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ISSUE BRIEF

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What's the Deal with the State and Local Tax Deduction?

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No one ever said that reforming the numerous carve-outs and deductions littering the tax code would be easy. If anyone did, they have been proved wrong in recent weeks, as one hang-up for legislators has been the state and local tax deduction. Sometimes known as the SALT deduction, legislators in high-tax states have been leaping to defend it ever since the Big Six tax reform framework proposed to eliminate it. This concern for retaining the SALT deduction is misguided; the provision departs from principles of sound tax policy and unwisely abets the behavior of high-tax states, enabling big government.

The bottom line…

- SALT enables tax hikes and bigger government by forcing federal taxpayers to pick up the tab for profligate states
- SALT overwhelmingly benefits the wealthy - 84 percent of the benefits flow to those with incomes over $100,000, while only 3.5 percent flow to those with incomes under $50,000
- SALT doesn't prevent "double taxation," since state/local taxes and federal taxes fund different sets of services
- Lower rates and a bigger standard deduction will blunt most, if not all, of the impact of SALT elimination for those of modest incomes
- Eliminating SALT can help fuel tax cuts that grow the economy, benefiting all taxpayers

What Is the SALT Deduction?

The SALT deduction allows individuals to deduct some taxes that are paid at the state and local level from their federal income tax bill. Filers can deduct state and local property taxes plus either income taxes or sales taxes.[1] Those who elect to deduct sales tax can choose to either list their real expenses on sales taxes or use a calculator provided by the IRS that estimates taxes paid based on income.[2]

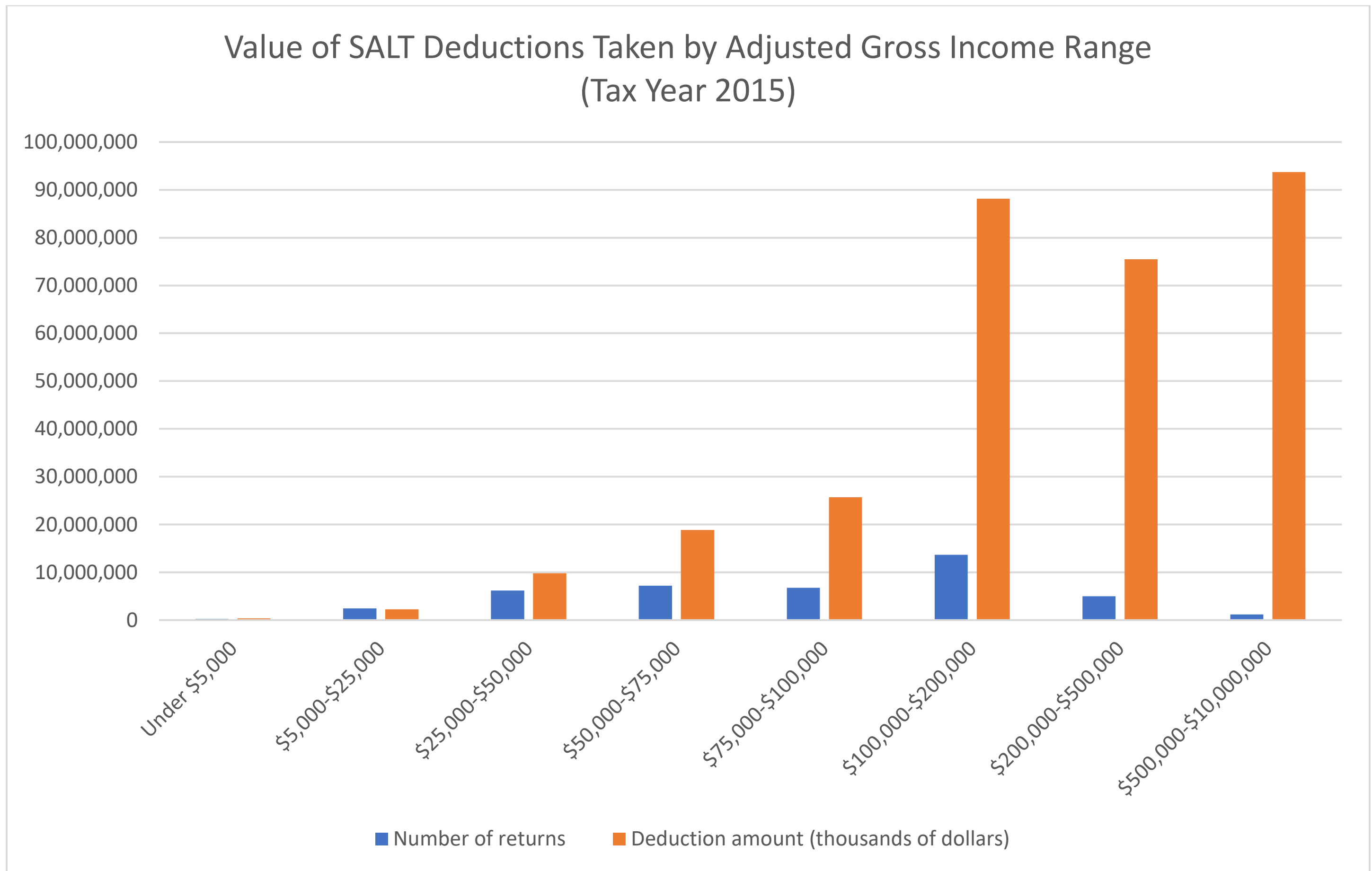
To understand the issues with the SALT deduction, it is helpful to understand itemizers in general. In tax year 2015, 30 percent of federal income taxpayers chose to itemize rather than claim the standard deduction. Itemizers overwhelmingly reported higher incomes than the average filing population—78 percent of itemizers had an adjusted gross income (AGI) above $50,000.

The benefit of the SALT deduction is skewed towards wealthier Americans to an even greater degree. In the same year, over 84 percent of the benefit of the SALT deduction went towards those with incomes above $100,000. A mere 3.5 percent went to those with income levels below $50,000. The top 3 percent of filers collected 38 percent of the benefits from SALT, while the bottom 50 percent of filers collected just over 15 percent of benefits. A mere 17,376 filers received nearly 11 percent of the benefits of the SALT deduction.[3]

Additionally, there are stark differences in the average benefit that tax filers in different income ranges receive. Filers in tax year 2015 with an AGI between $5,000 and $25,000 who claimed the SALT deduction received an average of about $920 in benefits.[4] Meanwhile, filers with an AGI above $10,000,000 received an average of $2.2 million in benefits. This

suggests that any reform, whether an outright elimination, some sort of means-testing, a cap on the deduction,[5] or something else entirely, would primarily impact higher-income households.

Percentage of Filers Claiming Salt Deduction and Average Deduction by Adjusted Gross Income (Tax Year 2015)		
AGI	**Percentage of Filers in Income Range Claiming SALT Deduction**	**Average Deduction Taken (in thousands)**
Under $5,000	2%	$1.36
$5,000-$25,000	5%	$0.92
$25,000-$50,000	17%	$1.59
$50,000-$75,000	36%	$2.62
$75,000-$100,000	53%	$3.81
$100,000-$200,000	74%	$6.44
$200,000-$500,000	92%	$15.11
$500,000-$10,000,000	92%	$78.34
Over $10,000,000	96%	$2,210.60



Perverse Incentives

The SALT deduction is far more than a financial benefit for wealthier filers—it is also an incentive for bad policy and bigger government. With the SALT deduction in place, states are effectively encouraged to levy higher taxes on their citizens. Every time a state increases its taxes, taxpayers who itemize receive a larger deduction on their federal income taxes. Taxpayers who itemize therefore are more effectively shielded from the full impact of a tax hike compared to those who take the standard deduction.[6]

Yet while states have this incentive to increase taxes, taxpayers who take the standard deduction do not receive a corresponding write-off. Since taxpayers claiming the standard deduction tend to be less wealthy; state tax increases can fall more heavily on the backs of lower-income taxpayers. States are encouraged to raise taxes, but the majority of less-wealthy taxpayers do not receive any offsetting benefits when states do so.

A few states have taken particular advantage of the SALT deduction. According to a Tax Foundation analysis of IRS data, six states receive more than half of the benefits of the SALT deduction.[7] One of these states, Illinois, provides a useful case study for understanding how perverse incentives can encourage tax-and-spend policies that ultimately ruin state economies.

Case Study: Illinois

Illinois is the most financially troubled state in the nation.[8] Following a two-year battle over how to fix the state's floundering finances, Illinois finally passed a budget in July which still failed to balance.[9] However, the state's problems go back much further than the inception of the budget battle, which culminated three months ago.

According to the Illinois Policy Institute, Illinois has not successfully passed a balanced budget since 2001. Each year, Illinois ignored rapidly increasing unfunded liabilities, particularly for government employee pensions. Since its budget rules count borrowed funds as government revenue, state legislators were able to claim that their budgets were balanced.[10]

In 2011, Illinois went into crisis mode. Facing a debt of $8.5 billion, the state approved a massive, albeit temporary, tax hike on individuals and corporations. The individual income tax spiked from 3 percent to 5 percent, while the corporate income tax jumped from 4.8 percent to 7 percent. The tax increases promised to raise $31.6 billion, more than Illinois spends on core government services in a year. Yet three years after the tax hike was put in place, Illinois was still stuck in a $7 billion hole.[11]

This cash infusion failed to solve Illinois's budgetary issues, because it failed to address the state's underlying issues with overspending. While Illinois was once a low-tax, low-expenditure state, it has spent beyond its means since the late 1980s. Since the mid-1990s, Illinois has outspent the national average.[12]

The SALT deduction encourages this type of behavior by states. Illinois legislators were able to pass a massive tax hike in part because the impact of the tax was blunted by the SALT deduction. Yet there is no such thing as a "free" deduction, and the practical impact was that taxpayers in Illinois who take the standard deduction had to pay the full amount of the state tax increase, while wealthier taxpayers who itemize were able to reduce their share of the tax hike via the SALT deduction. Had the SALT deduction not been in place, Illinois legislators would have had a greater incentive to enact real reform rather than a band-aid tax increase.

Today, Illinois continues to flirt with junk-bond status,[13] while its total 10-year GDP growth has been a meager 4 percent (for reference, the U.S. economy ended up growing by nearly 10 percent during the Great Depression in the 1930s).[14]

Such fiscal profligacy is not entirely attributable to the SALT deduction,[15] but the presence of the deduction does encourage such policies.

While it is true that some taxpayers would be impacted by elimination of the SALT deduction, it is undeniably true that many more taxpayers are being impacted by the *existence* of the deduction today. It has made governance more difficult by making necessary budget reforms less likely and harmful tax hikes (from which lower-income taxpayers can't hide) more likely. It has been used to fight *against* common sense tax limitations, and to fight *for* tax increases, all on the premise that the feds will pick up a portion of the tab.

Some may point out that one rarely sees a politician arguing in favor of a tax hike on the basis that voters who itemize will receive a proportionately larger deduction. It is true that this is a fairly weak argument to put in front of a voter. Opponents of California's Proposition 13, one of the most significant state-level tax cuts in history,[16] proved this in 1978. By attempting to argue that Proposition 13 would decrease the deduction received by itemizers (despite remaining a substantial tax cut overall), they showed that SALT was difficult to use effectively to defend tax hikes to voters. Californians wisely rejected this argument.[17]

On the other hand, this line of thinking remains alive and well among policymakers. Wonkish legislative aides and legislators can make tax hikes that much larger when they know that part of any tax increase will never be felt by their constituents. In other words, a fair assessment of the deduction would account for the largely hidden ways that it is already harming constituents in so-called "beneficiary" states.

Does SALT Protect Against "Double Taxation?"

Supporters of the SALT write-off generally frame the deduction as a protection against "double taxation," making it a point of fairness that the SALT deduction be preserved. However, this misunderstands double taxation.

Double taxation occurs when income is taxed twice to finance the same set of government-provided benefits and services. For example, when the federal government levies taxes on shareholder dividends, that income has already been taxed once via the corporate income tax. In other words, the same dollar is facing two layers of taxation by the same government in order to finance the same set of federal programs. This is not the case with SALT. The dollar in question has been taxed by two *different* governments in order to finance two *different* sets of programs.

While the additive burdens of local, state, and federal taxes may be frustrating to taxpayers in high-tax areas, it is not necessarily the case that they are facing double taxation. Each layer of government levies its own tax burdens to finance its own set of programs. Therefore, the solution to local and state taxes being high, either on their own or in combination, is not a poorly-structured federal deduction that spreads the pain out to taxpayers in lower-tax areas, it is instead to lower taxes in places where they're too high.

Localities and states should be responsible for the consequences of their decisions in establishing tax rates, rather than relying on a federal deduction to bail them out of their profligacy.

Is the SALT Deduction "Territoriality for Individuals"?

One argument that more intellectually rigorous proponents of the SALT deduction could make would be that the SALT deduction is for individuals what territoriality is for businesses. The Big Six framework provides for foreign earnings of American parent companies to be exempted from American taxation, so some may argue that the same principle should apply to state and local taxes.

There are some problems with this line of reasoning. Territoriality exempts profits that were derived in a separate jurisdiction from the government services received as a result of taxation, whereas American jurisdictions overlap. For example, an American multinational corporation's German subsidiary is not (directly) benefiting from any of the services the American government funds through taxation. Branches of a company's business located in the United States and benefiting from U.S. government services still do pay taxes. An individual living in the city of Chicago, on the other hand, is always benefiting from both state and local services as well as federal services, be it interstate highways or national defense. That is in part why states generally do not allow residents to exempt most local taxes from their state returns.

The other distinction is the effects of the policies. Whereas territoriality for businesses reduces the incentive to relocate overseas, "territoriality for individuals" in the form of the SALT deduction only has the effect of encouraging states to raise their tax rates. The tax code should be aiming to eliminate policies that contain significant perverse incentives, not protect them.

A Tax Hike?

Some organizations have suggested that all taxpayers will face a tax hike with the elimination of the SALT deduction. However, this ignores the context of the elimination of the SALT deduction. The SALT deduction would not be eliminated on its own, but as a part of comprehensive tax reform.

One organization, the Government Finance Officers Association (GFOA), betrays itself with its own numbers while attempting to argue that eliminating the SALT deduction would represent a tax hike.[18] The organization' s report attempts to quantify the impact that eliminating the SALT deduction would have on several different income ranges by showing the estimated average tax increase on taxpayers.

Unfortunately for the GFOA, the numbers highlight the minimal impact eliminating the SALT deduction would have on low- and middle-income taxpayers, and how using the savings from the elimination of SALT for an across-the-board tax cut would affect taxpayers in these income groups. According to the GFOA's own calculations, filers with an AGI between $50,000-$75,000 would lose $322, while taxpayers with an AGI between $10,000-$25,000 would lose a paltry $35. The Big Six framework's stated goals of lowering tax rates and doubling the standard deduction (not to mention increasing dependent credits) would more than make up the difference. That's why a survey of free market legislators found that 80 percent would support eliminating SALT in favor of lower rates.[19]

Conclusion

Congress has a historic opportunity to finally strike one of the most enduring and economically harmful deductions from the tax code. The SALT deduction encourages irresponsible budgeting while primarily benefiting the rich. Its elimination would help simplify the code while generating resources that can be used to implement pro-growth, pro-family tax policies. Congress should move forward with tax reform by getting rid of the SALT deduction.

About This Series

This is the third release in NTUF's "What's the Deal with Tax Reform?" series, designed to provide non-technical explanations of highly technical tax policy issues. Previous editions covered base erosion and full expensing and are available at www.ntu.org/foundation.

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Notes

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[2] Internal Revenue Service, *Tips and Guidance for Determining Sales Tax Deduction*. https://apps.irs.gov/app/stdc/

[3] Internal Revenue Service, *Table 2.1. Returns with Itemized Deductions: Sources of Income, Adjustments, Itemized Deductions by Type, Exemptions, and Tax Items, by Size of Adjusted Gross Income, Tax Year 2015 (Filing Year 2016)*. https://www.irs.gov/pub/irs-soi/15in21id.xls

[4] Filers with an AGI below $5,000 who claim the SALT deduction will likely have to recalculate their tax liability under the Alternative Minimum Tax, which has a separate set of deduction and exemption rules.

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[7] The six states are California, New York, New Jersey, Texas, Pennsylvania, and Illinois. Texas's inclusion on this list is more a function of its size than its policies. Whereas the GDP of Texas is greater than that of New York, Texas receives only 3.9 percent of all foregone revenue from the SALT deduction, whereas New York receives 13.3 percent.
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