The Daily Dish

A SALT on the States?

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Eakinomics: A SALT on the States?

One of the most controversial aspects of the Tax Cuts and Jobs Act (TCJA) was capping (at $10,000) the deductibility of state and local government property and income taxes — known as the SALT provision. The discipline of economics has a straightforward approach to thinking about the impact of SALT, with the best summary being that of Gilbert Metcalf in a 2008 paper. The basic notion is that federal deductibility affects the "price" of state and local taxes. Specifically, if you can't deduct, then the "tax price" of $1 of state and local taxes is $1. But if you can deduct, this price goes down. Suppose that your federal income tax rate is 50 percent and your state income tax rate is 10 percent. If you owe another dollar, you pay 10 cents in state tax. You also owe 50 cents of federal tax, but you first get to deduct the state tax. Instead of paying 50 percent of $1, you pay 50 percent of 90 cents ($1-0.10); your federal tax is lowered from 50 cents to 45 cents. In effect, your 10 percent doesn't cost a full 10 percent, because if you pay more state tax, you get an offset in the lower federal tax — the "tax price" of $1 of taxes is 50 cents (in this scenario).

So the impact of the TCJA came in two areas. First, the limitation of the deduction to the first $10,000 means that for state and local taxes above that amount, the tax price is a full $1 for every dollar of property and income taxes. Moreover, because the TCJA increased the standard deduction substantially, fewer individuals will itemize their deductions. For all of those who simply take the standard deduction, the tax price is a full $1 as well. The upshot is that state and local government activities financed by property and income taxes just got pricier.

This dynamic has generated some speculation that the affluent — those most likely to itemize and be above the $10,000 threshold — will flee high-tax states like New York. Perhaps, but heading for the exits is not the only possible response. People can also complain (yes, complain about government!) about the fact that 37 percent of aggregate state and local general revenue — the proportion that comes from income and property taxes — is more painful to fork over. They might even elect new state and local representatives to address the issue.

But what would those newly elected representatives do? A popular assertion is that high-tax/high-spending states will be forced to cut back on spending and shrink the footprint of government to keep taxes under the $10,000 limit. States might do this, but the research suggests that on the whole spending will be unaffected. Instead, the data indicate that states and localities will cut back on the use of income and property taxes and instead use more non-deductible taxes and fees (the other 63 percent of general revenue). So, while capping SALT will not decimate the delivery of public services in New York, New Jersey, California, Illinois, and other high-tax places, it will alter the portfolio of taxes and fees these regions use to finance the public sector. Since there is no compelling reason for the federal taxpayer to subsidize one part of those portfolios to begin with, this shift amounts to removing an unneeded distortion.