The Daily Dish

SALTy Tax Talk

DOUGLAS HOLTZ-EAKIN | NOVEMBER 21, 2017

Eakinomics: SALTy Tax Talk

One of the most contentious aspects of tax reform has been the elimination of federal deductibility of state and local taxes — known as the SALT provision. The Senate Finance Committee-passed version eliminates SALT entirely, while the House-passed version retains deductibility of up to $10,000 of property taxes. The proposal has some Representatives and Senators of high-tax states up in arms: Sen. Dianne Feinstein charged that "Californians will be hit especially hard by the elimination of the state and local tax deduction, or what we call SALT. The 6 million California households that claim the deduction could either see their tax bill go up or see cuts to vital services like schools and roads."

Indeed, a quick perusal of news sources yields slews of apocalyptic predictions about the impact of eliminating SALT. But what would actually happen? The best research on this topic has been conducted by Martin Feldstein and Gilbert Metcalf, and is nicely summarized by a 2008 Metcalf 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-local taxes is $1. On the other hand 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 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 "tax price" of $1 of taxes is $0.50.

What the data reveal about eliminating SALT is fascinating. First, states and localities are quite responsive to the tax price. If it goes from $0.604 (for someone in the 39.6 percent bracket) to $1, the use of deductible (e.g., income, property) taxes falls sharply. However — surprise — the data also indicate that this budget gap is filled by an increased use of non-deductible taxes and fees. As a result, the data show no overall impact on the total level of revenues collected, and no impact on the overall level of spending.

At least to my eye, there are two important conclusions stemming from this. First, the notion that eliminating SALT will decimate the delivery of public services in New York, New Jersey, California, Illinois, and other high-tax places is just wrong. However, eliminating SALT 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 amounts to removing an unneeded distortion.

That's what the data say. Stay tuned for a lot more chatter from the politicians.