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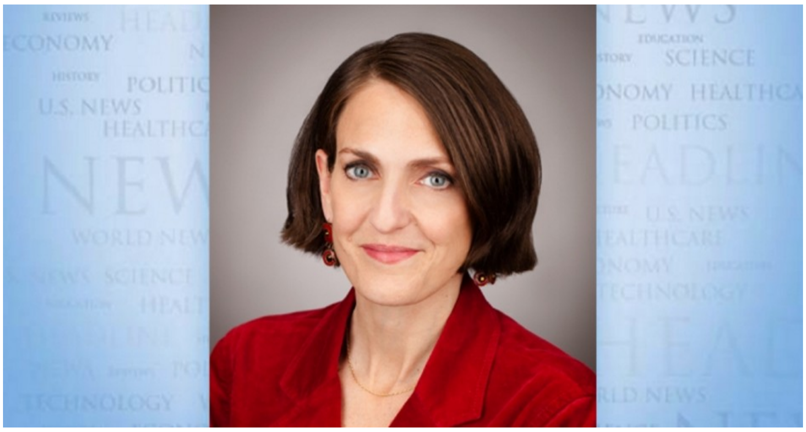
Cutting SALT From the Federal Tax Diet



In the quest for a better tax code, it shouldn't be difficult to agree that a tax deduction that mostly benefits rich people and subsidizes high-tax state and local governments must go. That's what the state and local tax, or SALT, deduction does, and it was rightly slated for termination in the tax reform framework by the "Big Six," to the displeasure of some in Congress. Resistance from these lawmakers, however, is misplaced, because a repeal of SALT — alongside other reforms in the plan — would most likely leave the vast majority of taxpayers better off and our tax code much fairer and simpler.

The ability to deduct state and local taxes from one's federal tax bill goes as far back as the income tax itself. According to the most recent Trump administration budget, it is the sixth-largest individual income tax expenditure and represents a loss of revenue of $100 billion annually.

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That's a lot of money, considering it benefits the less than 30 percent of taxpayers who choose to itemize deductions, and even then, it's only those who aren't limited by the alternative minimum tax. Some argue that SALT is an expression of our federalist tradition to give priority to localized spending or is a way to avoid the double taxation of state and local taxpayers' income, but these arguments are overwhelmed by the fact that the targeted benefits mostly favor higher-income earners in high-tax states and are highly distortive.

Data show that the lion's share of the SALT flows to high-income taxpayers, who are most likely to itemize. According to the Tax Policy Center, "about 10 percent of tax filers with incomes less than $50,000 claimed the SALT deduction in 2014, compared with about 81 percent of tax filers with incomes exceeding $100,000."

SALT also benefits states that combine high incomes and high-tax environments. According to a Tax Foundation study, the majority of the benefits are concentrated in California, New York, New Jersey, Illinois, Texas and Pennsylvania. California alone claims 19.6 percent of the total cost of the tax expenditure. That's what I call concentrated benefits and diffuse costs.

Indeed, the deduction provides an indirect federal subsidy to state and local governments in high-income areas by decreasing the net cost of nonfederal taxes to those who pay them. As the Tax Policy Center notes, in some instances these state and local governments effectively "export a portion of their tax burden to the rest of the nation."

Estimates show that by sheltering state and local taxpayers from the spending decisions of their lawmakers, the deduction encourages anywhere between 2 and 20.5 percent more spending. Not surprisingly, the deduction distorts the financing decisions made by state and local lawmakers. In 2016, for instance, Alaska Gov. Bill Walker cited SALT as instrumental in proposing a hike in income taxes over a hike in the sales tax. He said, "We selected an income tax over a sales tax for a couple of reasons…. State income taxes are deductible from your federal taxes."

Translation: "Thanks to SALT, we can increase your taxes without upsetting you as much as we should." You don't have to be a genius to understand that when taxpayers are less vigilant about policy changes and lawmakers' spending behaviors, we don't get the best policies implemented.

High-tax and big-spender states have already expressed their discontent. California and New York lawmakers in particular aren't eager to make the cost of their policies more visible. That said, taxpayers in these states shouldn't worry about the repeal of SALT. According to one estimate, the repeal, when combined with other features of the tax reform framework — such as lower individual income tax rates and the doubling of the standard deduction — would most likely result in a lower tax burden for all Americans who make less than $1 million, which is 99.7 percent of tax filers. The only potential losers are those who make more than $1 million a year. The degree to which they would pay more taxes depends on the impact that repealing the alternative minimum tax would have on these filers.

Finally, though I don't like the idea of paying for tax reform with more revenue, I'm fully behind getting rid of bad tax deductions to make the tax code fairer, simpler and less favorable to special interests and big-government policies. This is one of those instances. That it would raise money to pay for good tax reform is an added bonus.

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