



The Daily Dish

Tax Reform and State-Local Taxes

DOUGLAS HOLTZ-EAKIN | SEPTEMBER 7, 2017

Eakinomics: Tax Reform and State-Local Taxes

Talk of tax reform is heating up again. To date, most of the attention has focused on the issues in business taxation — investment incentives, the high corporate rate, the taxation of overseas earnings, etc. But there is increasing attention on some of the issues in individual income taxation, including proposals to eliminate the deductibility (for federal tax purposes) of state-local taxes. What are the key issues?

The current approach lowers the effective cost of state tax dollars. In a simple example, suppose that your federal tax rate is 50 percent and your state 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 then you 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 effective cost of state funds is 5 percent.

The simple observation about eliminating deductibility is that it makes the cost of a dollar of state taxes the full dollar because there is no offset. This is appealing because it means that state lawmakers have to confront the real cost of their tax (and spending) activities without a distortionary hidden subsidy from the federal taxpayers. That is the basic motivation for eliminating the deductibility in tax reform. But now the complications begin, namely:

1. Not everyone deducts their state-local taxes. If your income is low enough, it makes more sense to simply take the standard deduction. And if your income is above roughly \$315,000 (married) your ability to deduct itemized deductions is phased out. In either case, there is no real change from the tax reform.
2. High-tax states tend to be dominated by elected Democrats, so the proposal is often characterized as partisan warfare — but should not be. It is a straightforward issue of efficiency in budgeting incentives.
3. Taxes are higher — other things equal — for some people. Notice that before tax reform, total taxes were 55 cents — 10 cents at the state level and 45 cents at the federal level. After such a reform, taxes would rise to 60 cents. This is a simple example of the fact that tax reform has winners and losers, and these would appear to be among the losers. But it is an incomplete argument because the whole point of eliminating deductions and otherwise broadening the tax base is to be able to lower the tax rates. Thus, if the reform broadened the base but lowered the rate from 50 percent to 45 percent, the person in my example would be held harmless. Even greater rate reduction would lower the total taxes on the additional dollar.

This latter point is really the key. Yes, tax reform will have many provisions. Some will be good news (for you) and some may be bad (for you). But the only fair way to judge the reform is as a whole — rate reductions, base broadening, and improved growth prospects.