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Eliminating State and Local Tax Deduction to Pay for Tax Cuts for Wealthy a Bad Deal for Most Americans

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The tax plan from President Trump and congressional Republican leaders would end the federal deduction for state and local taxes (SALT) — which allows taxpayers who itemize deductions on their federal income taxes to deduct state and local property taxes and either state and local income taxes or general sales taxes. Some proponents argue that ending that deduction would not hurt low- and middle-income households because most of the direct benefits would go to higher-income filers. To be sure, eliminating the deduction would — by itself — make the federal income tax more progressive. But that ignores the actual tradeoff that the GOP tax plan proposes, which is to eliminate the SALT deduction and use the revenue to pay for marginal income-tax rate cuts. That trade would be a bad deal for most Americans, especially low- and middle-income people, for two reasons.

First, the tax plan's rate cuts are *more* tilted to the top than the SALT deduction. That's part of the reason why by 2027 (when key elements of the plan would be fully in effect), 80 percent of the plan's *net* tax cuts would go to the top 1 percent of Americans, the Tax Policy Center estimates.

Second, the SALT deduction helps state and local governments fund public services that provide widely shared benefits. That's because, with this deduction, higher-income filers are more willing to support state and local taxes. Repealing the deduction would almost certainly make it harder for states and localities — many of which already face serious budget strains — to raise sufficient revenues in the coming years to fund K-12 and higher education, health care, and other services. To balance their budgets with insufficient revenue, state policymakers would likely make cuts in such services that would be widely felt. States and localities could also respond by raising taxes or fees that fall less heavily on the higher-income residents most affected by the deduction's loss. That would push more costs to middle- and low-income people, and make state and local tax systems even more regressive overall than they already are.

Further, the proposal to end the SALT deduction, and thereby make it harder for states and localities to fund current programs, comes as the President and congressional Republicans propose in their ten-year budget plans to shift substantial *new* costs to states, by sharply cutting Medicaid and other health funding and potentially cutting federal support for state and local services such as education, transportation, environmental protection, and low-income housing.

Responding to criticism from Republican members of Congress who represent states that would be hit particularly hard by ending the SALT deduction, GOP leaders have floated several “compromises” to partly, rather than entirely, end it. These include capping the deduction, ending it for income taxes but not real estate taxes, and letting filers take either the SALT deduction or another deduction such as the home mortgage interest deduction, but not both. Partially ending the deduction could be nearly as harmful to low- and middle-income Americans as fully ending it, however, since that would still substantially weaken states’ and localities’ ability to raise adequate revenues.

Trading SALT Deduction for High-Income Tax Cuts a Bad Deal for Most Americans

Trump Administration officials recently pointed to estimates showing that most of the SALT deduction’s federal tax benefits go to people with incomes over \$100,000.¹ Higher-income filers benefit more from the deduction because they’re likelier to itemize, to claim higher amounts of itemized deductions (including SALT), and to face higher federal tax rates (which means that they receive greater federal tax savings per dollar of itemized deductions). The Administration points to such figures to argue that eliminating the deduction would make the federal income tax more progressive.

That would be true if policymakers eliminated the deduction and did nothing else. The Republican tax plan, however, would replace the deduction with tax cuts that are, on net, even more tilted to the top. As a whole, by 2027 (when key elements of the plan would be fully in effect), 80 percent of the net tax cuts would go to the top 1 percent of Americans, the Tax Policy Center estimates.² These estimates count all of the plan’s provisions.

For the highest-income filers, the GOP tax plan would more than offset the effect of SALT repeal through extensive tax cuts that include cutting the top personal income tax rate from its current 39.6 percent to 35 percent; repealing the estate tax (which only the wealthiest two of every 1,000 estates face); repealing the Alternative Minimum Tax; and setting a special, lower top rate for “pass-through” business income (which the owners of partnerships, S corporations, and sole proprietorships report on their individual tax returns and on which they currently pay tax at the rates that apply to wages and salaries). The revenue raised by ending the SALT deduction (\$1.3 trillion over ten years) roughly equals what the GOP tax plan would spend just on income-tax rate cuts (\$1.2 trillion), and nearly equals what the plan would spend by cutting taxes for pass-through businesses and eliminating the estate tax (\$770 billion and more than \$200 billion, respectively).³ Many other provisions of the tax plan would affect the tax bills of low- and middle-income people, but their impact would largely be a wash on average.⁴

¹ Toby Eckert, “White House digs in on eliminating state and local tax deduction,” *Politico*, October 5, 2017, <http://www.politico.com/story/2017/10/05/white-house-eliminate-state-local-tax-deduction-243508>.

² “A Preliminary Analysis of the Unified Framework,” Tax Policy Center, September 29, 2017, http://www.taxpolicycenter.org/sites/default/files/publication/144971/a_preliminary_analysis_of_the_unified_framework_0.pdf.

³ “A Preliminary Analysis of the Unified Framework.”

⁴ For further discussion, see Chuck Marr, “Republican Leaders’ Tax Framework Provides Windfall to High-Income Households with Working Families Largely an Afterthought,” Center on Budget and Policy Priorities, October 2, 2017,

Not only would the direct benefits of repealing the SALT deduction thus go overwhelmingly to the wealthy in the form of even more regressive tax-rate and other cuts, but it also would be an adverse trade for most Americans due to its negative impact on state and local budgets.

Repealing SALT Deduction Would Strain State and Local Budgets

Ending the SALT deduction would strain state budgets over time by making it harder for states and localities to raise the revenues needed to invest adequately in their communities.

The SALT deduction is effectively a form of revenue sharing between the federal government and state and local governments. To understand how it works, consider a taxpayer in the 28 percent federal income tax bracket. When a state raises \$1 of additional revenue from this taxpayer, his overall taxes rise only by \$0.72 because for that additional \$1 in state tax payments, he or she can deduct 28 cents. Without that deduction, taxpayers would be less likely to support current state and local tax levels. As a result, states and localities would likely struggle even more than they do now to raise adequate revenue.

Also without the deduction, states and localities also would likely find it costlier and harder to borrow money. Most states and localities borrow funds on the bond market, mainly to invest in multi-year infrastructure and related projects. Rating agencies, which largely determine the interest cost on state or local government bonds, look negatively at actions that can make it harder for states or localities to raise revenue when necessary. Thus, regarding the proposal to end the SALT deduction, Moody's writes: "The proposed elimination of the deduction for state and local taxes would be credit negative for the public finance sector by raising the effective cost of state and local taxes."⁵ Ending the deduction consequently could raise state and local borrowing costs.

This strain on state and local budgets from repealing the federal SALT deduction would likely result in cuts down the road to state and local services. These cuts could well include reductions in support for education — the single largest part of state budgets — as well as cuts to infrastructure spending and other investments that are key to the nation's long-term economic prospects. Since states and localities provide over 90 percent of K-12 school funding, and pay 75 percent of the cost of maintaining and improving the nation's non-defense public infrastructure assets, their capacity to make these investments is particularly important to the nation's future economic strength. Further, many states *already* have cut funding for these crucial investments, making the prospect of additional cuts particularly disturbing. For example, the average state has cut funding for higher education per student by 16 percent over the last decade, after adjusting for inflation. And more than a quarter of the states have cut general support for K-12 education by 7 percent or more per student over the same period.⁶ In addition, state and local government spending on physical infrastructure dropped

<https://www.cbpp.org/research/federal-tax/republican-leaders-tax-framework-provides-windfall-to-high-income-households>. Some filers in the 85th to 95th percentiles would face net tax increases, in substantial part due to the loss of the federal SALT deduction. Given the distribution of the net tax cuts from the overall plan, most of those savings effectively pay for tax cuts flowing to high-income households.

⁵ Larry Light, "Which investments would GOP tax plan help - or hurt?" CBS News Money Watch, October 3, 2017. <https://www.cbsnews.com/news/which-investments-gop-tax-plan-help-or-hurt/>.

⁶ See Michael Mitchell, Michael Leachman, and Kathleen Masterson, "A Lost Decade in Higher Education Funding," Center on Budget and Policy Priorities, August 23, 2017, <https://www.cbpp.org/research/state-budget-and-tax/a-lost-decade-in-higher-education-funding>.

from its high of 3 percent of the nation’s gross domestic product in the late 1960s to less than 2 percent in 2015.⁷

The additional strain on state and local budgets that likely would result from a SALT deduction repeal also could spur increases in state and local taxes or fees that fall most heavily on low- and moderate-income Americans, as described in more detail below. Either through cuts to public education and other state and local services, or through these tax and fee increases, or a combination of the two, low- and moderate-income Americans likely would end up bearing some of the burden of repeal — while, as noted above, the federal revenues raised by ending the deduction would go for federal tax cuts that overwhelmingly benefit the nation’s highest-income households.

SALT Repeal Would Jeopardize Funding for Services With Widely Shared Benefits

Because the SALT deduction supports state and local budgets, eliminating it would likely make it harder for states and localities to maintain existing funding for schools, roads, and other building blocks of thriving communities.

“Deductibility of state and local taxes,” the National Governors Association has stated, “has contributed to the stability of state revenues that are essential for providing public services.”⁸ Similarly, in analyzing the GOP tax plan, the Tax Policy Center warned, “Eliminating the deduction ... could affect the mix of revenue used by state and local governments and could lead to reductions in spending for programs and services.”⁹ Even SALT deduction critics agree that eliminating it would reduce state and local services, although some see that as a benefit. “The state and local tax deduction ...” the Heritage Foundation writes, “supports detrimental economic policies: high levels of taxation and inefficient and wasteful government spending.”¹⁰

If state and local policymakers cut their budgets, middle- and lower-income families likely would feel the impact most acutely. The largest areas of state spending are education (both K-12 and higher education) and health care. States fund a wide variety of other services, as well, including transportation, corrections, pensions for public employees, care for those with mental illness and developmental disabilities, assistance to low-income families, and aid to local governments. Local governments also fund important services including police and fire, parks, libraries, and community health facilities.

Many of these services are essential to the nation’s long-term economic vitality or to strong, healthy communities. They often directly improve residents’ quality of life — especially middle- and low-income families that otherwise are less able to afford various services. State and local revenue shortfalls endanger these public services because, unlike the federal government, states and localities

[decade-in-higher-education-funding](#), and Michael Leachman, Kathleen Masterson, and Eric Figueroa, “A Punishing Decade for School Funding,” Center on Budget and Policy Priorities, forthcoming.

⁷ Elizabeth McNichol, “It’s Time for States to Invest in Infrastructure,” Center on Budget and Policy Priorities, updated August 10, 2017, <https://www.cbpp.org/research/state-budget-and-tax/its-time-for-states-to-invest-in-infrastructure>.

⁸ “Tax Reform (State and Local Tax Deduction and Municipal Bonds),” National Governors Association, September 22, 2017, <https://www.nga.org/cms/nga-letters/state-local-municipal-tax-reform>.

⁹ “A Preliminary Analysis of the Unified Framework.”

¹⁰ Rachel Greszler and Kevin Dayaratna, “Time to End the Federal Subsidy for High-Tax States,” Heritage Foundation, March 26, 2015, <http://www.heritage.org/taxes/report/time-end-the-federal-subsidy-high-tax-states>.

generally cannot run annual operating deficits. Revenue shortfalls that they cannot address with additional revenues directly lead, therefore, to cuts in services.

The damaging effects of such cuts would extend beyond the borders of individual states and localities. For example, residents attending state universities at taxpayer-subsidized tuition rates may move after graduation to another state for a job, benefiting the economy somewhere else. Or taxpayer-subsidized recreation facilities that one county builds may be used by people who live elsewhere and are visiting. The SALT deduction helps spread the cost of these subsidies more widely and may increase support for these types of services. A Congressional Research Service report notes: “If deductibility were eliminated, state and local governments might be less willing to finance projects that generate benefits that extend beyond their taxing jurisdiction,” which is one reason why a “reduction in state and local public good provision may adversely affect low-income individuals relative to high-income individuals.”¹¹

Tax and Fee Increases Could Disproportionately Hit Most Vulnerable

In most states, state and local taxes fall hardest on the most vulnerable families because sales and property taxes — two of the three largest sources of state and local revenue — fall hardest on the poorest families as a share of their income.¹² The SALT deduction helps states maintain income taxes that fall harder on those with higher incomes, offsetting some of the overall regressivity of state and local tax systems.

Higher-income taxpayers are the SALT deduction’s major beneficiaries because they tend to itemize deductions more than other taxpayers. Without the deduction, these taxpayers could demand a less progressive income tax or a shift to more consumption taxes or fees, for which they pay a smaller share of their income. These shifts would make state and local tax systems even more regressive than they are.

As states and localities react to a SALT deduction repeal by cutting services, raising regressive taxes, or both, low- and moderate-income Americans likely would suffer. That’s a poor trade for most Americans, given that the federal revenues raised would overwhelmingly go for tax cuts that disproportionately benefit the highest-income Americans. It would be an especially adverse trade when one considers that the pending Trump, House, and Senate budget plans would also heavily shift costs to states and localities through a wide array of deep budget cuts, thereby adding significantly to pressures on state and local budgets — even as the GOP tax plan would make it harder for states to maintain their current revenues (see box).

¹¹ Steven Maguire and Jeffrey M. Stupak, “Federal Deductibility of State and Local Taxes,” Congressional Research Service, September 18, 2015.

¹² Institute on Taxation and Economic Policy, *Who Pays?*, January 2015, <https://itep.org/wp-content/uploads/whopaysreport.pdf>.

Tax Changes Part of Broad Agenda to Shift Massive Costs to States, Localities

Repealing the SALT deduction would be one part of a painful one-two punch that the budgets of President Trump and congressional Republicans would deliver to state budgets, many of which are already weak.

The President's 2018 budget and the pending House and Senate budget plans would shift substantial costs to states and localities over the next decade. In particular, these plans would cut Medicaid and Affordable Care Act funding by \$1.3 trillion to \$1.9 trillion over the next ten years. That would effectively require states to: reduce health services for their residents; cut funding for other services to free up funding to offset some of the lost federal health care funding; raise state taxes; or some combination of all three. The Trump and House and Senate budget plans also would cut annually appropriated programs outside of defense, which are known as "non-defense discretionary" (NDD) programs, by between \$800 billion and \$1.5 trillion over the coming decade.^a About one-third of NDD funding comes in the form of grants to state and local governments to help them deliver various services, including K-12 education, infrastructure, police and fire, environmental protection, low-income housing, and water treatment. The GOP budget plans justify these cuts and related cost-shifts in part as a way to help address *existing* federal budget deficits. But the GOP tax plan would add substantially to those deficits over the next decade and beyond, increasing the pressure for even more such cuts and cost shifts in the future.

Many states and localities already struggle to meet their residents' needs for schools, health care, transportation, and other services. Some 30 states had to address revenue shortfalls for fiscal year 2017, 2018, or both.^b Repealing the SALT deduction could make state residents less likely to support the revenue-raising measures that other parts of the GOP federal budget plans may force upon states, or that are needed in various states to maintain existing services while addressing budget shortfalls.

^a Richard Kogan, "Similarities Among Senate, House, and Trump Budget Plans Outweigh Their Differences," Center on Budget and Policy Priorities, October 6, 2017, <https://www.cbpp.org/research/federal-budget/similarities-among-senate-house-and-trump-budget-plans-outweigh-their>.

^b Elizabeth McNichol and Samantha Waxman, "States Faced Revenue Shortfalls in 2017 Despite Growing Economy," Center on Budget and Policy Priorities, Updated October 4, 2017, <https://www.cbpp.org/research/state-budget-and-tax/states-faced-revenue-shortfalls-in-2017-despite-growing-economy>.

Partially Ending Deduction Could Be Nearly as Harmful as Fully Ending It

Republican lawmakers reportedly are also considering proposals to partially, rather than entirely, repeal the SALT deduction as a way to secure the votes of Republicans from states that would be particularly hard hit by full repeal. Partial repeal, however, would still jeopardize states' and localities' ability to raise adequate revenues.

For example, the most prominently discussed "compromise" approach — capping the deduction¹³ — likely would be nearly as harmful to state finances as full repeal. If the deduction is capped at a level that's less than what many taxpayers using the deduction currently receive, an *additional* dollar of state or local revenue would, for many households, no longer generate an additional federal tax deduction. That would be true whether the cap is set on the size of the deduction allowed or on the income of taxpayers allowed to claim the deduction. As a result, that

¹³ Tory Newmyer, "The Finance 202: House GOP may cap state and local tax deduction amid outcry from moderates," *The Washington Post*, October 13, 2017, https://www.washingtonpost.com/news/powerpost/paloma/the-finance-202/2017/10/13/the-finance-202-house-gop-may-cap-state-and-local-tax-deduction-amid-outcry-from-moderates/59dff50230fb041a74e75d47/?utm_term=.ed671a89bdb9.

would impose political pressure on state and local policymakers to limit or reduce their income and other taxes.

The SALT deduction has been an integral part of the federal tax code for more than a century, and with good reason. The GOP tax plan would change that to finance tax cuts largely for those at the top and, in so doing, would threaten many states' ability to raise sufficient revenue to provide adequate services to their residents. The net effect would likely be negative for lower- and middle-income households overall, even though the SALT deduction is itself regressive. Accordingly, policymakers should not eliminate the deduction, either in whole or in part, in the coming tax legislation.