subject to the maximum Federal marginal rate (70 percent), the combined tax on an additional dollar of income is 73 cents. Deduction of the State tax leaves 90 cents of Federal taxable income, on which the tax is 63 cents. The 10 cent gain in State revenue costs the Federal Government 7 cents and the taxpayer only 3 cents.

If the State tax law permits the taxpayer to deduct his Federal tax liability, determination of the tax liabilities requires solution of two simultaneous equations. Though a description of the calculations involved will not be attempted, the results are illustrated in the second half of table 25 . The taxpayer gains even more from reciprocal deductibility. The Federal Treasury loses less than under unilateral deductibility, but the State foregoes as much as 68 percent of the revenue it would have obtained if it did not allow the Federal tax to be deducted. In both cases the taxpayer's gain from deductibility increases as his income rises. With unilateral deductibility the 10 percent State tax on an additional dollar

TABLE 25.--EFFECT OF THE DEDUCTIBILITY OF A FLAT-RATE 10 PERCENT STATE TAX ON COMBINED FEDERAL AND STATE PERSONAL MARGINAL INCOME TAX RATES, AT SELECTED NET INCOME LEVELS UNDER 1965 RATES 1/

Federal taxable income	Federal marginal rate for an unmarried individual	If State does not allow deduction of Federal tax				If State allows deduction of Federal tax			
		Tax owed on each additional dollar of income to--			Amount State tax adds to taxpayer's total liability 2/	Tax owed on each additional dollar of income to--			Amount State tax adds to taxpayer's total liability
		State Government	Federal Government	Federal and State		Federal Government	State Government	Federal and State	
$ 5,000	22%	$0.100	$0.198	$0.298	$0.078	$0.2025	$0.0798	$0.2823	$0.062
25,000	50	.100	.450	.550	.050	.4737	.0526	.5263	.026
50,000	62	.100	.558	.658	.038	.5949	.0405	.6354	.015
100,000	70	.100	.630	.730	.030	.6774	.0323	.7097	.010

1/ The marginal rate is the rate applicable to the additional taxable income resulting from an additional dollar of income. The Federal Government allows taxpayers to deduct State income taxes in computing net taxable income for Federal purposes. More than half of the income tax States allow deduction of Federal tax in computing the State tax. The top State rate is as high as 10% in only 6 States. In 2 of these the rate is 10%, and in 2 it is 11%. In Minnesota a rate of 12% is applicable to income above $20,000. In Alaska a rate of 14.56 percent is applicable to income above $200,000.

2/ Federal and State tax liability less Federal tax in absence of State income tax.

Source: U.S. Treasury Dept., Office of Tax Analysis.

of income adds 7.8 cents to the bill of a taxpayer whose income is $5,000, but only 3 cents to the bill of a taxpayer with a six figure income. Reciprocal deductibility increases the wealthy taxpayer's advantage from a ratio of 7.8-3 to a ratio of 6.2-1.

The same principles considered here in reference to the effects of the deductibility of State income taxes on Federal liability apply to all other deductible State (and local) taxes. The Federal Treasury absorbs the revenue loss, and the advantage to the taxpayer increases as his income rises, whether the State levy involved is an income tax or a sales tax.

Chapter 6

THE FEDERAL ROLE IN THE STATE INCOME TAX MOVEMENT

Since the Federal Government's personal income tax collections are approximately 11 times larger than those of State and local governments, its income tax policies are critically important to any assessment of the future of income taxes below the Federal level.

The historical evidence marshalled in Chapter 3 supports the finding that heavy Federal use of the personal income tax, especially since 1940, has been the single most important deterrent to its expanded use by the States. It has enabled the opponents of State income taxation to gain a sympathetic hearing with the argument that the Federal Government has effectively "preempted" this tax; that, therefore, State and local governments must necessarily depend primarily on consumer and property taxes.

It is significant that not a single State adopted a personal income tax between 1937 and 1960, a period during which 12 States adopted general sales taxes. 1/ Although 3 new State income taxes have been enacted since 1960, approximately 95 percent of current collections from this source go to States that enacted such taxes before 1938--over a quarter century ago. In contrast, only 68 percent of general sales tax revenue is collected by States that adopted this tax prior to 1938.

In the light of this record and our conclusion that the national interest would be served by expanded State use of the personal income tax, the next question is whether it would be appropriate to urge the Federal Government to neutralize the deterrent effect of its heavy income tax on the States' use of this revenue source.

With respect to this issue three general policy alternatives appear to be available to the Federal Government:

1. A strong inducement policy--according State income tax payments such Federal income tax preference over other tax payments that no State could afford to forego a personal income tax.

1/ Alaska adopted an individual income tax in 1949, when it was a territory.

2. A status quo position--continuing the present Federal tax treatment (deduction) of State tax payments in general and of State income tax payments in particular, i.e., according no preferential treatment to State income taxes.

3. A compensatory policy--according State income tax payments a limited degree of preferential tax treatment calculated to be just enough to offset the deterrent effect of the massive Federal income tax; every State would not necessarily be encouraged to adopt an income tax.

STRONG INDUCEMENT POLICY

The Federal Government could obviously bring every State into income taxation by providing financial inducements so attractive that no State could resist them. The Congress followed this kind of inducement strategy in 1935 when it provided a 90 percent credit against its unemployment compensation tax for taxes paid to States to insure that every State would adopt an unemployment insurance system. The 80 percent estate tax credit for death taxes paid to States, enacted in 1926 to halt competitive State tax reductions, is another example. Federal inducement to State income taxation could be provided forcefully also through an appropriately devised grant program.

An inducement policy carrying this degree of compulsion would be difficult to justify in the case of State income taxation. If the case for State taxation of personal income is as strong in its own right as we here develop it (Chapters 1, 2 and 5), it should be unnecessary to employ highly coercive inducements in order to bring about expanded State use of these taxes.

Moreover, a strong Federal inducement policy, as exemplified by a full credit of State income taxes (not to exceed, say, 20 percent of Federal tax liability) could be extremely costly. While the initial cost to the U. S. Treasury would approximate $3 billion, this cost would increase rapidly as States moved to take full advantage of the credit. Quite apart from these cost considerations, however, State legislatures ought to be left free to shape their own tax policies in the absence of compelling national interest requirements.

STATUS QUO POLICY

Federal income taxpayers may now claim a standard deduction equal to 10 percent of adjusted gross income or $1,000 (whichever is smaller), 1/ or

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1/ The Revenue Act of 1964 provides the following minimum standard deductions: $300 for a single individual; $400 for a married couple, and an additional $100 for each dependent up to a ceiling of $1,000.

they may deduct specifically-itemized State and local income, property, sales, and gasoline tax payments (among authorized deductions).

These Federal provisions can be viewed as being neutral with respect to the State and local taxes that are eligible for itemization. A continuation of this policy of neutrality--the rejection of all types of inducements, be they mild or strong--has several considerations to recommend it.

The Case for Status Quo--No Preferential Treatment

Preferential Federal tax treatment for State personal income tax payments might be viewed as both imprudent and unnecessary: imprudent because it would violate the traditional concept of neutrality as the general public understands it and unnecessary because the growing fiscal crisis at the State level is likely eventually to force most States to make greater use of the personal income tax--their last major source of untapped revenue--without overt Federal encouragement.

Because preferential tax treatment for State income tax payments would be very expensive for the Federal Treasury--the initial cost would range from several hundred million to several billion dollars, depending upon the kind of inducement utilized--it can also be argued that no such program should be adopted without a comprehensive study of the whole State and local fiscal system and the various alternatives available to the Federal Government for relieving the financial burdens of State and local governments.

It must also be emphasized that special treatment for State personal income tax payments could discriminate in favor of Federal taxpayers residing in the two-thirds of the States with income taxes and against those in States that rely on other sources of revenue. The property taxes paid by the homeowner in New Jersey and the sales taxes paid by the consumer in Illinois come out of personal income and should be entitled to the same Federal treatment as the income tax payments of the residents of other States. This kind of discrimination would quickly trigger a demand that Congress provide comparable treatment for sales and property taxes. If Congress heeded these demands, the goal of the incentive plan--greater State use of the personal income tax--would be nullified.

It is also necessary to point out that it is impossible to devise a "moderate" inducement or compensatory policy just adequate to compensate for the deterrent effect of the heavy Federal income tax. Because of the diverse political and economic circumstances in each State, a limited preferential treatment policy implemented through a fractional tax credit would overcompensate for the Federal income tax in some States and undercompensate for it in others. Moreover, it can also be contended that if the case for State taxation of personal income is a strong one in its own right, it should not require buttressing by preferential Federal treatment.

The Probable Effects of a Status Quo Policy

Given the gradual rise in effective rates over the last fifteen years, it is probably safe to assume that many of the 25 States that now levy both a broad-based income tax and a general sales tax will gradually increase their personal income tax yields by either raising rates or broadening the tax base, or by making both base and rate adjustments. Some of the 9 income tax States that now have no general sales tax can be expected to broaden and diversify their revenue structures through the adoption of general sales taxes within the next decade in response to the public's demand for property tax or income tax relief or both. When Wisconsin adopted its sales tax in 1961 most of the sales tax revenue was earmarked for property tax relief, while the adoption of a sales tax in Idaho in 1965 was accompanied by some income tax reduction.

The two States that have neither a broad-based income tax nor a general retail sales tax--New Jersey and New Hampshire--could go either way. It is also conceivable that either or both of these States might compromise by enacting an Indiana-type broad-based, flat rate income tax coupled with a general sales tax, with part of the revenue perhaps earmarked for property tax relief.

The 14 non-income tax States currently levying a sales tax pose the most difficult forecasting problem. Some of them will almost certainly be forced to broaden and diversify their tax systems through the adoption of a personal income tax within the next decade.

Several considerations suggest that the State income tax movement may be regaining its forward momentum. We have already stressed the States' pressing need for additional revenue and the remarkable revenue performance of the personal income tax in response to economic growth during the last few years. These two facts, coupled with growing public confidence in the ability of national economic policies to sustain economic growth and to prevent the recurrence of serious economic recessions, is both increasing State interest in the revenue potential of the income tax and reducing State concern with the instability of this revenue source. State receptivity to income taxes will increase also as general sales tax rates reach or approach the 4 or 5 percent level--a kind of psychological ceiling--and as property tax loads continue to mount.

There appears to be an increasing awareness that a broad-based income tax, integrated with a general sales tax through a system of income tax credits (and refunds to non-income taxpayers) to safeguard the low income groups, can help bypass or overcome the traditional political stalemate between personal income tax and sales tax supporters. Indiana's, Colorado's, and Hawaii's recent decisions to integrate their income and sales tax systems through the tax credit device have already been noted.

Finally, as a result of the major Federal income tax reduction of 1964, the Federal income tax may have lost some of its "preemptive" character for legislators in the non-income tax States.

The central aim of a compensatory policy would be to provide a limited degree of preferential Federal tax treatment for State income tax payments to offset the deterrent effect of the heavy Federal income tax. A compensatory policy rests on the expectation that once the State income tax movement is liberated from the restraining influence of the Federal income tax, State legislators would look with favor on this revenue source because (a) it represents the last major untapped State revenue source, (b) it has unique revenue growth potential, and (c) it enjoys certain unique advantages from the standpoint of tax fairness.

Modification of Present Deductibility System

Because a compensatory policy is based on the premise that the Federal Government's present treatment of State and local tax payments does not adequately compensate for the heavy Federal income tax, it logically raises the question of the means the Federal Government might employ to neutralize most effectively the deterrent effect of its own income tax for State tax policy purposes. Three lines of preferential action are possible and the justification for taking any one of them is to be found in the fact that such action recognizes that personal income, unlike consumer expenditures and property, is heavily taxed by the Federal Government.

1. The Federal Government could restrict the itemization privilege to State and local income tax payments by disallowing property, gasoline and sales tax deductions--the constriction approach.

2. It could broaden the itemization privilege for State and local income tax payments only by permitting persons using the standard deduction to itemize, in addition, income tax payments--the liberalization approach.

3. It could modify the present deductibility system by permitting all Federal income taxpayers a choice between (a) continuing to itemize income tax payments made to State and local governments, or (b) claiming such payments as a partial credit against their Federal tax liability--the optional partial tax credit approach.

Constriction approach--While disallowance of property, gasoline, and sales tax deductions probably would be sufficient to neutralize the deterrent effect of high Federal income taxes, such a proposal can be expected to encounter bitter political opposition. Homeowners, who have long been accustomed to deducting their residential property tax payments in computing their taxable income for Federal tax purposes, would be especially aroused. Moreover, such "corrective" or neutralizing action could also be expected to trigger stout opposition from State and local governmental officials, who view the present deductibility system as a form of intergovernmental comity--with the Federal Government underwriting a system of general tax relief for State and local taxpayers.

Liberalization approach--The second possible modification of the deductibility system--permitting persons using the standard deduction to take, in addition, State income tax payments as an itemized deduction--would undoubtedly enjoy greater political acceptability because it would give standard deduction filers (generally those with smaller incomes) visible relief for State income tax payments. Persons using the standard deduction would be in a position to "write off" their State income payments against their Federal liability at the average rate of about 17 cents on the dollar.

This proposition, however, is not without major defects. First, it would conflict with the Federal objective to simplify the tax liability formula in order to facilitate automated tax computation and ease the compliance burdens of low-income taxpayers. Second, and far more important, this alternative would provide only token compensation for the presence of heavy Federal income tax rates, because approximately 60 percent of all State income taxpayers already itemize their Federal deductions and would receive no benefit from it, while the other 40 percent--standard deduction filers--tend to fall in the lowest Federal tax rate brackets, and on the average would enjoy only a 17 percent write off.

The token character of this alternative is indicated by the fact that if it had been in effect in 1964, it would have cost the Federal Government less than $150 million in tax revenue. Thus, while it would tend to move in the right direction--leveling the tax policy scales--it would probably fall far short of truly neutralizing the presence of the Federal income tax.

Optional partial credit approach--A partial or fractional tax credit stands out as a more promising method for providing compensatory Federal treatment of State income tax payments. For example, Congress could give Federal income taxpayers a choice between continuing to itemize their State income tax payments *or* to claim instead a specified percentage of such payments as a credit against their Federal tax liability. The standard deduction provision would not be modified.

Because of its high visibility, even a partial credit has great political and psychological value. Under the present system, the State income tax payment appears as one component of the State and local tax deductions (alongside property, sales, and gasoline tax payments). A tax credit, available to *all* taxpayers whether or not they itemize, would be identified as a separate item to be subtracted by all from the amount of tax otherwise payable. This would make State tax policymakers mindful of its special Federal tax-reduction value. If the credit were set at 40 percent, virtually all taxpayers below the $50,000 adjusted gross income class would find it to their advantage to use the credit option.

Because the Federal Government now sustains a heavy revenue loss under the present deductibility system--approximately 24 cents on each dollar collected by State income tax officials--the *initial* cost of an optional credit plan would not be nearly as large as might be expected. In terms of Federal revenue foregone, it is estimated that the present system of itemizing State income tax payments cost the Federal Government approximately $700 million in fiscal year 1964, as compared with a potential revenue cost of $1.2 billion for an optional 40 percent credit for the same year (table 26). As the following tabulation shows, the additional 1964 cost attributable to the credit would have been about $500 million: 1/

Federal tax treatment	Federal revenue foregone ($000,000) Present law	Optional 40% credit
State income taxes claimed as itemized deductions	720	245
40% credit for State income taxes paid	---	975
Total cost	720	1,220
Additional cost of optional credit proposal	---	500
Federal revenue cost of each $1 of State income tax collections	.24¢	41¢

Table 27 projects these costs through 1968. In the fiscal year 1967, for example, the additional cost to the Federal Government of an optional 40 percent credit is estimated at about $730 million. It is estimated that the additional cost of a 33 percent credit proposal would be about $500 million, if it were to go into effect in fiscal year 1967.

On the very extreme assumption that a 40 percent credit would immediately encourage every State to enact an individual income tax with a yield equivalent to 3½ percent of the adjusted gross income reported on Federal income tax returns less personal exemptions (a most unlikely assumption), the additional cost in Federal revenue foregone would approximate $4.2 billion in fiscal year 1968. To produce this result the States would have to be collecting approximately $13 billion of personal income taxes by 1968--in contrast to an estimated $4.8 billion if present Federal policy is continued unchanged. In other words, the estimated additional Federal revenue cost would be offset by a gain in State revenues in the ratio of 2:1.

The case for a compensatory policy--The case for a compensatory policy implemented by an optional partial tax credit rests on the following general

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1/ These revenue cost estimates exclude local income tax payments because the distribution of these tax payments by income classes was not readily available. It is estimated that identical Federal tax credit treatment for local income tax payments would increase the Federal revenue loss by approximately 15 percent.

TABLE 26.--APPROXIMATE FEDERAL REVENUE COST IN FISCAL YEAR 1964 OF THE PRESENT TREATMENT OF STATE INCOME TAX PAYMENTS (DEDUCTIBILITY) COMPARED WITH THE INITIAL COST OF AN OPTIONAL CREDIT AGAINST FEDERAL TAX OF 40 PERCENT OF THE TAXPAYER'S STATE INDIVIDUAL INCOME TAX PAYMENT--CALENDAR YEAR 1963 INCOME LEVELS, FISCAL YEAR 1963 STATE INCOME TAX COLLECTIONS, AND 1965 FEDERAL TAX RATES

Adjusted gross income classes	State income taxes claimed as personal deductions on Federal returns: 1960 Amount ($000)	1960 Percentage of total State collections	1962 Amount ($000)	1962 Percentage of total State collections	Average of columns (3) and (5) (percentages)	Estimated personal deductions for State income taxes 1963 Federal returns 1/ ($000,000)	Estimated cost, FY 1964 (Federal revenue foregone) ($000,000): Present law (deduction only for itemizers)	Optional credit (40% of State tax liability for all Federal taxpayers)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Under $3,000	14,121	0.6	15,037	0.6	0.6	18	*	7
3,000 to 5,000	83,802	3.8	78,702	2.9	3.3	99	15	40
5,000 to 10,000	478,557	21.7	542,519	19.9	20.8	614	105	246
10,000 to 20,000	448,918	20.3	608,413	22.3	21.3	630	155	252
20,000 to 50,000	451,651	20.4	543,257	19.9	20.2	597	200	239
Over $50,000	360,232	16.3	415,844	15.2	15.8	466	245	245 2/
Nontaxable returns	38,118	1.7	50,526	1.9	1.8	53	0	0
Nonitemizers' returns	0	0.0	0	0.0	0.0	0	0	192
Totals	1,875,399 3/	84.9	2,254,298 3/	82.6	83.8	2,476 3/	720	1,221

* Less than $2.5 million.
1/ Total actual 1963 State income tax collections distributed on basis of column (6).
2/ Revenue loss from a deduction rather than a credit (same as entry in column 8). Marginal rates applicable to taxpayers in this AGI bracket are likely to exceed 40 percent, so tax liabilities would be minimized by deducting State income taxes rather than by claiming the credit.
3/ Total actual collections (which include taxes paid by Federal taxpayers who use the standard deduction--nonitemizers) were (in thousands) as follows-- 1960: $2,209,294 1962: $2,727,984 1963: $2,955,996.

TABLE 27.--APPROXIMATE FEDERAL REVENUE COST OF THE PRESENT TREATMENT OF STATE INCOME TAX PAYMENTS (DEDUCTIBILITY) COMPARED WITH THE INITIAL COST OF AN OPTIONAL CREDIT AGAINST FEDERAL TAX OF 40 PERCENT OF THE TAXPAYER'S STATE INDIVIDUAL INCOME TAX LIABILITY--FISCAL YEARS 1964 THRU 1968 1/

(In millions)

Estimated Federal income tax revenue cost of:	F.Y. 1964 2/ Present law	F.Y. 1964 2/ Optional credit	F.Y. 1965 2/ Present law	F.Y. 1965 2/ Optional credit	F.Y. 1966 2/ Present law	F.Y. 1966 2/ Optional credit	F.Y. 1967 2/ Present law	F.Y. 1967 2/ Optional credit	F.Y. 1968 2/ Present law	F.Y. 1968 2/ Optional credit
State income taxes claimed as personal deductions	$720	$ 245	$ 834	$ 284	$ 890	$ 302	$1,063	$ 361	$1,173	$ 399
40 percent credit for state income taxes paid	---	975	---	1,126	---	1,201	---	1,435	---	1,582
Total cost	720	1,220	834	1,410	890	1,503	1,063	1,796	1,173	1,981
Additional cost of the optional credit proposal	---	500	---	576	---	613	---	733	---	808

1/ These estimates are derived in the same way as those in columns (8), and (9) of table 26. State individual income tax collections (in millions) for the relevant fiscal years are: 1963--$2,956 actual, 1964--$3,415 actual, 1965--$3,642 prel., 1966--$4,350 est., and 1967--$4,800 est.

2/ Estimates are based on the assumption that this is the first year the proposal is in effect.

arguments. First, special Federal tax treatment for State and local income tax payments is necessary because the present system makes inadequate compensation for the heavy Federal income tax and, therefore, tends to divert State and local policymakers away from income taxes to consumer and property taxes. Thus, the Federal Government's present policy of "neutrality" is far more apparent than real. As has already been explained, the present deduction treatment, originally adopted in 1913, lost its neutral character when the National Government embarked on the policy of placing primary reliance on the individual income tax during World War II.

If it is appropriate to exhort the States to make fuller use of the personal income tax in the national interest, it is equally appropriate to exhort the Federal Government to abandon its present policy, which works against heavier State reliance on the income tax, and, as a minimum, to pursue a policy of true neutrality by providing State income tax payments the special consideration necessary to achieve that neutrality. While it is not possible to define the precise amount of special consideration that would just compensate for the deterrent effect of the Federal income tax, reasonable inferences can be drawn from historical experience. We know, for example, that a 90 to 100 percent credit would tip the scales decisively in favor of State income taxation. We know also that the present deductibility system, which is equivalent to an average credit of about 24 percent, does not compensate for the high Federal rates, and that, as a consequence, Federal tax policy tips the scales in favor of State and local consumption and property taxes. This suggests that a credit in the 30 to 50 percent range might be an appropriate compromise between undercompensation (status quo) and overcompensation (the 100 percent or full credit).

It can also be argued that it is necessary to hurry history along because letting nature take its course, albeit convenient, is too costly. The point must be emphasized that any decision to impose a new general tax on the public must be viewed as a last resort type of political decision, and policymakers in the non-income tax States can be expected to exploit less controversial revenue sources before adopting a personal income tax, particularly in view of the fact that the massive presence of the Federal income tax tips the scales in favor of consumer taxes at the State level. Thus, in the absence of some type of compensatory Federal action, many if not most of the non-income tax States will continue to be hobbled by their relatively inelastic tax structures.

No comprehensive study of all possible ways of aiding State and local governments can overrun the hard logic that States should be encouraged to tap their tax potential to the fullest extent before Congress is urged to consider any large-scale revenue sharing plan. Thus, while a compensatory policy might be viewed as Federal intervention in State tax policy matters, it is more logical to regard it as a measure to reinforce the independence of the States by placing them in a better position to solve their fiscal problems out of their own resources.

A Federal income tax reduction in the form of a substantial credit for State income tax payments could be expected to have a far greater expansionary effect on State income tax yields than the conventional type of

Federal income tax reduction. While each dollar of conventional Federal income tax reduction is likely, through its expansionary effect on State and local tax bases, to increase collections on the order of 10 to 20 cents, each dollar of a Federal tax reduction in the form of, say, a 40 percent credit would produce approximately a $2.50 increase in State revenue yield, to the extent that it prompted the States to step up their income tax performance. Of course, to the extent that taxpayers chose to take a tax credit rather than the present deduction for State income taxes already in force, the loss of Federal revenue attributable to State income taxes would not be offset by increased State revenues.

In this connection, it should be noted that, while preferential tax treatment for State income tax payments would have the initial effect of discriminating in favor of Federal taxpayers residing in income tax States, this transitional cost is necessary if the policy is to have the desired influence. To the extent the policy is effective the discrimination would be short-lived. State legislators in non-income tax States would have ample opportunity and incentive to prevent the horizontal inequity from continuing for long.

Moreover, by making the partial credit provision effective some (say 2 or 4) years after the date of enactment, Congress would be giving the legislators in the non-income tax States an opportunity to enact a personal income tax and thereby prevent discriminatory Federal tax treatment for their constituents. It should also be emphasized that this prospective approach would alert the legislators in the income tax States in sufficient time to permit them to raise their State income tax rates to offset the Federal tax reduction. Because many of the income tax States make rather inadequate use of this revenue source, it is reasonable to assume that they would tend to take immediate advantage of the impending Federal income tax reduction via the partial tax credit route and raise their State income tax rates. Thus, adoption of this prospective approach could conceivably produce results somewhat similar to a revenue maintenance provision but without its coercive aspects.

SUMMARY

Although in theory there are three basic policy positions that the Federal Government can take on the State income tax issue--a strong inducement strategy, a compensatory or mild inducement policy, or a status quo position--in actual fact there are only two practical alternatives. The strong inducement approach exemplified by the 90 percent unemployment tax credit for taxes paid to States appears to be neither necessary nor available, at least at this time, for the purpose of encouraging the State personal income tax movement.

The issue thus reduces itself to the relative merits of a status quo position, which rejects any type of preferential Federal tax treatment for State income tax payments, and a compensatory or mild inducement policy, which would use a partial credit to "neutralize" the deterrent effect of the heavy Federal income tax.

The status quo supporters can be expected to take a bleak view of the political effect of any proposal for granting preferential Federal tax treatment, no matter how limited, for State and local income tax payments on the grounds that it would violate the accepted or traditional concept of neutrality and would be interpreted as Federal intervention in State tax policy matters. The status quo advocates, on the other hand, can be expected to take a rather optimistic view of the future of the State income tax movement. They can point to recent State income tax enactments and to the States' compelling need for additional revenue in support of their view that the fiscal winds have shifted and are now propelling rather than retarding the personal income tax movement.

The case for a moderate inducement policy rests on the claim that the present deductibility system fails to compensate adequately for the heavy Federal income tax, and that Federal tax policy, therefore, tips the scales away from income taxes in favor of consumption and property taxation at the State and local levels. Thus, if it is in the national interest to exhort the States to make fuller use of the personal income tax, it is equally appropriate to exhort the Federal Government to abandon its present policy, which works against fuller use of income taxes by the States, and to urge that, as a minimum, it pursue a policy of "true" neutrality by providing special consideration for State income tax payments. In essence, this argument rests on the assumption that this case requires the Federal Government to discriminate in order to be fair.

The belief that present Federal policy is non-neutral rests on the fact that the heavy Federal reliance on the personal income tax since the late 1930's stands out as the single most important deterrent to expanded State use of this revenue source.

Supporters of a mild inducement or compensatory policy also challenge the sanguine view that the winds are now behind the State income tax movement. They emphasize that the decision to impose a new general tax on the public must be viewed as a last resort type of political decision on the part of governors and legislators. Thus, policymakers in the non-income tax States can be expected to exploit less controversial revenue sources before adopting a personal income tax, particularly in view of the fact that the massive presence of the Federal income tax tips the scales in favor of consumption taxes at the State level. In the absence of some type of compensatory Federal action, many of the non-income tax States will continue to be hobbled by their relatively inelastic tax structures.

As indicated earlier, we do not here consider alternative ways by which the Federal Government could share its revenue with the States or provide them with other forms of financial assistance. Our purpose is limited: to consider the amount of financial inducement that would be required to offset the deterrent effect of the heavy Federal income tax on the State personal income tax movement. It is for this reason that we do not advance a precise percentage for such partial income tax credit, recognizing that the measurement of the amount required to achieve the limited, neutralizing purpose sought is essentially a political judgment that can best be assessed in the legislative arena.

Finally, it needs to be recorded that we have considered various techniques for encouraging more effective State use of income taxes. Our present discussion is limited, however, to only some of these, those found to have particular relevance as instruments for neutralizing the deterrent effect of the Federal income tax.

Chapter 7

UNIFORMITY AND ADMINISTRATIVE ISSUES

A widely-treasured premise of the tax policy debate surrounding the American federal system has long held that fiscal responsibility would best be served if each level of government--Federal, State and local--could have its own preserve in which to hunt for revenue undisturbed by poachers from the other levels. Efforts to translate this proposition into policy guidelines were accustomed to assign individual and corporate income to the Federal Government, consumption expenditures to the States, and property to local governments.

Experience since World War II, however, has tended to call into question some of the assumptions underlying this separation of revenue sources view. As intergovernmental transfers of funds--grants-in-aid--have risen from minor to major significance in the budgets of all levels of government,[1/] the accumulating experience has assuaged some of the original reservations about interlevel fiscal dependence. Moreover, the traditional case against overlapping taxation of the same tax base by more than one level of government has lost much of its persuasiveness. In part the concern has shifted from Federal-State and State-local overlapping to the intensifying problems of inter-State and inter-local multiple taxation of business and individuals.

Setting aside its traditional hands-off policy on questions of interstate tax jurisdiction, the Congress is increasingly concerning itself with the interstate problems associated with corporation income and general sales-use taxes. In part it is simply that the States' stake in the income tax field and local governments' stake in the sales tax area have deprived "separation of revenue sources" goals of their realism. Proposals that these governments' important vested interests be uprooted and reallocated can no longer be taken seriously. Indeed, many of those who in the past have tended

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1/ In 1946 grants to State and local governments accounted for less than 2 percent of Federal general expenditures. By 1964 they had risen to 9.4 percent, and such grants had doubled in relative importance as a source of State revenue. During the same period grants from State and Federal governments increased as a percentage of local general revenue from 26 to 32 percent. Bureau of the Census, Census of Governments: 1962, Vol. VI, No. 4, Historical Statistics on Governmental Finances and Employment, 1964, pp. 36, 42, 45; Governmental Finances in 1963-64, May 1965, pp. 19, 22.

to favor State abandonment of the individual income tax seem to have recognized that the chief disadvantages of overlapping--administrative inefficiency and taxpayer inconvenience--actually can be mitigated by measures that fall far short of the elimination of overlapping. Thus, the reaction to overlapping, especially in the income tax area, has shifted from a call for separation of sources to a quest for conformity between the provisions of the Federal and State income tax laws.

INTERGOVERNMENTAL CONFORMITY IN THE DEFINITION OF TAXABLE INCOME

Evidence of the growing influence of the conformity view is voluminous. Since World War II four States--including the then (1949) territory of Alaska--have adopted new individual income taxes, and each of these laws explicitly conforms its provisions to the Federal Internal Revenue Code. Wisconsin has just completed major action designed to conform its law to the Federal Code. Many State tax studies have looked into the advantages and disadvantages of conformity, and the widespread interest expressed in the progress of this Commission's present study is testimony to the proposition that statutory conformity between State and Federal laws is "an idea whose time has come." At the very least, this appears to be a propitious juncture for an appraisal of the actual extent of progress toward conformity and the case for speeding it on. In the following pages the general forms such conformity has taken are also considered, as are the factors that must be taken into account in choosing among the various alternatives.

Existing Diversity: Extent and Factors Responsible

The existing extent of conformity between the exclusion and deduction provisions of the Federal Internal Revenue Code and State individual income tax laws is discussed in detail in Technical Paper 2 and is not repeated here. 1/ Our findings make clear that conformity is substantial. The summary tables in the Technical Paper contain far more X's, indicating conformity, than blanks or footnotes, indicating non-conformity. However, with respect to certain provisions, especially in the area of deductions, conformity is still substantially lacking. Not insignificantly, moreover, diversity is most evident among the most complicated and widely-used deductions--for medical expenses, charitable contributions, and the child-care expenses of working parents--as the extensive numbers of footnotes for these provisions indicate.

Many factors account for the persistence of variety in the definitions of the individual income tax base. Some diversity is beyond the control of State legislatures, though if the variations were limited to such cases they would be of relatively minor concern. State provisions necessarily differ

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1/ See p. 167, ff.

from the Federal with respect to the taxation of interest from government securities. Present constitutional interpretations or statutory provisions bar the Federal Government from taxing State and local interest payments and vice versa, but all governments are free to tax interest on their own obligations and States are free to tax the obligations of other States.

Some differences originate in the fact that the dates of adoption of income taxes differ among the States and the Federal Government. Capital gains accrued up to the time an income tax is adopted cannot be subject to taxation, for example. Tax accountability for capital gains began in 1913 under the Internal Revenue Code; at later dates under the laws of most of the States. Such forms of diversity are relatively few, and they affect only a very small minority of taxpayers. The States that have conformed their laws to the Federal Code have demonstrated that these kinds of differences are quite manageable.

A more serious problem arises for the States in which enactment by reference to the Federal Internal Revenue Code provisions has been interpreted to be an unauthorized delegation of legislative authority by State legislatures. In these situations the State legislature at any one time can adopt by reference only provisions of the Federal law that are already in effect. It cannot follow this practice prospectively with respect to subsequent amendments of the Internal Revenue Code, and the Code undergoes significant amendment every two or three years on the average. The only remedy in these situations is amendment of the State constitution, as was done, for example, by New York and was recently initiated in California--a tortuous process for some States; a difficult one for all. This issue is discussed in Technical Paper 1 (p. 153, ff.).

Far more important than these relatively few "mandated" differences are those arising out of efforts to serve in differing ways social and economic policy objectives that are not always viewed in the same light by Federal and State policy makers. Although every State has elected to follow the Federal Code in exempting life insurance proceeds from taxation, 11 States do not exempt unemployment compensation payments, as the Federal law does. Twenty States use exemption from their income taxes as a means of indirectly subsidizing their teachers' retirement systems, and Minnesota stands alone in its attempt to relieve the burdens of campaigning for public office by allowing candidates to deduct a limited amount of their own expenses.

The freedom of the States to experiment in the field of social and economic policy has always been one of the most valued advantages of the American federal system. Decisions to differ from the Federal definitions, nevertheless, do tend to involve inconvenience to taxpayers, higher administrative costs, and revenue losses or gains although they may be motivated by considerations of equity among taxpayers as where, in the view of the State, special Federal provisions favor some taxpayers over others with equal incomes who are unable or unwilling to take advantage of the provisions. All of these factors must be taken into consideration and balanced against the value of the social and economic policy purposes served. It is hard to avoid the conclusion that a great deal of the present diversity in the area of definitions is without redeeming social or economic policy importance. Ultimately, however, the decision with respect to particular provisions can only be made by the elected representatives of the taxpayers in the jurisdiction concerned.

No State that embarks today upon a general discussion of the income tax--whether in the context of debate over initial adoption or re-evaluation of an existing law--can avoid the question of conformity between State definitions and the Internal Revenue Code. Whatever course a State ultimately decides upon, a decision on the extent-of-conformity issue is necessarily involved, and the issue should be faced explicitly, as California's Assembly Interim Committee on Revenue and Taxation is doing. 1/

Alternative Approaches to Conformity

A State can adopt, with respect to the relationship between the Federal Internal Revenue Code and its own definitions, any one of 6 relatively clear-cut postures. The alternative policies, which range from none to complete conformity, are as follows:

(1) In theory, a State can elect to ignore the Federal Code completely. This would not necessarily mean that there would be no similarities between State and Federal provisions. In practice, as Technical Paper 2 makes clear, every State law contains some provisions that effectively are the same as those in the Internal Revenue Code. 2/ We do not know, however, whether the provisions are similar by coincidence or by design. This first category is necessary to cover the case of coincidental conformity, though most cases of conformity to particular provisions probably are examples of the next-mentioned alternative.

(2) A State can conform intentionally to the Internal Revenue Code with respect to particular exclusion and deduction provisions. The laws of 18 States and the District of Columbia conform in varying degrees to specific Federal provisions, placing them in this category or in category 1, depending on whether the conformity is intentional or coincidental.

The extreme example of a category 2 State is California, which follows a deliberate policy of adoption of specific Federal provisions as soon as practicable after their enactment by the Congress. California has been so conscientious in its implementation of this approach that the actual extent of uniformity between its tax law and the Internal Revenue Code (IRC) compares favorably with the situation of several States that have elected

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1/ Conformity of State Personal Income Tax Laws to Federal Personal Income Tax Laws, Volume 4, Number 10, Part 3, September 1964.

2/ Nebraska's new income tax, still subject to a referendum, and the limited New Hampshire, New Jersey, and Tennessee taxes are not considered here.

policies that rank closer to complete conformity than this category. The California case illustrates the difficulty of formulating a perfectly consistent and non-overlapping conformity classification. Nonetheless, a policy of the type pursued by California would logically be expected to yield a lesser degree of uniformity than those discussed below.

(3) The next step toward complete conformity in State and Federal definitions has been taken by two States--Minnesota and Indiana. It involves the adoption by reference of the Federal definition of adjusted gross income. In the case of Minnesota the taxpayer must itemize his State deductions separately--roughly a category 2 situation with respect to deductions. Indiana's "adjusted gross income" tax makes no provision for personal deductions.

(4) The next most comprehensive form of statutory uniformity between the Federal Internal Revenue Code and the personal income tax laws of the individual States is found in the laws of a half dozen States. In essence this policy defines net income (before personal exemptions) for State purposes as Federal net income (before exemptions), with certain specifically-defined modifications, some of which are necessary in order to satisfy certain constitutional constraints. 1/ Basically, the constitutional constraints relate to the treatment of interest on government securities. This approach is implemented in two ways. Of these the alternative involving the lesser degree of uniformity adopts the definition of net income that appears in the IRC as amended to a specific date. Five States have adopted this alternative. Of these, three are current (Hawaii, Iowa, and North Dakota), that is, their statutes refer to the IRC as amended through December 31, 1964, a date that follows the most recent amendments to the Federal Code. One other State has lagged in updating its statutory references to the Internal Revenue Code--Kentucky (IRC as of January 1, 1956). Finally, Vermont gives its taxpayers a choice between the IRC definition as amended to January 1, 1963, or the definition as amended to the end of the taxable year in question. The Vermont policy (which may have been adopted in deference to the question of delegated legislative authority), on the basis of its inclusion of the latter alternative, in fact spills-over into the sixth category.

Adoption by reference of the current and prospective Federal definition of net income is sufficiently closer to complete conformity to warrant distinguishing it from a policy of reference to a particular date. This form of uniformity appears in the income tax law of Colorado.

(5) The final logical step toward complete conformity with the Internal Revenue Code would involve adoption by reference of Federal taxable income as the State tax base. This approach differs from the preceding one only in that the State would also conform to the Federal policy on personal exemptions. Two States--Idaho and West Virginia--have adopted this alternative on a retrospective basis, though they are both current at the present time. Alaska, Montana, New Mexico, and New York have adopted Federal taxable income on a prospective basis. Note, however, that none of these States really conforms completely to the Federal Code, because each

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1/ The question of personal exemptions is considered in Chapter 5.

has elected to go beyond the constitutionally mandated exceptions to provide for at least one exclusion or deduction that is not allowed by the Internal Revenue Code.

(6) Complete statutory uniformity could also be achieved by "basing" the State tax on the taxpayer's Federal individual income tax liability (with appropriate adjustments to satisfy constitutional requirements). This is the approach that usually comes first to mind when Federal-State conformity is mentioned. It epitomizes taxpayer convenience. Since the Federal tax is progressive, a State tax equal to a uniform percentage of the Federal tax would build into the State tax a corresponding degree of graduation. The State tax, however, does not necessarily need to be defined as a uniform percentage of the Federal. The State rate schedule could be structured to achieve any tax burden pattern desired. In substance--though not, of course, in form--this approach is indistinguishable from category 5 so long as the modifications of Federal definitions are confined to those mandated by State and Federal constitutions. 1/ If the State tax base is the "same" as the Federal, then identical tax liabilities can be derived from State rates defined as percentages of the Federal liability and from an appropriate State rate schedule applied to Federal taxable income. In fact the distinction between categories 5 and 6 has no more than academic significance, because none of the States that has adopted the Federal definition of taxable income has confined its exceptions to the constitutional requirements. Nor, it might be added, is a State likely to exercise such restraint, since the temptation to enact modifications is inherent in the fifth approach.

This form of conformity lends itself to two forms of administration; the choice between them probably would involve little more than the question of administrative efficiency. The completely-conforming State tax could be administered conventionally by a State department of revenue, or it could be handled by the Internal Revenue Service--in which case it would be referred to as a "supplement" to the Federal personal income tax.

Choice of a Conformity Policy

An individual State's choice among these alternative postures vis a vis the Federal Internal Revenue Code involves the most delicate balancing of the considerations mentioned earlier--compliance and administrative costs, revenue effects, and equity. As far as taxpayer convenience and administrative efficiency are concerned, the evidence suggests that differences among alternatives 3, 4, 5, and 6 are relatively insignificant. The advantages

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1/ Defining the State tax base as the Federal tax liability rather than Federal taxable income extends conformity to the Internal Revenue Code one step further in substance. The Federal tax credits--the most important of which is the retirement income credit--are incorporated into the State law in addition to the Federal exclusions and deductions.

of conformity can be achieved relatively well under any of these approaches, with some slight advantage to 6 over alternatives 3-5. Policies 1 and 2, however, require the taxpayer to compute his State liability each year with help from his Federal return, at best, only with respect to the amounts of income and specific deductions and exclusions to the extent that they happen to conform to the Federal. The advantage of policies 3-6 is that the taxpayer can take one figure from his Federal return, make two, or three, or four calculations, and be done with his State return. Similar considerations apply to the ease with which the advantages of Federal-State administrative cooperation can be exploited.

We discuss in Chapter 5 the essential aspects of the revenue implications of the alternative conformity policies. Little can be said regarding alternatives 1 and 2, but we can be fairly specific about the others. Federal adjusted gross income less Federal personal exemptions would provide a tax base larger by a quarter than Federal taxable income. The practical significance of this is simply that a 3.2 percent average tax rate applied to the modified Federal adjusted gross income base would, on the average, yield as much as a 4 percent rate applied to Federal taxable income. To a State that is concerned about its competitive position, a choice between alternatives that involve a 25 percent difference in average tax rates merits serious consideration. Uniformity policies 4-6, of course, all involve conformity to Federal taxable income. The Indiana version of alternative 3 represents conformity to adjusted gross income. If modified adjusted gross income conformity is selected, the State may well want to require its taxpayers to add to their Federal adjusted gross income some of the classes of income that presently are excluded from the Federal tax base, as many States do in their laws (see Technical Paper 2). The resulting increase in the tax base could be as much as 10 percent if, for example, the State were to require inclusion of the 50 percent of long-term capital gains presently excluded from Federal adjusted gross income. 1/

Against the revenue considerations must be balanced the advantages and disadvantages of the various conformity postures from the point of view of tax fairness. In general, of course, complete conformity to the Internal Revenue Code brings with it all of the special provisions in the Federal law that are debatable on grounds of equity: discrimination against renters and in favor of homeowners, against consumers who pay cash and in favor of those who buy on credit, against the user of public transportation and in favor of the commuter who drives his private car to work, against the worker unfortunate

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1/ Based on an estimate by Richard Goode of the average amount of revenue the Federal Government would have gained during the period 1949-60 "if capital gains had been taxed in full at ordinary rates and the volume of realized net gains had not been affected." The Individual Income Tax, Studies of Government Finance, The Brookings Institution, Washington, 1964, p. 194.

enough not to be covered by a sick pay plan and in favor of the worker who is, to cite a few of the more obvious cases. Elimination of the provision for any exclusion or deduction will broaden, of course, the base of the State tax. In these cases, the objectives of tax fairness and base-broadening are not in conflict.

Consideration of conformance to the Federal exclusion of 50 percent of long-term capital gains from adjusted gross income poses a hard question for State tax policy makers, involving an evaluation of the pros and cons of this long-standing controversial issue in terms of a State's, as distinguished from the National government's, objectives. Several aspects of the issue can be noted without presuming to prejudge it. Not only does the Federal capital gains exclusion confer favored status on the taxpayer with such income relative to the salaried employee in the same gross income bracket, but it also has important implications for the relative tax burdens at different income levels, the vertical equity of the tax. While relative consumer expenditures for housing, and the incidence of homeownership, do not tend to vary significantly among different family income classes, capital gains vary as a proportion of gross income from under 2 percent, among taxpayers whose Federal adjusted gross income is less than $10,000, to over 60 percent among taxpayers with Federal AGI in excess of $200,000. 1/ In short, the benefits of the capital gains provision of the Internal Revenue Code are very heavily concentrated at the upper end of the income scale and are quite costly in revenue foregone. 2/

1/ Ibid., p. 195. The special treatment accorded to capital gains income is chiefly responsible for the fact that in 1960, when the steeply progressive 1954 Internal Revenue Code rate schedule provided for an average rate of 86.5 percent on incomes between $500,000 and $1,000,000, the average rate actually paid by individuals in that income bracket amounted to only 30.2 percent (ibid., p. 326).

2/ Special treatment of capital gains income under the Federal tax is based on two primary considerations. First, such income is highly irregular. Not only do capital gains accrue at highly variable rates, but for practical reasons the tax must be based on realized gains, which are quite likely to be even more irregular than accruals, though the exact time of realization is usually at the option of the taxpayer. In the absence of a perfect income-averaging device, the steeply progressive Federal rate structure taxes an individual with irregular income more heavily over a period of years than it does a taxpayer whose income does not fluctuate as widely. Secondly, the special treatment of capital gains income is designed to encourage investment in enterprises that may yield capital gains in order to accelerate economic growth. The extent to which these arguments are relevant in the case of State income taxes is debatable. In the case of a flat-rate State tax, the equity argument is not relevant, because such a tax does not penalize irregular income. In flat-rate States special treatment would create a horizontal inequity in favor of capital gains income. The moderate progression found in most State taxes may justify either an income-averaging procedure or moderate concessions on rates, but it is questionable whether it justifies exemption of 50 percent of long-term gains. With respect to the economic growth justification (footnote continued on following page)

A special problem posed for States in electing to conform to Federal adjusted gross income stems from the fact that the concept does not provide for the deduction of all the legitimate expenses of earning income, but leaves some of these deductions to be handled at a later stage of the tax calculation. More specifically, it provides for the deduction of expenses incurred to earn income as an employee only as an itemized personal deduction, a step subsequent to the determination of adjusted gross income. In contrast, those (very narrowly-defined) costs of earning income which are deductible in arriving at Federal adjusted gross income if the taxpayer is self-employed, include uniforms, special work apparel and tools, union and professional association dues, professional journal subscriptions, and educational expenses required as a condition of employment. Similarly, expenses incurred for the management and safe-keeping of intangible investments, and for the determination and payment of taxes are not deductible in arriving at Federal adjusted gross income.

FEDERAL-STATE ADMINISTRATIVE RELATIONS

The States have access to a substantial body of information produced by the Internal Revenue Service and to a lesser degree, the Internal Revenue Service can derive benefit from State tax records. Present Federal-State cooperative arrangements are described in this section, followed by a discussion of the feasibility of a unified collection system--Federal collection of State personal income taxes on an optional basis.

Federal-State Cooperative Agreements

States have had access to Federal returns from the very beginning of Federal income taxation. 1/ In the early years, States were able to send tax personnel to Washington to examine returns under informal arrangements. The procedure was formalized by the Revenue Act of 1926, which opened Federal returns to inspection of State officials at the request of the governors. State employees were allowed to make transcripts of audit reports or to purchase photostatic copies. Federal income tax returns became more accessible to State tax officials after the decentralization of the Internal Revenue Service to field offices was completed in 1953.

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for special treatment of capital gains income, it is doubtful that the tax incentive provided by special State provisions would be worth the cost to the State treasury, given the relatively low marginal rates involved in the typical State law. In any event, the incentive would be appropriate only if confined to capital gains accrued on assets located within the State.

1/ Clara Penniman and Walter W. Heller, State Income Tax Administration (Chicago: Public Administration Service, 1959), pp. 217-232.

A formal Federal-State cooperative audit program was started in 1950 on an experimental basis with North Carolina and Wisconsin. Colorado, Kentucky, and Montana were added to the experiment in 1951 and 1952. These original agreements covered only income taxes. Minnesota entered into a cooperative agreement in 1957 which both expanded the kinds of information to be covered and set the pattern for subsequent agreements.

By the end of 1965, the District of Columbia and 29 of the 34 States with broad-based personal income taxes, including those in the original experimental program, had agreements with the Internal Revenue Service for cooperative exchange of tax records (table 28). 1/ These agreements deal with all areas of tax administration, except alcohol and tobacco taxes. It is significant to note that 11 States without a personal income tax have also entered into cooperative agreements.

In general, the agreements provide for the establishment of mutually acceptable programs for the cooperative exchange of information, allowing the Federal and State governments to obtain each other's returns and other related information necessary to insure effective compliance. Each agreement is tailored to the particular State's tax structure by means of an "attachment" which typically includes the following income tax provisions:

<u>Exchange of audit information</u>--Exchange of information as to audit adjustments of tax returns resulting in deficiencies, over-assessments, refunds, or overpayment of taxes;

<u>Delinquent returns</u>--Exchange of information relating to persons failing to file tax returns, including lists or other records identifying persons filing delinquent returns with either jurisdiction; and

<u>Collection information</u>--Exchange of information that will assist in locating the whereabouts, sources of income, or employers, of taxpayers whose accounts are delinquent.

Some agreements provide for "cooperative audits," by authorizing the District Director of Internal Revenue to make available to the State tax administrator those Federal income tax returns of State taxpayers that are not scheduled for further examination. The State tax agency may select for examination those returns that are likely to result in significant adjustment of both State and Federal taxes. The results of such audits are shared with the Internal Revenue Service, thus minimizing duplication of audit activity.

The application of automatic data processing to tax administration will significantly broaden the scope of the exchange of information. The Internal Revenue Service is rapidly completing a comprehensive electronic data processing system (expected to be fully operational by 1967), and the

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1/ All of the original agreements have been renegotiated and broadened.

TABLE 28--FEDERAL-STATE COOPERATIVE AGREEMENTS IN EFFECT, 1965

State	Date of Agreement	State	Date of Agreement
Wisconsin	2/6/50 [1]	Nebraska [2]	8/26/63
North Carolina	2/6/50 [1]	Florida *	9/17/63
Montana	7/16/51 [1]	Tennessee *	10/28/63
Kentucky	7/16/51 [1]	Washington *	11/15/63
Colorado	3/28/52 [1]	Oklahoma	11/15/63
Minnesota	5/27/57	New York	11/19/63
Kansas	7/5/60	Massachusetts	12/10/63
California	1/5/61	New Mexico	12/13/63
Utah	2/2/61	Wyoming *	2/10/64
Ohio *	8/21/61	Idaho	3/31/64
Indiana	10/31/61	New Hampshire *	5/13/64
Oregon	12/14/61	South Dakota *	7/7/64
Missouri	6/13/62	Maine *	8/19/64
West Virginia	10/25/62	South Carolina	8/24/64
Iowa	12/13/62	North Dakota	9/14/64
Maryland	1/10/63	Michigan *	3/20/65
District of Columbia	2/14/63	Vermont	6/4/65
Illinois *	3/13/63	Pennsylvania *	4/19/65
Arkansas	5/22/63	Delaware	6/29/65
Virginia	6/21/63	Hawaii	8/18/65
		New Jersey	Pending

* States without broad-based personal income tax.

1/ Renegotiated: Wisconsin 5/23/58; North Carolina, 10/6/60; Montaña, 4/14/60; Kentucky, 1/9/61; Colorado, 5/25/64.

2/ Personal income tax effective 1/1/67, subject to referendum.

Source: Internal Revenue Service.

processing of tax returns is already automated in a number of States. As an aid to finding delinquent taxpayers, a number of States are using Internal Revenue Service tapes listing all Federal income taxpayers filing in their States. Some use these tapes to prepare their own mailing lists. This compliance potential is recognized in a provision now being incorporated in Federal-State tax cooperative agreements:

> The Commissioner and the District Director will explore possible opportunities for the exchange of information (including information on employer accounts) obtained from State and Federal tax returns by use of mechanical or electronic equipment, for the purpose of ascertaining delinquencies or making audit adjustments under either jurisdiction, or for other purposes. If it appears that such information will provide either jurisdiction with substantial assistance in securing delinquent returns, at the appropriate time procedures for joint use of records will be developed to the extent feasible.

According to the Internal Revenue Service, cooperative agreements are especially beneficial in the income tax field. 1/ In addition to increasing State income tax revenue, estimated in excess of $10 million annually, the program has contributed to better administration by improving voluntary taxpayer compliance.

Nevertheless, the extent to which these agreements are being utilized is spotty, depending in many instances upon the initiative used by State tax administrators and district directors of Internal Revenue. In some States there is uncertainty as to whether their tax administrators possess the requisite legal authority to exchange information with the Internal Revenue Service; in other States there exists legal doubt as to the kinds of information that can be made available to the Internal Revenue Service.

In an earlier report, the Advisory Commission pointed up the need for legislative authority that would enable State tax administrators to exchange tax information with one another and with the Internal Revenue Service. 2/ The Commission also recommended that an inventory be made of the information available in State tax files that would potentially be useful to the Internal Revenue Service. 3/ While the mere existence of cooperative agreements and the publicity surrounding their ceremonial signing by the Governor and the Commissioner of Internal Revenue may strengthen enforcement efforts through

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1/ Internal Revenue Service, Research Division, "Federal-State Program for Coordination of Tax Administration," December 1964 (mimeographed).

2/ Advisory Commission on Intergovernmental Relations, Intergovernmental Cooperation in Tax Administration (A-7), June 1961, p. 10.

3/ *Ibid*., p. 11.

better voluntary taxpayer compliance, the full enforcement potential of such agreements has yet to be realized.

Statistical Services

In 1962 the Congress amended the Internal Revenue Code authorizing the Secretary of the Treasury

> ...upon written request, to make special statistical studies and compilations involving data from any returns, declarations, statements, or other documents required by this title or by regulations or from any records established or maintained in connection with the administration and enforcement of this title, to engage in any such special study or compilation, upon the payment by the party or parties making the request, of the cost of the work or services performed for such party or parties. 1/

The authorization also provides that any fees collected by the Internal Revenue Service under P.L. 87-870 are to be credited to its appropriation, thus making it possible for the Service to bolster its staff for this purpose.

This provision opens up a significant, as yet largely untapped, flow of information potentially useful to State tax administrators. Such information can help, for example, to measure the distribution of revenue in a State, to assess the revenue effects of changes in income tax provisions, and to measure the effectiveness of States' tax enforcement efforts.

As of a recent report, the Internal Revenue Service has provided special statistical services under P.L. 87-870 to only three State tax departments. Detailed tabulations, by source of income, have been prepared for New York annually since 1962, and Georgia requested a similar tabulation in 1962. In connection with the overhaul of its gross income tax in 1963, Indiana obtained for research use information from the Internal Revenue Service "Statistics of Income" sample of Indiana tax returns.

Statistical services are available under P.L. 87-870 to local governments and to private individuals and organizations, as well as to States. Numerous requests have been received from private individuals and organizations and about a dozen such projects have been completed. The Internal Revenue Service will fill such requests only if they can be fitted into its work schedule and if the information is useful to the Treasury Department as well as to the individual or organization requesting the service. It makes no special effort to "sell" this service.

1/ P.L. 87-870, Sec. 3. This implemented a recommendation of the Advisory Commission (*Ibid.*, p. 12).

Training of State Tax Personnel

Public Law 87-870 also authorizes the Secretary of the Treasury to admit State tax personnel to training courses conducted by the Internal Revenue Service and to provide them with textbooks and other training aids. The Internal Revenue Service conducts many classroom training courses for its agents in the various field offices and also makes correspondence course materials available to them. Some 40,000 employees participate each year.

To help plan a program for State tax personnel, the National Association of Tax Administrators in 1964 polled the States as to their prospective needs and desires in this area. The findings of that survey indicated that States anticipated making rather modest demands upon the Internal Revenue Service: that about 150 State tax people would attend classroom training, about 1500 would use correspondence course materials, and about 600 would request textual and other training aids. The Internal Revenue Service would have little difficulty fitting a program of such modest proportions into its extensive training operations.

Federal Collection of State Personal Income Taxes

Any inventory of Federal-State cooperative efforts of necessity should include the possibility of Federal collection of the State income tax. This kind of device, sometimes referred to as a tax supplement, is familiar to Americans only in its use for State collection of local sales taxes. 1/ In the income tax field, only Kentucky could exploit this coordination device because only in that jurisdiction are both State and local income taxes levied at this time.

The use of a tax supplement in income taxation is familiar in Canada. There, when the National Government restored to the provinces the right to levy income taxes recently, it undertook to collect the provincial taxes for the provinces electing to accept the offer.

Federal collection of State personal income taxes can be considered to involve four stages, starting with simply adding the State tax to the

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1/ Eight States are now using the approach successfully in administering general sales taxes (California, Illinois, Mississippi, New Mexico, New York, Tennessee, Utah, and Wyoming). They allow their local governments to levy a general sales tax (generally $\frac{1}{2}$ or 1 percent) as a supplement to the State tax. The local supplement is collected by the State together with its own tax. By and large, the local taxes are required to conform in all respects with the State taxes, for ease of administration. See, Advisory Commission on Intergovernmental Relations, Tax Overlapping in the United States, 1964 (M-23), July 1964, p. 107 (New York and Wyoming enacted local sales tax supplements in 1965).

Federal withholding system and progressing to a comprehensive system that would include the State tax in the entire Internal Revenue Service audit procedure. The four successive stages of Federal collection are as follows:

(1) Withholding of income at the source;
(2) The taxpayer's declaration of estimated income;
(3) Initial arithmetic verification of the taxpayer's return; or
(4) Audit of the taxpayer's return.

Stage 1--Withholding--The simplest stage at which Federal collection can be implemented is to add the State tax to the amount withheld for Federal tax purposes. The employer would merely withhold on the basis of the State withholding rates or table (preferably on the amount of taxable wages as defined for Federal purposes), make current payments on both taxes in accordance with the Federal depositary receipt system, and render a single quarterly return covering both State and Federal withheld taxes. 1/ The depositary receipts and quarterly tax returns would distinguish the portion of tax to be credited to the State in which the employer's place of business is located. The individual taxpayer would continue to file an annual return with the State tax agency, taking a credit for the amount withheld. The Federal Reserve System and the Internal Revenue Service would credit the appropriate State's account with the total amounts withheld by all employers in each State. The State tax agency would be relieved of handling the withholding system but would continue to receive, process and audit annual returns. The annual W-2 Forms would be expanded to provide the detailed information by individual taxpayers for purposes of State audit.

Stage 2--Declaration of estimated income--At this stage, the Internal Revenue Service would administer both the withholding and declaration systems. The individual taxpayer with income not covered by withholding would file his declaration with, receive bills from, and make quarterly payments directly to the Internal Revenue Service, in accordance with Federal rules covering both the Federal tax and the State tax. As in stage (1), he would file an annual return with the State tax agency. The Internal Revenue Service would credit tax payments received to the appropriate State's account and furnish an annual information return to the State showing the amount received on estimated tax from each taxpayer for purposes of State audit.

Stage 3--Arithmetic verification--The Internal Revenue Service would handle withholding, declarations, and annual returns. The taxpayer would file a single return, with an appropriate schedule attached to reflect

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1/ Under the Federal depositary receipt system, an employer withholding $100 or more per month deposits his withholdings monthly in a local National or State bank (almost all National and State banks have been designated "Federal depositary banks"). He receives a receipt, validated by a Federal Reserve bank, which he attaches to his quarterly tax return.

adjustments to Federal adjusted gross income and computation of State tax, with the Internal Revenue Service in accordance with Federal filing requirements as to forms, time and place of filing, etc. The Service would process the State schedule only to the extent of checking it for arithmetic accuracy (including the amount of any refund due or overpayment), and credit any remittances received to the State's account. It would then send a copy of each return to the appropriate State tax agency for audit. When the taxpayer is subject to tax in more than one State, he would file an additional copy of the entire return for use by each taxing State, including the supporting State schedules.

Stage 4--Audit--As in stage (3), the taxpayer would file a single return (with supporting State tax schedules) with the Internal Revenue Service, covering both Federal and State taxes. In addition to its regular mathematical verification, revenue collection, and accounting processes, Internal Revenue would apply its regular collection, audit, and appellate procedures to the State schedule as well as to the Federal portion of the return, taking appropriate actions to effect any final adjustments with the taxpayer as to refunds, credits, additional assessments, penalties, and interest. At this stage, the Service would be relieved of having to furnish to the States any formal information reports for individual taxpayers relating to either declaration of estimated tax or annual tax returns. Of course, States would continue to have the right of inspection of tax returns and be informed as to the status of any compliance actions in connection with taxpayers of a particular State. Employers would be relieved of providing additional copies of W-2's for State use, and State tax agencies would no longer be burdened with handling information and tax returns. The State tax agency would be expected to assist the Service only in handling those returns requiring adjudication as to residence and related questions of taxing jurisdiction.

Advantages to Taxpayer--Federal collection, particularly if applied at stage (3) or (4) (arithmetic verification or audit), has obvious attraction to taxpayers because it frees them of the necessity of filing separate State and Federal tax returns and therefore minimizes their compliance burdens substantially. Applied at stage (1) (withholding), the tax supplement will not affect the taxpayer, as he will see no change in the withholding pattern and he will still have to file a return with the State. The individual who is required to file a declaration of estimated income (under stage (2)) will have the advantage of filing a single declaration form with Internal Revenue, but he will still have to file separate annual Federal and State returns.

Advantages to Employer--The employer would feel the impact of Federal collection at stages (1) and (4) only. His paperwork would be reduced substantially as he would be depositing his collections at one place rather than two. He would still have to send information returns to the State tax agency at stage (1), but this requirement would be eliminated if Internal Revenue performed the audit function (stage (4)).

Advantages to State Tax Agency--The greatest gain to the State tax agency from a Federal collection system would be increased taxpayer compliance that would result from automatically covering all employees into Federal withholding for State tax purposes. There would also be substantial administrative savings, particularly at stages (3) and (4). While the Internal Revenue Service may require reimbursement of any additional expenses it incurs in handling the State tax, its collection costs are considerably below those of the States. It has been estimated that the average cost of administering a State personal income tax approximates 2 percent of the tax collections. 1/ This rough estimate, based on the experience of 13 States in 1960, indicates a considerable expenditure of State funds--upwards of $80 million a year. The Internal Revenue Service spends about one-half billion dollars annually to collect about $100 billion in taxes (before refunds), about half of which comes from the personal income tax. Its administrative cost thus approximates $\frac{1}{2}$ of 1 percent of collections.

Policy Issues--If the supplement system were administered at any of the first three stages, the Internal Revenue Service would be acting purely in an administrative capacity, so that few policy issues would be involved. With one possible exception, there would be no need to restructure any of the present State personal income taxes. Because withholding is geared to place of employment, the Internal Revenue Service might well insist that those States now allowing a credit to nonresidents drop that provision to qualify for inclusion in a Federal collection system. This would eliminate the need to require employers to withhold taxes from employees with tax liabilities to another income tax State.

A stage (4) supplement system, involving total handling of the State tax by the Internal Revenue Service, raises a number of important policy issues. 2/ Placing the audit function with Internal Revenue means that it has complete responsibility for enforcement of State income tax laws. In

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1/ "Third Interim Report to the Committee on Cost of Taxpayer Compliance and Administration," National Tax Association, Proceedings of Fifty-Fifth Annual Conference, Miami Beach, September 3-7, 1962 (Harrisburg: National Tax Association, 1963), p. 304.

2/ Consideration of a system of Federal-State collection would have to explore, among a variety of administrative problems, the question of Federal vs State priorities: (1) Under present Federal law, if remittances from employers of withheld taxes and from taxpayers on declarations and annual tax returns were to amount to less than the aggregate of Federal and State taxes due, the Federal tax liability would have to be satisfied fully before any amounts could be credited to the State account. Presumably, the Internal Revenue Code would have to be amended to permit the Internal Revenue Service to apply some other priority rule--for example, in proportion to the balance due each taxing jurisdiction. (2) The priority issue would also have to be resolved in connection with the enforcement of tax liens and levies, particularly under a stage (4) agreement. One possible approach might be to amend the Internal Revenue Code to the effect that a State tax shall be deemed a Federal liability for enforcement purposes.

these circumstances, the Internal Revenue Service would probably insist that the States at least adopt as their tax base the Federal definition of either adjusted gross income, taxable income, or tax liability. The effect on State tax policy of using each of those bases is described below.

Adjusted gross income--The use of the Federal definition of adjusted gross income would permit the States considerable tax policy latitude. They would have complete freedom on the tax rate side and they would also be able to determine the amount of personal exemptions. Even if they were simply to take the Indiana approach of allowing the deduction of personal exemptions from Federal adjusted gross income and applying a flat rate to the resulting "taxable income," they would achieve some degree of progressivity.

The revenue effect of such an approach on State personal income tax revenue is shown in table 23 . 1/ If all 50 States and the District of Columbia were to levy a flat 2 percent tax against Federal adjusted gross income less personal exemptions of $600 per capita (the Federal exemption), the 1964 yield of State personal income taxes would have been increased by more than one-half, from $3.4 billion to $5.2 billion. For the 33 States with broad-based personal income taxes and the District of Columbia, this method would result in a slight reduction in total yield because the high-yield States, notably New York, tax income at considerably higher rates than 2 percent of adjusted gross income. However, the great majority of the States would gain from a flat 2 percent tax on Federal adjusted income reduced by the Federal personal exemptions.

Taxable income--A second alternative is to levy a State rate (or a series of graduated rates) against Federal taxable income--that is, the final income figure on the Federal return from which the taxpayer computes his Federal tax. This approach would have the distinct advantage of reducing both the taxpayer compliance burden and the administrative burden to an absolute minimum. It would involve one additional calculation in the case of a flat-rate supplement and several computations in the case of a graduated rate schedule. It would, however, tie the States' taxes directly to the Federal tax structure, with the exception, albeit a significant one, of the rate schedule. The States would thus be adhering to the Congressionally determined definition of income, including provisions pertaining to capital gains, investment income, depreciation, depletion allowances, etc. Personal exemptions and deductions from income would be identical to the Federal provisions (including the deduction of State income taxes and the denial of deductibility for the Federal personal income tax).

One prerogative is reserved to the States under this supplement approach. Because they would have complete freedom on the tax rate side, the States could still determine the distribution of the tax burden among income classes. By using Federal taxable income as the base, they can make the State tax mildly progressive with a flat-rate tax; or they can raise the progressivity by levying a graduated rate schedule.

1/ See p. 103.

Federal tax liability--A similar result could be obtained by allowing the taxpayer to compute his State tax as a percentage of his Federal tax. This approach has been used by States at various times--most recently by West Virginia and Alaska. However, there are some inherent problems which eventually led West Virginia to abandon and Alaska to modify the procedure.

One disadvantage is that a flat percentage of the Federal tax liability automatically ties the State tax to the steep graduation in the Federal tax. While in theory this effect could be offset by applying a diminishing State rate structure to the Federal tax liability, in fact no State has ever adopted a seemingly regressive rate structure for obvious political reasons. Also, as in the previous plan (use of Federal taxable income), the State's tax is linked to the Federal system of personal exemptions, deductions, and income exclusions. The vulnerability of the tax yield to Congressional income tax decisions stands out as the third disadvantage. A State desiring a specific tax burden pattern would have to revise its own rate structure every time Congress changed the Federal rates.

Other policy considerations--From the viewpoint of the States, the receptivity to Federal collection can be expected to be influenced by several considerations. The device would probably be most attractive to any non-income tax State at the time it considered adopting one. The non-income tax States would not be confronted with the vexing questions of abandoning their own statutory design, of reassigning their own tax staff, and of the need to appraise the comparative merits of their own versus the Federal Government's enforcement.

The idea of Federal collection would probably be least attractive to the States that already have personal income taxes--especially those with well-developed statutory concepts embedded in local political preferences and with effective tax enforcement machinery. Not a few States can be expected to hold the view that the quality of their enforcement, particularly at the lower income level, compares favorably with counterpart Federal enforcement.

Because most States labor under the handicap of inadequate enforcement personnel, they would have no difficulty in making very effective use of tax enforcement personnel made surplus by shifting the responsibility for income tax administration to the Internal Revenue Service. However, rationality cannot always be expected to govern. State political leadership takes pride in its administrative organization and there is a predisposition to protect it.

Undoubtedly, the most fundamental policy issue regarding the application of stage (4) to State personal income taxes (but not the first three stages) revolves around the question of State sovereignty--and the extent to which even the non-income tax States would be willing to transfer to the Congress the power to shape their general income tax structure and, more particularly, the definition of taxable income. An obvious case is the exemption of interest earned on State and local securities from Federal taxation. Even if the States were to agree to tie their personal income taxes to one of the figures on the Federal tax return (adjusted gross income, taxable income, or tax liability), they would surely insist on retaining Federal-State comity in the matter of reciprocal exemption of interest on government securities.

From the viewpoint of the Internal Revenue Service, there are a number of additional policy considerations. The Treasury Department has traditionally taken the position that any national system for collecting State taxes would require all States to levy a uniform tax and to participate in the system. Since one-third of the States still lack a personal income tax and there is considerable variety in the existing State income taxes, such a position would preclude using the Internal Revenue Service's facilities for collecting State income taxes. However, recent developments in the use of electronic data processing equipment--Internal Revenue expects to be completely automated by 1967--change the picture considerably. Moreover, Treasury would reportedly have no reservations about a pilot project with one or more States, governed by mutually satisfactory conditions, to permit experimentation with Federal collection of the State tax.

INTERSTATE RELATIONS

The growing tendency for individuals to cross State lines to earn all or part of their livelihood points up two kinds of interstate problems. The first stems from the legal and administrative problems in regard to a State's taxing jurisdiction over its own residents and over residents of other States earning income within its borders. The second involves the extent to which States cooperate in enforcing their personal income tax laws.

Taxing Jurisdiction

It is a well established principle in State personal income taxation that a State can tax its residents on all their income, wherever it is earned, and can tax the income of nonresidents earned within its borders. Strict adherence to this principle, where both States employ income taxes, would necessarily subject any income an individual earns in a State other than where he resides to double taxation--by his State of residence and by the State in which he earns the income.

To avoid double taxation, the States have devised a system of resident and nonresident credits (table 29). All of the income tax States but Alaska 1/ allow credits to their residents for taxes paid to other States, and in most instances this residence credit is allowed whether or not the State of employment reciprocates. Eleven States allow credits to nonresidents for personal income tax liabilities to their own States (applicable primarily to income from personal services) provided those States reciprocate; two States (West Virginia and Wisconsin) exempt nonresidents from their personal income taxes

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1/ Alaska taxes only income derived within the State.

TABLE 29 .--CREDIT ARRANGEMENTS FOR PERSONAL INCOME TAXES PAID TO OTHER STATES

State	Credit allowed		Reciprocity required	
	Resident	Nonresident	Resident	Nonresident
Ala.	X	--	--	--
Alaska	--	--	--	--
Ariz.	X	X	--	X
Ark.	X	--	--	--
Calif.	X	X	X 1/	X
Colo.	X	--	--	--
Dela.	X	X	X	X
D.C. 2/	X 3/	--	--	--
Ga.	X	--	--	--
Hawaii	X	--	X 1/	--
Idaho	X	X	X 1/	X
Indiana	X	X 4/	--	X 4/
Iowa	X	--	--	--
Kansas	X 5/	--	--	--
Ky.	X	X 4/	X 1/	X 4/
La.	X	--	--	--
Md.	X	X 4/	X 1/	X 4/
Mass.	X 7/	--	--	--
Minn.	X	--	--	--
Miss.	X	--	--	--
Mo.	X 8/	--	--	--
Mont.	X	--	--	--
Nebr.	X	X	--	X
New Mex.	X 9/	X	--	X
N. Y.	X	--	--	--
No. Car.	X	--	--	--
No. Dak.	X	--	--	--
Okla.	X 10/	--	--	--
Ore.	X	--	X 1/	--
So. Car.	X	--	--	--
Utah	X	--	--	--
Vt.	X	X	X 1/	X
Va.	X	X 11/	X 1/	X 11/
W. Va.	X	6/	X 1/	6/
Wisc.	X	6/	--	6/

X Denotes "yes"; -- denotes "no" or "not applicable."

1/ Credit is given if the other State does not give credit.

2/ Personal income tax on residents only.

3/ For income and intangibles taxes required to be paid a State as a domiciliary.

4/ Provides for exemption if other State reciprocates (by agreement).

5/ Deductions limited.

6/ Exempts income of nonresidents if other State reciprocates for its residents.

7/ Limited to taxes on professional and business income.

8/ Residents may deduct from gross income the income on which tax is paid to another State.

9/ Credit limited to $1\frac{1}{2}$ percent of taxable income earned outside of State.

10/ Limited to taxes paid on compensation for personal services.

11/ Exempts income of nonresident commuters if their States provide similar exemption (applies to residents of Kentucky, Maryland, West Virginia, District of Columbia.

if the residence States do likewise; and the District of Columbia taxes only residents. Of the 11 States that allow reciprocal nonresident credits, four--Indiana, Kentucky, Maryland, and Virginia--have provision for reciprocal agreements with other States to mutually exempt nonresidents (the Virginia provision applies to commuters only). Thus, in 6 States and the District of Columbia it is possible for nonresidents to be relieved of filing income tax returns on their salaries and wages with the State in which they are employed.

Clearly, this system of resident and nonresident credits and exemptions meets the objective of minimizing, if not entirely eliminating, double taxation. 1/ However, it gives rise to a number of complications.

With almost universal adoption of withholding, the State income taxes of most individuals residing in one income tax State and employed in another are withheld in the State of employment and paid over to that State. Such a taxpayer is then required to file income tax returns with both States. If his residence State's income tax is higher than that of his State of employment, he will pay the difference between the two tax liabilities to his own State (having paid the other State, through withholding, the total amount he owes it under its income tax law).

The usual situation is for a State to credit its own residents for taxes they pay to another State, in effect shifting their income tax liability from their own State to their States of employment. There has been a discernible trend in State personal income taxation away from the allowance of a nonresident credit, leaving it up to the State of residence to adjust for double taxation. As recently as 1956, when 31 States and the District of Columbia (only three less than now) taxed personal incomes, 19 States and the District of Columbia either exempted or allowed credits to nonresidents--7 more than at present. 2/ In 1941, when there were also 31 income tax States, 20 exempted or allowed credits to nonresidents. 3/

Two factors are chiefly responsible for the increasing tendency on the part of States to tax each others' residents under their personal income taxes--the quest for revenue and the introduction of payroll withholding.

Maximization of revenue--The right of States to tax the income of nonresidents derived within their borders was sustained as early as the

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1/ Some double taxation is still possible because of differences in the way States define "resident" and "nonresident." Conceivably, a taxpayer could find himself a legal resident of two States because of diverse definitions, thus liable to both States' taxes on the same income. Conversely a taxpayer could take advantage of these differences to evade State income taxes. See discussion below.

2/ Federation of Tax Administrators, Provisions Limiting Double Taxation of Income by States, RM-340, September 1956.

3/ Roy G. Blakey and Violet Johnson, State Income Taxes (New York: Commerce Clearing House, Inc., 1942) p. 86.

1920's. In their search for additional revenue the States found nonresidents fair game, facilitated by the fact that each could readily safeguard its own residents against the reciprocating levies of other States by means of a resident credit.

Taxing nonresidents was particularly fruitful for the industrial States when industry was concentrated in a few States. As more States become industrialized and the incidence of interstate commutation becomes more widespread, the imbalance between the numbers of commuters moving into and out of a particular State tends to diminish and with it the revenue advantage of taxing nonresidents and the significance of the method selected for eliminating double taxation.

The fact that States can either tax nonresidents or grant them relief from taxes has produced some anomalous situations. When New Jersey enacted its "commuters' income tax" in 1961, the intent was to levy the tax on New York residents working in New Jersey and on New Jersey residents working in New York. At that time, New York allowed a credit to nonresidents for taxes they paid to their own States. However, to minimize the revenue loss from the New Jersey tax, New York repealed the nonresident credit. 1/ Since New Jersey allows a credit to its residents for taxes paid another State, New Jersey residents working in New York pay only the New York tax. Similarly, New York residents working in New Jersey pay only the New Jersey tax, as New York allows a credit to its residents who earn their livelihood and are taxed in another State.

Although New York repealed its nonresident credit primarily in retaliation against the New Jersey tax, this action also affected residents of other States. Thus, as a result, Delaware no longer allows a credit to its own residents for income taxes they pay to New York because the Delaware credit is contingent upon reciprocal treatment of Delaware residents by the other State. Delaware residents may take the taxes they pay to New York as a deduction from income, but not as a tax credit.

Another example occurred in 1961, when Wisconsin enacted legislation exempting nonresidents from the Wisconsin tax if their own States treated Wisconsin residents in a like manner. That same year Minnesota repealed its nonresident credit in retaliation to a similar action by North Dakota, thus precluding Wisconsin from extending the provision of its 1961 law to Minnesota residents. As a result, both States collect the tax from each other's residents and allow a credit to their own residents for income taxes they pay to the other State. To date, Wisconsin has agreements with only three States--Indiana, Kentucky, and Maryland--for mutual forbearance in the taxation of nonresidents' income.

1/ As a result of this action, New Jersey's annual take from its "commuters' income tax" was reduced by some $30 million, which would otherwise have been shifted from New York.

An interesting situation developed in the Maryland-Virginia-District of Columbia area in 1962 when Virginia introduced withholding. These three jurisdictions exempt the salaries and wages of nonresidents from their own income taxes: The District of Columbia exempts all nonresidents while Maryland and Virginia do so on condition of reciprocity. When Virginia introduced withholding, it repealed the section relieving commuters of filing income tax returns. Maryland and District of Columbia residents working in Virginia, many of them employees of the Federal Government, complained about this action. The Virginia Commissioner of Taxation asserted that if the Federal Government would arrange to withhold Virginia income taxes from Virginia residents employed by it in Maryland and the District of Columbia, he would recommend restoration of the exemption for nonresident commuters. Such action was eventually taken by the Federal Government (applicable to residents of all jurisdictions) and by Virginia, so that Virginia, Maryland, and District of Columbia residents employed as nonresidents in any of those jurisdictions need not file nonresident returns.

The effect of withholding--Recognizing the value of collection at the source for maximizing State personal income tax collections, the States did not lag far behind the Federal Government in establishing withholding systems. Oregon adopted withholding in 1948, the first State to do so, and withholding as a means of collecting income taxes from wage and salary recipients at the source is now virtually a universal feature of State personal income tax laws (table 30). On December 31, 1965, general withholding, applicable to both residents and nonresidents, was on the statute books of 30 States and the District of Columbia, and Nebraska has adopted the system beginning January 1, 1967 as part of its new income tax law, which is subject to referendum. That leaves only Mississippi, North Dakota, and California without general withholding (California does require withholding from nonresidents, however). More than half of the States that now employ withholding have adopted it since 1959.

Like the Federal Government, States require withholding from salaries and wages, but not interest, dividends, rents, or royalties. However, most States, including those that do not use withholding, require payers of interest, dividends, etc., to file informational reports. Hawaii, New Mexico, and New York require employers to remit withheld income taxes every month; all other States withholding from residents require quarterly returns. A number of States that use the quarterly return system, however, require monthly payments when the aggregate withholdings of individual taxpayers exceed a specified amount.

Withholding has improved income tax enforcement strikingly. The increase in collections has been estimated to range up to 25 percent, with a median increase of 10 percent. 1/ These increases have been attributed

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1/ Alan P. Murray, "Wage-Withholding and State Income Taxes," National Tax Journal, Vol. XVIII, No. 4, December 1964.

TABLE 30.--WITHHOLDING OF STATE PERSONAL INCOME TAXES

State	Withholding required	Year effective	Periodicity of employer returns
Alabama	X	1956	Quarterly
Alaska	X	1949	do
Arizona	X	1954	do
Arkansas	X	1966	do
California	1/	--	Annually
Colorado	X	1954	Quarterly
Delaware	X	1949	do
Dist. of Col.	X	1956	do
Georgia	X	1960	do
Hawaii	X	1957	Monthly 2/
Idaho	X	1955	Quarterly
Indiana	X	1963	do
Iowa	X	1966	do
Kansas	X	1966	do
Kentucky	X	1954	do 3/
Louisiana	X	1961	do 4/
Maryland	X	1955	do
Massachusetts	X	1959	Quarterly 5/
Minnesota	X	1961	do
Mississippi	--	--	--
Missouri	X	1961	Quarterly
Montana	X	1955	do 6/
Nebraska	X	1967 7/	do
New Mexico	X	1961	Monthly
New York	X	1959	do
North Carolina	X	1959	Quarterly
North Dakota	--	--	--
Oklahoma	X	1961	do
Oregon	X	1948	do 3/
South Carolina	X	1959	do
Utah	X	1959	do
Vermont	X	1951	do 8/
Virginia	X	1963	do
West Virginia	X	1961	do 9/
Wisconsin	X	1962	do

X Denotes "yes;" -- denotes "no" or "not applicable."

1/ Withholding applies to nonresidents only.

2/ The Director of Taxation may grant permission to employers with an annual liability to pay over withheld income taxes not exceeding $200 to make returns and payments on a quarterly basis.

3/ Except that employers withholding income taxes amounting to $100 or more per month are required to remit on or before the 15th of the following month.

4/ At the request of the employer, the Collector of Revenue may permit a withholding tax return to be submitted and the tax to be paid on a monthly basis.

5/ Except that returns and payment of taxes withheld by any employer who can reasonably expect that taxes withheld will exceed $600 for the calendar year are due monthly.

6/ If total quarterly taxes withheld are less than $10, an employer may make an annual return.

7/ Subject to referendum.

8/ Except that where the amount withheld is at least $200 per calendar month or exceeds $600 per calendar quarter, employers are required to report monthly.

9/ The Tax Commission may by regulation provide for returns and payment on the 15th day of each month for employers withholding taxes of $100 or more for the preceding calendar month.

almost entirely to the improved taxpayer compliance produced by withholding. States with large numbers of nonresident earners find withholding particularly helpful in their tax collection efforts.

The widespread adoption of payroll withholding in recent years was probably more influential in pushing the States toward the elimination of the nonresident credit than was the quest for revenue. Since the income tax is collected by the employer, the nonresident employee can be readily included. Why forego the revenue when it is readily at hand? It is significant, in this connection, that 8 of the 9 States that dropped their nonresident credit or exemption since 1956 have installed a withholding system since that time.

Definition of "Residence"

While the system of resident and nonresident credits effectively minimizes the possibility of double taxation under State income tax laws, the variation in legal definitions and administrative interpretations as to the conditions under which an individual is considered a resident of a particular State give rise to some cases of double taxation. It is also possible for an individual to avoid State income taxes because of the different residence definitions used by the States.

A Committee of the National Tax Association identified at least five kinds of definitions in the State income tax laws of 1947. 1/ These were:

(1) A "resident" is a person who either is domiciled within the State or maintains a permanent place of abode for any length of time therein during the taxable year.

(2) A "resident" is a person who either is domiciled within the State on the last day of the taxable year or maintains a place of abode within the State for a specified portion of the taxable year.

(3) A "resident" is a person who either is domiciled within the State or maintains a place of abode within the State and spends in the aggregate a specified portion of the taxable year within the State.

(4) A "resident" is a person who is in the State for other than temporary purposes and every person domiciled within the State, with a presumption that a person who spends in the aggregate a specified portion of the taxable year within the State is a resident.

1/ National Tax Association, "Report of the Committee on Multiple Personal Income Taxes," Proceedings of the Fortieth National Conference, 1947, pp. 308-313.

(5) A "resident" is a person coming within the scope of a special statutory definition or a member of a group undefined by statute.

Although the Committee recommended a uniform definition for adoption by all States, there has been little, if any, progress in this direction. The variety of definitions is as wide now as it was in 1947. They range from a simple statement in the Kentucky law that "'resident' means any individual domiciled within this State," 1/ to extremely lengthy definitions in the New Mexico 2/ and Virginia 3/ statutes. In between is the definition adopted by California and a few other States, and the one used by New York. The California law defines a "resident" to include the following: 4/

> "(a) Every individual who is in this State for other than a temporary or transitory purpose. (b) Every individual domiciled within this State who is outside the State for a temporary or transitory purpose. Any individual who is a resident of this State continues to be a resident even though temporarily absent from the State."

The New York definition is somewhat more precise: 5/

> "...A resident individual means an individual: (1) who is domiciled in this state, unless he maintains no permanent place of abode in this state, maintains a permanent place of abode elsewhere, and spends in the aggregate not more than thirty days of the taxable year in this state, or (2) who is not domiciled in this state but maintains a permanent place of abode in this state and spends in the aggregate more than one hundred eighty-three days of the taxable year in this state..."

The major points of difference in the various definitions of "resident" are:

(1) The length of time a person must have resided in the State to be considered a resident;

(2) The distinction between "domicile," "place of abode," and "residence"; and

(3) The handling of "temporary absence."

1/ Kentucky Revised Statutes, Sec. 141-010.

2/ New Mexico Statutes, Sec. 72-15-3.

3/ Virginia Code, Sec. 58-77(8).

4/ California, Revenue and Taxation Code, Sec. 17014.

5/ New York, Consolidated Laws, Ch. 60, Art. 22, Sec. 605(a).

Until these differences can be resolved, State tax administrators and the courts will continue to spend an inordinate amount of time adjudicating residence questions and taxpayers will be liable to double taxation or they will use their ingenuity and that of their attorneys to evade State income taxes.

Interstate Cooperation in Enforcement

Most State income tax laws make some provision to permit authorized personnel of out-of-State tax agencies to inspect their tax records in connection with the audit of income tax returns. Some States permit only limited exchange of information or provide that tax information can be made available only on a reciprocal basis.

There is no evidence of formal agreements between States or among groups of States for massive exchange of tax information. At one time, New York State entered into agreements with 20 States for reciprocal exchange of personal income tax information. 1/ These arrangements have apparently been discarded, probably because of the expanded use of Federal-State cooperative agreements. Nevertheless, it is common for State tax agencies to solicit help from other States, on an informal basis, in tracking down former residents who have moved without paying their income tax liabilities or to substantiate a credit for taxes paid to another State. Generally, such a request simply involves a telephone call or a letter, and most State tax administrators believe there is little or no need for more formal arrangements.

All but six States with personal income taxes have reciprocal comity statutes allowing other States to sue in their courts for the collection of unpaid tax liabilities (the States without such comity statutes are Colorado, Missouri, Montana, New Mexico, Utah, and Vermont). Missouri has a general statutory provision permitting suits in its courts "...whenever a claim exists under the law of another State..." 2/ Massachusetts is the most recent to accord reciprocal interstate comity, having enacted such legislation in its 1964 legislative session. 3/ Little use is made of the comity laws in connection with income tax enforcement, except where the tax liability is particularly large. Undoubtedly, the very existence of such laws has some deterrent effect on the evasion of income tax liabilities by those moving out of a State and the adoption of uniform comity laws by all States would be helpful.

1/ Mortimer M. Kassell, "Progress Toward Achieving Uniformity in State Income Tax Administration," in Symposium on Income Tax Administration (New York: Tax Institute, Inc., December 15-17, 1948), p. 301.

2/ Missouri Revised Statutes, Sec. 507.202.

3/ Massachusetts General Laws, Chap. 58, Sec. 28 C.

TECHNICAL PAPERS

Technical Paper 1

THE PERSONAL INCOME TAX AND STATE CONSTITUTIONS

Two basic State constitutional issues are relevant to an examination of Federal-State coordination of personal income taxes. The first involves the extent to which State constitutions specifically authorize or prohibit State personal income taxes, or, in the absence of explicit constitutional language, how the courts have interpreted State legislative authority to levy such a tax. Involved here are questions relating to the kind of rate schedule that can be levied (graduated or flat rate) and whether personal exemptions and deductions can be allowed.

The second issue concerns the constitutionality of a State adopting the personal income tax provisions of the Federal Internal Revenue Code. Is such action an unconstitutional delegation of a State's legislative authority and responsibility to the Federal Government?

These constitutional questions are relevant to determining the extent to which recommendations that may be made by the Commission about State use of personal income taxes, or to minimize differences between the State and Federal income tax may run afoul of existing State constitutional provisions; whether they could be implemented by State legislation or whether constitutions would need to be amended. Such restrictions do not necessarily require abandonment of efforts to secure the maximum degree of uniformity between Federal and State income taxes or to secure adoption by all States of an income tax where such recommendations might conflict with an individual State constitution. However, the nature and extent of the constitutional questions that may be present could well determine the approach that should be taken in a given situation. If the basic goal can be achieved with or without a constitutional amendment, the latter course is obviously to be preferred.

Many of the 34 States that now levy a broad-based personal income tax amended their constitutions before doing so, believing it necessary or advisable. Others were able to do so without constitutional action. The following brief survey of State constitutional provisions sheds some light on the course that State personal income taxation has taken thus far and on possible constitutional problems that face the 16 States that do not now tax personal incomes.

AUTHORITY TO LEVY AN INCOME TAX

A number of factors have more or less influenced constitutional questions concerning State personal income taxes. The decision of the United States Supreme Court in Pollock v. Farmers' Loan and Trust Company,[1/] declaring the Federal income tax statute of 1894 unconstitutional, was based on grounds which should not have affected the authority of State legislatures to adopt income taxes. Nevertheless, the Court's reasoning undoubtedly presented a psychological block to State adoptions. The important constitutional issues in the States concerned the nature of State constitutional provisions affecting tax uniformity, proportionality, definitions of property for tax purposes, and inherent powers of the legislature. Whether or not such requirements were included in individual State constitutions, and the way each State Supreme Court interpreted their meaning, affected the course of the income tax development in the individual State. The impact of this development is apparent from table 31, which shows the basic constitutional provisions affecting the levy of personal income taxes in the 34 States that impose such a tax at the present time.

The constitutions of 20 of these 34 States contain specific provisions authorizing the legislature to impose an income tax. In 12 of the 20, this authorization was contained in a specific amendment to the State constitution adopted since 1900. As will be made apparent below, it is questionable whether a constitutional amendment was a necessary prelude to income taxation in each of these States. The other eight States, with the exception of California and New York, adopted their constitutions since 1900. The California Constitution, adopted in 1879, contains the earliest specific authorization for an income tax among the constitutions of the 34 States utilizing the tax.

Thirteen States levy an income tax, although their State constitutions contain no specific authorization for imposing such a tax. In four--Alaska, Hawaii, Iowa, and Vermont--the State constitution contains no specific reference which would in any way affect the authority of the legislature to levy an income tax. The constitutions of Delaware, Georgia, Idaho, Kentucky, Maryland, Minnesota, Mississippi, New Mexico, North Dakota, and Oregon contain specific uniformity provisions. In each, the uniformity requirement is phrased in terms of the class of subjects, objects, or the property that may be taxed by the legislature. With the flexibility thus granted, and in the context of general powers of legislative bodies, these provisions have been held not to bar the levying of a progressive income tax by the States. The Nebraska Constitution gives the legislature broad authority to adopt nonproperty taxes, but prohibits a State property tax, except for capital improvements, whenever an income tax is adopted.

1/ 157 U.S. 429 (1895).

TABLE 31. --CONSTITUTIONAL PROVISIONS OF STATES WITH BROAD-BASED PERSONAL INCOME TAXES

State	Year tax adopted	Date of present constitution	Constitutional amendment	Provision
Alabama	1933	1901	1933	Authorizes tax on net income. Specifies maximum rate and minimum exemption.
Alaska	1949	1959	--	No reference.
Arizona	1933	1912	--	Authorizes graduated tax.
Arkansas	1929	1874	1934	Graduated tax levied by statute incorporated in constitution may be increased by 3/4 vote of legislature or referendum approval.
California	1935	1879		Income taxes assessed as provided by law.
Colorado	1937	1876	1936	Authorizes graduated tax.
Delaware	1917	1897	--	Uniform on same class of subjects. May provide exemptions.
Georgia	1929	1945	--	Uniform on same class of subjects. Legislature free to classify. Includes money. May tax classes at different rates.
Hawaii	1901	1959	--	No reference.
Idaho	1931	1890	--	Uniform on same class of subjects. Legislature to define and classify property.
Indiana	1963	1851	1932	Authorizes tax on income at rates determined by law.
Iowa	1934	1857		No reference.
Kansas	1933	1861	1932	Authorizes graduated tax.

See footnotes at end of table.

TABLE 31. --CONSTITUTIONAL PROVISIONS OF STATES WITH BROAD-BASED PERSONAL INCOME TAXES (Cont'd)

State	Year tax adopted	Date of present constitution	Constitutional amendment	Provision
Kentucky	1936	1891	--	Uniform on same class. May levy tax based on income.
Louisiana	1934	1921	--	Authorizes graduated tax. Specific statute with rates incorporated in constitution.
Maryland	1937	1867	--	Uniform rates. Legislature may classify land and personalty.
Massachusetts	1916	1780	1915	Authorizes income tax. Different rates based on source, but uniform on income derived from same source. Exemptions authorized.
Minnesota	1933	1857	--	Uniform on same class of subjects.
Mississippi	1912	1890	--	Uniform and equal. Property taxed in proportion to value.
Missouri	1917	1941	--	May tax income. Rates uniform on same class of subjects.
Montana	1933	1889	1934	Authorizes graduated tax.
Nebraska	1965[1/]	1875	1954, 1965[2/]	Taxes other than on property may be authorized by law. No State property tax, except for capital improvements, on adoption of income tax.
N. Mexico	1933	1912	--	Tangible property in proportion to value. Others equal and uniform on subjects of same class.
New York	1919	1895	--	Authorizes graduated tax.

See footnotes at end of table.

TABLE 31. --CONSTITUTIONAL PROVISIONS OF STATES WITH BROAD-BASED PERSONAL INCOME TAXES (Concl'd)

State	Year tax adopted	Date of present constitution	Constitutional amendment	Provision
No. Carolina	1921	1868	1918, 1920, 1924, 1936	Only "net income" may be taxed. Maximum rate and minimum exemptions specified.
North Dakota	1919	1889	1904, 1914, 1918	Uniform on same class of property.
Oklahoma	1915	1907	--	Authorizes graduated tax.
Oregon	1930	1859	1932	Uniform rules for assessment and taxation. Uniform on same class of subjects.
So. Carolina	1922	1895	1932	Authorizes graduated tax.
Utah	1931	1896	1900, 1906, 1918, 1930, 1946	Income tax <u>must be</u> graduated. Revenue for public school system.
Vermont	1931	1793	--	No reference.
Virginia	1916	1902	--	Authorizes income tax on incomes in excess of $600.
W. Virginia	1961	1872	1932	Authorizes graduated tax.
Wisconsin	1911	1848	1908	Authorizes graduated tax.

1/ Effective January 1, 1967, subject to referendum.

2/ To be submitted to electorate at general election November 1966.

Source: Columbia University, Legislative Drafting Research Fund, <u>Constitutions of the United States, National and State</u>. (Dobbs Ferry, N.Y.: Oceana Publications, 1962).

At the present time, four States--Indiana, Massachusetts, Maryland, and Nebraska--levy a flat rate income tax with personal exemptions; the other 30 States levy a graduated tax with exemptions. The Massachusetts tax was levied pursuant to a 1915 constitutional amendment, authorizing a "proportional" tax on income. The amendment has been interpreted as prohibiting a graduated income tax.[1] In Maryland, a proposed constitutional amendment authorizing the imposition of a personal income tax was defeated at the polls in 1933. Despite this, the Maryland Court of Appeals in 1935 upheld the imposition of the flat rate income tax with a differential tax rate on income (above $500) derived from investments.[2] An Attorney General Opinion to the Montgomery County delegation (of the State legislature) dated March 4, 1955, indicated that the State legislature has the power to levy a graduated income tax.

The constitutional provisions of the 16 States that do not presently levy a general personal income tax vary somewhat more than do the provisions of the other States.[3] Essentially, they fall into four groups (table 32).

The first group consists of Florida and Tennessee. The constitution of Florida contains a specific prohibition against the levying of an income tax of any kind. The Tennessee Constitution specifically authorizes a tax on the income derived from stocks and bonds, and thus has been interpreted as prohibiting any general income tax.[4]

The States of Michigan, Ohio, South Dakota, and Texas form the second group. The constitutions of these States specifically, or by necessary implication, authorize the imposition of an income tax, although a tax "graduated as to rate or base" is prohibited in Michigan. The Attorney General of Michigan has interpreted this as permitting a flat rate tax with exemptions.[5]

The third group of States includes Connecticut, Maine, New Hampshire, and Rhode Island where there appears to be no State constitiononal provision which would in any way prevent them from imposing a personal income tax. Thus, the inherent power of the legislature would be a sufficient basis for the adoption of the tax. In New Hampshire the authority to levy a tax on net income is clear, but use of graduated rates appears to be unconstitutional.[6]

1/ Opinion of the Justices (1929) 266 Mass. 583, 165 NE 900.

2/ Ousler v. Tawes (1940) 178 Md. 471, 13 Atl. 2d 763.

3/ Two of these States, Tennessee and New Hampshire, levy an income tax on income from stocks and bonds.

4/ Evans v. McCabe (1912) 164 Tenn. 672, 52 SW 2nd 159.

5/ Opinion No. 4415, to State Senator Basil W. Brown, February 25, 1965.

6/ See Opinion of the Justices, (1927) 82 N.H. 561; Opinion of the Justices, (1949) 95 N.H. 537; and Conner v. State (1925), 82 N.H. 126.

TABLE 32.--CONSTITUTIONAL PROVISIONS OF STATES WITHOUT A BROAD-BASED PERSONAL INCOME TAX

State	Date of present constitution	Constitutional amendment	Provision
Connecticut	1818	--	No reference.
Florida	1887	--	Income tax specifically prohibited.
Illinois	1870	--	Proportional to value. subjects and objects other than land may be taxed.
Maine	1820	--	No reference.
Michigan	1964	--	Tax "graduated as to rate or base" prohibited.
Nevada	1864	1906, 1942, 1960	Uniform and equal rates of assessments and taxation.
New Hampshire[1/]	1787	1903	Proportional and reasonable assessment rates and taxes. May tax polls, estates, and other classes of property.
New Jersey	1947	--	Property assessed and taxed by uniform rules.
Ohio	1851	1912	Authorizes graduated tax.
Pennsylvania	1874	1923, 1958	Uniform on same class of subjects.
Rhode Island	1843	--	May provide for valuation of property and assessment of taxes.
South Dakota	1889	1912, 1918	Authorizes graduated tax.

See footnotes at end of table.

TABLE 32. --CONSTITUTIONAL PROVISIONS OF STATES WITHOUT A BROAD-BASED PERSONAL INCOME TAX (Concl'd)

State	Date of present constitution	Constitutional amendment	Provision
Tennessee 2/	1870	--	May tax income from stocks and bonds not subject to property tax.
Texas	1876	--	May tax income. Taxation equal and uniform. Property taxes in proportion to value.
Washington	1889	1930	Uniform on same class of property. Property means tangible or intangible "subject to ownership."
Wyoming	1890	--	All taxation equal and uniform.

1/ Tax on income from stocks and bonds imposed since 1923.

2/ Tax on income from stocks and bonds imposed since 1931.

Source: Columbia University, Legislative Drafting Research Fund, Constitutions of the United States, National and State (Dobbs Ferry, N.Y.: Oceana Publications, 1962).

Finally, there is a group of six States in which the authority of the legislature to impose a graduated or flat rate income tax with exemptions is subject to some degree of uncertainty. These States are Illinois, Nevada, New Jersey, Pennsylvania, Washington, and Wyoming. In each instance the question of the authority of the legislature to act depends upon court interpretation of uniformity provisions, or the definition of taxable property contained in the State's constitution, and on the relationship between the two. In Wyoming and Nevada no court case directly in point is available. In Wyoming the constitution appears to contain no restriction on the power of the legislature, but the "uniform rate" requirement of Nevada may prohibit an income tax with graduated rates. While the authority of the New Jersey Legislature to impose an income tax has been questioned,[1/] in 1961 it did levy a graduated income tax on New York residents working in New Jersey--the so-called "commuters' income tax." This act has not been challenged.

In three States--Illinois, Pennsylvania, and Washington--a personal income tax has been declared unconstitutional.[2/] In each instance the tax on which the highest court of the State ruled was a graduated income tax. Some observers feel, however, that if the question were posed today, the Court's finding may be different. The view has been expressed that a graduated income tax with exemptions would be sustained in Illinois.[3/] In Pennsylvania the actual court decision indicates the likelihood that a flat rate net personal income tax with certain specified exclusions might well be sustained. Analysis seems to indicate, on the other hand, that in Washington any income tax would require a constitutional amendment.[4/]

To summarize, of the remaining 16 non-income tax States, the legislatures of 11, if they so desired, probably could levy either a graduated or flat rate income tax. In two States--Florida and Tennessee--the State constitution apparently prohibits the legislature from imposing any kind of a tax measured by income. Finally, in three States--Pennsylvania, Illinois, and Washington--the authority of the legislature to adopt a personal income tax of any kind is debatable.

1/ See Proceedings of New Jersey Constitutional Convention - Monograph on Taxation - The Tax Clause, by Aaron K. Neeld.

2/ Bachrach v. Nelson (1932), 394 Ill. 579, 182 NE 909; Kelly v. Holodner (1935), 320 Pa. 180, 181 A. 598; Bronson v. Henneford (1936), 185 Wash. 209, 53P 2d 607.

3/ Report of the Commission on Revenue, State of Illinois, (Springfield: Frye Printing Company, 1963) pp. 362-373.

4/ James V. O'Conner and Robert E. Schillberg, "A Study of Income Taxation in Washington," 33 Wash. L. Rev. 398 (1958).

USE OF FEDERAL CODE OR DEFINITIONS

Constitutional issues involved in securing maximum uniformity between State and Federal personal income taxes raise several questions. The maximum degree of uniformity and minimum taxpayer compliance burden would be achieved by basing the State income tax on the individual's Federal tax liability. A lesser degree of uniformity would be achieved by utilizing some other figure derived from the Federal income tax return such as taxable income, or adjusted gross income, making a series of specific adjustments to that figure and then applying the appropriate State tax rate. Obviously, from the viewpoint of the taxpayer's compliance burden, maximum uniformity ranks highest. However, the constitutional issues involved in such an approach are more complicated than that involved in utilizing some earlier starting point for computing the State tax. In addition to the question of delegation of legislative authority discussed below, a Federal constitutional question and a number of other State constitutional questions are raised.

The Federal constitutional question relates to the authority of a State to tax the securities of the Federal Government since interest received on Federal securities is included in income reported for Federal income tax purposes. In the absence of an Act of Congress authorizing States to tax such income, such a tax would be unconstitutional, though there can be no doubt that Congress possesses the authority to consent to such State taxation. Conversely, since some States tax the income from State and local securities, complete Federal-State uniformity would bring into question the power of Congress to impose a tax on such income.

At the State level, applying a State rate to the Federal tax liability persents additional constitutional difficulties. The constitutions of some States (Louisiana, North Carolina, and Alabama), for example, specify minimum personal exemptions. Where State constitutions prescribe exemptions from State taxation, or limit the legislature's authority to provide exemptions, such constitutions would need to be amended before this method could be employed.

Levying the State tax against Federal adjusted gross income or taxable income could resolve the above-mentioned constitutional questions by permitting adjustments to the Federal base figure necessary because of constitutional requirements. Such adjustments could be made according to State constitutional and statutory requirements and the appropriate State rate--graduated or flat--could be imposed against the final income figure. Under such a procedure, the only constitutional question remaining is the authority of the State to utilize Federal terms, definitions, etc. It is clear that one way or another the States could adopt for these purposes the Federal statute in effect on a specified date.

Since Federal income tax law is amended frequently, State conformity with Federal law on a continuing basis, in absence of annual legislative action,1/ would require that the State adopt the Internal Revenue Code provisions, including any subsequent amendments. This might entail a delegation of State legislative authority to the United States Congress, which may be unconstitutional in some States.2/

Recognizing the value that may be secured in following this procedure, Colorado, New Mexico, and New York recently adopted constitutional amendments authorizing the State legislature to define income subject to State taxation by reference to provisions of the Federal Internal Revenue Code.3/ The language of the New Mexico amendment reads as follows:

> Notwithstanding the foregoing or any other provision of this constitution, the legislature in any law imposing a tax or taxes, may define the amount on, in respect to or by which such tax or taxes are imposed or measured, by reference to any provision of the laws of the United States as the same may be or become effective at any time or from time to time, and may prescribe exceptions or modifications to any such provision.

The language of this amendment clearly authorizes as a starting point for computing the State income tax any figure as it may be defined on the date

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1/ A central issue in this approach is the fact that the Federal income tax law is usually amended every year. Therefore, continued uniformity would require annual legislation in the States. Whether such adoption could be made by reference, or whether it would require a formal printing of the full Federal statute would again have to be answered in the context of individual State constitutional requirements. Obviously, where the terms of a State income tax law must be printed in full, the annual printing of the full tax statute would create an impossible situation. In addition, the administrative difficulties may prohibit the effective utilization of such a procedure in many States. Thus, when Congress amends the income tax law in July of a given year, most State legislatures desiring to conform their tax law to accord with the Federal action could not act until after they convene on the following year. In many instances such action could not be made retroactive to the preceding year's tax return.

2/ For discussion of numerous cases involving delegations, see 79 LEd. 474, 133 A.L.R. 401, 166 A.L.R. 516, and 177 A.L.R. 467. See also Report of the Commission on Revenue, State of Illinois, op. cit., pp. 373-380.

3/ Colo. Const. Art. X, Sec. 19, approved 11/6/62; N.M. Const., Art. IV, Sec. 18, amended 11/3/64; and N.Y. Const., Art. III, Sec. 22, amended 11/3/59. A similar constitutional amendment (L.B. 79, 1965) will be placed on the Nebraska ballot in November 1966.

of adoption of the State act, or in the future, appearing on the Federal income tax return.

Other States have found that use of Federal definitions as subsequently redefined have not resulted in court action declaring their action unconstitutional. Thus, the Connecticut corporation business tax defines gross income as follows: "'Gross income' means gross income as defined in the Federal corporation net income tax law in force on the last day of the income year." It goes on to prescribe subsequent modifications required to satisfy other constitutional provisions and policy decisions that the legislature may make in the future.[1/] Montana, by statute, has adopted the Federal definition of adjusted gross income appearing in Section 62 of the Internal Revenue Code of 1954, "or as that section may be labeled or amended."[2/]

Alaska, by statute, incorporates all provisions of the Federal income tax, subject to certain exceptions in its tax law.[3/] A similar statute was adopted under its Territorial Organic Act, granting the Territorial Government the privilege of levying taxes and collecting revenue in a manner similar to a State. Based on this grant, the Territorial Act was upheld.[4/]

Vermont has adopted a somewhat different approach designed to secure the maximum degree of uniformity. Section 5603(8), Title 32, Vermont Statutes Annotated, defines Vermont personal income in terms of the Internal Revenue Code of the United States in effect January 1, 1963, or, "However, if the taxpayer so elects, 'Vermont taxable income for any taxable year' means the same as taxable income as defined under the laws of the United States in effect for such year,..." Under either section deductions required pursuant to constitutional immunity questions and other policy decisions of the legislature are made. The provision in Vermont law apparently has not yet been tested in court.

Before concluding this discussion of the constitutional questions that may be raised by a State's attempt to adopt Federal income tax definitions as amended in the future, it is appropriate to take note of other instances where similar techniques have been used. Recognizing that standards for delegation

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1/ Laws of Connecticut, Title 12, Ch. 208, Sec. 12-213.

2/ Montana Statutes, Sec. 84-4950. The same approach is used for deductions, Sec. 84-4906.

3/ Alaska Statutes, Sec. 43-20.300 adopting Internal Revenue Code "as now in effect or hereafter amended."

4/ Alaska Steamship Company v. Mullaney (1950) 12 Alaska 594, 180 F 2nd 805.

of legislative authority may be somewhat different under the Federal Constitution, some reference thereto seems appropriate. Thus, we see Federal statutes incorporating State law prospectively for purposes of imposing health and safety standards in areas subject to Federal regulation.[1/] The delegation at the Federal level goes even further in that a Federal criminal statute--fugitive Felony Act--bases a Federal criminal act itself upon State definitions of individual felonies.[2/]

At the State level, in addition to the references made above to delegation in the income tax field, extensive use of the procedure is made in estate and gift taxes.[3/] State food and drug requirements often follow statutory requirements of the Federal law.[4/] In the latter instance, it is clear that much can be accomplished pursuant to State law under which an administrator may promulgate appropriate regulations. However, while exhaustive State studies in this area are few, a recent Wisconsin study points up the problem.[5/] It notes that the State estate tax is applicable in any instance where an estate is subject to the Federal tax. Similarly, various regulatory agencies have authority to adopt regulations adopted by a corresponding Federal agency, e.g., State conservation department, fish and game commission, and regulations of the Department of Interior. Further, the State Aviation Commission is directed to let "contracts in the manner prescribed by the Federal authority...notwithstanding another State law to the contrary...."[6/] And finally, the study notes that in a number of instances State legislatures either authorized or directed the prospective

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1/ See, for example, Walsh-Healy Act, 41 U.S.C. 35(e).

2/ 18 U.S.C. 1073.

3/ Forty-five States to one degree or another base their estate or inheritance tax on liability under the Federal estate tax. In five States the tax is limited to estates subject to the Federal tax and to the amount of the Federal tax credit. Advisory Commission on Intergovernmental Relations, Coordination of State and Federal Inheritance, Estate and Gift Taxes (A-1) January 1961, pp. 34-5. But see, also, Charleston National Bank v. Fox, 116 W. Va. 487 (1935).

4/ See Public Administration Service, A Study of State and Local Food and Drug Programs, 1965, Table III-5.

5/ James O. Huber, "Constitutionality of a Federalized Income Tax," Wis. L. Rev., May 1963, p. 445.

6/ Wisconsin Statutes, Sec. 114.32(2), 1961.

use of material developed by private organizations. The study cites use of mortality tables, definitions of drugs, and the meaning of the term "kosher." The Wisconsin article, concerning problems with the income tax concludes as follows: "A number of factors seem to favor an 'intergovernmental relations' exception to the usual analysis afforded the delegation issue.[1/]

It appears reasonable to conclude that if a State legislature determines that there is merit in the adoption of Federal income tax definitions as they may be amended in the future, a substantial number of States could do so without a constitutional amendment. States considering this course will want to make a careful study of their statutory laws and constitutional interpretations in other areas where such a procedure had been followed. The conclusion reached will necessarily be affected by the significance of the revenue measure. A court decision declaring adoption of future FDA regulations for drug tolerances to be unconstitutional cannot necessarily be presumed to govern a tax question.

A possible adverse court decision involving a State income tax cannot be contemplated lightly because of its immediate budgetary consequences. This consideration suggests that in the event of doubt respecting the constitutionality of the adoption of a Federal definition, as it may be later amended, the State might want to consider testing the question by starting with a tax with relatively minor revenue significance. This kind of approach would afford a practical opportunity for resolving constitutional issues without jeopardy to the State's financial position.

1/ Huber, *op. cit.*, p. 457.

Technical Paper 2

THE EXTENT OF FEDERAL-STATE CONFORMITY IN STATUTORY DEFINITIONS OF NET INCOME

Our discussion in Chapter 7 of alternative approaches to conformity between State and Federal personal income tax provisions emphasized the significant variations that still remain, especially as to the exclusion and deduction adjustments to gross income in arriving at net income for tax purposes. This Technical Paper discusses the specifics of these variations, which are detailed in tables 36-39 at the end of the paper.

EXCLUSIONS UNDER THE FEDERAL INTERNAL REVENUE CODE

Fifteen States have adopted explicitly by reference the definition of adjusted gross income that appears in the Federal Internal Revenue Code of 1954, as amended. These conforming States, with all the other income tax States, also exclude interest on United States Government obligations, a provision that is required by the Constitution and by Federal statutes.

Five of the 15 States (Alaska, Indiana, New Mexico, Vermont, and Wisconsin) follow the Federal practice and exclude interest on all State and local securities. Three (Hawaii, Iowa, and Montana) do not allow any such exclusion. Four of the conforming or "IRC," States (Minnesota, New York, North Dakota, and West Virginia) exclude only interest paid by themselves and by their own local governments; Colorado does so only if the statute authorizing the bond issue specifically exempts the interest; and the remaining two (Idaho and Kentucky) permit the taxpayer to exclude only particular types of their own interest payments. The only other exceptions, among these IRC States, to the list of Federal exclusions are as follows: Hawaii does not accept the Federal dividend exclusion and the exemption of cost-of-living allowances (Kentucky and Alaska, respectively, concur with one or the other of these exceptions); Kentucky also does not provide for exemption of gains on the sale of a residence by a taxpayer 65 and older; and Wisconsin requires that a new residence be located in that State to qualify for the general sale-of-residence roll-over provision.

With respect to only two of the Federal exclusions are the provisions of the 19 non-conforming States [1/] universally the same as the Internal

1/ Including the District of Columbia, which is treated here as a State.

Revenue Code, as amended to January 1, 1965: life insurance payments made by reason of the death of the insured; and gifts, bequests, and inheritances. Only Oregon applies more restrictive standards than the Federal Code in defining excludable compensation or damages received for injury or sickness.

Conversely, only one Internal Revenue Code exclusion (the $100 dividend exclusion) is not available to the taxpayers of any of the 19 non-conforming States. Federal Government cost-of-living allowances for civilians are not excludable in any of the non-conforming States except Louisiana which treats such allowances as excludable reimbursement for travel away from home. In addition, only California, Louisiana, North Carolina, and Oregon follow the Internal Revenue Code in not requiring the reporting of reimbursements received by existing employees for their moving expenses, and only Oklahoma allows the exclusion of income earned abroad.

Retirement Income

Every State but Mississippi excludes Social Security Act benefits from gross income. Veterans' pensions are fully excludable in every State but Oregon, which limits the exclusion to $3,000 per year. 1/ Similar universality does not extend to Railroad Retirement Act benefits, which must be reported as gross income in 3 of the 19 non-conforming States (Arizona, Arkansas, and Georgia).

The treatment of income from annuity and endowment and life insurance contracts under the IRC--the exclusion ratio--is followed completely only by Kansas, Louisiana, and Oklahoma. North Carolina applies the exclusion ratio test to annuities but not to endowment and life insurance contracts. Either or both of the following formulas are employed by States as alternatives to the Federal exclusion ratio:

> (1) Amounts received under such a contract, whether during the term or at maturity or upon surrender of the contract, need not be reported as gross income until the aggregate amount received equals the total amount of premiums paid.
>
> (2) Amounts received in each taxable year that exceed 3 percent of the aggregate premiums paid for the contract are excluded from gross income until the total exclusion equals the sum of the premiums.

The first rule is applied by 10 of the non-conforming States to endowment/life insurance and annuity contracts alike. 2/ The first rule is applied to

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1/ Oklahoma excludes all compensation of military personnel, and this treatment presumably extends to pensions.

2/ Alabama, Arizona, Arkansas, Delaware, Mississippi, Oregon, South Carolina, Utah, Virginia, Wisconsin.

endowment and life insurance contracts and the second to annuity contracts by five States (California, District of Columbia, Georgia, Maryland, and Missouri). North Carolina uses the first formula for endowment and life insurance contracts, and Massachusetts taxes these classes of income at special rates.

Interest on State and Local Securities

We have noted that the States are constitutionally barred from taxing interest paid by the Federal Government on its obligations, and that, as the situation is currently interpreted by the courts, the Federal Government is required to accord the same privileged status to interest on State and local securities. No such constraints stand in the way of one State taxing interest paid by the others, and only the District of Columbia, of the 19 non-conforming States, has elected to follow the Internal Revenue Code practice of excluding all State and local interest from gross income. Utah does not provide for any exclusion. The most common practice is to include in gross income only interest paid by other States and their local governments. Fifteen of the non-conforming States have adopted this approach, though Oregon allows the exclusion only in the case of obligations issued after May 24, 1961. Kansas and Oklahoma permit the exclusion only of interest on their own turnpike authority bonds.

Gain on Sale of Residence

Gain from the sale of the taxpayer's principal residence is treated by 10 States as it is under the Internal Revenue Code. Oklahoma also allows the exclusion on the condition that the taxpayer's new residence is located within the State. Of the remaining non-conforming States, five (Alabama, Delaware, Louisiana, Mississippi, and Missouri) do not permit any such exclusion. The District of Columbia, Maryland, and Massachusetts make no special provision for this case, but such gains are not taxable under other sections of their revenue laws.

Only California, of the non-conforming States, follows the Federal law's broadening of the exclusion in the case of taxpayers 65 years of age and older. Such gains are not reportable, of course, in the three States--mentioned in the paragraph immediately above--that have broader provisions excluding non-business, non-profit gains from the sale of property.

Compensation of Armed Services Personnel

Only South Carolina, of the non-conforming States, follows the Federal law exactly in its treatment of military combat pay. Aside from the 6 States that provide for its exclusion only in the context of their broad exemption of military compensation from taxation, 10 States require that such pay be included in gross income, and 2 States--Alabama and Maryland--treat such compensation somewhat differently than does the Internal Revenue Code.

Mustering-out payments of military personnel are expressly excluded from gross income--the Internal Revenue Code policy--by six of the non-conforming States (Arizona, California, Kansas, Maryland, North Carolina, and South Carolina). Taxpayers in Arkansas and Oklahoma presumably may exclude their mustering-out pay under these States' general policies of (unlimited and limited, respectively) exclusion of military compensation. The remaining 11 States require mustering-out pay to be included in gross income.

The Internal Revenue Code treatment of the subsistence and rental allowances of armed services personnel is followed in 8 of the 19 State tax laws under discussion here (Arkansas, California, Louisiana, North Carolina, Oklahoma, Oregon, South Carolina, and Utah). Arizona and Kansas provide for exclusion of rental but not subsistence allowances, and the remaining States require inclusion of all allowances in gross income.

Miscellaneous Exclusions

The Internal Revenue Code's provision for exclusion of a limited amount of death benefits paid by an employer appears in the laws of six of the non-conforming States (Arizona, California, Louisiana, Mississippi, North Carolina, and Oklahoma). Arkansas and Oregon do not limit the amount of such benefits that may be excluded.

Provisions identical to the Federal exclusion of sick pay from gross income appear in the laws of California and Maryland. The Federal provision as it was prior to the 1964 amendments is followed by three States (Kansas, Louisiana, and Oklahoma). The District of Columbia provides for an exclusion in the cases of plans that have been approved by its Revenue Division. The other non-conforming States require the inclusion of sick pay in gross income.

Only five of the non-conforming States require taxpayers to report their employers' contributions to sickness and health plans as gross income (Alabama, Arkansas, Arizona, Massachusetts, and Utah). The other 14 follow the Internal Revenue Code in excluding such contributions.

The Federal provision that a clergyman may exclude from his gross income the rental value of a residence furnished for personal use by his church or synagogue (or a rental allowance) is followed by 11 of the non-conforming States, and Missouri also allows the exclusion if the house or apartment is owned by the clergyman's church. The other non-conforming States do not permit the exclusion.

The Federal treatment of scholarships and fellowships is followed by seven of the non-conforming States (California, District of Columbia, Louisiana, Maryland, North Carolina, Oklahoma, and Oregon). Massachusetts restricts the exclusion to degree candidates; Arizona and Delaware allow the exclusion only for government grants to ex-servicemen.

Meals and lodging furnished by an employer at his convenience to his employees at the place of employment are not reportable as gross income--the

IRC provision--in all but three of the 19 non-conforming States (Delaware, Mississippi, and South Carolina).

Unemployment compensation payments may be excluded from gross income, following Federal practice, in eight of the States (California, Kansas, Louisiana, Maryland, Massachusetts, Oregon, South Carolina, and Virginia) but they must be included in the other 11 non-conforming States.

The Federal provision for the exclusion of unsolicited prizes and awards has been adopted by five of the non-conforming States (California, Kansas, Louisiana, Missouri, and Oregon). Such receipts must be reported as gross income in the remaining four.

Periodic payments received for the support of minor children (but not alimony) are excluded from gross income, as provided in the Federal Code, by the laws of all the States except the District of Columbia and Mississippi.

Very few States appear to have followed the Federal example with respect to the remaining categories of exclusions from gross income. The Internal Revenue Code restriction on the excludability of accident and health insurance benefits has been adopted by only four of the non-conforming States (California, Kansas, Louisiana, and Oklahoma). Income from the discharge of business indebtedness is excluded from gross income--the IRC provision--by three of the 19 States (Arkansas, California, and Louisiana). Income realized by a lessor on termination of a lease from improvements made by the lessee is excludable in only three States (Arizona, California, and Oregon). The Federal provision for excluding income from recovery of previously deducted bad debts (where no tax benefit resulted from the original deduction) appears in the laws of six of the States (Arizona, California, Georgia, Louisiana, Oklahoma, and Oregon). Finally, only California, Louisiana, and Oklahoma have adopted the recent amendment to the IRC provision for exclusion of premiums paid by an employer for his employees' group life insurance, but five other States (Arkansas, Kansas, Mississippi, North Carolina, and Oregon) have on their books the Federal provision as it stood prior to the 1964 amendment.

EXCLUSIONS UNIQUE TO STATE LAWS

Only two of the 15 IRC States (Indiana and New Mexico) have succeeded in restricting their exclusions to interest on Federal obligations and to those enumerated in the Internal Revenue Code. In general, however, the remaining 13 conforming States have held the line against additional exclusions more firmly than the non-conforming States.

The major categories of additional exclusions are retirement and investment income. Of the 15 conforming States, 10 exclude one or more forms of retirement income, with the most frequently excluded type being public teachers' retirement system benefits. Ten of the IRC States (Alaska, Colorado, Hawaii, Idaho, Minnesota, Montana, New York, Vermont, West Virginia, and

Wisconsin) have elected to provide this form of subsidy to their teachers' retirement systems. The next most important retirement income exclusion is provided by seven of the conforming States (Colorado, Hawaii, Minnesota, Montana, New York, Vermont, and West Virginia) to their government employees. Eleven of the 19 non-conforming States permit complete or partial exclusion of teachers' retirement benefits, and 10 allow the same exclusion for State employees. Four of the IRC States (Colorado, Hawaii, Minnesota, and Montana) and 6 of the other 19, provide for full or partial exclusion of U. S. Civil Service Retirement System annuities. Eight States (Colorado, Delaware, Hawaii, Louisiana, Massachusetts, Montana, Oklahoma, and Wisconsin) exempt, in full or in part, other types of retirement income--4 of the 8 are among the IRC States. Hawaii is the most generous of all the States in exempting retirement income, but it is followed closely by Colorado and Massachusetts.

In general, fewer States exempt dividends and interest, and none of those that do has the sort of very broad exclusion that is found in the case of retirement income. Seven of the 15 IRC States (Colorado, Iowa, Kentucky, Minnesota, Montana, New York, and Vermont) exempt some type of investment income, but only Vermont and New York exclude more than one type, as these classes are defined in this analysis. Twelve of the 19 non-conforming States provide for the exclusion of some type of investment income; 7 of these States (Arkansas, Georgia, Kansas, Louisiana, Maryland, Massachusetts, and Virginia) exempt more than one class of dividends and interest.

Of the remaining types of exclusions that are not found in the Internal Revenue Code, only the exclusion of the pay of members of the U. S. Armed Forces is of reasonably widespread incidence in State tax laws. Twelve States exempt regular military pay in one way or another, but only 4 (Alabama, Hawaii, Minnesota, and Vermont) are among the IRC States.

Several (Alabama, Arkansas, Delaware, and Kansas) of the eight States that do not permit alimony to be deducted by the payer provide for its exclusion from the gross income of the recipient. Maryland, Vermont, and the District of Columbia do not include capital gains (variously defined) in gross income. Arkansas, Louisiana, and North Carolina exclude gains from certain involuntary conversions of property. Massachusetts and Louisiana permit many employees to exclude from their gross income their own contributions to retirement plans, and they also provide for exclusion of rental income from real estate. Each of the remaining types of exclusions is unique to the law of a single State, and few would appear to be of appreciable revenue significance.

DEDUCTIONS UNDER THE FEDERAL INTERNAL REVENUE CODE

Taxes

The 13 States that have adopted by reference the Federal definition of taxable income, with the exception of Hawaii and Wisconsin (and Vermont effectively) differ from the Federal treatment of taxes with respect only to income taxes. Seven of the conforming States do not permit deduction of their own income taxes, and the remaining three (Colorado, New York, and West Virginia) do not permit their taxpayers to deduct any State and local income taxes.

Similar provisions pertaining to the deductibility of State-local income taxes appear in the laws of the 19 non-conforming States. 1/ Eleven of these States prohibit deduction of State-local income taxes, five (Arkansas, Delaware, Louisiana, Minnesota, and Utah) permit deduction of other States' income taxes but not of their own; Arizona allows a deduction only for its own; and two (Missouri and Oklahoma) provide for deductibility only of taxes on income from personal services or of municipal income taxes on personal services.

With respect to other taxes the laws of the non-IRC States conform quite closely to the Federal provisions. Real and personal property taxes are fully deductible in 16 of the States; 3 forbid deduction if the taxes are paid to other States and their local governments. State and local general sales (and use) and motor fuel taxes are treated by 13 of the 19 States as they are in the Federal Code. Georgia allows deduction of general sales taxes but not motor fuel taxes, and Mississippi allows only out-of-state sales taxes. Maryland permits only its own sales and fuel taxes to be deducted. North Carolina prohibits deduction of these taxes unless they are related to the taxpayer's business and profession, and Louisiana follows this policy with respect to motor fuel taxes only. Oregon forbids deduction of sales taxes paid to other States and their localities, and it permits motor fuel taxes to be deducted only if they are related to the taxpayer's business and profession. Every one of the 19 States (not including Indiana and Massachusetts) allows the taxpayer to deduct any other State and local taxes that qualify as business expenses, and 6 States also provide for deduction of any Federal taxes that qualify as business expenses.

Losses

Three of the IRC States (Hawaii, Kentucky, and Vermont) have retained exceptions to the Federal treatment of losses. Only California among the non-conforming States has the same loss provisions as the Federal law. California is not included in the figures that appear in the following discussion. Sixteen 2/ of the non-conforming States follow Federal practice with respect to individuals' losses from trade, business, or profit-making transactions. Three of these States (Minnesota, Oklahoma, and South Carolina) require that the loss involve property located within the State to be

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1/ Not counting Indiana, which allows no deduction for taxes (or any other personal deductions), and Massachusetts, which permits taxes to be deducted only to the extent they are related to the taxpayer's business or profession.

2/ Including Indiana, which must be mentioned in this context because this provision is a deduction allowed in arriving at adjusted gross income in the Federal law.

deductible. Delaware does not permit deduction of losses arising out of transactions entered into for profit unless the transactions were related to the taxpayer's trade or business.

Two of the 13 IRC States permit casualty losses to be deducted in full. 1/ This pre-1964 Federal provision appears in the laws of 16 of the non-conforming States. Three (Alabama, Maryland, and Missouri) of the non-conforming States provide that only intrastate casualty losses are deductible, and these three States happen also to be among those allowing full deductibility. Only Massachusetts does not permit deduction of such losses under any circumstances.

Gambling losses may be deducted to the extent of gambling gains (the Federal provision) in 11 of the non-conforming States. This deduction is not available to taxpayers in eight of the non-conforming States, and Maryland permits only legal transactions to qualify.

Individuals' capital losses are not deductible by Vermont taxpayers, a provision that is the counterpart of the exemption accorded capital gains. The same situation prevails in the two non-conforming States that do not tax capital gains (Maryland and the District of Columbia). Five of the non-conforming States (California, Georgia, Indiana, Minnesota, and Oregon) 2/ follow the Federal lead with respect to this deduction; seven have no special provisions for capital losses, thus permitting such losses to be deducted in full. The remaining States' provisions differ from the Federal Code in certain substantial respects.

Expenses of Individuals

The treatment by every State of the trade and business expenses of individuals is effectively the same as the Federal law. 3/ Differences in administrative and judicial interpretation surely exist, but they cannot be considered here.

1/ Kentucky, since its law refers to the IRC as it was before the 1964 amendments, which added a provision barring deduction of the first $100 of each casualty or theft, and Hawaii, which retained this provision, although it amended its law in 1965 to conform to the 1964 amendments in many respects.

2/ Including Indiana, since this is a deduction that is allowed by the Federal Code in arriving at adjusted gross income.

3/ In the Internal Revenue Code these expenses are classified as deductions from gross income rather than from adjusted gross income. The distinction has no particular significance for this discussion, and we ignore it except insofar as the unique case of Indiana is concerned.

In the case of individuals' expenses for the production or collection of income, for the management of income property, and in connection with taxes, all the States but Indiana are very close to the Federal provisions. Since these expenses are classified as deductions from adjusted gross income rather than from gross income by the Federal Code, Indiana parts company with the rest of the States. The only other significant exceptions are Maryland's refusal to permit deduction of expenses incurred in the payment of taxes; the policies of Massachusetts and South Carolina confining tax expenses to those related to the taxpayer's business, trade, and profession; and the Massachusetts provision that bars deduction of expenses involved in the management of personal investments.

Interest on Personal Indebtedness

Taxpayers in every income tax State may deduct, in full or in part, interest paid by them on personal indebtedness. Apart from the cases of Indiana and Massachusetts, which only allow deduction of interest incurred in transactions related to the trade-business-profit interests of the taxpayer, 1/ the differences between the State laws and the Federal Code are confined to the treatment of interest paid on installment purchases of personal property. Seventeen States, including the IRC States, explicitly follow the Federal rule, which permits the taxpayer to assume a six percent rate on the average unpaid balance whenever the exact interest rate cannot be ascertained. In the absence of contrary indications, we assume that 10 other States also permit their taxpayers to use this procedure to estimate interest payments. The remaining States (Alabama, Kansas, Maryland, Missouri, and Utah) take the position that interest is not interest unless it is separately stated in the contract and definitely ascertainable; the deduction may not be claimed unless these two conditions are met. Interest attributable to property located outside the State may not be deducted by Oklahoma taxpayers.

Charitable Contributions

Charitable contributions may be deducted from adjusted gross income by taxpayers in every State except Indiana and Massachusetts. The provisions of only two of the conforming States (Hawaii and Kentucky) differ from the Federal Code, and these exceptions are insignificant to all but a very small minority of taxpayers. The Federal law provides that, with certain exceptions, the deduction may not exceed 30 percent of the taxpayer's adjusted gross income. Mississippi limits the deduction to 10 percent of net income, and ten other non-conforming States do not permit the deduction to exceed 15 percent of income (variously defined). Among the States limiting the deduction to 15 percent is the District of Columbia, which also provides, as does Oregon, that only organizations "the activities of which are carried on to a

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1/ Massachusetts does allow limited deductibility (from interest and dividends income) of interest paid on certain kinds of personal unsecured indebtedness.

substantial extent" within the State qualify as objects of deductible contributions. The exceptions to the Federal Code that appear in the laws of the remaining States are relatively insignificant.

Child-Care Expenses of Working Parents

Thirteen States provide the same deduction as the Federal Code for expenses incurred by working parents for necessary care of their children. Of these, California is again the only non-conforming State. The remaining IRC State (Kentucky) differs because it has not yet adopted the 1964 amendments to the Federal Code, a situation shared by two of the non-conforming States (Maryland and Oklahoma). Fourteen of the non-conforming States (including Indiana) do not permit the deduction of any child care expenses. Arizona and Georgia allow a somewhat more liberal deduction than the Internal Revenue Code; Oregon's provision is somewhat tighter.

Alimony

Alimony and separate maintenance payments (by court order or by written agreement), following the Federal Code are deductible by the payer in the 13 IRC States and in six (Arizona, California, Minnesota, Missouri, North Carolina, and Oregon) of the non-conforming States. Seven of the non-conforming States do not permit the deduction of payments made pursuant to a written separation agreement. The remaining eight States do not allow the deduction.

Moving Expenses

A new provision in the Federal law permits individuals to deduct non-reimbursed moving expenses incurred by new or continuing employees in connection with certain changes in job locations. Because this provision is classified as a deduction in arriving at Federal adjusted gross income, it has been adopted by Indiana; since the provision was new in 1964, it does not appear in the Kentucky law. Among the non-conforming States only Utah and California have adopted the provision, but California restricts its applicability to cases in which both the new and the old residences are located within the State.

Medical Expenses

The range of provisions governing the deductibility of medical expenses is a dramatic illustration of the diversity that remains in State individual income tax laws after several decades of trend toward uniformity. The nature of these provisions permits us to summarize the chief areas of diversity in two tables, which take into consideration only the 20 States whose provisions differ significantly from the Internal Revenue Code. The IRC State that has not yet incorporated the 1964 amendments to this section of the Federal

Code (Kentucky) is joined by another IRC State 1/ and by all of the non-conforming States in differing from the Federal law. 2/

Table 33 shows that slightly greater diversity exists in the case of the general provisions governing the "deductible" portion of medical expenses than exists in the case of provisions pertaining only to elderly taxpayers. Five or six of the 20 States in question, depending on the case, do not limit the amounts that may be deducted, and the remaining States have upper limits that range from $750 to $40,000, depending upon the taxpayer's status (table 34).

Miscellaneous Deductions

The Federal Code allows the taxpayer to deduct any debt that becomes worthless during the tax year, but non-business bad debts must be treated as short-term capital losses. The same deduction for bad debts is provided for in the laws of 18 States. Eight of the non-conforming States do not allow a deduction for worthless non-business debts; the remaining non-conforming States permit the taxpayer to treat all bad debts as if they were attributable to business or profit-making transactions.

In nearly all other respects the State laws are quite similar to the Federal Code. The non-conforming States' provisions tend to be less restrictive than the Federal as far as entertainment, business gifts, and foreign travel expenses are concerned. Some differences of treatment and definition appear with regard to some highly technical issues such as depreciation, depletion, and pension and annuity plans, but the lengthy discussion that an examination of these questions would require cannot be entered into in this report.

DEDUCTIONS UNIQUE TO STATE LAWS

Taxes account for nearly all the deductions allowed by States that are not also available to the taxpayer on his Federal return. Nineteen States (seven of them IRC States--Colorado, Idaho, Iowa, Kentucky, Montana, New Mexico, and North Dakota) provide for the deductibility of Federal personal income taxes. Although the definition of the exact amount deductible in a particular year varies from State to State, only Massachusetts restricts the deduction to the Federal income tax liability attributable to income from the taxpayer's profession, employment, trade, or business. The deduction may not exceed $500 on South Carolina returns and $300 ($600 on a joint return) on

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1/ North Dakota, which permits deduction in full of all medical expenses not compensated by insurance or otherwise.

2/ The tables also exclude Indiana, Louisiana, and Mississippi, none of which permits any deduction for medical expenses.

TABLE 33.--STATUTORY DIVERSITY AMONG TWENTY SELECTED STATES WITH RESPECT TO THE AMOUNTS THAT MEDICAL EXPENSES MUST EXCEED TO BE DEDUCTIBLE 1/

(Number of States using each provision)

Status of taxpayer	Minimum is expressed--				
	In dollars			As percentage of adjusted gross income	
	0	50	100 2/	3	5
In general	3 3/	1	1	7 4/	8 5/
Taxpayer and/or spouse is 65 years or older	10	1	1	1	7

Note: The Federal provisions are indicated by the underscored figures.

1/ States providing for a medical deduction that differs in some respect from the Federal provision.

2/ Single taxpayer only: $200 in the case of a joint return.

3/ For all taxpayers; payments for dependent parents 65 years and older are not subject to a minimum exclusion in three additional States.

4/ The provision of one of these States refers to "gross income."

5/ The provisions of two of these States refer to "gross income."

TABLE 34.--STATUTORY DIVERSITY AMONG TWENTY SELECTED STATES WITH RESPECT TO THE MAXIMUM AMOUNT OF DEDUCTION FOR MEDICAL EXPENSES 1/

(Number of States using each provision)

Status of taxpayer	$750	$1,250	$1,500	$2,500	$5,000	$10,000	$15,000	$16,250	$17,500	$20,000	$25,000	$30,000	$40,000	No limit
SINGLE TAXPAYER (or separate return)														
(1) No dependents	2	5	-	5	<u>3</u>	-	-	-	-	-	-	-	-	5
(2) Maximum including dependents	2	4	-	2	5	<u>2</u>	-	-	-	-	-	-	-	5
(3) 65 years and older	-	5	2	4	<u>3</u>	-	-	-	-	-	-	-	-	6
(4) 65 years and disabled	-	1	2	3	1	-	5	-	-	<u>2</u>	-	-	-	6
JOINT RETURN														
(1) In general	-	-	2	4	3	4	-	-	-	<u>2</u>	-	-	-	5
(2) Taxpayer and/or spouse is 65+ 2/	-	-	2	5	5	<u>2</u>	-	-	-	-	-	-	-	6
(3) Spouse is 65+ and disabled 2/	-	-	2	3	2	-	-	2	3	-	<u>2</u>	-	-	6
(4) Taxpayer <u>and</u> spouse 65+ and disabled 2/	-	-	2	3	2	-	-	-	-	-	-	5	<u>2</u>	6

Note: The Federal provisions are indicated by the underscored figures.

1/ States providing for a medical deduction that differs in some respect from the Federal provision.

2/ Taxpayer and spouse have no dependents.

returns filed in Delaware. Table 35 summarizes the frequency with which certain other taxes are deductible by State income taxpayers.

Five States (California, Hawaii, Minnesota, Missouri, and Utah) permit deduction of limited amounts of political contributions.

The remaining additional deductions are unique to the laws of one or two States. Among the most important and interesting of these are the following: New York provides for deduction of the first $150 of premiums paid for an endowment or life insurance policy on the taxpayer (an additional $150 may be deducted on a joint return for premiums on a policy on the taxpayer's spouse). Minnesota allows its taxpayers to deduct their personal political campaign expenditures to the extent that they are not paid by others. 1/ Limited amounts of the costs incurred in constructing fallout shelters are deductible by taxpayers in Alabama and Oklahoma. Finally, Arizona and California allow their taxpayers to deduct expenses they incur in the process of adopting children.

1/ The deduction is limited to $5,000 for a candidate for Governor or U. S. Senator, $3,500 for other State offices and for U. S. Representative, $500 for State Senator and Representative and for Presidential-Elector-at-Large.

TABLE 35.--FREQUENCY WITH WHICH TAXES THAT ARE NOT DEDUCTIBLE ON FEDERAL RETURNS ARE DEDUCTIBLE ON STATE PERSONAL INCOME TAX RETURNS

Tax	Number of States permitting deduction	
	IRC	Non-IRC
Social Security and Railroad Retirement Act taxes	--	5
Certain State and local tobacco taxes 1/	--	9
Certain State and local alcoholic beverage taxes 1/	--	10
State and local admissions taxes	--	14
State and local occupancy taxes	--	11
Poll taxes	--	14
Automobile drivers' license fees	--	13
Automobile registration fees	--	15
Federal transportation and telephone-telegraph tolls taxes	--	15
Import duties paid directly by the taxpayer	--	11
Miscellaneous other Federal excise and stamp taxes paid directly by the taxpayer	--	11
Federal estate taxes	--	2
Federal gift taxes	--	4

1/ Reference is (approximately) to the Federal rule (repealed in 1964) that declared such taxes eligible for deduction "if the amount of the tax is separately stated...to the extent that the amount so stated is paid by the consumer...to the seller." [Sec. 164 (c)(1), IRC of 1954].

TABLE 36. --STATE PERSONAL INCOME TAXES: EXCLUSIONS FROM GROSS INCOME THAT ARE ALSO EXCLUDABLE UNDER THE FEDERAL INTERNAL REVENUE CODE OF 1954, AS AMENDED TO JANUARY 1, 1965

PART A - States That Have Adopted The Federal Definition Of Adjusted Gross Income By Reference To The IRC

Item	Alaska	Colo.	Hawaii	Idaho	Ind.	Iowa	Ky.	Minn.	Mont.	N.Mex.	N.Y.	N. Dak.	Vt.	W. Va.	Wis.
Life insurance payments made by reason of death..................	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Death benefits paid by employer (up to $5,000).	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Gifts, bequests, inheritances, etc.......	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Exclusion ratio: endowment and life insurance contracts..............	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
--annuity contracts.......	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Compensation or damages received for injury or sickness...............	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Sick pay..................	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Accident and health insurance benefits (restriction)...........	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Employer contributions to sickness and health plans..................	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Clergyman: rental value of house or rental allowance..............	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Income from discharge of business indebtedness...	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Income from lessee's improvements: lessor.....	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Recovery of previously-deducted bad debts, etc., where no tax benefit resulted...............	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Combat pay of Armed Services personnel......	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Mustering-out payments....	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Dividends from certain domestic corporations (max. of $100/year/taxpayer).................	X	X	...	X	X	X	...	X	X	X	X	X	X	X	X

See footnotes at end of table.

TABLE 36. --STATE PERSONAL INCOME TAXES: EXCLUSIONS FROM GROSS INCOME THAT ARE ALSO EXCLUDABLE UNDER THE FEDERAL INTERNAL REVENUE CODE OF 1954, AS AMENDED TO JANUARY 1, 1965 (Cont'd)

PART A - States That Have Adopted The Federal Definition Of Adjusted Gross Income By Reference To The IRC (Concl'd)

Item	Alaska	Colo.	Hawaii	Idaho	Ind.	Iowa	Ky.	Minn.	Mont.	N.Mex.	N. Y.	N. Dak.	Vt.	W. Va.	Wis.
Scholarships and fellowships....................	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Meals & lodging furnished employee at convenience of employer.............	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Social Security Act benefits................	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Unemployment Compensation..	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Railroad Retirement Act annuities and pensions...	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Veterans' pensions (not retirement pay).........	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Cost-of-living allowances: Foreign Service Officers & Federal civilian employees abroad.........	...	X	...	X	X	X	X	X	X	X	X	X	X	X	X
Subsistence and rental allowances: Armed Services personnel.......	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Moving expenses of existing employees (reimbursement payments).	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Gain on sale of residence of taxpayer 65+	X	X	X	X	X	X	...	X	X	X	X	X	X	X	X
Gain on sale of residence when new residence is purchased within year....	X	X	X	X	X	X	X	X	X	X	X	X	X	X	1/
Premium paid by employer for employee's group term life insurance......	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Income earned abroad.......	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Prizes and awards..........	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Interest on State and local securities.........	X	2/3/	...	4/	X	...	5/	2/	...	X	6/	2/	X	6/	X
Periodic payments received for the support of minor children................	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X

See footnotes at end of table.

TABLE 36. --STATE PERSONAL INCOME TAXES: EXCLUSIONS FROM GROSS INCOME THAT ARE ALSO EXCLUDABLE UNDER THE FEDERAL INTERNAL REVENUE CODE OF 1954, AS AMENDED TO JANUARY 1, 1965 (Cont'd)

PART B - "Non-Conforming" States

Item	Ala.	Ariz.	Ark.	Calif.	Del.	D. C.	Ga.	Kans.	La.	Md.	Mass.	Miss.	Mo.	N.C.	Okla.	Oreg.	S. C.	Utah	Va.
Life Insurance payments made by reason of death......	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Death benefits paid by employer (up to $5,000).............	...	X	7/	X	...	...	...	...	X	...	...	X	...	X	X	7/ 8/	...	...	...
Gifts, bequests, inheritance, etc.......	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Exclusion ratio: endowment and life insurance contracts..	9/	9/	9/	9/	9/	9/	9/	X	X	9/	10/	9/	9/	9/	X	9/	9/	9/	9/
--annuity contracts....	9/	9/	9/	11/	9/	11/	11/	X	X	11/	10/	9/	11/	11/	X	9/	9/	9/	9/
Compensation or damages received for injury or sickness...	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	12/	X	X	X
Sick pay...............	...	...	...	X	...	13/	...	14/	14/	X	...	...	...	...	14/	...	...	...	...
Accident and health insurance benefits (restriction)........	...	...	...	X	...	...	...	X	X	...	...	...	...	...	X	...	...	...	...
Employer contributions to sickness and health plans.........	...	...	...	X	X	X	X	X	X	X	...	X	X	X	X	X	X	...	X
Clergyman: rental value of house or rental allowance............	...	X	...	X	...	X	...	X	X	X	...	...	15/	X	X	X	X	...	X
Income from discharge of business indebtedness...........	...	...	X	X	...	...	...	...	X	...	...	...	...	...	...	...	...	...	...
Income from lessee's improvements: lessor.	...	X	...	X	...	...	...	...	...	...	...	...	...	...	...	X	...	...	...
Recovery of previously-deducted bad debts, etc., where no tax benefit resulted.....	...	X	...	X	...	...	X	...	X	...	...	...	...	...	X	X	...	...	...
Combat pay of Armed Services personnel...	16/	17/	17/	17/	...	...	...	17/	...	18/	...	...	...	...	17/	17/	X	...	...
Mustering-out payments............	...	X	17/	X	...	...	...	X	...	X	...	...	...	X	17/	...	X	...	...
Dividends from certain domestic corporations (max. of $100/year/ taxpayer)...........	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...

See footnotes at end of table.

TABLE 36. --STATE PERSONAL INCOME TAXES: EXCLUSIONS FROM GROSS INCOME THAT ARE ALSO EXCLUDABLE UNDER THE FEDERAL INTERNAL REVENUE CODE OF 1954, AS AMENDED TO JANUARY 1, 1965 (Cont'd)

PART B - "Non-Conforming" States (Cont'd)

Item	Ala.	Ariz.	Ark.	Calif.	Del.	D. C.	Ga.	Kans.	La.	Md.	Mass.	Miss.	Mo.	N.C.	Okla.	Oreg.	S.C.	Utah	Va.
Scholarships and fellowships.........	...	19/	...	X	20/	X	...	...	+	+	21/	...	...	X	X	+	...	...	...
Meals & lodging furnished employee at convenience of employer............	X	X	X	X	...	X	X	X	X	X	X	X	...	X	X	X	...	X	X
Social Security Act benefits........	X	X	X	X	X	X	X	X	X	X	X	...	X	X	X	X	X	X	X
Unemployment Compensation........	...	...	...	X	...	...	...	X	X	X	X	...	...	...	...	X	X	...	X
Railroad Retirement Act annuities and pensions...........	X	...	...	X	X	X	...	X	X	X	X	X	X	X	X	X	X	X	X
Veterans' pensions (not retirement pay)................	X	X	X	X	X	X	X	X	X	X	...	X	X	X	17/	22/	X	X	X
Cost-of-living allowances: Foreign Service Officers & Federal civilian employees abroad....	...	...	...	...	...	...	...	...	23/	...	...	...	...	...	...	...	...	...	...
Subsistence and rental allowances: Armed Services personnel...........	...	24/	X	X	...	...	...	24/	X	...	...	...	...	X	X	X	X	X	...
Moving expenses of existing employees (reimbursement payments)...........	...	...	...	X	...	...	...	...	X	...	...	...	...	X	...	X	...	...	...
Gain on sale of residence of taxpayer 65+	...	...	...	X	...	25/	...	...	...	26/	27/	...	...	...	...	...	...	...	...
Gain on sale of residence when new residence is purchased within year..........	...	X	X	X	...	25/	X	X	...	26/	27/	...	...	X	1/	X	X	X	X
Premium paid by employer for employee's group term life insurance............	...	...	28/	X	...	...	...	28/	X	...	...	28/	...	28/	X	29/	...	...	...
Income earned abroad	...	...	...	...	...	...	...	...	...	...	...	...	...	...	X	...	...	...	...
Prizes and awards......	...	...	...	X	...	...	...	X	X	...	...	...	X	...	...	+	...	...	...
Interest on State and local securities.....	2/	2/	2/	2/	2/	X	2/	30/	2/	2/	2/	2/	2/	2/	30/	31/	2/	...	2/

See footnotes at end of table.

TABLE 36. --STATE PERSONAL INCOME TAXES, EXCLUSIONS FROM GROSS INCOME THAT ARE ALSO EXCLUDABLE UNDER THE FEDERAL INTERNAL REVENUE CODE OF 1954, AS AMENDED TO JANUARY 1, 1965 (Cont'd)

PART B - "Non-Conforming" States (Concl'd)

Item	Ala.	Ariz.	Ark.	Calif.	Del.	D. C.	Ga.	Kans.	La.	Md.	Mass.	Miss.	Mo.	N. C.	Okla.	Oreg.	S. C.	Utah	Va.
Periodic payments received for the support of minor children.......	X	X	X	X	X	...	X	X	X	X	X	X	X	X	X	X	X	X	X

X --signifies State exclusion is effectively the same as the Federal.
+ --signifies only a minor difference between State and Federal exclusions.
... --signifies there is no such State exclusion.

1/ New residence must be located in this State.
2/ Not excluded is interest on obligations of States (and their political subdivisions) other than this State and its political subdivisions.
3/ Interest on obligations of Colorado (and its political subdivisions) excluded only if specifically exempted by particular authorizing statutes.
4/ Not excluded is interest on all State and local obligations other than those issued to finance public works by this State's municipalities.
5/ Not excluded is interest on all State and local obligations other than those issued by County and Regional Housing Commissions in this State if they are the liability exclusively of such commissions.
6/ Not excluded is interest on obligations of States (and their political subdivisions) other than this State and its political subdivisions, where the obligation is "created by compact or agreement to which this State is a party."
7/ No maximum limit on the amount of death benefits excludable.
8/ Not excludable are death benefits paid for any reason other than "accidental injury arising out of and in the course of employment."
9/ Excludable only until the total amount received equals the aggregate premiums or other consideration paid for the contract.
10/ A special tax rate of 1.5 percent applies to all annuity income in excess of the following exemptions: the smaller of--
(1) $1,000, or $1,500 if taxpayer (or either party to a joint return) is 65+ before close of calendar year preceding;
(2) Unused portion of the exemption allowed for income from professions, etc.
Providing that income from all sources--taxable or not--
(a) of single person is less than $5,000;
(b) of husband and wife is less than $7,500.
11/ Excludable only to the extent that the amount received during the taxable year exceeds 3 percent of the aggregate premiums or consideration paid for the contract, and then only until the total amount excluded equals the aggregate premiums or other consideration.
12/ Except sickness disability benefits and disability pensions (other than for accidental injury incident to employment) which are not received through accident or health insurance, and which are not collectible as damages or in lieu of damages.
13/ Each plan must be approved by the Revenue Division. No available indication of the criteria applied in evaluating plans.
14/ Federal law prior to 1964 amendments:
(1) If absence is due to personal injury, the employee need not be hospitalized to qualify for exclusion during his first 7 days absence.
(2) No requirements that sick pay be less than 75 percent of regular pay, or that it not exceed $75 per week.
(3) Sick pay up to $100 per week is excludable after 7 days absence from work.
15/ Not excludable is rental allowance used to rent a house/apartment not owned by the clergyman's church.
16/ Full amount of combat pay is excludable by all full-time armed services personnel during and within six months following period of war or hostilities.

(Footnotes continued on next page).

TABLE 36. --STATE PERSONAL INCOME TAXES, EXCLUSIONS FROM GROSS INCOME THAT ARE ALSO EXCLUDABLE UNDER THE FEDERAL INTERNAL REVENUE CODE OF 1954, AS AMENDED TO JANUARY 1, 1965 (Concl'd)

17/ No special provision, but see table 37 for a general exclusion of the pay of armed services personnel.

18/ Only payments up to $1,500 per year are excludable, and hospitalized personnel appear to forfeit the exclusion if they leave the combat zone.

19/ Not excludable are scholarships and fellowships other than those granted by Federal or State legislation with respect to service in the armed forces of the U. S.

20/ Not excludable are scholarships and fellowships other than those received under the G.I. Bill of Rights by members of the armed forces during World War II.

21/ Exclusion appear to be available only if recipient is a degree candidate.

22/ Pensions may not be excluded in excess of $3,000 per year and then only pensions arising out of physical disability incurred in the performance of active service in the armed forces, except in cases where pensions are exempted in full from State taxes by Federal law.

23/ Treated as reimbursement received for travel away from home.

24/ Subsistence allowances are not excludable, only rental allowances.

25/ No special provision, but gains from sale of property held for more than two years and not related to taxpayer's trade or business are excluded from taxable income.

26/ No special provision, but gains from sale of property not related to taxpayer's trade or business are excluded from taxable income.

27/ No special provision, but gains from transactions not "incident to the taxpayer's trade or business nor entered into for profit" are excluded from taxable income.

28/ (1) Exclusion does not appear to be available to retired employees.
(2) No limit on the amount of coverage the premiums for which are excludable.

29/ (1) No instance has been discovered of the imposition of a tax on such income of a retired employee.
(2) No limit on the amount of coverage the premiums for which are excludable.

30/ Not excluded is interest on all State and local obligations other than those of this State's Turnpike Authority.

31/ Not excluded is interest on obligations of States (and political subdivisions of States) other than this State (issued after May 24, 1961).

TABLE 37. --EXCLUSIONS FROM GROSS INCOME THAT ARE UNIQUE TO STATE PERSONAL INCOME TAXES
PART A - States That Have Adopted The Federal Definition Of
Adjusted Gross Income By Reference To The IRC

Item	Alaska	Colo.	Hawaii	Idaho	Ind.	Iowa	Ky.	Minn.	Mont.	N. Mex.	N. Y.	N. Dak.	Vt.	W. Va.	Wis.
Interest on Federal Government obligations....	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Payments from State teachers' retirement system of this State......	X	X	X	X	...	...	...	X	X	...	X	...	X	X	X
Payments from State employees' retirement system of this State......	...	X	X	...	...	...	...	X	X	...	X	...	X	X	...
U.S. Civil Service Retirement System payments..................	...	X	X	...	...	...	...	X	1/	...	...	...	...	...	...
Retirement benefits from political subdivisions of this State............	...	2/	X	...	...	...	...	X	...	...	X	...	...	...	...
Retirement benefits from "any other public...system"......................	...	...	X	...	...	...	...	...	...	...	...	...	...	...	...
Miscellaneous other types of retirement benefits....	...	3/	4/	...	...	...	...	...	5/	...	...	...	...	...	6/
Pay of members of the Armed Forces of the U.S...	X	...	X	...	...	...	...	7/ 8/ 9/10/	...	...	...	...	X	...	...
Dividends from corp's that have paid income taxes to this State................	...	...	...	...	...	...	...	...	...	...	...	11/	...	...	...
Dividends from stock of national banks............	...	...	...	...	...	...	X	...	12/	...	...	...	...	...	...
Dividends from stock of banks and trust companies incorporated in this State.	...	...	...	...	...	...	X	...	...	...	...	...	...	...	...
Interest on obligations of industrial development corporations in this State.	...	...	...	...	...	...	...	...	...	...	...	...	X	...	...
Interest & dividends rec'd by non-residents of this State (non-business).......	...	X	...	...	...	...	...	X	X	...	X	...	X	...	...
Miscellaneous other types of interest and dividends.....	...	...	...	...	...	13/	...	...	...	...	14/	...	...	...	...
Employee contrib's to this State's pub. school teachers' retirement system.......................	...	...	...	...	...	...	...	...	...	...	...	...	X	...	...

See footnotes at end of table.

TABLE 37. --EXCLUSIONS FROM GROSS INCOME THAT ARE UNIQUE TO STATE PERSONAL INCOME TAXES (Cont'd)
PART A - States That Have Adopted The Federal Definition Of
Adjusted Gross Income By Reference To The IRC (Concl'd)

Item	Alaska	Colo.	Hawaii	Idaho	Ind.	Iowa	Ky.	Minn.	Mont.	N. Mex.	N. Y.	N. Dak.	Vt.	W. Va.	Wis.
Employee contrib's to this State's public employee retirement system.........	...	...	...	...	...	...	...	...	...	...	...	...	X	...	...
Employee contrib's to the U.S. Civil Service Retirement System.........	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Employee contrib's to the retirement systems of this State's political subdivisions.................	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Employee contrib's to private retirement plan associations.........	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Alimony and separate maintenance payments received...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Gains from the (non-trade/business) sale of capital assets....................	...	...	...	...	...	...	...	...	...	...	...	...	X	...	...
Rental income from leasing and subleasing real estate.	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Rental income and gains from dealings in real estate located outside this State.	...	...	...	...	...	...	...	...	...	...	...	...	...	...	X
Income rec'd by legal rep. of decedent administering est. subj. to this State's taxes.	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Income from carrying goods/passengers on high seas in interstate/foreign commerce.	...	...	...	...	...	...	...	X	...	...	...	...	...	...	...
Pay of patient with Hansen's disease employed in place where the disease is treated	...	...	X	...	...	...	...	...	...	...	...	...	...	...	...
Gain from certain involuntary conversions of property.....	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Non-government unemployment compensation................	...	...	15/	...	...	...	...	...	...	...	...	...	...	...	...
All income derived from sources located outside this State except income from intangibles................	X	...	...	...	...	...	...	...	...	...	...	...	...	...	...

See footnotes at end of table.

TABLE 37. --EXCLUSIONS FROM GROSS INCOME THAT ARE UNIQUE TO STATE PERSONAL INCOME TAXES (Cont'd)
PART B - "Non-Conforming" States

Item	Ala.	Ariz.	Ark.	Calif.	Del.	D. C.	Ga.	Kans.	La.	Md.	Mass.	Miss.	Mo.	N. C.	Okla.	Ore.	S. C.	Utah	Va.
Interest on Federal Government obligations...	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Payments from State teachers' retirement system of this State.....	X	...	...	...	16/	...	X	X	X	...	X	...	...	X	X	X	X	X	...
Payments from State employees' retirement system of this State.....	X	...	...	...	16/	...	X	X	X	...	X	...	...	X	...	X	X	X	...
U.S. Civil Service Retirement System payments.................	...	17/	...	...	16/	...	...	X	...	...	X	...	...	...	...	18/	...	X	...
Retirement benefits from political subdivisions of this State...........	...	...	...	...	16/	...	...	...	19/	...	X	...	...	X	...	X	...	...	X
Retirement benefits from "any other public...system".....................	...	...	...	...	...	...	...	...	19/	...	...	...	...	...	...	...	...	...	...
Miscellaneous other types of retirement benefits...	...	...	...	...	4/16/	...	...	...	19/	...	20/21/	...	...	...	22/23/	...	...	...	...
Pay of members of the Armed Forces of the U.S..	...	24/	25/	24/	...	...	...	8/23/ 25/	X	...	...	...	...	...	23/	10/25/	26/	...	...
Dividends from corp's that have paid income taxes to this State...........	27/	...	...	...	...	...	...	11/28/	...	X	...	...	...	...	...	...	...	...	11/
Dividends from stock of national banks...........	X	...	X	...	...	...	X	X	X	X	...	29/	...	...	...	...	...	...	...
Dividends from stock of banks and trust companies incorporated in this State....................	...	...	X	...	...	...	X	X	X	...	...	...	...	...	...	...	...	...	...
Interest on obligations of industrial development corp's of this State.....	...	...	X	...	...	...	...	...	X	...	...	...	...	X	...	...	...	...	...
Interest and dividends rec'd by non-residents of this State (non-business).....	...	...	...	...	...	...	...	...	X	X	X	...	...	...	...	...	X	X	...
Miscellaneous other types of interest and dividends	...	...	...	...	...	...	...	...	...	30/	31/	...	...	...	...	...	...	...	32/
Employee contrib's to this State's pub. school teachers' retirement system..................	...	...	...	...	...	...	...	...	X	...	X	...	...	...	...	...	...	...	...

See footnotes at end of table.

TABLE 37. --EXCLUSIONS FROM GROSS INCOME THAT ARE UNIQUE TO STATE PERSONAL INCOME TAXES (Cont'd)
PART B - "Non-Conforming" States (Concl'd)

Item	Ala.	Ariz.	Ark.	Calif.	Del.	D.C.	Ga.	Kans.	La.	Md.	Mass.	Miss.	Mo.	N.C.	Okla.	Oreg.	S.C.	Utah	Va.
Employee contrib's to this State's public employee retirement system........	...	X	...	...	...	...	...	...	X	...	X	...	...	...	...	...	...	...	...
Employee contrib's to the U.S. Civil Service Retirement System........	...	...	...	...	...	...	...	...	X	...	X	...	...	...	...	...	...	...	...
Employee contrib's to the retirement systems of this State's political subdivisions............	...	...	...	...	...	...	...	...	X	...	X	...	...	...	...	...	...	...	...
Employee contrib's to private retirement plan associations........	...	...	...	...	...	...	...	...	X	...	...	...	...	...	...	...	...	...	...
Alimony and separate maintenance payments received..	X	...	X	...	33/	...	...	X	...	...	...	...	...	...	...	...	...	...	...
Gains from the (non-trade/business) sale of capital assets....................	...	...	...	...	...	X	...	...	33/	X	...	...	...	...	...	...	...	...	...
Rental income from leasing and subleasing real estate	...	...	...	...	...	...	...	...	X	...	X	...	...	...	...	...	...	...	...
Rental income and gains from dealings in real estate located outside this State	...	...	...	...	...	...	...	...	...	...	X	...	...	...	...	...	X	...	...
Income rec'd by legal rep. of decedent administering est. subj. to this State's taxes	...	...	...	...	...	...	...	...	...	X	...	...	...	...	...	...	...	...	...
Income from carrying goods/passengers on high seas in interstate/foreign commerce	...	...	...	...	...	...	...	...	X	...	...	...	...	...	...	...	...	...	...
Pay of patient with Hansen's disease employed in place where the disease is treated....................	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Gains from certain involuntary conversions of property..................	...	...	X	...	...	...	...	...	X	...	...	...	...	X	...	...	...	...	...
Non-government unemployment compensation..............	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	34/	...	...	...
All income derived from sources located outside this State except income from intangibles.........	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...

See footnotes at end of table.

TABLE 37. --EXCLUSIONS FROM GROSS INCOME THAT ARE UNIQUE TO STATE PERSONAL INCOME TAXES (Concl'd)

X --signifies there is such an exclusion.
... --signifies there is no such exclusion.
1/ The exclusion may not exceed $3,600 per year.
2/ For policemen and firemen only.
3/ Pensions received from union welfare funds or by agreement between union and employer, and payments from emeritus retirement plans of Colorado institutions of higher education.
4/ Pensions received from employers.
5/ Benefits paid under the Montana Highway Patrol Retirement Act.
6/ Milwaukee city and county employee retirement system pensions.
7/ Pay received in the armed forces of the United Nations may also be excluded.
8/ No limit on amount excludable if the serviceman dies while on active duty.
9/ If serviceman dies while on active duty; (a) all unpaid taxes, penalties, additions, etc. are cancelled, and (b) all taxes paid for years after 12/31/49 during which decedent was in active service may be received as refund on application filed within 7 years of return for which claim is made.
10/ The exclusion may not exceed $3,000 per year.
11/ The exclusion is reduced proportionately when a corporation pays this State's income tax only on a portion of its income.
12/ The exclusion does not apply when bank does not have situs in this State.
13/ Interest on postal savings accounts.
14/ "/ Non-public _/ obligations . . . to the extent exempt from income tax under the laws of this State." For example, under the New York Private Housing Finance Law.
15/ The amount of the exclusion may not exceed the amount provided by the unemployment security laws.
16/ The exclusion may not exceed $2,000 per year.
17/ The exclusion may not exceed $2,500 per year.
18/ The exclusion may not exceed $2,400 per year.
19/ Excludable where specific retirement act so provides.
20/ Income from any Savings Bank Employees Retirement Association, from any Cooperative Banks Retirement Association; pensions paid directly by the Carnegie Foundation; and pensions paid by the Massachusetts Board of Ministerial Aid and Unitarian Service.
21/ Retirement annuities of any form paid to nonresidents.
22/ Military retirement pay.
23/ The exclusion may not exceed $1,500 per year.
24/ The exclusion may not exceed $1,000 per year.
25/ The serviceman must be on full-time active duty.
26/ Not excludable other than compensation attributable to "the customary training periods" of this State's national guard or the reserve components of the U.S. Armed Forces.
27/ The exclusion is not allowed if less than 50 percent of a corporation's net income was earned in this State.
28/ The exclusion is not allowed if less than 15 percent of a corporation's net income is derived from sources within this State.
29/ The exclusion does not apply to banks domiciled outside this State unless the State of domicile provides for a similar exclusion.
30/ Dividends or interest from building, saving and loan, or homestead associations, if: (1) they are not withdrawn; and (2) the association is declared by a court to be insolvent and is placed in receivership. The exclusion not allowed in the taxable year in which the receivership is terminated and the assets are distributed.
31/ Interest received from: (1) "any savings bank chartered by the Commonwealth" or deposits smaller than the legal maximum; (2) credit unions chartered by the Commonwealth; (3) banks in certain States; (4) mortgage loans secured by real estate taxed as such in this State; (5) cooperative banks incorporated in the Commonwealth; and (6) deposits in the Massachusetts Hospital Life Insurance Company.
32/ Obligations of certain educational institutions (including William and Mary College, University of Virginia, VMI, and VPI).
33/ Providing that the payer is subject to this State's tax on the income from which the payments are made.
34/ "Apparently excluded in any amount under ORS 316.110(12)."

TABLE 38. --STATE PERSONAL INCOME TAXES: DEDUCTIONS FROM GROSS INCOME THAT ARE ALSO DEDUCTIBLE UNDER THE FEDERAL INTERNAL REVENUE CODE OF 1954, AS AMENDED TO JANUARY 1, 1965

PART A - States That Have Adopted The Federal Definition of Taxable Income By Reference To The IRC

Item	Alaska	Colo.	Hawaii	Idaho	Iowa	Ky.	Mont.	N. Mex.	N. Y.	N. Dak.	Vt.	W. Va.	Wis.
State, local, foreign real property taxes	X	X	X	X	X	X	X	X	X	X	X	X	+
State and local personal property taxes	X	X	X	X	X	X	X	X	X	X	X	X	+
State, local, foreign income & profits taxes	1/	...	X	1/	1/	1/	1/	1/	...	1/	2/	X	X
State & local general sales (& use) taxes	X	X	X	X	X	X	X	X	X	X	X	X	X
State & local motor fuel taxes	X	X	X	X	X	X	X	X	X	X	X	X	X
All other State-local taxes--business expenses	X	X	X	X	X	X	X	X	X	X	X	X	X
Losses of individuals--trade business, profit trans.	X	X	X	X	X	X	X	X	X	X	X	X	+
--casualty & theft	X	X	3/ 4/	X	X	3/	X	X	X	X	X	X	X
--from wagering transactions	X	X	X	X	X	X	X	X	X	X	X	X	X
--capital: non-corporate	X	X	X	X	X	X	X	X	X	X	...	X	+
Bad debts	X	X	X	X	X	X	X	X	X	X	X	X	X
Interest paid on indebtedness	X	X	X	X	X	X	X	X	X	X	X	X	X
Trade-business expenses--salaries & compensation	X	X	X	X	X	X	X	X	X	X	X	X	X
--traveling expenses	X	X	X	X	X	X	X	X	X	X	X	X	X
--rent payments	X	X	X	X	X	X	X	X	X	X	X	X	X
Individuals' expenses--production/collection income	X	X	X	X	X	X	X	X	X	X	X	X	X
--management income, property	X	X	X	X	X	X	X	X	X	X	X	X	X
--in connection with taxes	X	X	X	X	X	X	X	X	X	X	X	X	X
Employer contributions to employee accident } health } plans	X	X	X	X	X	X	X	X	X	X	X	X	X
Deductions for pension, annuity, etc. plans	X	X	X	X	X	X	X	X	X	X	X	X	X
Charitable contributions	X	X	5/	X	X	6/	X	X	7/	X	X	X	X
Medical expenses	X	X	X	X	X	8/ 9/	X	X	7/	10/11/ 12/	X	X	X
Child care expenses	X	X	X	X	X	13/ – 16/	X	X	7/	X	X	X	X
Alimony	X	X	X	X	X	X	X	X	X	X	X	X	X
Real estate taxes, interest--cooperative housing	X	X	X	X	X	X	X	X	X	X	X	X	X
Moving expenses--new & continuing employees	X	X	X	X	X	X	X	X	X	X	X	X	X

See footnotes at end of table.

TABLE 38. --STATE PERSONAL INCOME TAXES: DEDUCTIONS FROM GROSS INCOME THAT ARE ALSO DEDUCTIBLE UNDER THE FEDERAL INTERNAL REVENUE CODE OF 1954, AS AMENDED TO JANUARY 1, 1965 (Cont'd)

PART A - States That Have Adopted The Federal Definition of Taxable Income By Reference To The IRC (Concl'd)

Item	Alaska	Colo.	Hawaii	Idaho	Iowa	Ky.	Mont.	N. Mex.	N. Y.	N. Dak.	Vt.	W. Va.	Wis.
ITEMS EXPRESSLY NOT DEDUCTIBLE PER FEDERAL CODE													
Personal, living, family expenses	X	X	X	X	X	X	X	X	X	X	X	X	X
Permanent improvements or betterments	X	X	X	X	X	X	X	X	X	X	X	X	X
Restoration of depreciated property	X	X	X	X	X	X	X	X	X	X	X	X	X
Premiums paid--life ins. on certain officers	X	X	X	X	X	X	X	X	X	X	X	X	X
Interest on debt incurred for certain ins. policies	X	X	17/	X	X	17/	X	X	X	X	X	X	X
Expenses & interest incurred to obtain tax-free income	X	X	X	X	X	X	X	X	X	X	X	X	X
Taxes--carrying charges chargeable to capital account	X	X	X	X	X	X	X	X	X	X	X	X	X
Losses & unpaid interest--vis a vis "relatives"	X	X	X	X	X	X	X	X	X	X	X	X	X
Debts owed by political parties	X	X	X	X	X	X	X	X	X	X	X	X	X
Entertainment expenses (restrictions)	X	X	X	X	X	18/	X	X	X	X	X	X	X
Business gifts (restrictions)	X	X	X	X	X	18/	X	X	X	X	X	X	X
Foreign travel (restrictions)	X	X	X	X	X	18/	X	X	X	X	X	X	X
Local benefit-based assessments	X	X	+	X	X	+	X	X	X	X	X	X	X

See footnotes at end of table.

TABLE 38. --STATE PERSONAL INCOME TAXES: DEDUCTIONS FROM GROSS INCOME THAT ARE ALSO DEDUCTIBLE UNDER THE FEDERAL INTERNAL REVENUE CODE OF 1954, AS AMENDED TO JANUARY 1, 1965 (Cont'd)

PART B - "Non-Conforming" States

Item	Ala.	Ariz.	Ark.	Calif.	Del.	D.C.	Ga.	Ind.	Kans.	La.	Md.	Mass.	Minn.	Miss.	Mo.	N.C.	Okla.	Ore.	S.C.	Utah	Va.
State, local, foreign real property taxes..............	X	X	X	X	X	X	X	...	X	X	19/	20/	X	X	X	+	19/	21/	X	X	X
State and local personal property taxes..............	X	X	X	X	X	X	X	...	X	X	19/	20/	X	X	X	X	19/	21/	X	X	X
State, local, foreign income and profits taxes..............	22/	23/	1/	...	1/	...	...	...	22/	1/	...	24/	1/	...	25/	...	26/	...	...	1/	...
State & local general sales (& use) taxes..............	X	X	X	X	X	X	X	...	X	X	19/	20/	X	27/	X	20/	X	21/	X	X	X
State and local motor fuels taxes..	X	X	X	X	X	X	...	...	X	20/	19/	20/	X	...	X	20/	X	20/	X	X	X
All other State-local taxes--business expenses...........	X	+	+	X	X	28/	29/	...	X	X	29/	X	29/	X	29/	+	29/	29/	+	+	X
Losses of individuals --trade, business, profit trans.......	X	X	X	X	20/	X	X	X	X	X	X	X	30/	X	X	+	30/	X	30/	X	X
--casualty & theft...........	3/31/	3/	3/	X	3/	3/	3/	...	3/	3/	3/31/	...	3/31/	3/	3/31/	3/	3/30/	3/	3/	3/	3/
--from wagering transactions.....	...	X	...	X	X	X	X	...	X	X	32/	...	X	...	...	...	...	X	...	X	X
--capital: non-corporate........	33/	+	34/35/	X	35/ 36/37/	...	X	X	37/38/	36/37/	...	39/	X	34/	39/40/	33/	33/	X	41/	33/	33/
Bad debts............	42/	X	43/	X	42/	44/	42/	42/	43/	45/	43/	42/	X	42/	X	42/	42/	43/	43/	X	43/
Interest paid on indebtedness.......	46/	X 47/	X 47/	X	X 47/	X 47/	X 47/	48/	46/	X 47/	46/	49/	X	X 47/	46/	X	47/50/	X	X 47/	46/	X 47/
Trade-business expenses--salaries & compensation....	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	+	X
--traveling expenses........	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	+	+	X	X
--rent payments...	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Individuals' expenses--production /collection income...........	X	+	+	+	X	X	X	...	X	X	X	+	X	+	X	X	X	X	+	X	X
--management income, property.	X	+	+	+	X	X	X	...	X	X	X	...	X	+	X	X	X	X	+	+	X
--in conn. with taxes..........	X	+	+	+	X	X	X	...	X	X	...	51/	X	+	+	X	X	X	51/	+	X

See footnotes at end of table.

TABLE 38. --STATE PERSONAL INCOME TAXES: DEDUCTIONS FROM GROSS INCOME THAT ARE ALSO DEDUCTIBLE UNDER THE FEDERAL INTERNAL REVENUE CODE OF 1954, AS AMENDED TO JANUARY 1, 1965 (Cont'd)
PART B - "Non-Conforming" States (Cont'd)

Item	Ala.	Ariz.	Ark.	Calif.	Del.	D.C.	Ga.	Ind.	Kans.	La.	Md.	Mass.	Minn.	Miss.	Mo.	N.C.	Okla.	Ore.	S.C.	Utah	Va.
Employer contrib's to employee accident/health plans...	+	X	X	X	X	X	+	X	X	X	X	+	+	+	X	+	X	X	+	+	X
Deductions for pension, annuity, etc. plans........	+	X	+	+	...	X	...	X	X	...	X	...	X	+	...	+	X	...	...	X	X
Charitable contributions....	52/	5/	5/52/	53/ 54/55/	5/ 56/57/	5/ 58/ 59/	5/58/	...	5/	53/ 54/57/ 58/60/	5/57/	...	5/61/	5/ 62/63/	5/ 57/58/	5/ 57/ 58/	5/ 57/64/	5/ 55/ 64/	65/66/	5/ 67/	5/ 58/
Medical expenses.........	8/9/	10/ 68/	11/69/ 70/71/	72/	11/12/ 73/74/	11/ 69/ 75/ 76/	9/77/	...	11/ 12/ 69/ 78/	...	8/79/	X	10/ 11/12/	...	8/11/ 75/76/	8/ 11/ 75/ 80/	8/11/ 81/82/	11/ 69/ 75/	11/12/ 69/75/	11/ 59/ 77/ 82/	11/ 69/ 75/ 83/
Child care expenses........	...	84/ 85/ 86/ 87/	...	X	...	...	85/88/ 89/90/	...	...	...	13/14/ 15/91/	...	...	...	...	...	13/14/ 15/91/	17/ 92/ 93/ 94/	...	...	...
Alimony...........	...	X	...	X	...	95/	95/	...	...	95/	95/	...	X	...	X	X	...	X	95/	95/	95/
Real estate taxes interest--cooperative housing....	...	X	...	X	...	...	...	...	...	...	...	...	X	X	X	X	X	X	...	...	...
Moving expenses--new & continuing employees........	...	...	...	96/	...	...	...	X	...	...	...	...	...	...	...	...	...	...	...	X	...
ITEMS EXPRESSLY NOT DEDUCTIBLE PER FEDERAL CODE																					
Personal, living, family expenses..	X	X	X	X	X	X	X	...	X	X	X	X	X	X	X	X	X	X	X	X	X
Permanent improvements or betterments......	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Restoration of depreciated property.........	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Premiums paid--life ins. on certain officers.........	X	X	X	X	...	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X

See footnotes at end of table.

TABLE 38. --STATE PERSONAL INCOME TAXES: DEDUCTIONS FROM GROSS INCOME THAT ARE ALSO DEDUCTIBLE UNDER THE FEDERAL INTERNAL REVENUE CODE OF 1954, AS AMENDED TO JANUARY 1, 1965 (Cont'd)
PART B - "Non-Conforming" States (Concl'd)

Item	Ala.	Ariz.	Ark.	Calif.	Del.	D.C.	Ga.	Ind.	Kans.	La.	Md.	Mass.	Minn.	Miss.	Mo.	N.C.	Okla.	Ore.	S.C.	Utah	Va.
Interest on debt incurred for certain ins. policies........	...	17/	...	X	...	...	...	...	...	+	...	...	17/	...	...	...	...	...	+	...	...
Expenses & interest incurred to obtain tax-free income...........	...	X	...	X	X	...	X	X	X	X	X	...	X	X	...	X	X	X	X	X	X
Taxes--carrying charges chargeable to capital acct..	X	X	...	X	...	...	...	X	X	+	X	...	X	...	X	...	...	X	...	X	...
Losses & unpaid interest-- vis a vis "relatives"......	97/98/	X	...	X	...	...	+	X	98/	X	...	...	+	+	...	...	X	98/	98/	...	...
Debts owed by political parties	...	X	...	X	...	...	...	...	...	X	...	...	...	...	...	...	...	...	...	...	...
Entertainment expenses (restrictions)...	18/	18/	18/	18/	18/	18/	18/	X	18/	18/	18/	99/	18/	18/	X	X	18/	18/	18/	18/	18/
Business gifts (restrictions)...	18/	18/	18/	18/	18/	18/	18/	X	18/	18/	18/	18/	18/	18/	18/	X	18/	18/	18/	18/	18/
Foreign travel (restrictions)...	18/	18/	18/	18/	18/	18/	18/	X	18/	18/	18/	18/	18/	18/	18/	X	18/	18/	18/	18/	18/
Local benefit-based assessments	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X

X --signifies State deduction is effectively the same as the Federal.
\+ --signifies only a minor difference between State and Federal deductions.
... --signifies there is no such State deduction.
1/ This State's income tax is not deductible; foreign income taxes are deductible in full.
2/ Foreign income taxes are deductible in full.
3/ Full amount of eligible loss may be deducted.
4/ Eligible losses may be deducted in equal installments over 5 years.
5/ No "special" or "unlimited" deduction provisions.
6/ "Special" provision applies only to contributions to (a) a church or a convention or association of churches, (b) an educational institution, or (c) a hospital or a medical research organization.
7/ The appropriate New York deduction is defined by the amount of the Federal, rather than literally by the provisions--pertaining to percentages and dollar amounts--in the Federal Code.

(Footnotes continued on next page).

8/ Expenses of dependent parents 65+ are subject to 1 percent drug and 3 percent total deductibility provisions.
9/ Maximum amounts of deduction are: (1) Taxpayer or spouse 65+ and disabled, for disabled spouse's expenses (normal limit for other)--15,000; (2) Both 65+ and disabled--$30,000; (3) Single persons and married but separated, per dependent/return--$2,500/$5,000; (4) Married and head of household--$2,500/$10,000.
10/ Expenses are deductible in full up to maxima.
11/ No special provision pertaining to medicine-drug expenses.
12/ No maximum amounts of deduction.
13/ Deduction not available to man with living wife.
14/ Deduction may not exceed $600 for taxable year.
15/ Case of married woman living with husband: maximum deduction reduced by amount combined gross income of husband and wife exceeds $4,500.
16/ Married couple living together may claim deduction only if both are working.
17/ Federal Code restriction [Sec. 264(a)(3)] does not apply.
18/ No special rule: general rules for expenses apply.
19/ Not deductible if paid to jurisdictions outside this State.
20/ Deductible only to extent related to taxpayer's business or profession.
21/ Deductible when paid to jurisdictions outside this State only if properly business expenses, or if related to the production or collection of income or to property held for the production of income.
22/ No State or local income tax is deductible; foreign income taxes are deductible in full.
23/ Income taxes paid to jurisdictions other than this State are not deductible.
24/ Deductible only to extent taxes are on income from taxpayer's business, etc.; eligible foreign taxes are deductible in full.
25/ Only municipal taxes on income from personal services are deductible.
26/ Only taxes on income "derived from compensation for personal services" are deductible.
27/ This State's sales/use taxes are not deductible.
28/ Franchise taxes imposed by D.C. law are not deductible.
29/ Federal taxes that qualify as business expenses are also deductible.
30/ Losses on property without situs in this State are not deductible.
31/ Non-resident taxpayer may only deduct losses on property located in this State.
32/ Only losses from lawful gambling are deductible--against gains from lawful gambling.
33/ No special provision for capital losses--hence, they are fully deductible in the year incurred.
34/ Losses incurred in transactions involving real estate located outside this State are not deductible.
35/ No distinction between short-term and long-term capital losses.
36/ Losses may not be deducted in excess of gains.
37/ No capital loss carryover provision.
38/ Limit of deductibility is $2,000 plus amount of gains.
39/ Only capital losses on assets "employed in the taxpayer's business" may be deducted, and they may be deducted in full.
40/ Limit of deductibility is $2,500 plus amount of gains.
41/ No limit on amount of long-term losses deductible.
42/ Non-business bad debts are not deductible.
43/ Non-business bad debts are deductible as business bad debts.

(Footnotes continued on next page).

TABLE 38. --STATE PERSONAL INCOME TAXES: DEDUCTIONS FROM GROSS INCOME THAT ARE ALSO DEDUCTIBLE UNDER THE FEDERAL INTERNAL REVENUE CODE OF 1954, AS AMENDED TO JANUARY 1, 1965 (Cont'd)

44/ Non-business bad debts are deductible as business debts only to extent allowable as losses incurred in a transaction for the production of income taxable under the law.

45/ Business bad debts are deductible in full from gross income.

46/ Interest on installment purchases is deductible only where (a) definitely ascertainable, and (b) separately-stated in the contract.

47/ No explicit provision regarding interest charges on installment purchases.

48/ Interest incurred in non-business/non-profit-making transactions is not deductible.

49/ Non-business/profession interest paid on unsecured debt is deductible from interest and dividends income up to specified limits.

50/ Interest attributable to property owned outside this State is not deductible.

51/ Only tax expenses incurred in relation to business, trade, or profession are deductible.

52/ Maximum amount of general deduction is 15 percent of net income computed without regard to this provision.

53/ No "special" deduction provision.

54/ "Unlimited" deduction: all contributions eligible for general deduction are eligible.

55/ Contributions (plus income, war and excess profits taxes) must have equaled 90% of taxable income (without regard to this provision) in each of preceding 10 taxable years to qualify for unlimited deduction.

56/ Maximum amount of general deduction is defined as percentage of "net income, as computed without the benefit of this paragraph."

57/ Only this State and its subdivisions qualify as objects of contributions to governmental institutions.

58/ Maximum amount of general deduction is 15 percent of A.G.I.

59/ Only organizations "the activities of which are carried on to a substantial extent" in this State qualify as objects of contributions.

60/ "Unlimited" deduction: the 90% rule applies to "each of the preceding 8 taxable years."

61/ Deduction must be pro-rated: only proportion represented by ratio of net income taxable in State to total net income is deductible.

62/ Maximum amount of general deduction is 10 percent of net income computed without regard to this provision.

63/ Contributions to governmental agencies do not qualify.

64/ Only the Federal Government and this State and its subdivisions qualify as objects of contributions to governmental institutions.

65/ "Special" provision applies only to "churches, conventions or associations of churches, educational institutions, hospitals or medical research organizations situate" in this State.

66/ No "unlimited" provision.

67/ Maximum amount of general deduction is 15 percent of gross income.

68/ Maximum amounts of deduction are: (1) none; (2) none; (3) $2,500; and (4) $5,000 (see footnote 9).

69/ No special provisions for taxpayers or dependents 65+.

70/ The 3 percent total deductibility provision relates to gross income.

71/ Maximum amounts of deduction are: (1) $2,500/$5,000; (2) $2,500/$5,000; (3) $2,500/$5,000; (4) $2,500/$10,000 (see footnote 9).

72/ Maximum amounts of deduction are: (1) $15,000; (2) $30,000; (3) $1,250; (4) $2,500 (see footnote 9).

73/ Only expenses in excess of 5 percent of gross income may be deducted.

74/ If taxpayer or spouse is 65+ their full expenses are deductible.

75/ Only expenses in excess of 5 percent of AGI may be deducted.

76/ Maximum amounts of deduction are: (1) $1,250/$2,500; (2) $1,250/$2,500; (3) $1,250; (4) $1,250/$2,500 (see footnote 9).

77/ The 1 percent drug deductibility provision applies in all cases.

78/ Only expenses in excess of $50 per return may be deducted.

79/ Maximum amounts of deduction are: (1) $2,500; (2) $2,500; (3) $1,250; (4) $2,500 (see footnote 9).

80/ Maximum amounts of deduction are: (1) $5,000; (2) $5,000; (3) $5,000; (4) $5,000 (see footnote 9).

81/ Only expenses in excess of $100 per return may be deducted by single taxpayer; expenses in excess of $200 per return by husband and wife.

82/ Maximum amounts of deduction are: (1) $1,500; (2) $1,500; (3) $750; (4) $1,500 (see footnote 9).

(Footnotes continued on next page).

TABLE 38. --STATE PERSONAL INCOME TAXES: DEDUCTIONS FROM GROSS INCOME THAT ARE ALSO DEDUCTIBLE UNDER THE FEDERAL INTERNAL REVENUE CODE OF 1954, AS AMENDED TO JANUARY 1, 1965 (Concl'd)

83/ Maximum amounts of deduction are: (1) $15,000; (2) $15,000/$30,000; (3) $1,250/$2,500; (4) $1,250/$5,000 (see footnote 9).
84/ Deduction may not exceed $100 per month.
85/ Dependent must be under 16 years of age.
86/ Deduction permitted only if gross household income is under $6,000.
87/ No restrictions regarding physical condition of spouse.
88/ Only individual who would ordinarily care for child is eligible to claim the deduction.
89/ Deduction may not exceed "taxable gross income from personal services" of the eligible taxpayer.
90/ Deduction not allowed if eligible taxpayer's:
(a) "gross income, less business expenses, from sources other than personal services" exceeds $4,000 plus credits for dependents;
(b) spouse has "taxable gross income less business expenses" exceeding $4,000 plus credits for dependents.
91/ Dependent must be under 12 years of age.
92/ Deduction may not exceed $720 per taxable year.
93/ Deduction permitted only if household AGI is under $3,000.
94/ Dependent must be under 18 years of age.
95/ Payments pursuant to written separation agreement are not deductible.
96/ New and old residences must be located in this State.
97/ Losses between "relatives" are deductible if transaction is genuinely "at arms length."
98/ Appears to be no prohibition similar to Sec. 267(a)(2) of the Federal Code.
99/ Substantiation and justification rules are more stringent than for general expenses.

TABLE 39. --DEDUCTIONS FROM GROSS INCOME THAT ARE UNIQUE TO STATE PERSONAL INCOME TAXES[1/]

Item	Ala.	Ariz.	Ark.	Calif.	Del.	D.C.	Ga.	Ind.	Kans.	La.	Md.	Mass.	Minn.	Miss.	Mo.	N.C.	Okla.	Ore.	S.C.	Utah	Va.
Losses from shares in S&L Associations placed in receivership.........	...	...	...	...	...	...	...	...	...	...	X	...	...	...	...	...	...	...	...	...	...
Federal income tax liability for the State taxable year............	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	2/	X	...
Federal income tax actually paid during State taxable year..................	...	...	...	...	...	...	...	...	...	...	...	...	X	...	...	...	...	...	...	...	...
Federal income tax paid or accrued" during State taxable year.....	X	X	...	...	3/	...	...	...	X	X	...	...	...	...	X	...	X	X	...	...	...
Federal income tax liability on profession-employment-trade-business income........	...	...	...	...	...	...	...	...	...	...	...	X	...	...	...	...	...	...	...	...	...
Political contributions..........	...	...	...	4/	...	...	...	...	...	...	...	...	5/	...	6/	...	...	...	...	7/	...
Social Security and Railroad Retirement Act taxes..............	X	...	...	...	...	...	...	...	X	X	...	X	...	...	X	...	...	...	...	...	...
State and local tobacco taxes if separately stated and paid by consumer...............	X	X	X	...	X	X	...	...	...	X	...	...	...	...	X	...	X	...	...	X	...
State and local alcoholic beverage taxes if separately stated and paid by consumer...	X	X	X	...	X	X	X	...	...	X	...	...	...	...	...	...	X	...	...	X	X
Admission taxes..........	...	X	X	...	X	X	X	...	X	X	...	...	X	...	X	X	X	...	X	X	X
Occupancy taxes..........	...	X	X	...	X	X	X	...	X	X	...	...	...	X	X	X	...	...	...	X	...
Poll taxes...............	X	X	X	...	X	X	X	...	X	X	...	...	...	X	X	X	...	...	X	X	X
Automobile driver's license fees...........	X	...	X	...	X	X	X	...	X	X	...	...	...	X	X	...	X	...	X	X	X
Automobile registration fees...................	...	X	X	...	X	X	X	...	X	X	...	...	X	X	X	...	X	X	X	X	X
Federal transportation and telephone-telegraph tolls taxes..	X	X	X	...	X	X	...	...	X	X	...	...	X	X	X	X	X	X	X	X	...
Import-tariff duties paid directly by taxpayer...............	X	X	X	...	X	X	...	...	...	X	...	...	...	...	X	X	...	X	X	X	...

See footnotes at end of table.

TABLE 39. --DEDUCTIONS FROM GROSS INCOME THAT ARE UNIQUE TO STATE PERSONAL INCOME TAXES[1] (Cont'd)

Item	Ala.	Ariz.	Ark.	Calif.	Del.	D.C.	Ga.	Ind.	Kans.	La.	Md.	Mass.	Minn.	Miss.	Mo.	N.C.	Okla.	Oreg.	S.C.	Utah	Va.
Misc. Federal excises & stamp taxes............	X	X	X	...	X	X	...	...	...	X	...	...	X	...	X	...	...	X	X	X	...
Federal estate and gift taxes....................	...	...	...	...	8/	...	...	...	...	X	...	...	...	...	X	...	...	...	8/	...	...
Premiums on endowment or life ins. policy on taxpayer &/or spouse up to $150/$300...........	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Campaign expenditures personally paid by candidate, unreimbursed, to specified limits.....	...	...	...	...	...	...	...	...	...	...	...	...	X	...	...	...	...	...	...	...	...
Cost of constructing fallout shelters........	9/	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	10/	...	...	...	...
Expenditures by teachers for graduate study to improve teaching, to max. of $1,200..........	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	X
Expenses incurred by taxpayer/spouse to adopt a child...........	...	11/	...	12/	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
<u>ITEMS EXPRESSLY NOT DEDUCTIBLE PER FEDERAL CODE</u>																					
Deductions from income derived from or related to illegal activities...	...	X	...	X	...	...	...	...	...	X	...	...	...	...	...	...	...	...	...	...	...
Contributions to any "person" involved in litigation to which said person is not party..................	...	...	...	...	...	...	...	...	...	X	...	...	...	...	...	...	...	...	...	...	X

X --signifies there is such a deduction.
... --signifies there is no such deduction.
1/ "Non-conforming" States only. The only "unique" deductions to be found in the personal income tax laws of the States that have adopted the Federal definition of taxable income are: (1) Federal income tax (Colorado, Idaho, Iowa, Kentucky, Montana, New Mexico, and North Dakota); (2) political contributions (Hawaii--$100 maximum); and (3) premiums on endowment or life insurance policy on taxpayer and/or spouse up to $50/$300 (New York).
2/ Maximum of $500.
3/ Maximum of: $300 single return and $600 joint return.
4/ Maximum of $100.
5/ Maximum of $100, special provisions for party officials.

(Footnotes continued on next page).

TABLE 39. --DEDUCTIONS FROM GROSS INCOME THAT ARE UNIQUE TO STATE PERSONAL INCOME TAXES 1/ (Concl'd)

6/ Maximum of $50.
7/ Maximum of $25 per year.
8/ Gift taxes only.
9/ Maximum of $1,000 for family or community shelter.
10/ Maximum of $1,500 (single family dwelling), $750 (multi-family unit), and other restrictions.
11/ Only excess over 5% AGI (unless medical + adoption expenses 5%), to maximum of $1,250/$2,500.
12/ Deductible as medical expenses.

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PUBLISHED REPORTS OF THE ADVISORY COMMISSION
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