FEDERAL TAX REFORM AND THE DEDUCTION FOR STATE AND LOCAL TAXES

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ABSTRACT

Most proposals for federal tax reform envision the repeal of the deduction for state and local taxes (i.e, the SALT deduction). These proposals are not without precedent. The Reagan Administration's proposed repeal of the SALT deduction as part of its 1985 tax reform proposal generated substantial academic analysis of this reform option. Since that time, however, there have been numerous developments relevant to the possibility of repeal or reform of the SALT deduction. The growing significance of the alternative minimum tax, the influence of the Great Recession on state and local fiscal structures, mounting concerns with subnational revenue volatility, and various demographic changes have altered the framework for considering the influence of federal tax reform on state and local fiscal incentives.

We consider three specific reform options—the 2005 Presidential Advisory Panel on Federal Tax Reform, the Rivlin/Domenici plan, and the Simpson-Bowles National Commission on Fiscal Responsibility and Reform. Each of these proposals would repeal the SALT deduction in its entirety, yet the experience of TRA 1986 suggests that outright repeal is likely to face considerable political opposition from state and local government lobbyists. In an effort to anticipate the likely political instinct for reforms short of outright repeal, we also consider the merits of three alternative half-measures:(i) limiting the SALT deduction to a subset of taxpayers, (ii) limiting the SALT deduction to a subset of taxes, and (iii) converting the deduction to a flat-rate credit. Because of their differential effect on the tax price faced by state and local taxpayers, these reform options have very different implications for state and local fiscal incentives. These alternative reform options also implicate broader questions about the proper role of the federal government in the design of subnational tax structures.

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Introduction 2
I. Key Features of U.S. "Intergovernmental Tax Policy" 5
A. The Legal/Administrative Architecture of the Federal Income Tax 5
B. Federal (Statutory and Judicial) Limitations on State and Local Taxes 7
C. The Federal Income Tax Deduction for State and Local Taxes 9
D. Intergovernmental Tax Policy as a Target of Federal Tax Reform 11
II. Existing Research on the Effects of SALT Deductibility 11
A. Influence of Deductibility on Aggregate State and Local Spending 11
B. Influence of Deductibility on State and Local Tax Structure 12
III. An Empirical Snapshot of the Current SALT Deduction 15
IV. Federal Tax Reform and the SALT Deduction 17
A. The SALT Deduction under Current Federal Tax Reform Proposals 17
B. Modeling the Repeal of SALT Deduction 20
C. Distributional Implications of Repealing the SALT Deduction 21
D. Alternatives to Repeal: Identifying Defensible Half-Measures 22
1. Limiting the SALT Deduction to a Subset of Taxpayers 23
2. Limiting the SALT Deduction to a Subset of Taxes 23
3. Converting the SALT Deduction to a Flat-Rate Credit 25
Conclusion 26

INTRODUCTION

Tax reform is once again in the air. Over the past few years, numerous commentators and a pair of prominent commissions have presented options for restructuring the federal income tax. In addition, most of the Republican presidential candidates have proposed fundamental changes to the U.S. tax system. A key predecessor to these proposals is the report issued by the President's Advisory Panel on Federal Tax Reform in 2005, which advanced two alternative visions of fundamental tax reform at the federal level. The Advisory Panel's final report garnered virtually no political support when released late in the first year of President George W. Bush's second term, but of course fundamental law reform rarely follows quickly on the heels of expert recommendations. As expected, the recommendations were promptly shelved, but could form the basis of reform legislation down the road. More recently, the Rivlin-Domenici plan (November 2010) and the Simpson-Bowles plan (December 2010) have taken center stage as possible vehicles for considering fundamental tax reform. Like the Bush Advisory Panel five years earlier, these reports have at least some measure of bipartisan backing and could plausibly serve as a framework for fundamental tax reform legislation. Even more recently, President Obama announced in his 2012 State of the Union address that "we need to change our tax code so that people like me, and an awful lot of Members of Congress, pay our fair share of taxes."[1] Not to be outdone, Indiana Governor Mitch Daniels, offering the Republican response to the President's

[1] Presidential State of the Union Address, Barack Obama (January 23, 2012).

address, called for a "dramatically simpler tax system of fewer loopholes and lower rates."[2] Everyone, it seems, is talking about tax reform.

For better or for worse, in all of these discussions about tax reform, little attention has been given to the implications of federal tax reform for state and local governments. It's worth remembering, however, that the state and local public sector rivals the federal government in terms of its significance for the national economy. Based on 2009 data, total federal spending amounted to 14.9 percent of GDP,[3] whereas state and local government ownsource revenue was 13.3 percent of GDP.[4] After factoring in federal grants to state and local governments, total state and local revenue accounted for 17.1 percent of GDP in 2009. In short, roughly half of public sector domestic consumption in the United States is effectuated through state and local governments. Simply put, any discussion of tax reform that excludes subnational effects is seeing only half the picture.

The impact of federal tax reform on state and local governments is not a new concern among tax policy analysts. Economists and legal scholars have developed an extensive literature examining these issues—particularly in the years immediately preceding and following the Tax Reform Act of 1986. The story behind the 1986 Act is an important chapter in the ongoing development of U.S. institutions of fiscal federalism. As part of its proposal to overhaul the federal income tax, the Reagan administration proposed to repeal the deduction for state and local taxes available to taxpayers who itemize their deductions. This proposal prompted vigorous opposition from state and local political representatives, who contended that outright repeal of the SALT deduction would devastate state and local budgets. Then governor Mario Cuomo of New York lambasted the Treasury proposal, insisting that it would amount to a "regional death sentence" for his and other Northeastern states.[5] In part because of such concerns, Congress ultimately settled on a partial repeal option by eliminating the deduction for sales taxes but retaining it for income and property taxes. Since then, the deduction for sales taxes has been re-introduced, but only as an election in lieu of deducting income taxes.[6] In part because of these changes, as well as the likelihood of future legislative action, the academic community has undertaken to evaluate the impact of deductibility on the state and local public sector, examining the provision's effect on aggregate government spending, the distribution of state and local taxes, and the composition of state and local tax portfolios.

This literature has generated numerous insights—insights that we draw upon in our analysis in this paper—but an ever-changing landscape for state and local public finance has also introduced new factors that were not (and could not have been) considered in earlier studies. For example, in the years since the Tax Reform Act of 1986, state and local governments have experi-

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[2] Transcript: Daniels gives GOP response to State of the Union, http://www.cnn.com/2012/01/24/politics/sotu-gop-response-transcript/index.html (January 23, 2012).

[3] Fiscal Year 2012, Historical Tables, Budget of the U.S. Government, Table 1.2—Summary of Receipts, Outlays, and Surpluses or Deficits (-) as Percentages of GDP: 1930-2016, page 24 (2010) (2009 GDP just over $14 trillion).

[4] Census of Governments, State and Local Government Finances by Level of Government and by State: 2008-09.

[5] Dennis Farney, Congressional Frost Belt Coalition Fears Region Will Be Hardest hit by Tax, Budget Proposals, Wall Street Journal, page 1 (January 11, 1985).

[6] This election is typically most attractive for residents of states without an income tax, such as Florida and Texas.

enced periods of extremely strong revenue growth (e.g., the dot.com boom from 1995-2000 and the housing bubble from 2003-2006) but also the most severe drop in tax receipts since the Great Depression (e.g., 2008-2010). This fiscal tumult has focused new attention on the influence of state tax structure on revenue volatility, prompting a greater focus on long-term fiscal sustainability as a key element in state and local tax reform. Another development over the past several years is the growing significance of the alternative minimum tax (AMT) in the federal income tax structure. Because state and local taxes are not deductible under the AMT, an increasing number of high-income taxpayers enjoy little or no benefit from the SALT deduction. In effect, the AMT is leading to a de facto "creeping repeal" of the deduction for state and local taxes, subtly altering the fiscal incentives that subnational governments face in crafting their tax policies. Finally, long-term demographic changes—such as the shifting age structure of the U.S. population and the increase in income and wealth inequality over the past quarter century—also exert an important influence on state and local tax policy. With regard to K-12 education in particular, currently the largest expenditure obligation of state and local governments, recent studies suggest that changes in a population's age or income distribution may have an effect on political support for public spending.[7]

These and other developments highlight the value of reassessing tax reform's impact on state and local governments. While repeal of the SALT deduction is likely to figure prominently in the ongoing tax reform debate, policymakers in 2015 may wish to consider a broader range of policy options than were available for consideration in 1985. For example, given recent concerns about the effects of revenue volatility on state budgets, a case can be made for using federal tax reform as a vehicle for discouraging the adoption of volatile state tax structures (or at least neutralizing any incentives in favor of volatile revenue sources under current law). With regard to the increased significance of the AMT, it seems likely that the political economy of repealing the SALT deduction may be different in a world where some substantial number of itemizers are not benefitting from the deduction. And demographic changes of the sort described above might argue in favor of limiting the SALT deduction to some subset of the population.

The most prominent proposals for federal tax reform most recently under discussion—including the Bush Advisory Panel on Tax Reform, the Rivlin-Domenici plan, and the Simpson-Bowles—call for repealing the deduction for state and local taxes. If history is any guide, these proposals are likely to be the subject of considerable political opposition if and when Congress begins to seriously consider federal tax reform. That said, the political obstacles to outright repeal of the SALT deduction may not be as severe today as a quarter century ago. For example, if repeal is coupled with a permanent AMT fix, state or local officials might be more amenable to both actions, especially if Congress eases the pain with either increased direct grants or an expansion in subnational borrowing capacity through for example, the reintroduction of the Build American Bonds (BABs) program. We offer no particular insights regarding which configuration of proposals is most likely to survive the legislative gauntlet; however, understanding the current benefit of the tax deduction to state and local governments will help inform this debate.

[7] See, e.g., Sean P. Corcoran and William N. Evans, Income Inequality, The Median Voter, and the Support for Public Education (September 21, 2011); Randall Reback, Local Tax Price Discrimination in an Aging Society (February 2011).

I. KEY FEATURES OF U.S. "INTERGOVERNMENTAL TAX POLICY"

It is a basic feature of American federalism that state governments (and their political subdivisions) are generally free to decide how to fund public goods without interference from the federal government.[8] This is of course not always true in a federal system of governments. In some cases, the federal constitution will incorporate a specific assignment of tax instruments to the different levels of government.[9] By contrast, the American states have wide latitude in setting state and local tax policy. That said, it bears noting that there are several mechanisms by which federal law may, directly or indirectly, influence the design of state and local tax systems. Roughly speaking, these federal policies can be thought of as either *inducements* (i.e., policies that reduce the cost of relying on a particular revenue source) or *limitations* (i.e., policies that limit the ability of state and local governments to use a particular revenue source). In combination, these various mechanisms can be viewed as the federal government's "intergovernmental tax policy"—that is, the collection of policies, rules, and institutions that establish incentives or penalties for the design of state and local tax systems. Three specific policies deserve brief mention.

A. The Legal/Administrative Architecture of the Federal Income Tax

Perhaps the most obvious federal inducement for the design of state and local tax systems is the fact that Congress has established an elaborate and detailed legal framework for certain taxes—including, most notably, the individual and corporate income taxes—but not for others.[10] The very existence of the Internal Revenue Code, Treasury Regulations, IRS administrative guidance, and federal judicial case law provides a federal "subsidy" of sorts for adopting income taxes as compared to some other tax for which this framework is not available. While clearly not a decisive factor in every case (e.g., note that states such as Florida and Texas have chosen not to adopt income taxes), the benefits of conforming to federal law are unmistakable.

At the same time, however, there are potentially significant costs associated with having states piggyback on the federal income tax. It is well established that taxes suitable for use by a central level of government are not necessarily appropriate for use by state or local governments.[11] Among other considerations, national and subnational governments may be differentially capable of prudently managing revenue volatility. Some of the most volatile state revenue

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[8] The main caveat to this autonomy may be limits on state decisions that might hinder interstate commerce. Local government funding decisions are often specifically limited or demarcated by the state, with counties or cities that are incorporated with charter agreements typically having more autonomy than non-charter localities, who are subordinate to the state.

[9] See, e.g., Basic Law for the Federal Republic of Germany, Article 105 [Distribution of Powers Regarding Tax Laws] (https://www.btg-bestellservice.de/pdf/80201000.pdf).

[10] Ruth Mason, *Federalism and the Taxing Power*, 99 CALIFORNIA L. REV. 975, 1020 (2011) (discussing federal-state tax base conformity and noting that "[l]ittle attention has been paid in the federalism literature to this automatic (or semi-automatic mirroring of federal fiscal policy in state fiscal policy)").

[11] For the classic treatment of this "tax assignment" question, see Richard Musgrave, *Who Should Tax, Where, and What?*, in TAX ASSIGNMENT IN FEDERAL COUNTRIES (Edited by Charles McLure, 1983); *see also* Richard Bird, *Rethinking Subnational Taxes: A New Look at Tax Assignment*, IMF WORKING PAPER (1999) (available at http://www.imf.org/external/pubs/ft/wp/1999/wp99165.pdf).

sources are those upon which states rely by virtue of piggybacking on federal income tax. For example, Sobel and Holcombe show that state corporate taxable income exhibits significantly greater variability over the business cycle than all other major state revenue sources.[12] This is not to suggest that states should therefore abandon state corporate income taxes; they are a commonsense and logical source of revenue given the existence of the federal income tax. Nevertheless, it should be recognized that the availability of the federal tax base is not an unalloyed benefit; the volatility cost associated with reliance on corporate income taxes must be balanced against the benefits of relying on the federal base.

A similar analysis holds with respect to the individual income tax, especially as it applies to nonwage sources of income. While virtually all states with an income tax begin with the federal return, what is included as taxable income and what are allowable or disallowed deductions vary quite a bit. Twenty eight state income tax returns start with federal adjusted gross income (line 37 from the federal 1040), six states use taxable income from the federal return (line 43 from the federal 1040), and seven states create their own adjusted gross income from scratch using some elements of the federal adjusted gross income. In addition, two states only tax interest and dividends, and the remaining seven states do not have a tax on income.

While larger states are more likely to deviate more from the federal return, there isn't an absolute pattern. Eight states have twenty-five or more changes from federal AGI before getting to the state's definition of taxable income, while six states have less than 10 changes and Missouri only has one. New York has the most with 35 separate deductions. Common exclusions from state taxable income include interest on US government obligations, social security and other retirement benefits and military pay. But they can also be state specific, for example New York allows a deduction for distributions received as a victim of Nazi persecution, while California allows deductions of settlement payments from the Ottoman Empire, and Hawaii allows a deduction for compensation earned by those with Hansen's disease (lepers). Thus deductions often reflect political rather than economic considerations.

Generally speaking, capital gains and other nonwage sources of income exhibit substantially greater volatility than wages. The inclusion of capital gains in the federal income tax base, along with the realization rule that has been long embedded in federal law,[13] virtually guarantees that states with an individual income tax are going to experience substantial revenue volatility as a result of their decision to piggyback on the federal definition of income. This is especially true for those states, like California, that rely on the federal base and the federal realization rule, but tax capital gains income at the same rate as all other types of income.[14] In a report issued in 2005, the California Legislative Analyst's Office noted that "the most important factor in recent years [accounting for California's relatively high degree of revenue volatility] is the extraordi-

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[12] Russell S. Sobel & Randall G. Holcombe, *Measuring the Growth and Variability of Tax Bases Over the Business Cycle*, 49 NAT'L TAX J. 535, 543 (1996) (Table 2).

[13] Eisner v. Macomber, 252 U.S. 189 (1921).

[14] Elizabeth G. Hill, Legislative Analyst, *Revenue Volatility in California* (January 2005); *see also* Mac Taylor, Legislative Analyst, *Perspectives on the State's Revenue Structure*: *Presentation to Commission on the 21st Century Economy* 5 (January 22, 2009) (noting that with respect to volatility in California tax receipts, "Capital Gains Are the Main Story.").

nary boom and bust in stock market-related revenues from stock options and capital gains" and that "PIT [personal income tax] revenues from these two sources jumped from about $2 billion in 1995-96 to a peak of $17 billion in 2000-01, before plunging to about $5 billion in 2002-03.[15] Reliance on the federal base and federal definitions, can also leave states vulnerable to changes in revenues depending on changing federal tax rules. For example, Conway and Rork examine how changes in federal estate taxes affect state estate or inheritance taxes; and Maag examines how changing federal EITC rules can undermine state social nets.

In short, the mere existence of the federal income tax—for both individuals and corporations—must be regarded as a core feature of the federal government's intergovernmental tax policy. It would be naïve to assume that states will decide how to structure their tax systems without regard to the benefits associated with the existence of the federal tax structure. States can and do take advantage of the federal system, and by doing so reduce administrative costs but also introduce features that may not be suitable for subnational governments.

B. Federal (Statutory and Judicial) Limitations on State and Local Taxes

Beyond making available the administrative and legal infrastructure for a broad-based income tax, there are also certain features of federal law that limit state taxing authority. With regard to actual federal legislation, the most significant limitation is Public Law 86-272, a statute enacted in 1959 in response to the U.S. Supreme Court's decision in *Northwestern States Portland Cement v. Minnesota*.[16] In that decision, the Supreme Court rejected a commerce clause challenge to the imposition of a state corporate income tax on an out-of-state corporation whose sole activity in the taxing state consisted of small number of sales representatives who solicited orders for the purchase of the corporation's products. The *Northwestern States-Portland Cement* decision prompted sufficient alarm in the halls of Congress that it mobilized support for the enactment of Pub. L. 86-272, a federal statute addressing the circumstances in which a multistate business may owe state income taxes. Though intended as a stop-gap measure, P.L. 86-272 continues in full force today and remains a key feature of current U.S. intergovernmental tax policy. To the extent that Pub. L. 86-272 can be viewed as limiting the scope of state corporate income taxes, it might be regarded as a stability-enhancing feature of federal law.

Perhaps more significantly, ambiguities in the scope of Pub. L. 86-272 have raised questions regarding the validity of state tax reforms that might otherwise have the effect of stabilizing state business tax receipts. Here the question is which state business taxes should be regarded as "net income taxes" within the meaning of Pub. L. 86-272. While a tax labeled as a "net income tax" and designed with typical income-tax features would plainly fall within the scope of the federal limitation, other taxes - such as gross receipts taxes or modified "net" receipts taxes - have a less certain status. In part to resolve these uncertainties, some have proposed "modernizing" Pub. L. 86-272 to give it a broader reach.[17] The so-called "Business Activities Tax Simplification Act"

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[15] Hill, *supra* note XX at 8.

[16] Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959).

[17] Business Activities Tax Simplification Act (BATSA) 2009.

(BATSA) would amend P.L. 86-272 by, among other things, extending the statutory limitation to all "business activity taxes."

Where Congress has chosen not to act to limit state taxing powers, often times the Supreme Court has acted instead. Beginning with the 1824 decision in *Gibbons v. Ogden*,[18] the U.S. Supreme Court has taken it upon itself to police state regulations that it views as encroaching upon the plenary power of Congress to regulate interstate commerce. Under the Court's "dormant" commerce clause jurisprudence, states are generally prohibited from imposing taxes (or tax collection obligations) that unduly burden interstate commerce.[19] By far the most significant rule arising out of the Supreme Court's dormant commerce clause jurisprudence is the ruling in *Quill Corporation v. North Dakota* in 1992.[20] *Quill* extended the rule of the Court's 1967's decision in *National Bellas Hess* that a state may not collect sales taxes on an out-of-state firm whose only connection with the state is through the U.S. mail or common carrier.[21] The practical effect of this rule has been to carve out an area of tax-free consumption via mail-order or internet purchases. A key component to the overall U.S. intergovernmental tax policy, this rule is best understood as the central federal obstacle to the adoption by the states of a broad-based personal consumption tax. Any state tax reformer hoping to adopt a European-style value-added tax or a broad-based retail sales tax that reaches all household consumption must contend with this fundamental legal hurdle standing in the way of such reform.[22] To be sure, there are numerous other flaws in the design of state retail sales taxes that prevent the tax from deserving recognition as a broad-based tax on household consumption - the widespread taxation of business inputs and the general exclusion from the base of personal services are two main examples. Still, as long as the *Quill* rule stands, state retail sales taxes will remain nothing more than a weak imitation of a consumption tax.

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[18] Gibbons v. Ogden, (1824)

[19] For a state or local tax to withstand challenge under the Supreme Court's doctrine in this area, a state must show that (1) it has a "substantial nexus" with the taxpayer, (2) the tax is non-discriminatory (vis-à-vis intrastate and interstate activities), (3) the tax is "fairly apportioned", and (4) the tax bears a "fair relation" to the services provided by the state. These four "prongs" come from the Court's landmark decision in *Complete Auto* (1977), which established the modern framework for the resolution of dormant commerce clause disputes in the area of state and local taxation.

[20] Quill v. North Dakota 504 U.S. 298 (1992).

[21] More precisely, the *Quill* decision prohibits the state from imposing a use tax collection obligation on an out-of-state vendor whose only connection with the state is through the U.S. mail or common carrier. The "use tax" is a complementary tax to the standard retail sales tax and applies to items that are purchased in one state but then consumed in another. There is no question regarding the constitutionality of the substantive use tax liability on the in-state consumer; the question of *Quill* is instead whether the vendor can be made to collect that use tax on the state's behalf.

[22] Robert P. Strauss, *Federal Tax Mechanisms to Enable State Taxation of Final Consumption*, Testimony before the Subcommittee on Oversight, House Committee on Ways and Means, U.S. Congress (May 16, 2000) (available at https://www.andrew.cmu.edu/user/rs9f/wm00b.pdf) (noting the difficulties presented by *Bellas Hess* and *Quill* to a broad-based consumption tax).

C. The Federal Income Tax Deduction for State and Local Taxes

The various features of federal law just described form the basic framework of the U.S. intergovernmental tax policy. To summarize, it is a system of broad subnational fiscal autonomy, coupled with (i) federal provision of a legal/administrative infrastructure for individual and corporate income taxes, and (ii) various statutory and judicial limitations aimed at minimizing state interference with interstate commerce. It is within this framework that we find the provision that is the central target of our analysis—i.e., the SALT deduction and its differential treatment of alternative tax sources of state and local revenue.[23]

Here again the federal policy was not specifically designed with an eye toward influencing the composition of state and local tax systems, but the incentives for state policymakers are unmistakable. In calculating taxable income for purposes of the federal income tax, individuals who itemize their deductions are allowed to claim a deduction for (1) state and local real property taxes, (2) state and local personal property taxes (e.g., car taxes), and (3) state and local income taxes, or, at the taxpayer's election, state and local general sales taxes in lieu of state and local income taxes. This latter provision was added to the law in 2004 primarily for the benefit of taxpayers that live in states without an individual income tax (e.g., Florida, Texas).[24] By carving out a benefit for some but not all state and local taxes, the SALT deduction establishes clear price effects favoring the adoption of, say, income taxes over sales taxes.

Perhaps even more important than the thumb that §164 puts on the scale in favor of some taxes over others is the fact that a larger subsidy is made available to high-income taxpayers. There are two reasons for this: First, the SALT deduction is available only to those taxpayers who itemize their deductions, which typically means that only higher-income households will benefit from the deduction.[25] Second, because the subsidy is made available via a deduction from income (rather than, for example, a credit), its value to the taxpayer is a function of the taxpayer's marginal tax rate. In a system of progressive marginal tax rates, this means that those taxpayers with the highest levels of taxable income will enjoy the largest benefit from the SALT deduction. All else equal, state and local governments will have an incentive to design their tax systems to take maximum advantage of the SALT subsidy, which suggests a strong price effect in favor of a more progressive tax system and an incentive to raise taxes using either an income or a sales tax. Empirical studies have shown that the federal deduction for state and local taxes exerts a substantial influence on subnational progressivity.[26] When combined with the insight that states with more progressive income tax systems generally experience greater income tax

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[23] 26 U.S.C. §164 (2012).

[24] 26 U.S.C. §164(b)(5) (2012) (as amended by the American Jobs Creation Act of 2004).

[25] Statutory rates for taxable year 2010 range from 10 percent to 35 percent. 26 U.S.C. §1. Using 2004 data, Cullen and Gordon estimate that itemizers faced an average marginal tax rate of approximately 26 percent. *See* Julie Berry Cullen and Roger H. Gordon, *Deductibility of State and Local Taxes: Is There a Case for Continuing this Tax Expenditure?* page 7 (July 2008) (draft available at http://dss.ucsd.edu/~jbcullen/research/deductibility.pdf). Regarding nonitemizers, note that there was a temporary above-the-line deduction for property taxes, up to a maximum of $500 for singles and $1,000 for married individuals filing a joint return. 26 U.S.C. §63(c)(1)(C).

[26] *See*, *e.g.*, Howard Chernick, *On the Determinants of Subnational Tax Progressivity in the U.S.*, 58 NAT'L TAX JOURNAL 93 (2005).

volatility than those with less progressive tax systems, it becomes apparent that federal law, as currently structured, offers an inducement for states to adopt a more progressive, but also relatively volatile state tax structure.

On the question of deductibility of state and local taxes, one further point deserves mention. The continuing influence of the § 164 price effects just described is somewhat in a state of flux. For purposes of the alternative minimum tax (AMT)—a parallel system designed to ensure that taxpayers claiming certain tax preferences pay at least some minimum amount of tax - state and local taxes are *not* deductible.[27] In recent years, the AMT has grown in significance as more and more high- and even middle-income households have become AMT taxpayers.[28] Given the non-deductibility of state and local taxes under the AMT, one might view its increasing significance as a de facto gradual repeal of the SALT subsidy. It is worth noting, however, that many higher income taxpayers (especially those with large amounts of income subject to the current top marginal rate of 35 percent) actually "blow through" the AMT and thus "regain" the marginal benefit of the SALT deduction.[29] In addition, assuming that the Bush tax cuts expire on schedule and the two pre-2001 top marginal tax rates (of 36 and 39.6 percent) are reintroduced, a significant number of taxpayers currently subject to the AMT will revert to the regular income tax and thus once again benefit from the SALT deduction.[30] In his 2011 budget proposal, President Obama proposed to limit the value of itemized deductions to 28 percent, by limiting the value of deductions, more households would not be subject to the AMT.

Beyond subsidizing the particular list of specifically enumerated taxes, § 164 can also be viewed as "penalizing" (or at least "discouraging") the adoption of taxes for which no federal income tax deduction is available. The most obvious example of such a tax, following the amendments introduced via the Tax Reform Act of 1986, is the general retail sales tax. With the exception of § 164(b)(5) (discussed above), § 164 does not generally allow a deduction for state or local retail sales taxes. On balance, therefore, the federal subsidy disfavors greater state reliance on sales taxes, which tends to exhibit less volatility than income taxes.[31]

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[27] *See* 26 U.S.C. §56(b)(1)(A)(ii).

[28] Table T09-0385, *Aggregate AMT Projections and Recent History, 1970-2020*, TAX POLICY CENTER (available at http://www.taxpolicycenter.org/numbers/Content/PDF/T09-0385.pdf).

[29] This is the case, for example, for America's First Family. On their 2009 federal income tax return, President and Mrs. Obama claimed state and local tax deductions on Schedule A in the amount of $186,910 and owed no alternative minimum tax, for §164 federal subsidy of roughly $65,000 (i.e., $186,910 * 35%). *See* http://www.whitehouse.gov/sites/default/files/president-obama-2010-complete-return.pdf).

[30] In part this will depend on whether the AMT exemption reverts back to the 2001 level or is patched to keep pace with inflation. Assuming a patch of the AMT at the current tax rates would lead to x.x million households being on the AMT, while if top marginal tax rates reverted to 39.6% only yy households would be on the AMT. We examine these differences more in xx.

[31] In addition, it is worth noting that since 1979, federal law has disfavored state reliance on gasoline taxes. The Revenue Act of 1978 (P.L. 95-600, § 111(a), 92 Stat. 2763, 2777 (1978)), Congress repealed the deduction for state gasoline taxes.

D. Intergovernmental Tax Policy as a Target of Federal Tax Reform

If history is any guide, it is very unlikely that Congress will use federal tax reform as an opportunity to rethink the entire framework of what we have described above as the federal government's "intergovernmental tax policy." Indeed, the reader might justifiably question whether the fragmented policy and legal decisions just described even deserve to be labeled a "policy" – these are ad hoc, uncoordinated federal decisions that, in the aggregate and over time, exert some influence on state and local fiscal choices. The looming possibility of federal tax reform presents an opportunity to put this fragmented framework under the microscope. To be sure, the chief "target" of tax reform will be Title 26—i.e., the Internal Revenue Code. As much as we would like to see questions relating to P.L. 86-272 or the continuation of *Quill* folded into the federal tax reform discourse, we're not holding our breath. That said, there is one very important lever of intergovernmental fiscal relations that is in fact on the table: the federal income tax deduction for state and local taxes. It is to that specific provision—and research concerning its effects—that we now turn.

II. EXISTING RESEARCH ON THE EFFECTS OF SALT DEDUCTIBILITY

As noted above, the deduction of state and local taxes functions as a sort of "tax system within a tax system"—that is, it provides a set of rules governing the amount and allocation of the federal subsidy for state and local taxes. Under this system, certain tax structures are "rewarded" or "subsidized" (and therefore encouraged) while other tax structures are "penalized" or "taxed" (and therefore discouraged).

A. Influence of Deductibility on Aggregate State and Local Spending

Currently there aren't good, precisely calculated estimates of the effect of the tax subsidy currently in place to state and local governments. Tannenwald (1997) estimated (based on 1995 taxes) that the elimination of state and local tax deductibility would lead to an average tax price increase of 8.5 percent, or increase the tax price from $.84 to $.91.[32] That is, the cost to taxpayers of raising an additional dollar of state and local taxes would increase due to the lack of a federal subsidy. The change would vary across states with Wyoming facing less than a one percent change in tax price and Maryland facing a 10 percent increase. However, these estimates assume all current itemizers would lose this deduction. The actual benefit to states of the deductibility of SALT will be lower due to the effective elimination of these deductions for many households due to the AMT. However, it isn't clear whether taxpayers know they are not benefitting from the SALT. Also, the current median voter does not itemize in most states. Thus, median voter theory would imply that the level of taxes are optimally set. The paper most similar to this one is Metcalf (2011) where he estimates the federal deduction for state and local tax payments. In this paper, he examines the cost to taxpayers of eliminating the deduction and also tries to estimate how eliminating the deduction would affect state and local revenues. In prior work Feldstein and Metcalf (1987) found an effect of eliminating deductibility but could not differentiate between a change in the level of taxes from a shift in the composition of revenues. Metcalf (2011) finds

[32] See Robert Tannenwald, *The Subsidy From State and Local Deductibility,"* Federal Reserve Bank of Boston Working paper (1997).

that federal deductibility continues to have a significant and large effect on the use of deductible taxes at the state and local level. However, the size of this estimate, while negative, is imprecisely estimated. Thus, the presence of the federal deduction for state and local taxes supports progressive taxation at the state and local level.[33]

We first explore this question by examining the changes in state and local tax revenues after TRA-86. Recall, it was argued that eliminating sales tax deductibility would raise the effective cost of sales taxes, compared to income and property taxes. Because federal marginal tax rates also declined, this lowered the value of all deductions and end up effectively raising the price of income and property taxes relative to fees and specific sales taxes. Figure 3 shows little change in the aggregate amount of state and local taxes coming from general sales taxes following TRA86. Indeed in the years immediately following TRA86 no state lowered its general sales tax and 15 states had higher general sales tax rates in place in 1989 as compared to 1985. However, because marginal income tax rates were also lowered this led in general to a decline in overall taxes for wealthy households. It could be that the income effect of paying lower federal taxes offset any pressure from households to change the tax burden in light of the elimination of the sales tax deductibility in 1986.

B. Influence of Deductibility on State and Local Tax Structure

As demonstrated above, there are reasons to believe that the deduction for state and local taxes encourages state and local governments to adopt more steeply progressive tax systems than they otherwise would. For example, consider a state with four residents--Moe, Larry, Curly, and Bill Gates--that needs to raise $1 million in revenue. Assume that all taxpayers face a federal marginal tax rate of 20 percent except for Bill Gates, whose marginal rate is 50 percent. In the absence of a deduction for state and local taxes, the state may choose to impose a $250,000 tax on each resident that will be used to finance local public goods of an equivalent per capita amount.

The introduction of a deduction for state and local taxes fundamentally changes the incentives for structuring this fictional community's tax burden. If each resident continues to pay $250,000 in taxes, then the total federal SALT subsidy flowing to the residents would be $275,000: (1) Moe, Larry and Curly receive a federal SALT subsidy of $50,000 each, while (2) Bill Gates receives a federal SALT subsidy of $125,000. Another way of looking at the distribution of the community's tax burden is to say that while all residents face a nominal burden of $250,000, Moe, Larry and Curly face an effective burden of $200,000, and Bill Gates faces an effective burden of $125,000. However you view the situation, it is clear that the state is leaving money on the table, so to speak, by not altering the distribution of its tax burden to take account of the differential availability of the federal tax subsidy to its residents. More specifically, the state should shift a greater portion of its burden to Bill Gates in order to take maximum advantage of the fact that his federal SALT subsidy rate is the highest.

There are several alternatives for how the community might rearrange its tax burden in the presence of deductibility. The maximum federal subsidy is assured if the entire $1 million tax

[33] See Gilbert Metcalf, *Assessing the Federal Deduction for State and Local Tax Payments,* National Tax Journal, June 2011, 64 (2, part 2) , 565-590.

burden is imposed on Bill Gates. In this case, the total federal SALT subsidy flowing to residents would be $500,000--all of it going to Bill Gates. Alternatively, the city could rearrange the tax burden so that all four residents face an equal effective tax burden.[34] As yet another alternative, the state might change the overall level of tax revenues it raises. For example, it could raise $1.5 million in revenues instead of $1 million, again through a tax exclusively on Gates. Gates could be "compensated" by receiving half the tax proceeds ($750,000) in benefits, and the other three residents could receive $250,000 each.

In short, the federal deduction for state and local taxes introduces a wide range of distributional possibilities, all of which involve some shifting of the jurisdiction's tax burden to those individuals best positioned to receive the federal tax subsidy. Yet simply making this observation leaves unanswered a very important question: Have state and local governments in fact adjusted the distribution of their tax burdens to account for the differential value of the SALT deduction?

In a 1993 study, economists Charles Scott and Robert Triest examined the extent to which states modified the progressivity of their income taxes in response to the tax reforms of the 1980s.[35] Among other things, the Economic Recovery Tax Act of 1981 and the Tax Reform Act of 1986 substantially reduced marginal tax rates.[36] Whereas in 1980 the top marginal rate for individual filers was 70 percent, by 1988 the top marginal rate had dropped to 28 percent.[37] These changes in the federal income tax rate structure dramatically reduced the value of the deduction for state and local taxes for many high-income taxpayers. In the absence of any changes in state tax structures, this decline in the SALT subsidy rate for high-income earners would increase the effective progressivity of state income taxes--that is, the progressivity net of the federal offset. Thus, a state tax system that was already progressive would be made more progressive by the flattening of the federal tax rates, because the value of the deduction to high-income earners had declined.

Scott and Triest hypothesized that states would respond to the increase in effective progressivity by reducing statutory progressivity.[38] The rationale for doing so would be that the high-income earner's tax price had increased substantially (due to the decline in the subsidy rate) relative to the tax price faced by low- and middle-income earners. Faced with this new reality, state and local policy would, according to Scott and Triest's hypothesis, reduce the tax burden on high-income earners. Scott and Triest's results show that states did in fact reduce statutory progressivity in response to the tax reforms of the 1980s, but not enough to eliminate the increase in

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[34] This would involve imposing a tax of roughly $217,500 on Moe, Larry, and Curly, while imposing a tax of $347,500 on Gates. The result would be an equal effective burden of (roughly) $174,000 on each taxpayer.

[35] Scott & Triest, supra note XX.

[36] See Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172; Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085

[37] Individual income tax rate brackets for all years from 1944 onward may be viewed by clicking on "Tax Facts" on the Urban-Brookings Tax Policy Center web site, at http://www.taxpolicycenter.org.

[38] Scott & Triest, supra note XX, at 97 ("Suppose states act to maintain constant effective progressivity following federal tax reforms. Following a federal reform which lowers marginal tax rates, states would then reduce the statutory progressivity of their tax systems in order to maintain constant effective progressivity.")

effective progressivity.[39] One interpretation of these results offered by the authors is that by 1989 states had only partially adjusted their tax systems to the federal changes.[40] Whether the results would be the same if measured over a longer adjustment period is not known, in part because federal tax rate progressivity began to increase again throughout the 1990s.[41]

In a separate study published in 1992, economist Howard Chernick reached results similar to those presented by Scott and Triest. Chernick examined cross-sectional distributional data for state and local taxes for 1985.[42] Among other things, Chernick sought to gauge the discrete effect of deductibility on the overall progressivity of state and local tax systems.[41] To do this, Chernick regressed a measure of state and local tax progressivity against tax prices--determined for each jurisdiction based on estimates of the percentage of itemizers and average marginal tax rates--while controlling for several additional variables, including things such as welfare benefits, per capita income, and an index of "political liberalism."[42] Like Scott and Triest, Chernick found that "the deductibility incentive exerts a significant effect on the progressivity of state and local tax systems. A higher tax price--fewer itemizers and/or lower marginal tax rates--leads to a substantial decline in progressivity." [43]

Finally, Martin Feldstein, Marian Vaillant, and Daniel Altman have also examined the relationship between deductibility and state tax progressivity. In an unpublished 1994 paper the authors reported that "preliminary results provide some support for [the possibility that] state taxes are more progressive where deductibility is more common or where the federal marginal tax rate of itemizers is greater."[44] As with the Scott/Triest and Chernick studies, this finding supports the intuition that subnational governments adjust the distribution of their overall tax burdens to take account of changes in the value of the federal income tax deduction.

As these studies demonstrate, there is at least some preliminary empirical support for the proposition that the progressivity of state and local tax systems is influenced by federal deducti-

[39] This can be seen on page 99 of the Scott and Triest article by looking at the "State-actual payments" row in Tables 1 and 2. Scott & Triest use two measures of progressivity. Id. at 97. The Suits measure looks at the before-tax distribution of income and compares that figure with actual tax payments. The Reynolds-Smolensky measure subtracts the after-tax Gini coefficient from the before-tax Gini coefficient--a higher figure indicating greater tax progressivity.

[40] Id. at 102, 103-04.

[41] The top individual income tax rate rose to 31 percent in 1990 and 39.6 percent in 1993. For a brief history of the tax brackets over this period, see Leonard Burman & Deborah Kobes, Income Tax Brackets Since 1985, 100 Tax Notes 557 (2003). See also Adam Carasso & Gene Steuerle, A Brief History of the Top Tax Rate, 97 Tax Notes 1093 (2002).

[42] Chernick, supra note XX, at 576.

[41] Chernick calculated tax prices using itemization figures from the NBER/TAXSIM model. Id. at 577. These tax prices then served as one of seven independent variables in an ordinary least-squares regression model designed to explain the variance in state and local tax progressivity. Progressivity was measured using a ratio of the average tax burden imposed on the top 5 percent of the income distribution to the bottom quintile. Id. at 576.

[42] Id. at 578 tbl.1 (describing variables).

[43] Id. at 579.

[44] See Feldstein & Vaillant, supra note XX, at 7.

bility. Importantly, however, none of these studies has examined the question of whether the effect of deductibility varied depending upon the degree of income heterogeneity of a jurisdiction's residents. Yet in considering the effect of deductibility on subnational redistribution, this would appear to be a potentially significant factor. The reason is that deductibility--at least as currently designed--alters the relative tax prices of residents in an income-heterogeneous jurisdiction, but does not alter the relative tax prices of residents in an income-homogeneous jurisdiction.

For example, consider two jurisdictions, each of which has three residents. In jurisdiction A, the three taxpayers have incomes of 10, 50 and 100 each. In jurisdiction B, each of the three taxpayers has income of 100. If deductibility is introduced to this world subject to a rule limiting the deduction to taxpayers with income of, say, 75 or greater, then jurisdiction A would face an incentive to alter the distribution of its tax burden in response to the differential subsidy rates faced by its residents. By contrast, deductibility does not influence the relative tax prices of the residents of jurisdiction B. This suggests that deductibility-induced changes in the distribution of tax burdens are more likely to take place in income-heterogeneous jurisdictions and less likely to occur in income-homogeneous jurisdictions. Accordingly, one would expect the degree of income heterogeneity in a community to be correlated with the degree to which that community would alter its tax structure in response to federal deductibility.

III. AN EMPIRICAL SNAPSHOT OF THE CURRENT SALT DEDUCTION

To explore the fiscal and distributional effects of eliminating the deductibility of state/local taxes we first examine the current distribution of these taxes across income and geographic areas and discuss the characteristics of taxpayers that lead to higher deductions. We do find some evidence of greater reliance of deductible taxes in more heterogeneous states. Virtually all of the 47 million households who itemized in 2009 claimed a deduction for state and local taxes paid, totaling $443 billion in deductions claimed for the year.

Eighty-six percent of itemizers deducted real estate taxes, 74 percent of itemizers deducted state and local income taxes while 22 percent deducted sales taxes. Table 1 presents information on the number and amount of state and local tax deductions by state. While households who take these deductions are in every state, they are concentrated in a few. While taxpayers in California and New York make up 18 percent of households filing returns, and pay 22 percent of income taxes, they make up twenty percent of those itemizing and of those claiming deductions for all state and local taxes, and almost 30 percent of the value of the total state and local tax deduction and one-third of the deductions from state and local income taxes. Not surprisingly, the states that receive a large share of these deductions also pay a large share of federal income taxes.

Table 2 shows the average deduction claimed by itemizers in different states, with itemizers in seven states and the District of Columbia claiming on average over $10,000 per household, and taxpayers in New York, Connecticut and New Jersey claiming over $14,000.[47] Not surprisingly, the total amount of SALT deductions claimed is heavily concentrated in a small number of states. For example, three states—California, New York, and New Jersey—account for 36 per-

[47] New York also has the highest average amount of income tax deductions listed by those who itemize, followed by Washington DC, California, and Connecticut.

cent of SALT deductions claimed. The ten states with the largest SALT deduction amounts claimed account for 61 percent of the total.[48]

This "gross" deduction is only part of the story since the distributional implications of eliminating the deductibility of these taxes are complicated by the fact that under the current system there are limits on overall deductions and phase outs of these deductions under the AMT. Table 3 shows the percentage of households that are subject to the AMT by state. Not surprisingly the top seven states[49] in the two tables are the same: because of the preference status of state and local tax deductions, it is precisely the states with high average tax deductions that also have more households owing the AMT. In 2009 about 3.8 million AMT taxpayers lost part or all of the federal deduction. Under current tax law, the number of households facing the AMT limit will grow, further limiting the benefit of state and local deductions.

The geographic distribution of benefits can be explained in part by the distribution of wealth across states. State and local tax deductions are highest in places where state and local taxes are high, either due to relatively high or progressive income or property tax rates or relatively high incomes and property values or both. Thus, California and New York at the top of the list since they have some of the most expensive real estate in the country, large concentrations of wealth and progressive income tax systems. In 2009, taxpayers with AGI of $200,000 or more made up four percent of California returns and over 50 percent of federal taxes from California while those earning under $50,000 made up 65 percent of California federal returns and paid 8 percent of federal income taxes.

Table 4 shows the distribution of returns and state and local tax deductions by income class. More than sixty percent of all state and local tax deductions were claimed by the twelve percent of taxpayers with incomes exceeding $100,000, and over seventy percent of state and local income taxes were claimed by households making over $100,000 or more. These are the same households that are most likely to be subject to the AMT since 98 percent of AMT revenues come from households earning over $100,000 and itemizing deductions. If we examine the distribution of both taxes paid and deductions taken by state, we find that the highest income households are taking the largest deductions. In California the 15% of households that earned $100,000 or more accounted for 54 percent of state adjusted gross income and claimed 57 percent of listed deductions. However, they claimed 71 percent of all state and local tax deductions and 82 percent of income tax deductions. The higher percent of income tax deductions reflects California's higher reliance on a progressive income tax and lower property tax rates (due to Proposition 13).[50] Again this is before consideration of the AMT limitations faced by these households. Similar breakdowns exist for other states.

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[48] These include CA, NY, NJ, IL, TX, PA, MD, MA, FL, and OH.

[49] Even though DC is included as a state in this sentence, we understand that it is not a state.

[50] These calculations are based on information available from the IRS, Individual Tax Statistics – State Income for 2010, Tax Year 2009. Available at http://www.irs.gov/taxstats/article/0,id=171535,00.html.

IV. FEDERAL TAX REFORM AND THE SALT DEDUCTION

A. The SALT Deduction under Current Federal Tax Reform Proposals

While taxpayers are currently allowed to deduct state and local taxes against federal income, this deduction is under threat due to both implicit characteristics of the tax code (erosion from the AMT) and the fact that it is the deduction most often singled out for elimination in proposed reform measures. The current top marginal tax rate is 35 percent and allows itemizers to deduct state and local taxes paid at a 35 percent rate. However, for the last few years, many aspects of the tax code have included short term patches or fixes to avoid worsening the ten year budget forecast. These short term solutions, make measuring the cost of potential reforms more difficult due to the uncertainty about what is meant by the current tax code. This has led to a number of short term patches of the current and near term tax code. This makes calculating costs of other tax policy changes harder to estimate due to uncertainty about what actual policy will be in the coming years. There can also be real costs of delays in extending expiring tax provisions. For example, the postponement in reaching a budget agreement at the end of the year led to delays in the ability of taxpayers to file their taxes due to delays in the IRS's ability to codify tax law. Moving from a tax system that is based on annual patches of expiring provisions to one that examines the long term costs and benefits of tax rules and enacts tax rates and deductions for a longer term period would reduce uncertainty in tax policy. A number of commissions or proposals have been suggested that do this. Figure 1 lists some recent reform proposals as well as the tax plans of the major Republican candidates and summarizes some of the key characteristics of these reforms with regard to the repeal or reform of the SALT deduction.[51]

President Obama's 2012 Budget included allowing the top two rates to rise to 36 percent and 39.6 percent after 2012, would tax net long-term capital gains and dividends at a 20 percent rate Last year's budget proposal would have allowed the top marginal tax rate to rise to 39.6 percent after 2012, but would limit the value of itemized deductions to 28 percent. The budget also would permanently patch the AMT, thus limiting the number of taxpayers subject to the AMT. Under the 2012 budget proposal, the value of eliminating the SALT would be higher due to the decreased number of taxpayers on the AMT. The lower value of the tax deduction would imply a higher tax price for states increasing their income tax. However, because the number of households on the AMT would fall appreciably it is unclear whether the benefit to states of having more taxpayers able to deduct the SALT deduction would offset the fact that the deduction is limited to 28 percent.

The aforementioned President's Advisory Panel on Federal Tax Reform from 2005 issued its report on November 1, 2005. Their proposal had two separate options for the tax code, but they were quite similar in many respects. The stated goal of the panel was to "make the tax code simpler, fairer and more conducive to economic growth."[52] The panel proposed replacing the current

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[51] Information on the tax implications of tax reform proposals and the Republican Presidential Candidates Plans is drawn from the Tax Policy Center's analysis of these plans. http://www.taxpolicycenter.org/taxtopics/Analyzing-GOP-Tax-Plans.cfm

[52] *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, November 2005, http://www.taxpolicycenter.org/taxtopics/upload/Tax-Panel-2.pdf

individual income tax rate structure with either three tax brackets of 15, 25, and 30 percent or four tax brackets of 15, 25, 30, and 33 percent. Under both plans, both the AMT and the SALT deduction would be repealed.[53]

President Obama's Deficit Commission (Bowles-Simpson) issued its report almost exactly five years later on December 1, 2010.[54] This report was often referenced in the negotiations this summer as part of the passing a new debt ceiling. Bowles-Simpson included replacing the current six-bracket individual tax rate schedule with rates of 12, 22, and 28 percent, eliminating the AMT but also eliminating itemized deductions. Under Bowles-Simpson, states would face higher costs due to the lack of deductibility of state and local taxes. However, due to the broadening of the base and lower federal tax rates – states might be able to keep their current taxes despite the lack of subsidy.

Similarly, running almost concurrently with the President's Commission was an effort by the Bipartisan Policy Center to reduce the level of debt facing the country. This task force chaired by Alice Rivlin and Pete Domenici released a proposal entitled, *Restoring America's Future* in November 2010.[55] This proposal dramatically changes the federal tax code, simplifying existing deductions and credits and introducing a small broad-based consumption tax. From our perspective, the most important features of the plan to states are the elimination of the AMT and the itemized SALT deduction as well as the replacement of the current tax rate structure with a two rate structure (15 and 27 percent). There are four remaining major candidates for the Republican presidential nomination: Newt Gingrich, Ron Paul, Mitt Romney, and Rick Santorum. All have proposed various tax reforms, though the level of detail and realism of the proposals vary. However, unlike the budget reform suggestions offered by the prior commissions, most of the candidate proposals lower tax revenues substantially so make no progress in decreasing the country's debt level. All of the Republican candidates would eliminate the surtaxes contained in the 2010 Patient Protection and Affordable Care Act.

Governor Romney would permanently extend all the 2001 and 2003 tax cuts now scheduled to expire in 2013 and continue to "patch" the alternative minimum tax, but would allow some recently enacted provisions to expire and would repeal certain tax provisions in the 2010 health reform legislation. Tax provisions in the 2009 stimulus act and subsequently extended through 2012 would expire. These include the American Opportunity tax credit for higher education, the expanded refundability of the child credit, and the expansion of the earned income tax credit (EITC). The plan would also eliminate tax on long-term capital gains, dividends, and interest income for married couples filing jointly with income under $200,000 ($100,000 for single filers and $150,000 for heads of household) and repeal the federal estate tax, while continuing the gift tax with a maximum tax rate of 35 percent. It is likely his tax plan would retain state and local

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[53] Representative of the changing political discourse over the past seven years, in the entire report the word "deficit" is used once and "debt" is used only to discuss mortgage debt and debt versus equity financing by businesses.

[54] Summary available at http://www.taxpolicycenter.org/taxtopics/Fiscal_Commission_Final_Report.cfm.

[55] For more details of the Rivlin-Domenici plan see http://www.bipartisanpolicy.org/library/report/restoring-americas-future. An examination of the tax changes and revenue and distributional estimates can be found at http://www.taxpolicycenter.org/taxtopics/BPC_Plan.cfm.

tax deductibility. This plan would reduce federal tax revenues by $600 billion in calendar year 2015 with most of the declines in taxes going to high income taxpayers.

Mr. Gingrich's individual "flat tax" proposal would create an optional alternative tax system with a single 15 percent tax rate, which would apply to an income base similar to that in current law, with three major modifications: 1) capital gains, dividends, and interest income would not be taxable; 2) taxpayers could claim a standard exemption of $12,000 for each individual and dependent; and 3) the plan would eliminate the standard deduction and most itemized deductions and credits but would retain deductions for mortgage interest and charitable contributions as well as the child and earned income tax credits. The plan would also repeal the alternative minimum tax (AMT). The Gingrich plan would reduce federal tax revenues dramatically. TPC estimates that on a static basis, the Gingrich plan would lower federal tax liability by $1.28 trillion in calendar year 2015 compared with current law, roughly a 35 percent cut in total projected revenue.

Senator Santorum would permanently extend all the 2001-10 tax cuts now scheduled to expire in 2013 and further lower individual income taxes by collapsing the current six tax brackets into just two brackets with 10 percent and 28 percent rates. He would also triple the exemption for dependent children, cut the top tax rate on long-term capital gains and qualified dividends to 12 percent, and repeal the alternative minimum tax. The senator says he would "eliminat[e] marriage tax penalties throughout the federal tax code" but does not explain how. He would also eliminate the increased taxes which were part of the 2010 health reform legislation. Sen. Santorum's proposal retains deductions for charitable giving, home mortgage interest, healthcare, retirement savings, and children but does propose to eliminate the SALT deduction. The plan would also repeal the federal estate tax. Compared with the current law baseline, the Santorum plan would cut taxes for about 81 percent of taxpayers by an average of more than $9,700, while less than one-half percent would face tax increases averaging about $175. This plan is estimated to lower federal tax liability by about $1.3 trillion in 2015 compared to current tax laws.

Ron Paul hasn't come out with a tax reform plan but he officially supports any policies that lower the tax burden including a variety of tax credits and deductions. His ideal tax plan involves repealing the income tax and instituting a fair or a flat tax after that repeal. Thus short of repeal of the income tax he does not alter the SALT deduction.

Plan	State and Local Tax Deductibility	Top Marginal Tax Rate
Current System	Allowed	35%
President Obama Budget	Retain, but cap value of itemized deductions at 28%.	39.6%
Bush Panel	Eliminate	Proposal 1: 33%, Proposal 2: 30%
Rivlin-Domenici	Eliminate	27%
Bowles-Simpson	Eliminate	28%
Newt Gingrich	Choice: Pay taxes under current law, or pay flat tax with no state and local deductions.	35% (current system) or 15% (single rate)
Ron Paul	Retain, unless income tax is eliminated.	Prefers no Income Tax.
Mitt Romney	Retain	Current system
Rick Santorum	Eliminate	28%

B. Modeling the Repeal of SALT Deduction

While examining the current distribution of deductions and AMT is informative, the changing rules governing both the AMT and tax system mean that the impacts of eliminating state and local tax deductibility will change over time. How much money would eliminating the state and local deductions save the Federal government? Is the deduction already effectively being eliminated by the AMT? Would the elimination of these deductions be enough to offset the revenues lost by eliminating or indexing the AMT? To answer these questions we examine static simulation models of the revenue implications of eliminating or modifying state and local tax deductions beginning next year and then the cost over the next 10 years. We are assuming that any of these policies would go into effect in 2013 and be permanent. How much money is raised and how many households will be affected depends critically on what assumptions we make about the other moving parts of the tax system.[56]

[56] For more detailed information about the assumed parameters for these simulations see http://taxpolicycenter.org/numbers/displayatab.cfm?Docid=3130. Baseline A corresponds to the current law baseline for 2013, while baseline C corresponds to current policy. Baseline B assumes current law (expiration of the tax cuts from 2001 and 2003) except it includes a patch to the AMT

If we assume a baseline based on current law, (tax rates will go back to 2001 levels and the AMT exemption amount falls from $74,450 to $45,000 for joint filers) eliminating the deduction for state and local taxes, while leaving the AMT in place would generate $86.7 billion in 2013 or $956 billion in federal revenues over the period 2013-2022. (Table x, panel 1, option 1). This implies 21 million households on the AMT in 2013, increasing to 28 million households on the AMT by 2015. Thus the amount of money raised is tempered by the fact that so many households would be subject to the AMT. Eliminating the state and local deduction removes 8 million taxpayers from the AMT in 2013 or 10 million in 2015.

Baseline C, assumes current policy, or that existing tax rates and patches are maintained, so the AMT exemption amount is set at current real levels and marginal tax rates are constant. Under this assumption, eliminating the SALT deduction is slightly less valuable at the beginning of the period than under current law, increasing federal revenues by $86 billion in 2013 and raises about one trillion dollars over a ten year period. Since fewer households are on the AMT (4.6 million vs. 20.9 million in 2013), more households currently benefit from the SALT deduction, but the value per household is less due to lower marginal tax rates.

Finally, Panel B (baseline B) assumes that the AMT is patched or that the AMT exemption would be maintained at 2011 levels but that top marginal tax rates are allowed to revert to their 2001 levels, 36 percent and 39.6 percent. Using this baseline, the elimination of the SALT deduction would raise over a hundred billion dollars per year or $1.5 trillion over a ten year period as fewer people are on the AMT and the value of deduction is high due to higher tax rates.

C. Distributional Implications of Repealing the SALT Deduction

Given the interaction of the AMT and the SALT deduction, the distribution of the increased tax levels would also vary substantially depending on what baseline is used. Our distributional analysis is done for 2015. We start by examining the effects of eliminating state and local tax deductibility in 2015 as compared to the three different baselines.[57] Low income households are largely unaffected by these changes due to their taking the standard deduction and not being affected by the AMT not matter what baseline we use. Under all three baseline scenarios over seventy percent of households face no change in their tax bills.

Repealing the deduction for state and local taxes is expected to increase the tax bills of a majority of taxpayers in each income class over $75,000 (Table x, column 3). The size of these changes depends fundamentally on what the rest of the tax code looks like. Under Baseline A average federal tax rates increase by .8 percentage points, with the largest increases in average tax rates occurring for households earning more than $500,000. These tax payers face a 1.5 percentage point increase in tax rates or an average increase in their tax bills of over 5 percent for those earning between $500,000-$1 million and over 4 percent for those earning more than a million dollars. The loss comes about because they are still eligible for a portion of their state and local tax deductions after the phase-out of deductions. Taxpayers earning between $100,000-$200,000 also face an average percentage point increase of .8 percentage points. This is a smaller average tax increase but it also masks the fact that while 2/3rds of households in this range face

[57] Breakdown of the distribution of the Federal Tax Costs are also available for other years and for only repealing the state and local income measures from the author.

a tax increase, 1/3rd are largely unaffected due to effectively not receiving the deduction because of the AMT rules.

The above results are based on a comparison of changing the deductibility of state and local taxes (and the AMT) in a static model. The size and distribution of these effects will vary depending on what other changes are assumed. Thus, if the current, higher AMT exemption is extended (but top marginal tax rates return to their 2001 levels) then the distribution of tax increases across taxpayers also expands with households earning over $100,000 facing a higher average federal tax rate that is 1.3-1.6 percentage points higher or average tax bills that are four to six percent higher. Finally, if current tax rates and AMT rules are maintained then the households facing the largest increases in their tax bills are households earning between $100,000 and $200,000 (face a 1.1 percentage point or 5 percent increase) and those earning more than one million dollars (face a 1.2 percentage point or 4 percent increase). This is in large part because of taxpayers in the two hundred thousand and one million dollar tax range losing the deduction due to the AMT.

Note that the current interplay of the AMT and SALT deduction, offer states a particular inducement to pass millionaires taxes, or higher tax rates or surcharges on high income households. Because these households have phase outs of deductions and are no longer subject to the AMT, about 1/3 of the taxpayer cost of these higher tax rates are effectively paid by the federal government.

D. Alternatives to Repeal: Identifying Defensible Half-Measures

In the prior sections, we have considered only the possibility of outright repeal of the SALT deduction. Yet experience and common sense suggest that there is likely to be substantial political opposition to this proposal, most likely in the form of lobbying from groups representing the interests of state and local governments, such as the National Governors' Association, the Conference of Mayors, and the National Conference of State Legislatures. Governor Mario Cuomo's 1985 warning that outright repeal of the SALT deduction would amount to a "regional death sentence" is likely to echo through time, as new, vocal defenders of the subsidy (including Cuomo's son, current New York Governor Andrew Cuomo) develop even more histrionic claims about the consequences of repeal. Political events are by no means guaranteed to unfold in this manner, but the vigorous defense of SALT deductibility in previous years suggests to us that there is value in developing alternatives to outright repeal that have at least plausible defensibility on policy grounds. In addition, many of these half-measures would still raise hundreds of billions of dollars over a ten-year window. These partial repeals also will have different distributional effects and could also help nudge states in the design of their own tax systems.

Toward that end, we examine here three separate half-measures—variations on "partial repeal"—that we believe merit serious consideration in the event that some SALT subsidy is retained. Our analysis focuses on three conceptually distinct alternatives (1) limiting the SALT deduction to a subset of taxpayers, (2) limiting the SALT deduction to a subset of taxes, and (3) converting the SALT deduction to a nonrefundable credit.

1. Limiting the SALT Deduction to a Subset of Taxpayers

As noted above, under current law the deduction for state and local taxes is available only to those taxpayers who elect to itemize their deductions. In theory the standard deduction incorporates an approximate amount of state and local taxes to allow some standard subsidy for taxpayers who elect not to itemize their deductions; but of course the standard deduction has no effect on the marginal cost of state and local taxes to non-itemizing taxpayers. Because itemizing taxpayers have much higher incomes than those who claim the standard deduction, the current SALT deduction is necessarily limited to the wealthiest households. This feature of the current deduction (subject to the AMT caveat) creates an incentive for state and local governments to shift the tax burden to high-income households. There may be arguments for designing a federal SALT subsidy with such a preference for high-income households, but this approach brings with it a distortion in favor of relying on that subset of the population whose income is most volatile.

There are numerous alternatives to the current approach. In theory, the deduction could be limited by virtually any personal attribute identified on a federal income tax return (or even some not currently identified). We consider the possibility of a policy change that would limit the deduction by age, perhaps by disallowing the deduction for taxpayers under the age of 65. Few would suggest that this segment of the U.S. population needs to be singled out for preferential treatment by the federal government, but as an alternative to outright repeal of the SALT deduction, limiting the deduction to elderly taxpayers might have some attraction—in part because it closely approximates repeal. Moreover, it is likely that persons age 65 and older likely consume a smaller share of state and local public goods, at least (or especially) with regard to K-12 education.[58] An age-limited SALT deduction would recognize the differential opposition to K-12 education spending by age, partially muting objections to public school funding from empty-nesters. Repealing the SALT deduction for everyone but the elderly would decrease the ten year revenue impact by one to two hundred billion dollars (depending on the baseline) relative to outright repeal. Thus, such a reform would raise approximately $1 trillion over a ten year window.

2. Limiting the SALT Deduction to a Subset of Taxes

Because the SALT deduction applies to some taxes and not others, and because the deduction is only available to households that itemize, states have an incentive to favor deductible taxes that are paid disproportionately by itemizers. And while the AMT serves to limit this impulse to some degree, the fact that the highest income taxpayers often are not subject to the AMT means that state taxes on the wealthiest taxpayers enjoy the largest federal subsidy. As an example, President Barack Obama and First Lady Michelle Obama saved $27,394 in federal income taxes by virtue of their $78,269 deduction for state and local income and real estate taxes in 2010.[59] The nation's First Couple enjoyed the maximum SALT subsidy rate of 35 percent. As mentioned before, the current interaction of the AMT, itemization and the distribution of income within certain states, gives some states an added incentive to adopt highly progressive income tax systems and to favor higher top marginal tax rates or millionaire surcharges. For example, California, New York and New Jersey all face income distributions and tax schedules that would

[58] Randall Reback, Local Tax Price Discrimination in an Aging Society (February 2011).

[59] See Form 1040 for Tax Year 2010 at http://www.whitehouse.gov/sites/default/files/rss_viewer/POTUS_taxes.pdf.

lead to a portion of millionaire's taxes being exported to the federal government. Each of these states has either adopted or is considering adopting a so-called "millionaire's tax"—i.e., a special top tax rate that applies to the ultra-wealthy.[60]

To be sure, a case can be made for avoiding drastic cuts to vital public services with new revenue on high-income households. Less clear, however, is whether a highly regressive federal subsidy is needed to encourage the adoption of such policies. As we have noted throughout the analysis, increased progressivity almost always brings with it increased volatility. This is true in part because high income households derive a greater share of their income from investments—especially capital gains—than do less affluent households. In effect, the SALT deduction (along with other features of federal law discussed above) encourages states to adopt highly volatile taxes on a small segment of the population over broad-based taxes that promote long-term fiscal sustainability. Outright repeal of the SALT deduction would remove this effect, as would reforms involving a repeal of the deduction for state and local income taxes while retaining the deduction for other taxes.[61]

Another possible reform short of outright repeal would be to eliminate the SALT deduction for all taxes other than property taxes. Unlike income taxes, the percent of state and local revenues coming from the property tax has generally fallen over the last 40 years, precipitously so in states like California with property tax limits.[62] Retaining the deduction for property taxes while eliminating it for sales and income taxes could shift the relative cost of each type of tax. More reliance on the property tax has typically meant a more stable tax base, so could lead to less volatile state and local systems. In addition, because the property tax is usually controlled by local governments, any federal policy favoring the property tax may also shift the fiscal relationship between states and their local governments. Recent work by Shanske makes the normative case for federal policies that favor local property taxes.[63]

If the SALT deduction is limited to property taxes, we estimate that federal revenues would increase by more than $500 billion over ten years. These estimates are static—i.e., they do not account for any potential shifting of state and local tax burdens away from non-deductible taxes

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[60] Tami Luhby, States Look to Hike Taxes on Millionaires, CNN.com http://money.cnn.com/2012/01/16/news/economy/states_millionaire_tax/.

[61] One might add that much of the administrative/legal complexity of the SALT deduction derives from the operation of the so-called "tax benefit rule" (26 U.S.C. §111) which requires taxpayers receiving a state income tax refund in any given year to include that refund in their federal gross income for the year it is received unless the prior year's deduction did not have the effect of reducing the taxpayer's federal income tax liability for that prior year. In effect, this rule requires taxpayers to recalculate their prior year's federal income tax liability in order to determine whether the amount shown on a 1099-G is taxable for the year of the refund. This process involves completing a special worksheet (the "Form 1040 worksheet") unless one of ten situations applies, in which case must use the special "Worksheet 2" set forth in IRS Publication 525. These same rules apply for all deductible state/local taxes (indeed, all deductions) but the possibility of later year refunds is far greater with regard to income taxes because wage withholding merely approximates the taxpayer's annual liability, requiring an end-of-year reconciliation via the state income tax return. Property taxes and retail sales tax are far less likely to involve refunds in a year other than the year in which the tax is paid.

[62] California Constitution, Article XIIIA.

[63] Darien Shanske, How Less Can Be More: Using the Federal Income Tax to Stabilize State and Local Finance, __ Virginia Tax Rev. __ (forthcoming 2012).

into property taxes. As such shifting occurs, the revenue gain to the federal government would diminish. At the same time, however, a state and local tax system centered on a (federally-subsidized) property tax would likely exhibit less volatility over the business cycle. To the extent that the federal government is called upon to backfill lost state/local revenue in the trough cycle, as was the case in the past two recessions, it may be in the federal government's interest to promote the adoption of less volatile state and local revenue structures.

3. Converting the SALT Deduction to a Flat-Rate Credit

Finally, Congress could eliminate the effect of the progressive rate structure on the value of the deduction for state and local taxes by converting the subsidy from a deduction to a credit. A deduction reduces taxable income and thus has a value that depends upon the rate at which that income would have been taxed. As noted above, in a progressive income tax that value rises with income. By contrast, a credit is a reduction in the amount of tax owed and is taken into account after the progressive rate structure is applied to the taxpayer's income. The value of a credit depends upon the statutorily specified “credit percentage”-- that is, the percentage of expenditures that the credit is designed to reimburse. For example, if a credit is allowed for state taxes at a credit percentage of 25 percent and the taxpayer pays $10,000 of state taxes, then she would be entitled to a credit in the amount of $2500. In effect, the credit percentage serves the same function for credits that the marginal tax rate serves for deductions—it sets the dollar value of the subsidy.

The value of a credit may also be limited by the amount of expenditures that are considered to be “creditable” under the statute. Most commonly, credits will feature floors or ceilings that have the effect of reducing the amount of the credit depending upon the relationship between the expenditures incurred by the taxpayer and the trigger points for the ceiling and/or floor. In the case of a floor, the credit will only be allowed with respect to expenditures in excess of a threshold amount. By contrast, a ceiling specifies a maximum amount up to which the taxpayer's expenditures will be counted in calculating a credit. Assume, for example, that a credit for state taxes is allowed at a credit percentage of 25 percent but that taxes are creditable only to the extent that they exceed $1000 and that no taxes over $51,000 may be used in determining the amount of the credit. Under such a scheme, a taxpayer who has paid $21,000 of state taxes will be entitled to a credit of $5000 (that is, ($21,000- $1000) x .25). In addition, because of the ceiling, no taxpayer would be entitled to a credit in excess of $12,500 (that is, ($51,000- $1000) x .25). In addition credits can be refundable or non-refundable. A refundable credit allows the household to receive the value of the credit independent of any tax liability. A non-refundable credit can zero out tax liability but has no value for households without tax liability.

We have modeled the savings and costs of converting the state and local tax deduction to either a 15 percent or 25 percent non-refundable credit, with and without a ceiling. Our SALT credit, like the current SALT deduction is disallowed for households subject to the AMT. In all cases, except the most generous one (a 25 percent unlimited credit) the conversion would result in increased revenues for the federal government. For example, a 15 percent credit would raise between $238-$507 billion if there was no ceiling or $350-$637 billion if subject to a $7,500 credit ceiling. As with all of our estimates, the broad range of revenue outcomes turns on the choice of baseline.

How the value of the credit is distributed across households would also vary considerably from the current distribution. If we assume that current tax policy is maintained (2011 AMT exemption and tax rates, or scenario C in our simulations), and we changed from the SALT deduction to a 15 percent credit, 36.5 percent of households would receive a tax cut while 16.8 percent would face a tax increase (Table 7). A majority of households earning between $30,000-$100,000 would experience a tax decrease, while a majority of households earning over $100,000 would experience a tax increase. A majority of households would see no change in their tax bill due to either paying no federal income tax or due to being on the AMT. If we limit the value of the credit, the same pattern obtains across households in terms of who faces a tax cut vs. increase, though because of the limited value of the credit, those with a tax increase face a much larger average increase.

Importantly, each of the approaches discussed above—the above-the-line deduction for state and local taxes, the conversion of the subsidy from a deduction to a credit, and the use of ceilings and/or floors—relies upon the actual amount of state and local taxes paid by a taxpayer in order to determine the amount of the subsidy. Assuming for the moment that anything is possible (politically), it should be emphasized that this limitation is one that we impose upon ourselves and, at least as a thought experiment, may be worth disregarding in the design of a SALT subsidy. Unburdened by political limitations, one could imagine a SALT credit to be paid to each resident of a state or locality the amount of which depends upon some credit percentage of that taxpayer's per capita share of total taxes paid. This approach would involve an explicit decoupling of the credit from the amount of taxes actually paid by individual taxpayers. Under such a scheme, the federal subsidy begins to look more like an intergovernmental grant, albeit one that is paid directly to taxpayers rather than to the government itself.

CONCLUSION

As Congress embarks on the project of fundamental tax reform, it is important for lawmakers to understand how changes will affect not only the federal government's bottom line, but also the ability of state and local governments to raise revenues and possible changes to the attractiveness of different revenue instruments. Our analysis has considered how repeal of the deduction for state and local taxes would affect taxpayers across different states and income classes and also how it would likely influence state and local fiscal choices. While taxpayers in all 50 states claim this deduction, the benefits are concentrated in relatively few states. Those are the states with a disproportionate share of high-income households and relatively high and progressive state and local taxes. These taxpayers also pay a higher percent of federal income and are currently more likely to be subject to the AMT. The estimated federal savings and distribution of tax rate increases from eliminating the deductibility of state/local taxes depends on what assumptions are made concerning reform of the AMT. If we assume the current law where AMT expansion largely eliminates deductibility, then for many households, elimination of state and local tax deductibility is already likely to happen as part of the current tax system.