The Daily Dish

The SALT Controversy

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The Wall Street Journal reports: “House passage of Democrats’ $2 trillion education, healthcare and climate package has inflamed an intraparty debate about whether the bill gives overly-generous tax benefits to high-income Americans. At the center of the dispute is the House plan to raise the $10,000 cap on the deduction for state and local taxes to $80,000 through 2030. A small but committed group of lawmakers from high-tax states like New York and New Jersey have for years insisted on repealing the $10,000 cap, which Republicans put into place as part of the 2017 tax law.” How should one think about the so-called SALT (state and local tax) provision?

The first aspect to consider is the efficiency of state and local public finance. 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 make another dollar, you pay 10 cents in state tax. You also owe 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, the federal tax code subsidizes 5 cents out of the 10 cents of tax.

Getting rid of deductibility eliminates this distortion. One might think that the result would be a cutback in the provision of state and local services, but the empirical evidence does not support this thought. That literature is summarized in a 2008 paper by Gilbert Metcalf. 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 (which are roughly 60 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.

The second aspect is “fairness.” One kind of fairness argument is that eliminating deductibility imposes a double-tax on some income. There are two counterarguments. The first is that the federal code shows no aversion to double taxing income. When $1 is earned on the job, it is taxed. When the after-tax earnings are invested, the investment return to those earnings is again taxed, without any widespread claim of unfairness. Indeed, it is when investment earnings are less-than-fully taxed that the progressive left begins to cry foul.

The second response to the double-tax argument is that the state-local “tax” is really just the price of a particular bundle of goods and services. Especially with local services, people can vote with their feet to choose the exact bundle they want, so the “tax” is a self-inflicted cost just like any other purchase. Why should we subsidize it when we don’t allow the deduction of Twizzlers or P.F. Chang’s expenses to reduce the price of those particular goods and services?

Finally, one sometimes hears the argument that the SALT issue only matters to the affluent states that pay a disproportionate share of the federal income tax, so it is only “fair” that they get a break from the SALT deduction. This suggests, however, that a state should get back from the federal government just what it pays in; any imbalance represents unfairness. This kind of accounting framework doesn’t make sense in a federal context. The federal government is in the business of providing public goods such as national security where everybody gets out the same no matter what they put in.

It is painful to have to switch from deductibility to non-deductibility. But there is no good reason to slow a transition that ultimately makes sense.