ECONOMIC ANALYSIS

Why the SALT Deduction Is Always Under Attack

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Any tax reform in President Obama’s second term will bear little resemblance to the reform in President Reagan’s second term.

Back then there was so much more of the code that needed reform. The top rate was 50 percent, and there were more loopholes and shelters. The popular appeal of the 1986 reform was heightened by allowing tax increases on corporations to pay for cuts in individual taxes. Now competitiveness concerns make such a shift in the tax burden almost inconceivable. Also, by 1986 Congress and the White House had developed good working relationships from their efforts on the antecedents to the 1986 act — the now nearly forgotten Deficit Reduction Act of 1984, the Social Security amendments of 1983, and the Tax Equity and Fiscal Responsibility Act of 1982. The partisan divide in 2012 has grown so large that mistrust and unwillingness to compromise are normal.

Despite these critical differences, the history of the 1986 act can still teach us about the next tax reform effort. Among the most relevant lessons is that among the big three itemized deductions — the mortgage interest deduction, the deductions for charitable contributions, and the deduction for state and local taxes — the last is by far the one Congress is most likely to cut. As shown in Figure 1, the deduction cost the government $62 billion in 2010, and a lot of that revenue is from upper-income households. That is an attractive pile of cash, especially if the mortgage interest and charitable deductions are off the table.

Second-Class Status

Even in the early stages of the process that led to the 1986 act, limits on the mortgage interest deduction never received any serious consideration. And limits on the charitable deduction only briefly surfaced as part of the Treasury Department’s first offering in 1984. Treasury I proposed allowing charitable deductions only in excess of 2 percent of adjusted gross income. Treasury II in 1985 dropped the 2 percent floor, and Congress never again gave a broad-based limit on charitable deductions serious consideration.

In contrast, both Treasury I and Treasury II included complete elimination of the deduction for state and local taxes. And in his initial draft on tax reform, House Ways and Means Committee Chair Dan Rostenkowski proposed a complicated two-part limit whereby taxpayers would be able to deduct the greater of up to $1,000 in taxes paid or...
the amount of tax beyond 5 percent of AGI (Tax Notes, Oct. 7, 1985, p. 20).

Under severe pressure, Rostenkowski dropped the proposal in the Ways and Means bill. The Tax Reform Act of 1986 only eliminated the deduction for state and local sales taxes. In 2004 Congress temporarily reinstated the sales tax deduction for taxpayers who opted to forgo a deduction for state and local income taxes. Since then, the optional sales tax deduction has shared the fate of the long list of expiring tax provisions. The provision expired at the end of 2011, but it has widespread support and will likely be extended with other expiring tax provisions. All of this should make clear that we can expect a real struggle over any attempt to cut the state and local tax deduction. But if itemized deductions are to be cut, as wannabe tax reformers are always implying, the deduction for state and local taxes will be at the top of the list.

Another indication of the deduction’s second-class status is its treatment under the individual alternative minimum tax. The 1986 act left the mortgage interest and charitable contributions unscathed by the AMT. But deductions for state and local taxes are not allowed. That is one reason why the percentage of AMT payers is significantly larger in California and high-tax states in the Northeast than in the rest of the country. (Because the AMT already limits charitable deductions, the figures shown in Figure 1 would be significantly larger if — as any tax reform promises — the AMT were repealed.)

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More recent tax reform efforts show that there still exists a clear preference for cuts to the deduction for state and local taxes over cuts to any other itemized deduction. In 2005 President George W. Bush told his tax reform panel that it should recognize “the importance of homeownership and charity in American society” but did not make a corresponding endorsement of the importance of services provided by state and local governments. Accordingly, the panel treated the first two tax benefits more kindly than the deduction for state and local taxes. It recommended converting the mortgage interest deduction into a 15 percent tax credit and allowing charitable deductions to continue, but only for contributions in excess of 1 percent of AGI. For the state and local tax deduction, it recommended complete elimination. In 2010 both the Bowles-Simpson and Rivlin-Domenici deficit reduction panels followed this same pattern: partial cutbacks of the tax benefits for mortgage interest and charitable contributions and complete elimination of the deduction for state and local taxes.

Given the willingness of so many intelligent, well-intentioned tax reformers to put the deduction for state and local taxes on the chopping block, you might think the policy case for its elimination is rock solid. In fact, the opposite is true.

The Case of Zero Economic Benefit

For starters, consider the doubtful benefits of eliminating the deduction for state and local income taxes. The central goal of any major tax reform is the reduction of tax rates. One big advantage of a rate cut is that it increases the incentives for individuals to work, save, and invest. That is no small issue. Currently, these economic benefits are the main reason for Republicans’ reluctance to return to Clinton-era tax rates on the wealthy.

But, as pointed out to me by professor John Buckley of Georgetown University, the economic benefits of lower rates will be entirely eliminated to the extent rate cuts are funded by limiting the deductibility of state and local income taxes. A simple example illustrates this important point.

Suppose the statutory federal tax rate is 40 percent and the relevant state income tax rate is 10 percent. Under current law where state taxes are deductible, $100 of income results in $90 of federal taxable income and federal tax of $36. State tax is $10. The overall effective tax rate on $100 is 46 percent. With elimination of the deduction for state income taxes, a revenue-neutral federal reform can reduce the statutory rate to 36 percent. The federal government now collects $36 on $100 of taxable income. And the state government still collects $10. The overall effective tax rate is still 46 percent. So if the goal of tax reform is to improve the incentives for working and saving, there is nothing to be gained by cutting deductions for state and local income taxes to pay for statutory rate cuts.

According to the Census Bureau, state and local governments collected $302 billion of individual income taxes during the 12-month period ending June 30, 2012 (http://www.census.gov/govs/qtax). Figure 2 shows that more than half of all deductions for state and local taxes were deductions for income taxes.

Argument for Deductibility of State Taxes

Under an ideal income tax, the federal government would include in income all payments and services received from state and local governments. And because taxes are mandatory and clearly reduce households’ ability to pay federal income tax,
an ideal income tax would also allow deductions for all taxes paid to state and local governments. Because in most cases it is difficult to directly measure the value of government services, it could be acceptable for tax payments to serve as a proxy for the value of services received. That makes sense when the government receiving the payments and providing the services is small. But as Treasury pointed out in 1977:

When it comes to a larger collective organization, such as a State government, this approach is much less satisfactory. The payments to the organization are no longer good proxies for the value of services received. For that reason there is a strong equity case for allowing a deduction of such payments in calculating individual income. (Department of the Treasury, “Blueprints for Basic Tax Reform,” Jan. 17, 1977, p. 92.)

That is sound economic thinking. But for some reason, between 1977 and 1984 Treasury completely changed its mind about the proper federal tax treatment of tax payments to states. As noted above, Treasury I proposed eliminating the deduction for all state and local taxes, including taxes paid to state governments. We can only speculate here, but it doesn’t seem out of the question that the lack of other politically acceptable options for broadening the tax base forced Treasury to compromise on its principles.

State governments collected $768 billion, or 56 percent, of the total $1.393 trillion in taxes collected by state and local governments during the 12-month period ending June 30, 2012, according to Census Bureau data.

Here is how Treasury explained its revised view in 1985:

State and local taxpayers receive important personal benefits in return for their taxes, such as public education, water and sewer services and municipal garbage removal. In this respect, the determination by State and local taxpayers of their levels of taxation and public service benefits is analogous to their individual decisions over how much to spend for the purchase of private goods. (“The President’s Tax Proposals to the Congress for Fairness, Simplicity, and Growth,” May 1, 1985, pp. 64-65.)

And this view has been the mantra for tax reformers ever since. Justifications for total repeal of the deduction can be found in the 2005 report by the President’s Advisory Panel on Federal Tax Reform (Doc 2005-22112, 2005 TNT 211-14, at p. 83) and in the 2011 report by the Rivlin-Domenici commission (Doc 2011-22974, 2011 TNT 212-39, at p. 34).

**Local Property Taxes**

Figure 2 shows that 39 percent of deductions for state and local taxes were deductions for payments of real estate property tax. Based on the theory that government activity is analogous to services purchased from the private sector, the case for repealing the deductibility of taxes is probably strongest for local property taxes. But even here, it is far from clear-cut.
First, there are local government services that provide no direct benefits to any of the households paying the bulk of taxes. That would be the case, for example, when municipalities provide food, housing, and social services to the poor. Clearly, these expenditures are no more akin to personal consumption than are contributions to charities that support the poor. When you add the fact that the payments supporting these services are mandatory rather than voluntary, the benefit provided to funders is certainly less, and the comparison of tax payments to private consumption is even more strained.

There are also cases in which some taxpayers do receive explicit direct benefits but many others do not. Public education is the prime example. Yes, families using the public schools should in theory be taxed at the federal level on the value of those services. (Try explaining that at a town hall meeting!) And the disallowance of a deduction for the share of taxes that supports those services can serve as a crude approximation of the correct treatment. But not everybody has children, and many who do send them to private school. Certainly, the analogy of local taxation to private consumption does not hold in this case, and that rationale for limiting deductions does not apply.

Even in cases when there is a relatively good alignment of taxpayers and receivers of services, the justification for eliminating the deductibility of tax services can still be called into question. Take, for example, the provision of trash collection in a town where all households own their homes. In that case, everybody contributes (by virtue of their property tax payments), and everybody receives services analogous to personal consumption (made clear by the fact that trash collection can be privately provided). But given that property taxes are proportional to home values while the amount of trash probably doesn't systematically vary with income, there can be a significant amount of income redistribution because, in effect, wealthy households are overcharged and the poor get a discount.

Charitable Contributions

It would be a strange and unfair world if tax reformers succeeded in their efforts to eliminate the deduction for state and local taxes while retaining tax benefits for charitable contributions. Voluntary contributions to volunteer fire departments would be tax deductible, but mandatory tax payments to support municipal fire departments would not. Voluntary contributions to local schools, both private and public, where the contributor's own children are in attendance would be deductible, but mandatory tax payments to support public schools where the taxpayers have no children attending would not. Voluntary contributions to local home-