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The Deduction for State and Local Taxes Undermines Tax Reform and Subsidizes High-Tax States

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Tax reforms such as the flat tax could boost economic growth and reduce political corruption, but some oppose reform or view proposals like the flat tax as unrealistic because interest groups oppose the elimination of special tax breaks.

However, this is one of the strongest arguments for tax reform. The current tax system contains myriad special preferences that undermine economic performance by luring people into making inefficient decisions to reduce their tax liabilities. The economic damage is further magnified by the higher tax rates required to finance the plethora of deductions, exemptions, credits, and other loopholes.

- Deductions for state and local taxes promote higher taxes and more spending by state and local governments.
- Eliminating the deduction and lowering tax rates would benefit the vast majority of states. Only high-tax states such as New York would be disadvantaged.

The federal income tax deduction for state and local taxes is one of the largest loopholes in the tax code—saving selected taxpayers more than $50 billion annually—and also one of the most pernicious. This special tax break primarily benefits rich taxpayers while subsidizing bigger government. Eliminating the deduction would facilitate lower tax rates and help to control wasteful spending and high tax rates at the state and local levels.

Eliminating loopholes is an uphill battle, but there is an automatic constituency for getting rid of the state and local tax deduction. Only a small handful of states benefit significantly from current law. For instance, California, New York, and New Jersey account for 35 percent of the deduction. By contrast, the vast majority of states have relatively few taxpayers who are net beneficiaries. As many as 40 states would be net winners if the state and local tax deduction were repealed and the money used to lower tax rates.

Subsidizing Bigger State Government. One of the worst effects of the deduction for state and local taxes is that it rewards governors and state legislators for irresponsible fiscal policy. For instance, a taxpayer in the 35 percent federal tax bracket suffers only a 65-cent drop in after-tax income when state and local taxes rise by $1. Under a flat tax, a $1 increase in state and local tax would mean a $1 reduction in after-tax income. Needless to say, losing the state and local tax deduction would make taxpayers much more likely to resist the expansion of state or local government.

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This effect is widely understood. The Congressional Research Service recently wrote that, "Under current tax rules, taxpayers in high tax states can deduct more from federal income than can those in low tax states." State and local officials also understand how this game works, which is why the interest groups that represent them vociferously oppose tax reform.

Economists also recognize that federal deductibility translates into higher state and local taxes. For instance, Douglas Holtz-Eakin and Harvey Rosen's 1990 study in the *Journal of Urban Economics* estimated that "if deductibility were eliminated, the mean property tax rate in our sample would fall by 0.00715 ($7.15 per $1,000 of assessed value), or 21.1% of the mean tax rate."

Subsidizing the Most Destructive Type of Taxation. Another perverse effect of the deduction is that it rewards states for imposing the most destructive forms of taxation. After the 1986 Tax Reform Act, taxpayers could deduct only income and property taxes. Yet these forms of taxation—especially state income taxes—are particularly destructive. Sales taxes cause less economic damage, but the federal tax deduction explicitly discourages states from using them as a revenue source.

Tax legislation approved last year addressed that inequity, but in the wrong way. Instead of eliminating deductions for all forms of state and local taxation and using the money to lower tax rates, the legislation temporarily gave taxpayers an option to deduct the sales tax instead of the income tax. Itemized deductions, however, are much more likely to be used by wealthy taxpayers, who generally have larger state and local income tax liabilities than sales tax liabilities, so the bias still exists for state and local politicians to rely on the more destructive forms of taxation.

A Tax Deduction for the Rich. Some critics oppose the flat tax because they think the "rich" will benefit. This is rather ironic since upper-income taxpayers benefit disproportionately from itemized deductions and receive an enormous portion of the state and local tax deduction.

Only 35 percent of Americans itemize their deductions, and the number utilizing the deduction for state and local taxes is even smaller. These taxpayers tend to be wealthy. Indeed, IRS data confirm that more than 90 percent of taxpayers with incomes above $100,000 use the deduction, compared to less than 14 percent of taxpayers with incomes below $40,000. This is why the Congressional Research Service noted that:

> [I]f state/local tax deductibility were eliminated, the federal tax burden would shift from all federal taxpayers toward itemizers…. [I]temizers tend to be higher income, thus, federal income taxes may become more progressive if the state/local taxes paid deduction were eliminated.

Moreover, because the federal tax system has "progressive" tax rates that discriminate against those with higher incomes, the deduction is more valuable to a rich taxpayer than it is to a poor taxpayer. As the Congressional Research Service wrote:

> The federal tax savings from the deduction is equal to the taxpayer's marginal tax rate multiplied by the size of the deduction. Because the federal income tax rate regime is progressive, a deduction for itemizers, in contrast to a tax credit for all taxpayers, favors taxpayers in higher income tax brackets.

Conclusion. The interests of politicians in a few high-tax states should not dictate federal tax policy. A small handful of jurisdictions—including California, New York, Oregon, New Jersey, Minnesota, Maryland, Massachusetts, D.C., and Connecticut—benefit disproportionately, but the rest of the nation pays higher taxes to subsidize these profligate states.

The federal deduction for state and local taxes is bad tax policy, and it encourages bad fiscal policy at the state and local levels. By encouraging bigger government, it reduces economic performance. The deduction also necessitates higher federal tax rates, further hindering economic growth. To promote fairness and economic growth, Congress should eliminate the deduction.

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