The state and local tax deduction, explained

It's the biggest tax loophole that the GOP is trying to close.

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SALT defender Rep. Tom MacArthur (R-NJ). *Chip Somodevilla/Getty Images*

"New York will be destroyed," the state's Gov. Andrew Cuomo (D) warned in a tweet last Thursday, "if the deductibility of state and local taxes is included in any final plan that passes the House."

The "deductibility of state and local taxes" might seem like a rather esoteric culprit in the destruction of America's fourth-largest state. But while hyperbolic, Cuomo was responding to a real effort by Republicans in DC to end taxpayers' ability to deduct their state and local taxes when calculating federal income taxes.

The state and local tax deduction (SALT for short) was the most significant tax break eliminated under the tax reform "framework" released by the administration and its allies in the House in

Senate. That led to huge blowback, both from state politicians like Cuomo (because SALT is a subsidy to their governments: if they raise state taxes, taxpayers get much of the hike refunded back to them in federal taxes) and House Republicans in blue states.

The deduction's biggest beneficiaries, as my colleague Matt Yglesias has explained, often live in rich suburbs in states like New York, New Jersey, and California, and those suburbs tend to be in swing congressional districts held by vulnerable House Republicans. That's made those House Republicans, in turn, fierce opponents of ending the deduction. Rep. Tom MacArthur (R-NJ), who represents a swing district with many Philadelphia suburbs where 43 percent of people benefit from the deduction, opposed the GOP leadership's budget for fear it'd lead to a tax bill ending SALT, and claimed at least 21 other House Republicans stood with him on the issue.

So in the actual tax reform bill released by House Republicans, SALT isn't entirely repealed: the deduction for income and sales taxes is repealed but the deduction for property taxes is capped at $10,000 per person.

Retreating on SALT will making putting together a tax plan very difficult. The state and local tax deduction is basically the only major tax break Republicans have expressed a willingness to eliminate to pay for lower tax rates on individuals and businesses. If House Republicans from blue states can save the deduction, that makes it harder to pay for the rest of the tax plan and keeps its cost under the $1.5 trillion for which Republicans have budgeted.

SALT helps the wealthy — and residents of high-tax states — the most

The state and local tax deduction has two parts:

- a deduction for state/local property taxes
- a deduction that can be used for either state income taxes or state sales taxes, whichever is higher

The latter option provides a break for residents of states like Washington, Nevada, Texas, and Florida, which lack state income taxes but do levy sales taxes; generally you have to have receipts or at least credit card records to accurately compute how much you paid in sales tax for the deduction. And the property tax deduction is valuable both in generally high-tax states like New Jersey and Illinois and in otherwise low-tax states like Texas and New Hampshire that rely on property taxes heavily due to low or no taxes on everything else.

While the GOP tax framework specifies that both of these breaks should be repealed, congressional leaders have suggested they may be willing to let the property tax deduction stay.

The deductions only benefit taxpayers who itemize; low and middle-income people for whom the standard deduction is larger than their combined state/local tax burden, charitable giving, and mortgage interest payments don't get any help. And given that the standard deduction is $6,350 for singles and $12,700 for couples, you have to pay a lot of taxes or donate a lot to charity or pay a lot of mortgage interest for it to make sense to pass that up. And people who do pay that much in taxes/donations/interest tend to be pretty rich.

So, unsurprisingly, the share of people claiming the SALT deduction rises with income, with fewer than 20 percent of households making under $50,000, but more than 90 percent of households making $200,000 or more, claiming it.

In 2016, the Tax Policy Center's Frank Sammartino and Kim S. Rueben analyzed the effects of curbing or eliminating the deduction. They found that only a small minority of households making under $100,000, and especially under $75,000, would be affected, and even those affected would face a fairly mild tax increase on average (only $562 for people with a tax hike making between $50,000 to $75,000).

However, nearly 88 percent of households earning $1 million or more would get a tax hike, with those affected paying $46,550 more per year on average.

TABLE 4

Effect of Repealing the SALT Deduction

Tax change by expanded cash income level, 2016

Expanded Cash Income Level (thousands of 2016 dollars)[a]	Tax Units With Tax Increase[b]		Percent Change in After-Tax Income[c]	Share of Total Federal Tax Change	Average Federal Tax Change	
	Percent of Tax Units	Average Tax Increase			Dollars	Percent
Less than 10	0.0	0	0.0	0.0	0	0.0
10–20	0.5	148	0.0	0.0	1	0.1
20–30	2.0	197	0.0	0.1	4	0.3
30–40	6.5	263	-0.1	0.3	17	0.6
40–50	12.1	315	-0.1	0.5	38	0.7
50–75	22.2	562	-0.2	3.1	124	1.4
75–100	36.5	873	-0.4	5.3	319	2.2
100–200	59.2	1,500	-0.8	25.3	887	3.3
200–500	82.9	2,796	-1.1	25.1	2,317	3.4
500–1,000	87.7	8,555	-1.5	10.3	7,507	3.8
More than 1,000	87.6	46,550	-2.0	30.0	40,774	3.8
All	23.6	2,348	-0.8	100.0	555	3.1

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0515-1).

Number of AMT Taxpayers (millions). Baseline: 4.5 Proposal: 1.6

Notes: SALT = state and local tax. Proposal repeals the SALT deduction. For a description of TPC's current law baseline, see http://www.taxpolicycenter.org/taxtopics/Baseline-Definitions.cfm.

[a] Includes both filing and non-filing units but excludes those that are dependents of other tax units. Tax units with negative adjusted gross income are excluded from their respective income class but are included in the totals.

[b] Includes tax units with a change in federal tax burden of $10 or more in absolute value.

[c] After-tax income is expanded cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); estate taxes; and excise taxes.

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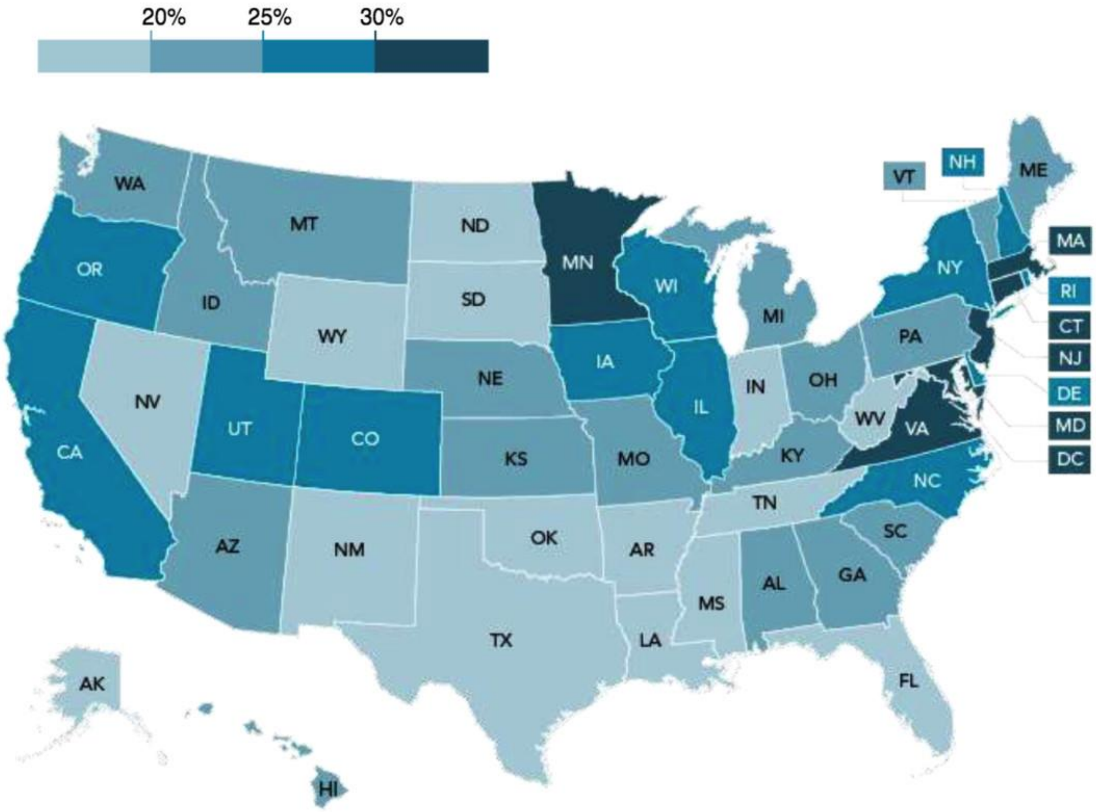
That said, the effects vary geographically. In many on the Eastern Seaboard, from Virginia up through Connecticut and Massachusetts, along with Minnesota, more than 30 percent of households would face tax hikes. In much of the South, including Texas, less than 20 percent of households would:

FIGURE 1
Percentage of Tax Units with Increase from SALT Repeal

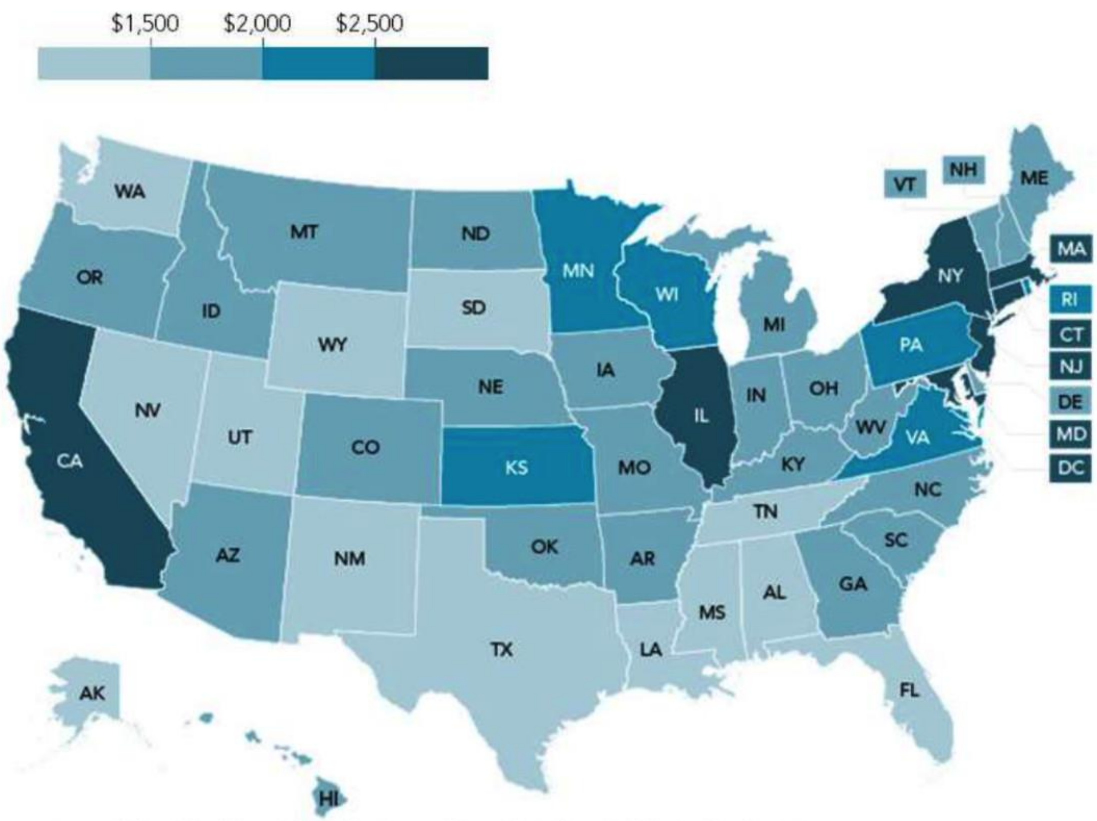


Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0515-1).

The size of the average tax increase is, naturally, much higher in rich states with high income and property taxes.

FIGURE 2

Average Tax Increase from Repealing SALT



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0515-1).

Note: Average increase only among tax units with tax increase from repeal of the state and local tax deduction.

"Taxpayers in California and New York, both populous states with relatively high taxes and many high-income taxpayers, would pay 31 percent of the total tax increase from eliminating the deduction," Sammartino and Rueben write. "Sixty-three percent of the tax increase would be concentrated in the 10 states with the highest shares of the increase."

While its effect on *federal* taxes is regressive, its effect on state taxes is likely progressive: The deduction is most valuable to high-income people in high-tax states, and thus provides a direct federal incentive for states to raise taxes on high-income people.

The case against SALT: it's regressive and encourages itemizing

The case against SALT, usually made by conservative analysts but also appealing in part to intuitions about progressivity that many people share, is clear and straightforward:

- It’s a regressive tax break at the federal level.
- As a form of revenue-sharing, it disproportionately helps rich liberal states rather than targeting funds to poorer conservative states like Mississippi or West Virginia.
- It reduces the tax base and requires higher federal income tax rates, hurting economic growth according to conservative economists.
- Eliminating it would lead many fewer people to itemize taxes, reducing the harm done by other truly awful deductions, like the mortgage interest deduction.

Most other rich countries with federal systems, like Canada and Germany, don’t have a state or local tax deduction. Instead, they rely on “equalization payments,” in which the federal government directly distributes grants to poorer states and provinces to make sure all states/provinces have adequate fiscal capacity. Endicott College’s Joshua McCabe, a right-leaning sociologist who studies taxation in the US and Canada, has proposed eliminating the state and local tax deduction and using the money to establish equalization payments in the US.

The case for SALT: it helps support state budgets

SALT’s defenders, in turn, argue:

- Eliminating it without a real replacement like equalization payments would strain state budgets that rely on the subsidy.
- Getting rid of it doesn’t enable less economic distortion through lower tax rates; it keeps income taxation roughly constant but shifts it from states to the federal government.
- Getting rid of it to pay for tax cuts for rich people and corporations is, effectively, upward redistribution, even if on its own SALT is regressive.

Jason Furman, President Barack Obama’s former chief economist and currently a professor of practice at the Harvard Kennedy School, made the argument compellingly in a series of tweets:

Progressivity is an irrelevant consideration for individual elements of a tax reform plan, only should focus on the distn of the full plan.

— Jason Furman (@jasonfurman) October 2, 2017

According to @TaxPolicyCenter the 12/25/35 rates cost $1.2 trillion & eliminating SALT raises is $1.3 trillion. https://t.co/8325XSVBTZ

— Jason Furman (@jasonfurman) October 2, 2017

With SALT might pay 39.6% rate but on only 88% of your income. With reform is 35% rate on 100% of your income. Same rate, no Δ labor/income.

— Jason Furman (@jasonfurman) October 2, 2017

Your view on whether that is a good or bad thing depends in part on your view of those public goods.

— Jason Furman (@jasonfurman) October 2, 2017

But you could also argue that redistribution & investment will be underprovided & collective action problems will generate suboptimal rates.

— Jason Furman (@jasonfurman) October 2, 2017

That is the right debate to have. Not one that assumes that rates must come down and then looks for payfors to make that work. END

— Jason Furman (@jasonfurman) October 2, 2017

In other words, the Trump administration isn't just eliminating SALT. It's eliminating SALT to, among other things, pay for lower individual income tax rates for the rich. Those two changes, put together, aren't actually progressive. They could actually be regressive and shift the tax burden from upper-middle-class people benefiting from SALT up to the very rich.

That's especially true when you consider that SALT is also partly paying for lower corporate and estate tax rates, cuts which are even more regressive than cutting the top rate for individuals.

SALT is one of the ways left for the GOP to pay for its plan

Given how contentious SALT is, and how valuable it is for constituents of vulnerable House Republicans, it's worth asking why curtailing it is so important to the tax reform effort in the first place.

When politicians talk about "tax reform," what they typically mean is that they want to eliminate tax deductions, credits, and other breaks, to pay for lower tax *rates*. Since economists, especially conservative-leaning ones, think tax rates play a bigger role in determining how much people work and invest, it's preferable all else being equal to have lower rates affecting more income.

This trade, also known as "base-broadening," is at the core of what the Trump administration and Congressional Republicans claim to be doing on taxes. The tax reform "framework" released by the administration and its allies in the House and Senate makes repeated reference to this goal. "Exemptions, deductions and credits for individuals riddle the tax code," it reads. "The framework envisions the repeal of many of these provisions to make the system simpler and fairer for all families and individuals, and allow for lower tax rates."

But there's a big problem: At least when it comes to individual income taxes, the administration doesn't actually want to get rid of many important exemptions, deductions, and credits.

The biggest and most important tax exemption, the exclusion of health insurance provided by employers from both income and payroll taxation, is unchanged in the framework. The preferential tax rates given to capital gains and dividend income? Also unchanged. Pension and retirement fund contributions? Unchanged. Mortgage interest deduction? Very mildly limited.

Charitable deduction? No change. Earned Income Tax Credit? No change. Child Tax Credit? Actually expanded.

That leaves the state and local tax deduction, for both property and sales/income taxes, as one of the few viable loopholes or tax breaks to close. If Republicans want to contain the cost of their reform effort at all, abandoning SALT elimination, or settling for weak limits, are going to leave them in a very, very difficult situation.