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Tax Reform Should Eliminate the Deduction for State and Local Taxes

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House Ways and Means Committee chairman Dave Camp (R–MI) and Senate Finance Committee chairman Max Baucus (D–MT) will face many difficult decisions as they proceed on tax reform. Among them will be whether to retain certain deductions currently in the tax code, including the deduction for state and local taxes.

Tax reform should eliminate the state and local tax deduction because it encourages state and local governments to raise their taxes higher than they would without it. If tax reform eliminated the deduction, state and local governments would face stronger pressure to keep their taxes low.

Violating Neutrality Appropriate in Certain Circumstances. The purpose of tax reform is to free the economy to grow stronger by setting a neutral tax base and by lowering tax rates in a revenue-neutral manner to improve incentives for families, businesses, investors, and entrepreneurs to engage in productive activity.

The principle of neutrality holds that taxes should not influence the economic decisions of taxpayers. To maximize economic growth, tax reform should institute the most neutral tax code possible. However, there are instances where violating neutrality is appropriate.

One is when a historical anomaly makes it unavoidable. This is the case with the exclusion for employer-provided health insurance. The exclusion is a historical artifact dating back to World War II. Because eliminating it without other reforms would create major disruptions in the health insurance market, sensible tax reform plans either retain the exclusion or better provide credits for families to purchase health insurance.[1]

Another instance is when the benefit of a particular policy justifies its harm to neutrality. Retaining the Earned Income Tax Credit to encourage low-income families to improve their situations is an example.[2]

Tax reform should also eliminate neutral policies that have negative unintended consequences that are greater than the harm that would be done to neutrality from their elimination.

State and Local Tax Deduction Is Neutral but Should Be Eliminated. The tax code allows taxpayers to deduct certain state and local taxes, including income taxes, sales taxes for residents of states that (wisely) go without an income tax, real estate taxes, and personal property taxes. State and local income taxes makes up about 95 percent of all state and local tax deductions.[3]

According to sound tax policy theory, the deduction is neutral because taxpayers should not have to pay tax on income they do not spend or save. State and local taxes deprive taxpayers the ability to do both with the income they claim.

However, the rubber of tax policy theory does not always hold up when it meets the rugged road

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of economic reality. When it comes to the state and local tax deduction, the harmful negative unintended consequence it creates in the real world outweighs the benefit of ensuring taxpayers do not pay tax on income they cannot spend or save.

The deduction therefore is another circumstance that warrants violating neutrality, and that is why tax reform should eliminate it.

Deduction Encourages State and Local Governments to Raise Taxes. The harmful unintended consequence of the deduction is that it encourages state and local governments to raise their taxes. Higher taxes allow state and local governments to grow larger because they spend up to the maximum amount of revenue they can collect.

The deduction encourages state and local governments to raise their taxes because it transfers a portion of their tax burdens from their residents to the federal government. For instance, for every dollar a state taxes a family paying the 33 percent federal marginal tax rate, the family effectively pays only $0.67 of the state tax, because the deduction on the family's federal taxes reduces their federal tax bill by $0.33.

This reduction in the "price" of the state's taxes encourages states to raise their taxes higher than they otherwise would, because taxpayers offer less resistance since they do not pay the full cost of the higher taxes. Taxpayers are more willing to accept higher taxes because of the deduction in the same way consumers are more willing to buy a product or service when prices fall.

However, there is no related reduction in the size of the federal government from the reduction in federal revenue due to the deduction. The federal government can and does borrow freely, so Congress sets spending amounts irrespective of tax revenue. State and local governments have much less latitude when it comes to borrowing, so their spending must more closely match their tax receipts.

If the deduction were eliminated in tax reform, the total amount of taxes taxpayers pay would likely not change. Tax reform should be revenue and distributionally neutral, meaning taxpayers would likely pay around the same amount of federal taxes as before, but their federal taxes would no longer effectively reduce the burden of their state and local taxes.

Faced with newly shouldering the entire burden of state and local taxes, taxpayers would markedly increase their opposition to state and local tax hikes. Taxpayers would also likely make stronger efforts to reduce their existing tax burden. Combined, these effects would help restrain the tax burdens of state and local governments.

Highest-Taxed States Would See Most Pressure. The highest-taxed state and municipalities would likely see the strongest efforts by their residents to lower taxes. Taxpayers in high-tax-burden states tend to have higher incomes. For instance, according to the Tax Foundation, New York, New Jersey, and Connecticut have the three highest state and local tax burdens and rank in the top five in terms of per-capita income. Most other high-tax states also have relatively high per-capita incomes.[4]

Higher-income taxpayers also overwhelmingly claim the deduction for state and local taxes. According to IRS data, taxpayers with adjusted gross income over $100,000 claim almost 76 percent of all state and local tax deductions.[5]

These data show that while taxpayers in high-tax states pay a hefty amount of state and local taxes, they also see that burden reduced the most because of the deduction. If tax reform eliminated the deduction, these taxpayers would see the biggest increase in their effective state and local taxes. They would likely put the most pressure on their state and local governments to stop tax increases and apply the most pressure on those governments to reduce their high taxes.

1. See J. D. Foster, "The New Flat Tax—Easy as One, Two, Three," Heritage Foundation *Backgrounder* No. 2631, December 13, 2011, http://www.heritage.org/research/reports/2011/12/the-new-flat-tax-easy-as-one-two-three.
2. Ibid.
3. Internal Revenue Service, "Individual Complete Report (Publication 1304), Table 2.1, Returns with Itemized Deductions: Sources of Income, Adjustments, Itemized Deductions by Type, Exemptions, and Tax Items, by Size of Adjusted Gross Income, Tax Year 2011," http://www.irs.gov/file_source/pub/irs-soi/11in21id.xls (accessed September 10, 2013).
4. Elizabeth Maim and Gerald Prante, "Annual State-Local Tax Burden Ranking: New York Citizens Pay the Most, Alaska the Least," Tax Foundation, October 2012, http://taxfoundation.org/sites/taxfoundation.org/files/docs/BP65_2010_Burdens_Report.pdf (accessed September 10, 2013).
5. Internal Revenue Service, "Individual Complete Report."

Lower Rates an Added Bonus. Eliminating the state and local tax deduction should be done only within the context of overall tax reform. Congress should not eliminate it (for instance, through "loophole closing") without other offsetting tax changes. To do so would be an unnecessary tax increase.

Eliminating the deduction in revenue-neutral tax reform would allow for even lower marginal tax rates for families. The state and local deduction reduces taxes by more than $1 trillion over 10 years.[6] That revenue would provide for substantial additional rate reduction. Lower rates enhance the growth-promoting potential of tax reform, which is an added bonus of eliminating the deduction.

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6. Office of Management and Budget, *Budget of the U.S. Government, FY 2014, Analytical Perspectives*, April 10, 2013, p. 261, http://www.whitehouse.gov/sites/default/files/omb/budget/fy2014/assets/spec.pdf (accessed September 10, 2013). Adding the score of deductibility of state and local taxes and the score for real estate taxes on owner-occupied property reduces tax revenue by $435 billion over five years. A traditional budget window is 10 years. The revenue reduction for these policies would grow in the second five years of a 10-year window enough to put the total revenue reduction in a 10-year window over $1 trillion.