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Easy on the SALT: A Qualified Defense of the Deduction for State and Local Taxes

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Congressional Republicans and Trump administration officials have said that they plan to repeal the deduction for nonbusiness state and local taxes (SALT) as part of a comprehensive tax reform package. This essay critically examines the major arguments for repealing the SALT deduction. Repealing the deduction and using the resulting revenues to reduce federal rates across the board would likely lead to greater tax-induced deadweight loss overall. Repealing the deduction also would distort decisions about the financing of education and health care, which together account for more than half of all state and local government spending. Repeal would further encourage a shift from nonbusiness to business taxes at the state and local level, and potentially would result in more borrowing by subnational governments in the short and medium term. It would have ambiguous effects on the progressivity of the overall tax system, and it would exacerbate existing differences in federal tax burdens across states. The essay concludes that the case against the SALT deduction fails on its own terms, and that the status quo of partial deductibility offers a number of underappreciated advantages vis-à-vis the alternative of full repeal.

The state and local tax deduction is in danger. House Speaker Paul Ryan's June 2016 blueprint for tax reform proposed to eliminate it.[1] Treasury Secretary Steven Mnuchin said in April 2017 that the Trump administration wanted to dump the deduction too.[2] The "Unified Framework" for tax reform published by the White House and congressional leaders in late September 2017 implicitly calls for repeal of the deduction by leaving it off the list of itemized deductions that would be retained.[3] The state and local tax deduction—included in every version of the federal income tax since the Civil War—may finally be on its way out.

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[1] See Paul Ryan et al., A Better Way: Our Vision for a Confident America—Tax 20 (2016) ("To simplify tax filings further for middle-income families, this Blueprint reflects the elimination of all itemized deductions except the mortgage interest deduction and the charitable contribution deduction.").

[2] See Jennifer McLoughlin, Trump's Tax Plan Dumps State, Local Tax Deduction, Bloomberg BNA Daily Tax Report (Apr. 27, 2017), https://www.bna.com/trumps-tax-plan-n57982087246.

[3] Unified Framework for Fixing Our Broken Tax Code (Sept. 27, 2017), https://www.whitehouse.gov/the-press-office/2017/09/27/unified-framework-fixing-our-broken-tax-code.

Opponents of the state and local tax (SALT) deduction make five main arguments against it. First, the deduction narrows the federal tax base, meaning that Congress must impose higher marginal tax rates (leading to larger deadweight losses) in order to meet its revenue goals.[4] Second, the deduction reduces the after-tax price of goods and services supplied by states and localities relative to goods and services supplied through the market, thus leading to overprovision of goods and services by subnational government.[5] Third, the deductibility of some but not all payments to states and localities distorts those governments' choices among tax instruments.[6] Fourth, the deduction disproportionately benefits high-income households and so makes the overall tax system more regressive.[7] Fifth, the deduction leads to inequities across jurisdictions, with low-tax states effectively subsidizing higher-tax states.[8]

[4] See, e.g., Rachel Greszler & Kevin D. Dayaratna, Time to End the Federal Subsidy for High-Tax States, Heritage Found.: Backgrounder, No. 2999, at 2, 4-5 (Mar. 26, 2015), http://thf_media.s3.amazonaws.com/2015/pdf/BG2999.pdf; Jeremy Horpedahl & Harrison Searles, The Deduction of State and Local Taxes from Federal Income Taxes 3 (Mercatus Ctr. at George Mason Univ., Mercatus on Policy, Mar. 2014), https://www.mercatus.org/system/files/Horpedahl_State-Deductions_MOP_030614.pdf; Jason Pye, Tax Reform Should End the Deduction for State and Local Taxes to Finance Lower Tax Rates, FreedomWorks (May 9, 2017), http://www.freedomworks.org/content/tax-reform-should-end-deduction-state-and-local-taxes-finance-lower-tax-rates.

[5] See, e.g., Louis Kaplow, Fiscal Federalism and the Deductibility of State and Local Taxes under the Federal Income Tax, 82 Va. L. Rev. 413, 489 (1996) ("[W]hen taxes are deductible, residents do not bear the full cost of their jurisdiction's public goods and services. As a result, residents will tend to favor greater public provision than otherwise . . . . If provision would otherwise be undistorted, the result might involve excessive provision of some goods and services and inefficient production of others . . . ."); Frank Sammartino and Kim Rueben, Revisiting the State and Local Tax Deduction, Tax Policy Ctr. 7 (Mar. 31, 2016), http://www.urban.org/sites/default/files/2000693-revisiting-the-state-and-local-tax-deduction.pdf (stating that the SALT deduction can "distort choices about the level of subnational government spending").

[6] See, e.g., Sammartino & Rueben, supra note 5, at 7 ("The deduction may encourage states to adopt a less economically efficient mix of taxes, relying more heavily on deductible taxes than on nondeductible user fees.").

[7] See, e.g., Jared Bernstein, Tilts in the Tax Code: Pictures of Regressive Deductions, Wash. Post, July 30, 2015, https://www.washingtonpost.com/posteverything/wp/2015/07/30/tilts-inthe-tax-code-pictures-of-regressive-deductions (describing SALT deduction as "regressive"); Ben Casselman, The Tax Deductions Economists Hate, FiveThirtyEight (Apr. 3, 2015), https://fivethirtyeight.com/features/the-tax-deductions-economists-hate ("The deduction for state and local taxes helps the rich even more than the mortgage-interest deduction."); The Blue Tax, Nat'l Rev., Dec. 14, 2012, http://www.nationalreview.com/article/335632/blue-tax-editors (SALT deduction is a "regressive subsidy").

[8] See, e.g., Greszler & Dayaratna, supra note 4, at 2-3; Jared Walczak, The State and Local Tax Deduction: A Primer, Tax Found., Fiscal Fact No. 545, at 6 (Mar. 2017), https://files.taxfoundation.org/20170315142330/Tax-Foundation-FF545.pdf ("Just as the state

All of these arguments are faulty. Repealing the deduction to finance an across-the-board rate cut would raise the combined (federal plus state) marginal rate for households in high-tax states and reduce the combined marginal rate for households in low-tax states; basic principles of public economics suggest that the net effect of these two changes on the supply of labor and capital is likely to be negative. As for the charge that the deduction distorts decisions about the provision of public goods and the financing of subnational government: repealing the deduction would remove some of these distortions but introduce several others. Finally, repealing the deduction would have ambiguous effects on both progressivity and interstate equity.

The literature on the SALT deduction is extensive.[9] This essay does not seek to recapitulate all of the arguments that have been made in favor of the deduction and against. Instead, it emphasizes a number of new or underappreciated points that are relevant to the repeal proposals emerging from the Republican leadership. Among others:

> — While the "broad base rule," which recommends lower rates on a broader base to minimize the deadweight loss of taxation, is sometimes invoked as a reason for repealing the SALT deduction, the intuition underlying the broad base rule may actually weigh in the SALT deduction's favor;
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> — Insofar as state and local tax taxes fund educational expenditures (the number one category of state and local government spending), full deductibility is appropriate under the consumption tax principles animating the Unified Framework;
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> — Insofar as state and local tax taxes fund health care expenditures (the number two category of state and local government spending), full deductibility is necessary to ensure equal treatment of employer-provided and subnational government-provided health care;
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> — Repealing the SALT deduction while retaining the charitable contribution deduction—which is what the Unified Framework proposes to do—would distort collective decisions regarding the financing of public goods;
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> — Repealing the deduction for nonbusiness state and local taxes while retaining the deduction for taxes paid by businesses—which is also what the Unified Framework apparently proposes—would introduce new distortions into the choice of revenue-raising instruments for state and local governments;

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and local tax deduction disproportionately favors wealthier taxpayers, it also benefits states which combine high incomes and high-tax environments.").

[9] Significant contributions in the law review literature include Brian Galle, Federal Fairness to State Taxpayers: Irrationality, Unfunded Mandates, and the "SALT" Deduction, 106 Mich. L. Rev. 805 (2008); Louis Kaplow, Fiscal Federalism and the Deductibility of State and Local Taxes under the Federal Income Tax, 82 Va. L. Rev. 413 (1996); and Kirk J. Stark, Fiscal Federalism and Tax Progressivity: Should the Federal Income Tax Encourage State and Local Redistribution?, 51 UCLA L. Rev. 1389 (2004).

— Repealing the SALT deduction would potentially lead to an increase in state and local government borrowing unless Congress could credibly commit not to revive the deduction down the road;

— Notwithstanding the fact that the benefits of the SALT deduction accrue disproportionately to high-income households, repeal of the SALT deduction in the service of across-the-board rate cuts would potentially make the federal tax system *less* progressive in important respects; and

— While interstate equity is a dubious objective for federal tax policy in the first place, those who believe that the federal government should seek to allocate the burdens and benefits of federal taxing and spending evenly across states ought to support—not oppose—the SALT deduction on those grounds.

Part I provides a brief overview of the SALT deduction and the debate surrounding it. Part II considers the deduction's effect on labor supply, capital investment, and overall economic growth. Part III evaluates the effects of the deduction on the revenue-raising and spending decisions of state and local governments. Part IV takes up equity-related arguments for and against the deduction. Part V concludes.

I. The SALT Deduction: An Overview

A. Evolution of the Deduction

The deductibility of state and local taxes has been a feature of the federal income tax throughout its history. The first federal income tax statute, the Revenue Act of 1861, allowed a deduction for "all national, state, or local taxes assessed upon property, from which income is derived,"[10] and Congress extended the deduction to nonbusiness state and local taxes four years later.[11] When the federal income tax was resurrected briefly in 1894, the deduction for all state and local taxes was revived as well.[12] The deduction reemerged in the Revenue Act of 1913, the first federal income tax statute enacted after ratification of the Sixteenth Amendment.[13] It has remained ever since, though with several notable modifications and fluctuations.[14]

First, while the deductibility of state and local income as well as real and personal property taxes has been a constant, the deductibility of state and local sales taxes has not been. The Revenue

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[10] See Act of Aug. 5, 1861, ch. 45, § 49, 12 Stat. 309. The Revenue Act of 1861 never went into effect, but the Revenue Act of 1862, which did take effect, included a nearly identical provision. See Act of July 1, 1862, ch. 119, § 91, 12 Stat. 473-74.

[11] Act of Mar. 3, 1865, ch. 78, 13 Stat. 479. On the early history of the SALT deduction, see William J. Turnier, Evaluating Personal Deductions in an Income Tax—The Ideal, 66 Cornell L. Rev. 262, 264-66 (1981).

[12] Act of Aug. 27, 1894, ch. 349, § 27, 28 Stat. 553.

[13] Act of Oct. 3, 1913, ch. 16, § II(B), 38 Stat. 167.

[14] See Turnier, supra note 11, at 267-69.

Act of 1964 limited the sales tax deduction to taxes on general sales, gasoline, and motor fuel, thus disallowing deductions for taxes on motor vehicle licenses, alcohol, and cigarettes (among others).[15] The Revenue Act of 1978 eliminated the deduction for state and local taxes on gasoline and motor vehicle fuel,[16] and the Tax Reform Act of 1986 dispensed with the deduction for sales taxes entirely.[17] From then until 2004, the status quo was that nonbusiness state and local income and property taxes were deductible, while nonbusiness sales taxes were not.

The American Jobs Creation Act of 2004 changed the SALT status quo in one important way: it gave taxpayers the opportunity to deduct state and local income taxes *or* state and local sales taxes (but not both).[18] The 2004 law also instructed the IRS to prescribe tables that allow taxpayers to estimate their state and local sales taxes based on their adjusted gross income, filing status, number of dependents, and the general sales tax rates in their state and locality.[19] Though the option to deduct state and local sales taxes was initially enacted as a temporary measure and set to expire at the end of 2005,[20] Congress has extended the option ever since, finally making it permanent at the end of 2015.[21]

Significantly, the treatment of sales taxes under section 164 means that taxpayers cannot deduct all state and local taxes paid. Thirty-nine states impose taxes on both income and general sales, meaning that taxpayers will lose the ability to deduct one or the other. The only exceptions are Delaware, Montana, New Hampshire, and Oregon, which have income taxes but not general sales taxes; Florida, Nevada, South Dakota, Texas, Washington, and Wyoming, which have general sales taxes but not income taxes; and Alaska, which has neither an income tax nor a general sales tax (though some localities impose sales taxes of their own).[22] Yet all of those states have selective sales taxes of some sort for which no deduction is allowed (e.g., taxes on alcoholic beverages, amusements, gambling, insurance premiums, motor fuels, tobacco, and utilities).[23] Thus, there is no state in which taxpayers have the option to deduct all state and local taxes paid.

Beyond the introduction of the option to deduct state and local sales taxes, three other changes affecting the SALT deduction merit mention. One is the advent of the standard

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[15] Pub. L. No. 88-272, § 207, 78 Stat. 40; see Turnier, supra note 11, at 268 & n.31.
[16] Pub. L. No. 95-600, § __, 92 Stat. __.
[17] Pub. L. No. 99-514, § __, 100 Stat. __.
[18] Pub. L. No. 108-357, § __, 118 Stat. __ (codified at I.R.C. § 164(b)(5)).
[19] Id. § __, 100 Stat. __ (codified at I.R.C. § 164(b)(5)(H)).
[20] Id. § __, 100 Stat. __.
[21] Protecting Americans from Tax Hikes Act of 2015, Pub. L. No. 114-113, § __, __ Stat. __.
[22] See Julie Garber, State Tax Chart, The Balance (Sept. 8, 2016), https://www.thebalance.com/state-tax-chart-3505461 New Hampshire's income tax applies only to interest and dividends, not to salaries and wages. Tennessee also has an income tax that applies only to interest and dividends.
[23] U.S. Census Bureau, 2016 Annual Survey of State Government Tax Collections Detailed Table (May 12, 2017), https://www.census.gov/govs/statetax.

deduction—initially introduced in 1944.[24] The fraction of taxpayers claiming the standard deduction has fluctuated over time—in tax year 2014, the most recent year for which comprehensive data are available, 69.0% of individual income tax returns claimed the standard deduction.[25] Since the SALT deduction is available only to itemizers, this means that less than one-third of individuals filing federal income tax returns claim any deduction for nonbusiness state and local taxes.

A second significant development is the advent of the alternative minimum tax (AMT). Introduced in 1969, the AMT has become an increasingly important element of the federal tax system over time. The percentage of tax returns showing liability under the AMT has climbed from around 0.1% in 1990 to nearly 2.9% in 2014 (the most recent year for which data is available).[26] The primary effect of the AMT on taxpayers who are subject to it is to reduce the value of the SALT deduction. Note that the AMT does not eliminate the value of the SALT deduction for taxpayers who are subject to it, even though state and local taxes are not deductible for AMT purposes. This is because taxpayers who are subject to the AMT still generally pay less than they would have if their liabilities had been calculated under the normal tax without a SALT deduction. For these taxpayers, the AMT diminishes the value of the SALT deduction—but not all the way down to zero.[27]

A third development is the introduction and resurrection of the Pease provision, which was in effect from 1991 through 2009 and has been in place from 2013 to the present. The Pease provision, also known as the overall limitation on itemized deductions, drives a wedge between the marginal rate and the rate at which deductions can be taken for taxpayers with adjusted gross income above a certain threshold ($261,500 in 2017 for single taxpayers, $313,800 for married

[24] On the history of the standard deduction, see John R. Brooks II, Doing Too Much: The Standard Deduction and the Conflict Between Progressivity and Simplification, 2 Colum. J. Tax Law 203, 209-18 (2011).
[25] Internal Revenue Serv., Statistics of Income Div., Publication 1304 tbl.1.3 (Aug. 2016).
[26] Id.
[27] To illustrate (using a publicly available tax return as an example): Tim Kaine and Anne Holton reported taxable income of $253,901 in 2014—including a $21,567 deduction for state and local taxes in that calculation. Their liability under the normal tax would have been $59,409; their tentative minimum tax for AMT purposes was $63,606; and so they paid the latter (larger) amount. But while the SALT deduction played no role in the calculation of their $63,606 liability under the AMT, they nonetheless received a benefit from the SALT deduction. That is because in the absence of the SALT deduction, their taxable income would have been $275,468, and their liability under the normal tax would have been $66,807. Another way of thinking about this is that while they would have received a SALT deduction worth $7,147 (33% times $21,657) under normal tax principles, while instead they received a benefit worth $3,201 (the difference between their liability under normal tax principles and under the AMT). That is, the AMT reduced the value of the SALT deduction to the Kaines by roughly 55%, not by 100%. See Tax Analysts, Tax History Project: Presidential Tax Returns http://www.taxhistory.org/www/website.nsf/web/presidentialtaxreturns (last visited Aug. 30, 2017) (follow link for Vice Presidential Candidate Tim Kaine's 2014 return).

couples filing jointly).[28] For taxpayers in the highest bracket, the effect is to increase the top marginal rate from 39.6% to 40.8% while still allowing deductions only at the lower 39.6% rate. This 1.2 percentage point increase is on top of Medicare taxes, which raise the top marginal rate for high-income households by as much as 3.8 percentage points to 44.6% without affecting the rate at which deductions can be taken.[29] The Pease provision and Medicare taxes have the effect of limiting the SALT deduction for top-bracket taxpayers to approximately 89 cents for every $1 of deductible state and local taxes paid (39.6%/44.6% ≈ 0.89).

These limits on the value of the SALT deduction matter for purposes of the present debate because they reduce the justificatory burden for SALT deduction defenders. That is, defenders of the SALT status quo must explain why a *partial* deduction for state and local taxes is appropriate—but need not explain why a full deduction would be appropriate because full deductibility is not the status quo. To be sure, one might accept the argument for partial deductibility but argue that the current rate of deductibility is too high (or too low). The central claim here is that a rule of zero deductibility is normatively undesirable, though I am much less confident that the current patchwork of limits on the value of the SALT deduction gets the rate of deductibility just right.

B. The State of the Debate

Much of the debate over the SALT deduction so far has focused on the question of horizontal equity. To concretize the question: Imagine that State X imposes a 10% income tax and State Y imposes no income tax. Imagine, moreover, that Worker A in State X earns 100, while Worker B in State Y earns 100 and Worker C in State Y earns 90. If we want the federal tax system to treat similarly situated taxpayers similarly, does that mean Worker A should pay the same amount in federal taxes are Worker B (no SALT deduction), the same amount as Worker C (full deduction), or less than Worker B but more than Worker C (the partial deductibility status quo)?

The horizontal equity debate has gone on for decades without reaching a clear resolution. Three observations stand out. First, at least with respect to the deduction for state and local income taxes, the answer to the deductibility question matters little for horizontal equity among workers if labor is fully mobile. To see why, imagine a federal tax rate of 40% and a Worker W who can earn 100 pre-tax (60 after taxes) by working for a firm in tax-free State Y. Assume, moreover, that there is no difference in amenity levels between State X and State Y but that State X imposes a 10% tax.[30] For a firm in State X to lure Worker W, it must offer him a wage such that he ends up

[28] See I.R.C. § 68.
[29] See I.R.C. §§ 1411, 3101, 3111.
[30] Adding in amenity level differences complicates the arithmetic but does not alter the result. To illustrate: Assume that taxes in State X finance amenities that Worker W values at 5. For worker W to be indifferent between the job in State X and the job in State Y, the offer from the firm in State X must leave him with 55 on an after-tax basis (plus untaxed amenities worth 5 equals 60). With no SALT deduction, the offer must be at least 110, in which case Worker W will pay 11 in state taxes and 44 in federal taxes, leaving him with 55 on an after-tax basis. With a SALT deduction, the offer must be at least 101.85, in which case Worker W will pay 10.19 in state taxes and 36.67 in federal taxes, leaving him with 55 (rounded) on an after-tax basis (plus untaxed amenities worth 5 equals 60). The key point is that insofar as State X offers amenities

at least as well off as in State Y (60 after taxes). With no SALT deduction, the offer must be at least 120, in which case Worker W will pay 12 in State X taxes and 48 in federal taxes, ending up with 60 on an after-tax basis. With a SALT deduction, the offer must be at least 111.11, in which case Worker W will pay 11.11 in State X taxes and 40 in federal taxes, ending up with 60 on an after-tax basis. Worker W is essentially indifferent as to whether there is or is not a SALT deduction: he ends up with 60 after taxes either way, and the SALT deduction only affects the cost to his employer.

To be sure, even with (indeed, especially with) full labor mobility, the SALT deduction affects the relative wealth of employers in State X and State Y. Firms in high-tax states benefit if the deduction is preserved; firms in low-tax states benefit if the deduction is repealed (assuming that the resulting revenues are used to cut federal rates across the board). However, horizontal equity supplies neither an argument for deductibility nor against: the principle of horizontal equity tells us that if two individuals are similarly situated pre-tax, then we should tax the two of them similarly as well, but a taxpayer's pre-tax economic situation is itself endogenous to whether we allow a SALT deduction. A similar argument applies with respect to the deduction for property taxes: turning on or off the SALT deduction for property taxes affects prices of owner-occupied residential real estate in State X and State Y, but that difference is likely to be reflected in house prices. Horizontal equity does not supply a reason for favoring one policy over the other.[31]

Second, if labor is immobile, then deductibility potentially affects horizontal equity among workers but not in a way that yields clear policy implications. Imagine that State X and State Y impose no income tax, that Worker A in State X and Worker B in State Y each earn 100, and that State X then imposes a tax of t that funds amenities per capita of a. Worker A may now be worse off than Worker B (if the value of $a < t$) or may be better off than Worker B (if the value of $a > t$). Because of labor immobility, wages do not adjust to restore equality between Worker A and Worker B.

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that State Y does not, those amenity differences will be reflected in wage differences when labor is fully mobile.

[31] See Kaplow, supra note 5, at 454-56. To illustrate: Imagine two homes, one in State X and the other in State Y, both of which cost 100 in a tax-free world. Assume a risk-free rate of return of 10% and that real estate is a risk-free asset. The user cost of living in either house is 10 per year (equal to the opportunity cost of capital, or the rate of return times the home price). Now imagine that State X levies a property tax of 1 per year and State Y levies no property tax. Assume that the federal tax rate is 40%, that there is no deduction for state and local property taxes, and that there is no amenity-level difference resulting from the new tax. For a potential homeowner to be indifferent between the house in State X and the house in State Y, the price on the house in State X must fall from 100 to 90 (in which case the user cost of living in the State X house, 1 in property taxes plus a capital cost of 9, will equal the user cost of living in the State Y house). With a deduction for state and local property taxes, the after-federal-tax cost of the property tax bill on the house in State X falls from 1 to 0.6, and the potential homeowner is indifferent between a house priced at 94 in State X and a house priced at 100 in State Y (in which case the user cost of living in the State X house, 0.6 in tax-related costs plus a capital cost of 9.4, will equal the user cost of living in the State Y house).

As a thought experiment, Louis Kaplow more than two decades ago proposed allowing a deduction for state and local taxes but then adding back to taxable income some estimate of *a* (i.e., the value of amenities provided by subnational government).[32] Assuming that state and local taxes paid exceed amenities for high-income households, such a scheme would look something like partial deductibility—which is the de facto regime for high-income households under the status quo. Arguably, lower-income households (for whom amenities more likely exceed state and local taxes paid) are being undertaxed under the status quo: while most lower-income households do not itemize and therefore claim no deduction for state and local income taxes, Kaplow's proposal might suggest that these households should bear a positive tax liability if on net they receive more from states and localities than they pay. Note, though, that if we think of intrajurisdictional transfers between net payors and net recipients as gifts mediated through state and local governments, then deduction for net payors and inclusion for net recipients would be inconsistent with the income tax's general treatment of gifts—which are neither deductible to the giver nor included in the income of the giftee. (This point is considered at greater length in Section II.B.)

Third, underlying the horizontal equity debate over the SALT deduction is the question of why we care about horizontal equity in the first place. A plausible view is that our worry about horizontal equity is derivative of our concern about vertical equity.[33] An additional dollar delivers greater utility to a poor person than to a rich one, and so transferring the dollar from the rich person to the poor person increases total welfare. Likewise, if two individuals have the same income (and, by hypothesis, the same marginal utility of income), then welfare is maximized by taxing the two of them the same. Put differently: If A and B have the same pre-tax income but A pays more in taxes, and the marginal utility of income is diminishing over income, then A's marginal utility of income is greater than B's; welfare can be enhanced by transferring dollars from B to A—which is to say, by shifting a portion of the tax burden from A to B. To decide who should be a transferor and who should be a transferee, we need a reasonably accurate measure of each individual's marginal utility of income. The Internal Revenue Code's system of inclusions, exclusions, deductions, and exemptions aims to do just that.

A focus on the marginal utility of income changes the terms of the debate over the SALT deduction. The question becomes *not* whether Worker A in State X who earns income of *i*, pays states taxes of *t*, and receives amenities of *a* is better off or worse off than Worker B in State Y who earns income of *i*, pays no state taxes, and receives no amenities. Rather, the question becomes whether Worker A in State X who earns income of *i*, pays state taxes of *t*, and receives amenities of *a* has a higher or lower marginal utility of income than Worker B in State Y who earns income of *i*, pays no state taxes, and receives no amenities. The answers to these two questions may differ because not all increases to utility diminish the marginal utility of income. Amenities provided by subnational governments may be substitutes for market consumption (in which case we might think that the marginal utility of income decreases over *a*) or may be complements to market consumption (in which case we might think that the marginal utility of income increases over *a*).

[32] See id. at 423-30.
[33] See Louis Kaplow, Horizontal Equity: Measures in Search of a Principle, 42 Nat'l Tax J. 139 (1989).

Consider, for example, the provision of police services. Arguably, police services function as a substitute for private security services that taxpayers would otherwise pay for out of pocket; taxpayers in jurisdictions with high-quality public policing therefore may have more disposable income available for (non-security) consumption, and so a lower marginal utility of income. But police services also can be complements to consumption insofar as they increase the value to individuals of market-purchased goods. A taxpayer might be more inclined to buy, say, a fancy sports car if the risk of theft or vandalism is low. Effective policing may expand and enrich the taxpayer's menu of consumption possibilities, thus raising the marginal utility of income.[34] From a welfarist perspective, the decision whether to allow a deduction for state and local taxes arguably depends not only on whether amenities (a) are greater than, equal to, or less than state and local taxes paid (t), but also on whether those amenities are substitutes for or complements to other goods and services.

The takeaway from this discussion is that even if labor is immobile, and even if the value of amenities provided by subnational government can be quantified, horizontal equity principles do not yield concrete implications for the deductibility of state and local taxes. Normative evaluations of the SALT deduction likely must rest on other bases. Parts II and III consider efficiency-related arguments for and against the deduction; Part IV turns to arguments based on principles of vertical equity and equity across states.

II. Broadening the Base To Lower Rates?

One motivation for repeal of the SALT deduction is base-broadening. As the House Republicans' blueprint emphasizes, "carve-outs reduce tax revenue," which, "in turn, typically requires increases in marginal rates to make up for lost revenue."[35] When marginal rates are higher, individuals are more likely to choose leisure over labor and less likely to make new investments. On this view, repealing the SALT deduction and using the resulting revenue to lower marginal rates would unleash economic growth. I will refer to this argument as the *base-broadening argument*.

The problem with the base-broadening argument as applied to the SALT deduction is that the deduction itself affects the combined federal-plus-state marginal tax rate on labor and capital income for the households that claim it. Repealing the SALT deduction and using the resulting revenues to reduce federal tax rates across the board will lower the combined federal-plus-state

[34] This point is related to—though not quite the same as—the classic Corlett-Hague tax rule, which holds that complements to labor should be taxed at a lower rate than complements to leisure. See W.J. Corlett & D.C. Hague, Complementarity and the Excess Burden, 21 Rev. Econ. Studs. 21 (1953). Some goods and services provided by state and local governments are labor complements (e.g., job training and commuter bus and rail lines); others are leisure complements (e.g., public parks). The Corlett-Hague rule may yield the recommendation that expenditures on state and local government be treated differently than other expenditures (either taxed at a lower rate if state and local taxes primarily fund the provision of labor complements, or taxed at a higher rate if state and local taxes primarily fund leisure complements). I will defer discussion of the actual uses of state and local tax dollars to Section III.1.

[35] Ryan et al., supra note 1, at 32.

marginal rate for households in low-tax states while raising the combined federal-plus-state marginal rate for households in high-tax states. The likely net effect is to increase the total deadweight loss of taxation—contrary to the objective behind base-broadening.

In an Appendix, I present a rudimentary model that illustrates the point more formally. I assume that labor supply is unit elastic and that the burden of taxation falls entirely on labor (which is assumed to be immobile). The model involves two states with equal populations: one state (State X) that imposes a 10% income tax, and another state (State Y) that imposes no income tax. The federal tax rate is 40% with a SALT deduction, meaning that the combined federal-plus-state marginal rate in State X is 46% (i.e., 40% federal plus 10% state minus 4% for the SALT deduction) and the combined rate in State Y is 40% (i.e., 40% federal with no state addition). Under these conditions, I show that repealing the SALT deduction reduces total labor output by approximately 0.56% and increases deadweight loss by approximately 2.31%.

This basic result holds so long as the price elasticity of labor supply in high-tax states is roughly equal to the price elasticity of labor supply in low-tax states. It is concededly possible that tax-insensitive individuals migrate to high-tax states (State X in the running example) while tax-sensitive individuals sort to low-tax states (State Y), in which case cuts in the effective tax rate in State Y may do more to spur labor output than tax hikes in State X would do to dampen. The burden on those advancing the base-broadening argument for SALT repeal is to show that the difference in elasticities is sufficient to justify an intervention that would widen the gap between effective rates in high-tax and low-tax states. Until then, the base-broadening argument for SALT repeal should be considered questionable at best.

The same analysis that applies to the deduction for state and local income taxes also applies to the deduction for state and local sales taxes, because the sales tax deduction—as implemented—is based on income.[36] There is, however, one significant category of state and local taxes to which the base-broadening argument for SALT repeal does apply: state and local property taxes on owner-occupied homes. The deduction for state and local property taxes does not reduce the combined federal-plus-state marginal rate on labor or capital income for any taxpayer, and so repealing the deduction for property taxes and using the revenue to reduce marginal rates across the board would be consistent with the intuition underlying prescriptions for base-broadening, rate-lowering tax reform.

Note, though, that the deduction for state and local property taxes on owner-occupied homes accounts for less than one-third of the federal tax expenditure associated with the SALT deduction.[37] Insofar as the base-broadening argument supports SALT repeal at all, it would support

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[36] Taxpayers who claim the itemized deduction for sales taxes generally use a calculator that estimates their sales taxes paid based on location, income, and household size. See Internal Revenue Serv., Sales Tax Deduction Calculator, https://www.irs.gov/individuals/sales-tax-deduction-calculator (last updated Nov. 28, 2016).

[37] The Joint Committee on Taxation's expenditure estimate for the deduction for state and local real property taxes is $36.4 billion for fiscal year 2018; the expenditure estimate for the deduction of other nonbusiness state and local government taxes is $74.1 billion. Staff of the J.

only the repeal of the deduction for state and local property taxes. And even that step—repeal of the deduction for state and local property taxes on owner-occupied homes—would seem to be in tension with the reasoning of the Unified Framework. While recommending the repeal of other itemized deductions, the Unified Framework would retain the home mortgage interest deduction on the view that the deduction promotes homeownership, which in turn "strengthen[s] civil society."[38] But the deduction for state and local property taxes on owner-occupied homes promotes homeownership as well—and unlike the home mortgage interest deduction, which delivers a larger benefits to recent homebuyers who still have large mortgage loan balances, the deduction for state and local property taxes on owner-occupied homes rewards households who remain a stable presence in their communities. Preserving the mortgage interest deduction while repealing the deduction for state and local property taxes on owner-occupied homes reflects an incoherent approach to the promoting the positive externalities (arguably[39]) associated with homeownership.

III. Efficiency of State and Local Government Decisionmaking

A second set of arguments for repeal of the SALT deduction focuses on the effect of the deduction on state and local government decisionmaking. Opponents of the deduction claim that (a) the deduction reduces the after-tax cost of goods and services provided by state and local governments relative to goods and services provided through market mechanisms, leading to excessive and inefficient provision of goods and services by states and localities; and (b) the deductibility of some but not all payments to subnational governments distorts the choice of revenue-raising instruments by states and localities. At least in the context of other features of the House Republicans' blueprint, neither argument provides a persuasive reason for repealing the deduction.

A. Effect on the Provision of Goods and Services

Consider first the claim that the SALT deduction leads to excessive and inefficient provision of goods and services and by states and localities. This section highlights two problems with that argument: (1) well over half of state and local government spending goes toward education and health care, and the deductibility of those expenditures is (at least arguably) consistent with the principles underlying the Unified Framework; and (2) deductibility for charitable contributions but not state and local taxes would (further) distort the choice between the nonprofit sector and subnational government as provider of public goods and services.

1. Deductions for What?

More than one-third of state and local government spending goes toward education (elementary, secondary, and higher), and the next largest spending category is health care (through

Comm. on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2016-2020, at 32, 40 tbl.1 (Jan. 30, 2017).

[38] Unified Framework, supra note 3, at 4.

[39] On the potential positive and negative externalities associated with homeownership, see generally Edward L. Glaeser & Jesse M. Shapiro, The Benefits of the Home Mortgage Interest Deduction, 17 Tax Policy and the Economy 37 (2003).

Medicaid/the Children's Health Insurance Program and otherwise).[40] (For a more detailed breakdown, see Table 1.) These two categories together account for more than half of all state and local spending.[41] The question of whether state and local taxes should be deductible thus largely comes down to the questions of (i) whether expenditures on education should be deductible and (ii) whether expenditures on health care should be deductible.

The answers to those questions depend, in part, on whether the relevant tax is an income tax or a consumption tax. Under an income tax, investments in human capital—like investments in physical capital—should arguably be capitalized and then amortized over their useful lives. The useful life of a high school or college degree might approximate the working life of the degree holder. This might suggest that taxpayers should be able to deduct a portion of the cost of their education each year. Immediate deduction for educational expenditures, however, would seem to be inconsistent with the capitalization-and-amortization principle underlying the income tax.[42] Yet the Unified Framework departs from income tax principles by allowing businesses to claim an immediate deduction for capital expenditures (at least for the next five years).[43] This would transform the income tax into a consumption tax: a tax on income *minus* savings/investment. Parity between the tax treatment of physical capital and the tax treatment of human capital would then require an immediate deduction for educational expenditures (i.e., investments in human capital assets).

[40] See also Urban Inst., State and Local Expenditures, http://www.urban.org/policy-centers/cross-center-initiatives/state-local-finance-initiative/projects/state-and-local-backgrounders/state-and-local-expenditures (last visited Aug. 29, 2017). The Urban Institute statistics split health care spending across the "public welfare" and "health and hospitals" category, with most Medicaid spending placed in the former category.

[41] See id.; see also Medicaid's Share of State Budgets, Medicaid & CHIP Payment & Access Comm'n, https://www.macpac.gov/subtopic/medicaids-share-of-state-budgets (last visited Aug. 29, 2017) (showing that more than half of all state spending in fiscal year 2015 went toward Medicaid and education).

[42] See Louis Kaplow, Human Capital Under an Ideal Income Tax, 80 Va. L. Rev. 1477, 1491, 1500-01 (1994); Michael Simkovic, The Knowledge Tax, 82 U. Chi. L. Rev. 1981, 2018-19 (2015).

[43] See Unified Framework, supra note 3, at 7.

Table 1. State and Local Government Expenditures by Category, 2013-2014[44]

Category	**Percentage of Direct General Expenditures** (excluding general administration and interest)
Education	36.6%
Elementary and Secondary	23.7%
Higher Education	10.9%
Other Education	2.0%
Public Welfare Vendor Payments (including Medicaid/CHIP)	17.8%
Health and Hospitals	10.3%
Public Safety	9.5%
Police	4.1%
Fire	1.8%
Corrections	3.0%
Other Public Safety	0.6%
Transportation	7.8%
Highways	3.5%
Airports	0.9%
Other Transportation	3.4%
Sewage and Solid Waste Management	3.0%
Housing and Community Development	2.0%
Parks and Recreation	1.5%
Other	11.5%

The fact that the taxpayers claiming the SALT deduction are not always the same people as the students acquiring the relevant human capital does not change matters. Under the Unified Framework, *A* could claim an immediate deduction for a capital expenditure and then transfer the capital asset to *B*, who would be taxed on income generated by the asset. Analogously, public financing of elementary, secondary, and higher education involves a large number of *A*s (i.e., taxpayers) investing in the development of human capital, claiming immediate deductions, and transferring that human capital to a large number of *B*s (i.e., public school and university students), who are then taxed on the resulting income (wages). State and local governments mediate thousands or (in some cases) millions of such transfers.[45]

[44] U.S. Census Bureau, 2014 Annual Surveys of State and Local Government Finances, Table 1. State and Local Government Finances by Level of Government and by State: 2013-14 (Dec. 7, 2016).

[45] Each of these transfers would presumably fall below the $14,000-per-year threshold for the taxation of gifts. While many households pay more than $14,000 per year in state and local taxes, it is doubtful that they pay more than $14,000 per year *per beneficiary*.

One response to this line of argument is that education—or, at least, higher education—"produces utility beyond an increase in future wages"[46] (e.g., the joy of learning, campus social life, and lifelong friendships). Insofar as that is the case, then an immediate and full deduction for educational expenditures might not be appropriate under consumption tax principles. It is, however, often the case that capital expenditures will yield some collateral consumption benefit (e.g., the CEO may derive aesthetic pleasure from a refurbished corporate headquarters). These collateral consumption benefits might be a reason to limit deductibility through mechanisms such as the Pease provision and the AMT; they provide a weak basis for repealing the SALT deduction entirely.

The appropriate treatment of health care expenditures under a consumption tax is somewhat less certain than the appropriate treatment of educational expenditures. Insofar as good health enhances productivity, immediate deduction is consistent with consumption tax principles. The characterization of health care expenditures as productivity-enhancing investments is less compelling with respect to patients who are beyond working age, but states and localities play a secondary role to the federal Medicare program in funding health care for retirees.

Analysis of the SALT deduction as applied to health care spending by subnational governments also requires consideration of the treatment of health care spending elsewhere in the Internal Revenue Code. Most significantly, the exclusion of employer-provided health care is the largest single federal tax expenditure, amounting to approximately $173 billion for fiscal year 2018 (i.e., $62 billion more than the expenditure associated with the SALT deduction).[47] The House Republicans' blueprint would preserve that expenditure: while stating that taxpayers "generally" should "include in income any compensation received related to employment or self-employment," the blueprint prioritizes "quality health care" as one of "[t]wo pressing national priorities" that "require exceptions to this general rule."[48] (The other is retirement security.) The Unified Framework does not directly address the exclusion of employer-sponsored health insurance, but there is no indication that the drafters foresee a change to the status quo treatment.

Insofar as subnational government revenues go toward health care expenditures, deductibility for state and local taxes establishes parity between the tax treatment of health care spending by states and localities, on the one hand, and the treatment of health care spending by employers, on the other. In both cases, the expenditure is deductible to the payor (i.e., the taxpayer or employer) and excluded from the income of the payee. Again, this is consistent with the characterization of health care spending as a human capital investment and the treatment of other capital expenditures under a consumption tax regime.

To be sure, the argument that educational and health care expenditures should be deductible under a consumption tax only gets us a little more than halfway toward justifying the SALT deduction under consumption tax principles because educational and health care expenditures account for only a little more than half of all state and local government spending. The largest

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[46] Joseph M. Dodge, Taxing Human Capital Acquisition Costs—Or Why Costs of Higher Education Should Not Be Deducted or Amortized, 54 Ohio St. L. J. 927, 939 (1993).
[47] See Staff of the J. Comm. on Taxation, supra note 37, at 37 tbl.1.
[48] See Ryan et al., supra note 1, at 28.

remaining categories include public safety (9.5%) and transportation (7.8%). As for expenditures on police and corrections, deductibility is not obviously inconsistent with consumption tax principles insofar as law enforcement is an expense of protecting physical and human capital from damage.[49] As for transportation, highways and other infrastructure are complements to both labor and leisure: smoother roads make us more productive and also allow us easier access to beaches, parks, malls, and movie theaters. Neither a rule of full deductibility nor a rule disallowing deductibility would seem to be appropriate.

In sum, the claim that the SALT deduction distorts by allowing taxpayers to purchase goods and services from subnational governments with after-federal-tax dollars overlooks the fact that the goods and services purchased from subnational governments are very often goods and services for which taxpayers otherwise could claim deductions under consumption tax principles. Concededly, there is an element of consumption to expenditures on education, health care, law enforcement, and roads, just as there is often an element of consumption to capital expenditures more generally (and under a consumption tax, consumption expenditures should not be deductible). At the same time, a rule disallowing deductibility would impose a higher effective tax rate on productivity-enhancing investments channeled through subnational government than on capital investments in the private sector. Leveling the playing field between subnational government and the private sector is thus a very weak argument for repealing the SALT deduction.

One might ask whether this same argument would support repeal of the SALT deduction in the event that the Republicans' tax plan is rejected. That question generates two responses. First, while the analysis above suggested that immediate deductibility might not be the appropriate treatment of educational and other long-term productivity-enhancing expenditures under an income tax, total repeal of the SALT deduction would not lead to appropriate treatment either. Parity between subnational government and the private sector would require capitalization and amortization of expenditures on productivity-enhancing investments with useful lives longer than one year. The status quo of partial deductibility arguably comes closer to approximating this capitalization-and-amortization approach than the House Republicans' alternative of full repeal.

Second, the proposal for immediate deductibility of capital expenditures in the House Republicans' blueprint is arguably the last step in a decades-long march toward consumption taxation, and we are already far down the path regardless of what happens to tax reform in the current Congress. For most American households—whose primary investments are in their homes, their IRAs and 401(k) plans, and their life insurance policies—the federal tax system as it affects them comes closer to a consumption tax than an income tax. The exclusion of net imputed rent and the $500,000 capital gains exemption for home sales lead to yield-exemption treatment for owner-occupied real estate, which—in light of the immediate deduction-yield exemption equivalence—conforms (more or less) to consumption tax principles. The immediate deduction for contributions to traditional IRAs and the exclusion for contributions to 401(k) plans approximate a tax on income minus savings, which is to say, consumption. The nontaxation of "inside build up" in long-term life insurance policies is likewise consistent with consumption tax

[49] Income tax principles would seem to support an immediate deduction for law enforcement expenditures just as surely as consumption tax principles, as the relevant expense is recurring.

principles, though not with income tax principles.[50] Finally, the decline of dividend yields on publicly traded stocks, the preferential tax rate on qualified dividends and capital gains, and the basis step-up for capital assets held at death all combine to drive the effective tax rate on equity investments down toward zero—even for stocks held in taxable accounts. The SALT deduction as applied to educational and (arguably) health care expenditures is consistent with these other features of the federal tax system regardless of whether the final brick in the consumption tax edifice—capital expensing—becomes law.

2. Subnational Government vs. the Charitable Sector

The analysis in the preceding subsection compared the tax treatment of (on the one hand) goods and services purchased through subnational government and (on the other hand) the tax treatment of similar goods and services purchased through market institutions. There is, of course, a third supplier of education, health care, and public goods more generally: the charitable sector. Following state and local institutions, charities are the leading providers of elementary, secondary, and higher education. Charities also operate more than half of all hospitals in the United States.[51] The tax treatment of contributions to these charitable institutions potentially influences the debate over the SALT deduction.

Martin Sullivan has argued that it would be "strange and unfair" to allow a deduction for charitable contributions but not for state and local taxes.[52] Oddity and equity aside, there is also a strong efficiency argument as to why the charitable contribution deduction and the SALT deduction should go hand in hand. Retaining the former while repealing the latter would encourage communities to favor charitable institutions over state and local governments as providers of education and health care even when state and local governments might be the more efficient providers of those services. An anti-distortion rationale would seem to suggest that both should be repealed or both should be retained.

The House Republicans' blueprint promised to preserve the charitable contribution deduction. According to the blueprint, "Americans are generous people who want to help their neighbors in need," and the tax system therefore should continue to encourage charitable giving through a deduction.[53] The Unified Framework calls for the charitable contribution deduction to be retained as well.[54] Neither House Republicans nor Trump administration officials have offered any rationale as to why "help[ing] . . . neighbors in need" through the charitable sector should lead to a deduction while doing the same through state and local government should not.

B. Effect on Revenue-Raising by State and Local Governments

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[50] See Edward J. McCaffery, Tax Policy Under a Hyrbid Income-Consumption Tax, 70 Tex. L. Rev. 1145, 1153 (1992).
[51] See Am. Hospital Ass'n, Fast Facts on U.S. Hospitals, http://www.aha.org/research/rc/stat-studies/fast-facts.shtml (last updated Jan. 2017).
[52] Martin A. Sullivan, Why the SALT Deduction Is Always Under Attack, Tax Notes, Dec. 17, 2012, at 1261, 1264.
[53] See Ryan et al., supra note 1, at 21.
[54] See Unified Framework, supra note 3, at 5.

Just as the SALT deduction is often attacked on the ground that it distorts decisions about the provision of goods and services by subnational government, so too is it attacked on the ground that it distorts the choice of revenue-raising instruments for states and localities. Again, the charge proves unpersuasive upon closer inspection.

1. Business vs. Nonbusiness Taxes

Significantly, neither the House Republicans' blueprint nor the Unified Framework says anything about changing the treatment of state and local taxes paid by businesses. Repealing the itemized deduction for nonbusiness state and local taxes while retaining the deduction for taxes paid by businesses would potentially encourage states and localities to shift from the former to the latter.[55] Consider again the case of Worker W in State X earning 100 pre-tax. Assume now that State X imposes an income tax of 10% and that the federal government imposes an income tax of 40%. With the SALT deduction, Worker W pays 40% x (100 – 10) = 36 in federal taxes. Now imagine that Congress repeals the deduction for nonbusiness state and local taxes but not for state and local taxes paid by businesses. State X can lift the tax on Worker W and impose a new employer-side tax of 11.11% on wages paid. Worker W's employer can pay her 90 in wages and pay a state tax of 11.11% x 90 = 10. After-tax results for all parties are the same as before, and all state taxes remain deductible for federal purposes.

This observation gives rise to at least two questions. First, if states and localities can preserve deductibility by shifting the nominal incidence of taxes to businesses, then why get so worked up about repeal of the SALT deduction? And second, if states and localities have this option, why don't they exercise it already? After all, most workers cannot deduct state and local income taxes (because they take the standard deduction), and even those taxpayers who itemize often cannot deduct state and local income taxes in full (because of Medicare taxes and—in some cases—the Pease provision and the AMT). The fact that we still see states and localities imposing taxes on nonbusinesses seems to suggest that arbitrage is not as easy as the previous paragraph makes it out to be.

With respect to the latter question, behavioral considerations may provide a partial answer. If workers focus on pre-tax wages, then they might prefer a wage of 100 and a state income tax of 10 over a wage of 90 and an employer-side payroll tax. Alternatively (and in my view more plausibly), states and localities may decide that administrative and other advantages of taxing income at the individual level outweigh the federal tax benefits of taxing employers on wages paid. Taxing income at the individual level allows for greater progressivity when some individuals have multiple income sources. (An employer-side tax on wages paid could in theory be progressive, with the rate rising over wages per worker; however, that would lead to a lower tax on Worker V who earns 50 each from two employers than on Worker W who earns 100 from one employer.) Individual-level taxation also allows states and localities to adjust tax burdens based on characteristics such as marital status, family size, medical expenses, and so on. States and localities may decide that the benefits of being able to tailor liabilities to individual characteristics outweigh the federal tax considerations.

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[55] See Kaplow, supra note 9, at 461-69.

The observation that employer-side taxation leads to a loss of tailored progressivity supplies an answer to the why-get-so-worked-up question as well. If nonbusiness taxes and business taxes were equivalent, then there would be little reason to care about the deduction for nonbusiness taxes. But if there are meaningful differences between the two, then there arises a real concern that repeal of the deduction for nonbusiness taxes will lead states and localities to shift to what—in the absence of a federal tax incentive—would be their less preferred method. While existing limits on the SALT deduction (i.e., the standard deduction, Pease, Medicare taxes, and the AMT) already give some impetus to such a shift, total repeal of the SALT deduction would turn the dial up.

To be sure, the status quo already distorts state and local government decisions regarding revenue-raising to some degree. States and localities have an incentive to choose *either* income taxation or sales taxation even if the optimal system would involve a mix of both. They have an incentive to avoid selective sales taxes (such as on alcohol and tobacco) even when those taxes might be consistent with Pigouvian prescriptions. The point here is that repealing the deduction for nonbusiness taxes while sticking with the status quo for business taxes simply replaces one federally induced distortion for another.

2. Now vs. Later

Any tax plan repealing the SALT deduction that becomes law during the current Congress will almost certainly pass via the budget reconciliation process, which allows the bill to bypass the legislative filibuster and pass the Senate with 51 votes (or 50 votes plus the Vice President as a tiebreaker).[56] Reconciliation legislation is subject to the so-called Byrd rule,[57] which requires (among other criteria) that reconciliation bills cannot add to the deficit outside the reconciliation "window" (generally 10 years or less[58]). That it itself does not stand in the way of permanent repeal of the SALT deduction because repeal would subtract from (not add to) the long-term deficit. However, repealing the SALT deduction by a narrow majority may introduce distortions because of the de facto temporary nature of such a measure.

If opponents of the SALT deduction build a broad-based congressional coalition that backs repeal, then that would send a credible signal to states and localities that repeal is likely to be permanent. Repeal by a bare majority, however, may lead states and localities to question whether repeal will stick. If states and localities expect that the SALT deduction will be restored in the near or medium term, then they will have a strong incentive to borrow today so as to defer tax

[56] See Brian Faler, GOP Plots to Return to Temporary Tax Cuts, Politico (Aug. 29, 2017), http://www.politico.com/story/2017/08/29/son-of-bush-gop-plots-return-to-temporary-tax-cuts-242154.
[57] 2 U.S.C. § 644(b)(1)(E).
[58] See Sahil Kapur, Republicans Warm to Tactic for Making Deep Cuts Last Longer, Bloomberg (June 15, 2017), https://www.bloomberg.com/news/articles/2017-06-15/gop-momentum-builds-to-change-rules-for-longer-lasting-tax-cuts.

collections to a time when payments will be deductible.[59] This is especially true if the tax exemption for interest on state and local bonds remains. (The House Republicans' blueprint and the Unified Framework say nothing about the state and local bond exemption, and President-elect Trump reportedly told mayors in December 2016 that the exemption would be preserved.[60]) And it is especially disconcerting if state and local government debt undermines electoral accountability and raises the risk of jurisdictional "death spirals."[61]

This observation can be considered the flip side of Jason Oh's argument that "[b]efore we can evaluate the desirability of any piece of temporary legislation, we must first understand the political uncertainty surrounding its renewal."[62] By the same token, before we can evaluate the desirability of any piece of nominally permanent legislation, we must first understand the political uncertainty surrounding its reversal. This is not to say that the SALT reduction should be retained just because repeal might conceivably be reversed. It is to say, though, that there are real-world costs that come with repeal by a narrow, partisan, and potentially fleeting majority.

IV. Vertical and Interstate Equity

A last set of arguments for repealing the SALT deduction focuses on equity concerns of a different sort than the horizontal equity claims examined in Section I.B. First, proponents of repeal argue that the SALT deduction's benefits flow disproportionately to the very wealthy. Second,

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[59] States may be somewhat constrained by balanced budget requirements, which bind to a varying degree in 46 states. *See* NAT'L ASS'N OF STATE BUDGET OFFICERS, BUDGET PROCESSES IN THE STATES 52 tbl.9 (2015).

[60] See Josh Dawsey, Mayors Startled When Trump Promises to Keep Tax-Exempt Bonds, Politico (Dec. 15, 2016), http://www.politico.com/story/2016/12/mayors-trump-tax-exempt-bonds-232720.

[61] As Julie Roin writes:

> It is economically rational for voters to elect politicians who will provide debt-financed public benefits when they have the option of moving to another jurisdiction before that debt falls due . . . . Such voters can have their proverbial cake—valuable public services—and "eat it too" by foisting the costs of debt repayments onto some combination of continuing and new residents, investors, and public employees. Moreover, the perverse incentives provided by this exit . . . option can make it harder for jurisdictions to return to solvency, as any financial demands placed upon remaining residents encourages more to leave the jurisdiction, and discourages newcomers from entering. In short, the "exit option" sets the stage for the sort of "death spiral" experienced by cities such as Detroit, Gary, and Stockton—and perhaps soon to be seen in Illinois and New Jersey.

Julie A. Roin, Retroactive Taxation, Unfunded Pensions, and Shadow Bankruptcies, 102 Iowa L. Rev. 559, 562 (2017).

[62] Jason S. Oh, The Pivotal Politics of Temporary Legislation, 100 Iowa L. Rev. 1055, 1056 (2015).

they argue that the SALT deduction forces low-tax states to subsidize high-tax states. Upon closer scrutiny, however, the case for repeal of the SALT deduction on these grounds is quite weak.

A. Vertical Equity

High-income households pay more in state and local taxes and are more likely to itemize deductions on their federal returns; unsurprisingly, the benefits of the SALT deduction flow largely to wealthy. Indeed, according to the U.S. Treasury Department, households in the top percentile of the income distribution will claim 37.1% of all SALT deduction benefits in 2017, and households in the top decile will claim 71% of SALT deduction benefits.[63]

One might therefore think that repeal of the SALT deduction would reduce inequality on an after-tax basis—i.e., it would make the bottom nine deciles better off relative to the top decile and the top percentile. Yet that intuition is not necessarily accurate if repeal comes coupled with rate reductions across the board. That is because the share of individual income taxes paid by households in the top percentile and top decile is even larger than the share of SALT deduction benefits that those groups claim: according to Treasury, households in the top percentile of the income distribution will pay 44.9% of all individual income taxes in 2017, and households in the top decile will pay 80.9%.[64] The groups that benefit the most from the SALT deduction are also the groups that would benefit the most from the rate reductions that repeal of the SALT deduction could finance.

In a forthcoming article, Kyle Rozema and I estimate the distributional effects of repealing the SALT deduction and using the resulting revenues to reduce taxes across the board. We find that the distributional consequences are highly sensitive to the form of the accompanying tax cut. One of the scenarios we model is as follows: the SALT deduction is repealed, all households calculate their tax liability without the SALT deduction, and the additional revenue from SALT repeal is rebated to households in proportion to their tax liability. We find that this revenue-neutral repeal of the SALT deduction would *increase* after-tax income inequality: on the whole, the bottom nine deciles would pay more while the top decile and top percentile would pay less.[65] The feature of the federal income tax system driving this result is the fact that high-income households claim a disproportionate share of SALT deduction benefits but pay an even greater share of all individual income taxes.

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[63] U.S. Dep't of the Treasury, Office of Tax Analysis, Distribution Table 2017 004c, Share of Tax Benefits of Selected Individual Income Tax Expenditures by Income Class (Mar. 30, 2016), https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/Selected-Credits-Deductions-and-Exclusions-2017.pdf.

[64] U.S. Dep't of the Treasury, Office of Tax Analysis, Distribution Table 2017 001, Distribution of Families, Cash Income, and Federal Taxes Under 2017 Current Law (Mar. 9, 2016), https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/Distribution-of-Tax-Burden-Current-Law-2017.pdf.

[65] See Daniel Hemel & Kyle Rozema, Inequality and the Mortgage Interest Deduction, Tax L. Rev. (forthcoming 2017), https://ssrn.com/abstract=2828970 (manuscript at 37 tbl.12).

There are, to be sure, scenarios in which repeal of the SALT deduction might reduce after-tax income inequality. For example, if the additional revenue from repealing the SALT deduction were rebated to taxpayers on a per-capita or per-household basis, then repeal would tend to make lower-income households better off and higher-income households worse off.

The distributional ambiguity of SALT repeal is especially apparent in the current political context. If the SALT deduction stays, then congressional Republicans and the Trump administration will presumably need to scale back other aspects of their tax-cutting package in order to hit their target of adding no more than $1.5 trillion to the deficit over the next decade.[66] If they respond by, say, scrapping their proposal to repeal the estate tax and adding a new surtax on millionaires, then the distributional consequences of retaining the SALT deduction become more progressive. If they respond by scaling back their proposed expansion of the child tax credit, then the distributional consequences of retaining the SALT deduction look much more regressive. The key point is that the distributional consequences of the SALT deduction depend critically on the allocation of the additional revenue that would be generated by repeal. In the abstract, without making assumptions about alternative revenue sources and uses, statements about the distributional consequences of repealing the SALT deduction are virtually contentless.

B. Interstate Equity

A final argument for repealing the SALT deduction emphasizes the fact that the deduction disproportionately benefits certain states. This observation is undeniably correct, but its normative implications are nonobvious. Many provisions of the Internal Revenue Code affect different states differently: the enhanced oil recovery credit benefits Texas more than Maine; [67] the credit for solar energy aids sunny Arizona more than Washington State.[68] There is almost certainly no good reason to believe that each provision of the Internal Revenue Code should affect each state equally.

Insofar as there is any value to interstate equity on a system-wide basis, however, the argument for repeal of the SALT deduction is shaky. Figure 1 serves to illustrate. It depicts the relationship between SALT deductions as a percentage of adjusted gross income and federal tax collections as a percentage of gross state product for all 50 states. The upward-sloping trend line indicates that the states benefiting more from the SALT deduction are, on balance, also the states that pay more in federal taxes (adjusted for economic output). The correlation is not perfect ($r = 0.31$), and there are a few notable outliers (e.g., New York, which ranks number one in terms of SALT deductions as a percentage of AGI but near the middle of the pack in terms of federal tax collections as a percentage of gross state product). The key takeaway, though, is that the SALT deduction disproportionately benefits states that pay a disproportionate share of federal taxes.

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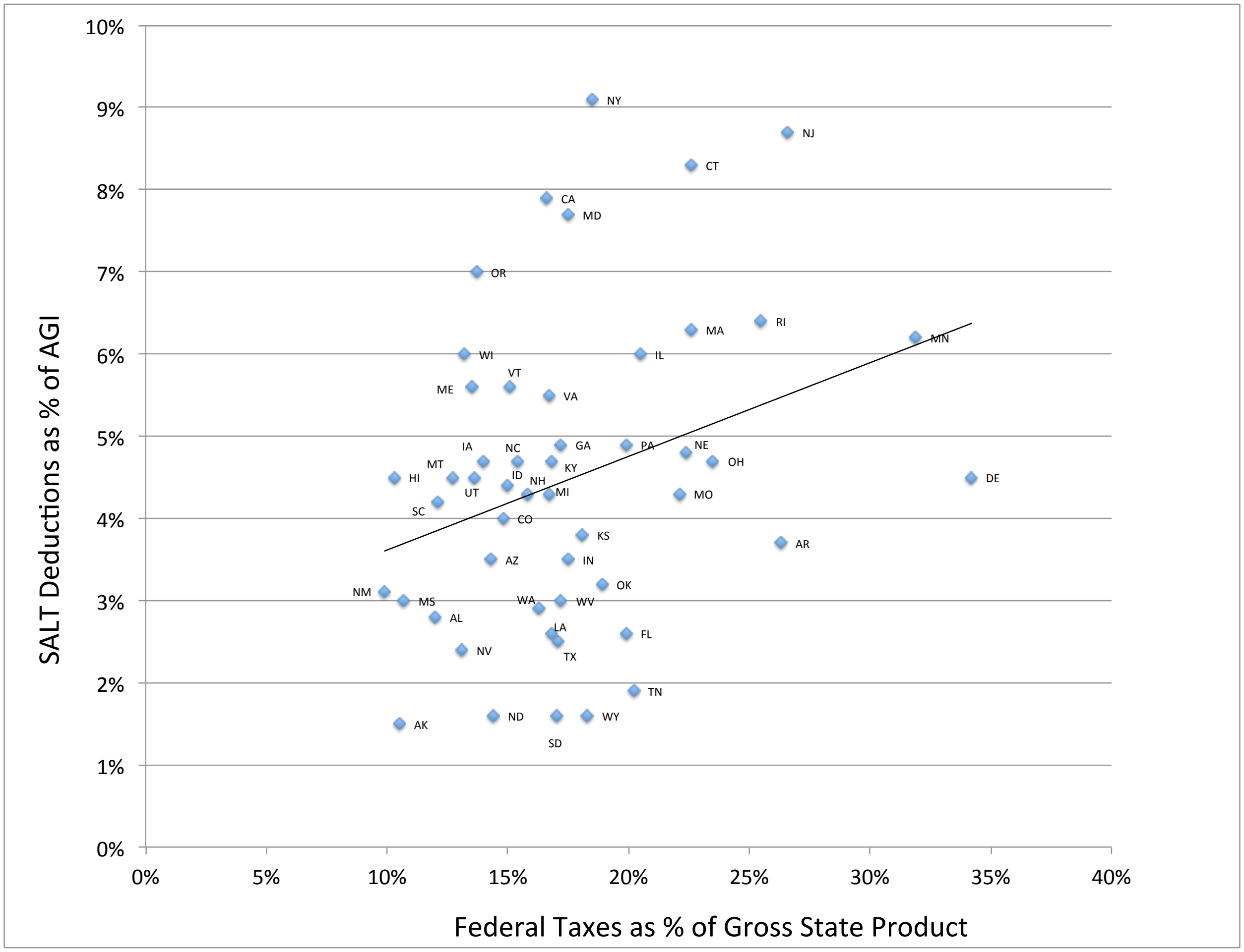
[66] This target is enshrined in the budget resolution passed in October. See H. Con. Res. 71, 115th Cong., 1st Sess. (passed Oct. 26, 2017).
[67] I.R.C. § 43.
[68] I.R.C. § 48.

Figure 1. Relationship Between SALT Deduction and Overall Federal Tax Burden, by State, 2014-2015[69]



Again, it is worth emphasizing that the relationship in Figure 1 does not supply an independent argument in favor of the SALT deduction. In a nation of unequal states, variation in federal taxes as a percentage of gross state product is a feature of a progressive federal tax system, not a bug. What it does suggest is that interstate equity, insofar as it is a value worth pursuing, would not weigh in favor of repealing the SALT deduction.

V. Conclusion

This essay has critically examined the main arguments for repealing the SALT deduction and has found that those arguments lack force. Far from unleashing economic growth, repealing the SALT deduction and using the resulting revenue to cut rates across the board would likely add

[69] See Bureau of Economic Analysis, U.S. Dep't of Commerce, Gross Domestic Product (GDP) by State (Millions of Current Dollars), http://bit.ly/2vXGbxz (last updated May 11, 2017); Internal Revenue Serv., Data Book—Oct. 1, 2014 to Sept. 30, 2015, at 12 tbl.5 (2015); U.S. Census Bureau, Table 1. Annual Estimates of the Resident Population for the United States, Regions, States, and Puerto Rico: April 1, 2010 to July 1, 2016 (Dec. 2016); Walczak, supra note 8, at 7 tbl.2.

to the deadweight loss of the overall tax system. It would distort decisions about the provision of public goods and services, push states toward suboptimal revenue-raising instruments, and potentially lead to more borrowing by states and localities in the short and medium term. Equity considerations (horizontal, vertical, and interstate) do little to enhance the case for repeal.

In comparison, the status quo of partial deductibility has much to recommend it. Partial deductibility reflects the fact that a large chunk of state and local government spending goes toward items—such as education and health care—that receive treatment similar to deductibility when provided by the nonprofit and/or private sector. Partial rather than full deductibility also reflects the fact that some state and local government spending substitutes for consumption expenditures that would otherwise be ineligible for deduction. Perhaps a better system would be one in which all taxpayers could deduct state and local taxes in part—as opposed to a status quo in which some taxpayers (e.g., itemizers not subject to the AMT) come close to full deductibility, and others (e.g., taxpayers who claim the standard deduction) cannot deduct at all. Yet despite its imperfections, the status quo reflects a reasonable compromise between arguments in favor of deductibility and against.

Appendix

The example in this appendix serves to illustrate the proposition that repeal of the SALT deduction negatively affects the supply of labor/capital and adds to the deadweight loss of the overall tax system. Consider two states, State X and State Y, each with identical populations and labor markets. For arithmetic ease, assume that the marginal product of labor for all workers is 100, that workers' pre-tax wages are equal to their marginal product, and that the labor supply curve in each state is $Q = 100(1 – t)$, where t is the tax rate. Thus, with no tax, $Q = 100$ in each state (200 units of labor total). Deadweight loss is equal to one-half the square of the product of the tax per unit and the change in the equilibrium quantity as a result of the tax.[70] Here, where $\Delta Q = 100\Delta t$, deadweight loss is $0.5 \times 100\Delta t \times 100\Delta t$, or $5000\Delta t^2$.

Next, imagine a federal tax on labor of 40%. Labor output in each state falls from $Q = 100$ to $Q = 100(1 – 0.4) = 60$ (120 units of labor total). Federal tax revenue from each state is $60 \times 0.4 \times 100 = 2400$ (4800 total). Deadweight loss in each state is $5000\Delta t^2 = 800$ (1600 total).

Next, imagine that State X (but not State Y) levies an additional state tax of 10%. Assume that state taxes are deductible from federal taxable income, so the effective federal tax rate in State X is 36% and the combined federal-plus-state tax rate in State Y is 46%. Labor output in State X is now $Q = 100(1 – 0.46) = 54$. Federal tax revenue from State X is $54 \times 0.36 \times 100 = 1944$. Deadweight loss in State X is $5000(0.46)^2 = 1058$. Federal tax revenue from State Y remains 2400, labor output in State Y remains at 60 units; and deadweight loss in State Y remains 800. Total federal tax revenue is now 1944 + 2400 = 4344; total labor output is now 54 + 60 = 114 units; and total deadweight loss is now 1058 + 800 = 1858.

Now consider the effect of revenue-neutral repeal of the state tax deduction. For repeal to be revenue neutral for the federal government, the new federal tax rate (r) must be set such that federal tax revenue from State X + federal tax revenue from State Y = 4344. Thus:

$$(Q_X)(r)(100) + (Q_Y)(r)(100) = 4344$$
$$-20000r^2 + 19000r – 4344 = 0$$
$$r \approx 0.3832 \text{ or } r \approx 0.5668$$

Assuming that the federal government chooses the lower rate of 38.32%, labor output in State X is now approximately 51.68 units, and deadweight loss in State X is now $5000(0.4832)^2 \approx 1167$. Labor output in State Y is now approximately 61.68 units, and deadweight loss in State Y is now $5000(0.3832)^2 \approx 734$. Total labor output is approximately $51.68 + 61.68 \approx 113.36$ units, and deadweight loss is approximately $1167 + 734 \approx 1901$.

Here, the same amount of federal tax revenue (4344) can be raised either (a) with a 40% federal tax rate and a state tax deduction or (b) with a 38.32% tax rate and no state tax deduction. Option (b) results in lower labor output than option (a) (113.36 units < 114 units, a reduction of approximately 0.56%) and greater deadweight loss (1901 > 1858, an increase of approximately 2.31%).

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[70] See, e.g., Bernard Salanié, The Economics of Taxation 54 (MIT Press, 2003).