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MAKING IT RAIN IN CALIFORNIA:
How The State and Local Tax Deduction Fuels Tax and Spend State Budgeting, and How Capping It Saves Most U.S. Taxpayers

Wayne Winegarden, Ph.D.

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Fuels Tax and Spend State Budgeting, and How Capping It Saves Most U.S. Taxpayers
By Wayne Winegarden
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Pacific Research Institute
101 Montgomery Street, Suite 1300
San Francisco, CA 94104
Tel: 415-989-0833
Fax: 415-989-2411
www.pacificresearch.org

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Introduction and Summary

The "Tax Cuts and Jobs Act" (TCJA) was signed into law on December 22, 2017. The Act reformed the U.S. corporate income tax code cutting the rate to a globally competitive 21 percent. Reforms on the personal income tax side, which are scheduled to expire in 2025, reduced the marginal income tax rate for most tax brackets. The TCJA also raised the standard deduction and reformed specific exemptions and deductions, which included capping the value of the state and local tax (SALT) deduction at $10,000.[1]

The SALT deduction creates concentrated benefits for a small group of people while imposing costs that exceed these benefits on all others. Such a scheme exemplifies the special interest loopholes that pervade the U.S. tax code and are currently diminishing the economic growth potential of the U.S. economy. While far from the ideal, the TCJA demonstrated that tax reforms are possible that will close special interest loopholes and lower marginal income tax rates. As discussed in the Pacific Research Institute's *Beyond the New Normal* research program, tax reforms that remove special interest loopholes and establish broad-based (ideally flat) taxes accelerate economic growth and promote broad-based economic prosperity.[2]

It is important to document the net benefits from capping the SALT deduction because the cap is set to expire and may even end sooner due to active efforts to either raise the cap or eliminate it all together. For example, H.R. 1757 was introduced on March 14, 2019 by Rep. Lauren Underwood (D-IL). H.R. 1757 would raise the SALT deduction cap from $10,000 to $15,000, $30,000 for married couples filing jointly; and would adjust these caps annually for inflation.[3] On February 11, 2019, Rep. Bill Pascrell (D-NJ) introduced H.R. 1142, which would repeal the cap all together and raise the top tax rate back up to 39.6 percent.[4] Reps. Nita Lowey (D-NY) and Peter King (R-NY) have also introduced the "Securing Access to Lower Taxes by Ensuring Deductibility Act of 2019" that would "fully restore" the SALT deduction.[5]

> "While special interests benefit, the SALT deduction imposes costs on other taxpayers, as well as the broader economy.

In light of these efforts, the purpose of this analysis is to review the adverse impact of the SALT deduction and demonstrate the benefits from reforms (like the TCJA) that limit the deduction in order to implement broad-based marginal tax rate reductions.

The first section of the analysis reviews the arguments in favor of the SALT deduction, and illustrates why these arguments are unpersuasive. After this review, the second section discusses the theoretical arguments that justify capping the SALT deduction.

Like all special interest tax breaks, the SALT deduction benefits a select group of taxpayers. In the case of the SALT deduction, the tax break reduces the federal tax burden for high-income taxpayers, particularly from high-tax states. The disproportionate impact from the cap on taxpayers from high-tax states explains why the legislators pushing for repeal are from the high tax states of New York, New Jersey, and Illinois.

While special interests benefit, the SALT deduction imposes costs on other taxpayers, as well as the broader economy. In part, the SALT deduction imposes costs on other taxpayers because the deduction is not an effective restraint on federal government spending. As Milton Friedman counseled, the actual tax burden is defined by how much the government spends, not by how that spending is financed (e.g. through either taxes or debt).

Since the SALT deduction does not constrain the growth in federal spending, the tax benefits that a select minority of taxpayers received from the SALT deduction are offset by the higher expenditure burden borne elsewhere in the economy. These burdens are manifested through higher than necessary tax rates on other taxpayers and higher than necessary levels of federal debt and debt costs.

Further costs arise because narrow tax breaks that benefit the few, by definition, preclude broad-based marginal tax rate reductions that could improve incentives for the entire economy. The lost economic benefits that could be gained are also a cost of special interest tax breaks like the SALT deduction.

More costs arise because the structure of the SALT deduction encourages state and local governments to spend more. Since it is taxpayers in lower-taxed states that are subsidizing the costs of government in these more profligate states, the SALT deduction creates inequitable outcomes between states. Due to these additional costs, the SALT deduction, on net, worsens economic incentives.

Following these theoretical discussions, the third section quantifies the impact of the SALT deduction on economic incentives. These impacts are quantified by comparing how the SALT deduction changes the average tax burden and marginal tax rates for taxpayers of different income levels in a state with high marginal income tax rates (California) compared to the economic incentives for taxpayers with the same taxable income in a state with low marginal income tax rates (Indiana). The analysis demonstrates that the tax benefits are larger for high-income taxpayers in high tax states. Further, the analysis illustrates how, without offsetting spending control, the subsidies created by the SALT deduction imposes costs on the broader economy.

The fourth section quantifies how the combined policy of capping the SALT deduction and lowering overall tax rates as implemented by the JCTA changed the underlying economic incentives for the same taxpayer scenarios examined in the third section. Specifically, the analysis illustrated that following the JCTA, the tax burden on high-income taxpayers from high-tax states increased. But, by broadening the tax base, the SALT deduction cap helped enable the lower personal income tax rates that improved economic incentives to work, save, and invest in the U.S. for everyone else. Further, the SALT cap reduced the unjustifiable wealth transfer from taxpayers in low-tax states to high-income taxpayers in high-tax states. As a result, this section demonstrates that, on net, capping the SALT deduction has improved the competitiveness of the U.S. tax code.

The SALT cap raises important issues for the high-tax states, however. The final section of the analysis reviews the impact from the cap on these high-tax states, using California as the example. While capping the SALT deduction increases the marginal tax rate for high-income taxpayers in California, it is important to note that the marginal tax rate increase in California arises because the reform reduced the costly subsidies that taxpayers from other states have been forced to pay. The removal of a benefit that other taxpayers have been forced to subsidize is different from the imposition of a cost.

Further, simply because taxpayers from other states have been masking the costs of the tax system in high-tax states like California, does not mean that this cross subsidization was the right policy. As the above sections demonstrated, cross subsidization was the wrong policy. Consequently, the economically sound answer is not for the federal government to re-establish these subsides and transfer the costs of California's tax system to taxpayers in other states. Instead, the more effective solution is to address California's high marginal tax rates and make the state more economically competitive.

Having reviewed the pros and cons of the SALT deduction, this analysis concludes that the costs of the SALT deduction far outweigh its benefits. Therefore, not only was capping the size of the deduction a positive economic reform, the current pressure to eliminate the SALT cap is wrongheaded. Instead, Congress should work toward eliminating the SALT deduction in its entirety.

Refuting the Arguments in Favor of the SALT Deduction

Allowing taxpayers to deduct their state and local taxes from their federal taxes has been part of the current income tax system since the *Revenue Act of 1913*, the Act that helped establish the individual income tax.[6] The proponents for this deduction, such as the Government Finance Officers Association, argue that "since the federal income tax was adopted in the early 20th century, it has been recognized that independent state and local government tax structures should be respected. The deduction of state and local taxes has contributed to the stability of state and local tax revenues that are essential for providing public services."[7] Specifically, advocates argue that the SALT deduction ensures that taxpayers are not double taxed on the same income, compensates for spillover effects in the provision of public services, encourages economic growth (due to the deductibility of income and/or sales tax), and incents homeownership and helps stabilize the housing market (including property tax deductibility).[8] Upon closer examination, these justifications are unpersuasive.

The SALT deduction does not prevent double taxation

Starting with the first argument, if people's incomes were actually "double-taxed" without the SALT deduction, then this would be an important justification for maintaining its full value. Tax systems that tax the same income multiple times (e.g. double-taxing income) foster unnecessary tax complexity and create strong anti-growth biases. The current U.S. corporate tax system exemplifies the problems with double taxing income.

Profits earned by companies are subject to the federal corporate income tax. The top tax rate is currently 21 percent. Then, if/when this income is distributed to the owners of the firm (e.g. the stockholders) through dividends or capital gains, the owners will pay personal income taxes on this income even though the income has already been taxed at the corporate level. Since this is the exact same income, the income was subject to double taxation – the same level of government taxed the same income multiple times in order to fund the same basket of government services.

Lots of problems arise because of this arrangement.[9] When the government double taxes income, tax laws have an inappropriately large influence on how businesses structure themselves and how they will return profits to their shareholders (e.g. dividends versus stock buybacks). These decisions are based, in part, on maximizing firms' and shareholders' tax efficiency instead of economic efficiency. When decisions are based on tax efficiency rather than economic efficiency, the consequences are slower economic growth, smaller wages, and diminished overall prosperity.

This is not what happens when state and local governments tax a person's income in addition to the federal government. When taxpayers pay taxes to different levels of government, these payments cover the costs of distinct public goods and services. Therefore, this is not double taxation.

To illustrate, imagine that the U.S. eliminated its federal system (our current system that empowers separate, and distinct, levels of government – federal, state, and local) in favor of a unitary system (where there is just one level of government). Under this unitary system, in addition to the current public goods and services that the federal government provides, it now provides all of the public goods and services currently provided by the state and local governments. Obviously, these services must now be funded by the federal tax system. The personal income taxes imposed by the federal government to cover the government services formerly provided by the state and local governments would not be considered double taxation. The revenues would simply fund distinct government goods and services. The same argument holds under our federal system. Different levels of government levying taxes to fund separate public goods and services is not an example of double taxing income.

Compensates for spillover effects

Another argument in favor of the SALT deduction is the existence of spillover effects. As the Congressional Budget Office described, spillover effects arise because

> some services, such as public assistance and education, provide general benefits that are not easily restricted to those who have financed them and that "spill over" to people in other states and localities. A so-called free-rider problem results: Citizens can live in communities that do not provide such services, and therefore avoid paying for them, but they may benefit from services provided by neighboring communities. Knowing that, state and local governments will tend to provide fewer of those services than they might otherwise.
>
> Financing public goods with large spillover benefits at the federal level would avoid that free-rider problem and the associated under-provision of services by state and local governments. However, the public services that the respective levels of government provide do not break down neatly along those lines. In practice, state and local governments supply a number of services that have nationwide benefits and therefore might be thought of as principally federal in nature. The potential under-provision of such services can be offset if the federal government assists those governments financially, either through direct grants or subsidies.[10]

The argument is effectively saying that without the SALT deduction, state and local governments will under-invest in certain public goods and services. As the PRI's *Beyond the New Normal* research program documented, there is little evidence that either the federal, state, or local governments are under-investing in government services – the evidence shows the level of government spending is excessive.[11]

However, even if the argument's premise is accepted (e.g., without the SALT deduction, there are state and local public goods and services that would not be provided) the argument still falls short. If there were cases where the federal government is the more efficient provider of a public good or service due to spillover effects, then the correct policy is for the federal government to provide these services – not to create a complex scheme in order to incent the state and local governments to provide them. Direct policy solutions are always more efficient than indirect workarounds.

There is also very little nexus between any theoretical spillover effects and taxpayers receiving the lions' share of the benefits from the SALT deduction. As Walczak (2017) noted,

> the deduction is a blunt instrument, applying no matter what the possible spillover effect of an expenditure is, and without regard to the mix of services that exist in a community.

> Many public expenditures have little or no spillover, yet they receive the same subsidy as those easily enjoyed by nonresidents. Specifically, it is highly unlikely that much spillover exists from high-income to low-income communities, yet it is high-income areas and taxpayers who benefit disproportionately from the deduction.[12]

These concerns demonstrate that, regardless of whether spillover effects exist, the SALT deduction is not an effective policy to address them. This assessment is only strengthened when the impact from the SALT deduction on the U.S. federal system is considered. As the CBO noted, the U.S. fiscal federalism system allows each state to reflect the preferences of its citizens and it empowers the states to experiment with alternative approaches to providing public goods and services. There are immense benefits for citizens from enabling this fiscal flexibility. However, the SALT deduction adversely influences the federalist system (discussed in more detail below.) These negative impacts are the primary concern with respect to the SALT deduction's impact on state and local governments, not the issue of spillover effects.

The deduction promotes economic growth

Perhaps no argument is more wrongheaded then the argument that eliminating the SALT deduction will decrease economic growth, or the stronger version that the deduction actually promotes economic growth.[13] Such a conclusion relies on incomplete economic analyses. Undoubtedly, the existence of the SALT deduction lowers some taxpayers' federal tax burden. However, there are several important dynamic formulations that need to be considered.

By subsidizing taxes in high-tax states, the SALT deduction encourages higher state and local taxes. These higher taxes create negative economic incentives that offset the positive incentives from the lower tax burden at the federal level.

> "By subsidizing taxes in high-tax states, the SALT deduction encourages higher state and local taxes.

Another important aspect that must be considered is the impact from the SALT deduction on taxpayers' marginal tax rates. The marginal tax rate is the additional tax owed from earning an additional dollar. Marginal tax rates profoundly influence economic incentives, with higher marginal tax rates discouraging additional economic activity. In this case, the SALT deduction does reduce some taxpayers' marginal tax rates.

Take high-income taxpayers in California as the example. While reviewed in greater detail below, a California taxpayer in the 13.3 percent marginal tax rate owes the state of California an additional $13.30 for every additional $100 they earn. At the current federal level tax rates, without the SALT deduction, they would be in the top tax rate (37 percent), so they would owe $37 to the federal government. In total, their marginal tax rate would be 50.3 percent, or they would keep $49.70 for every extra $100 they earn. Thanks to the SALT deduction, they would not owe $37 to the federal government. Instead, the federal tax burden would be based on the $100 in additional income minus the $13.30 in state taxes, or $86.70. Consequently, they would *only* owe $32.08 to the federal government, and their total tax burden would be 45.4 percent. The effective impact from the SALT deduction, consequently, is a reduction in a high-income Californian's tax burden from 50.3 percent to 45.4 percent – a more than 10 percent reduction in the marginal tax rate.

It logically follows from this simplified example that policies that cap the value of the SALT deduction will increase the tax burden, and raise the marginal tax rate, on those taxpayers who were receiving the break. A 2019 Treasury analysis "reviewed Federal tax returns filed in Tax Year 2017 and estimate that, if the SALT limitation had been in place in Tax Year 2017, it would have affected approximately 10.9 million taxpayers who would have been unable to deduct approximately $323 billion in SALT payments on Form 1040 Schedule A."[14] If this were the end of the story, then capping the SALT deduction would diminish overall economic prosperity.

But, this is only the beginning of the economic dynamics. The removal of the tax break simultaneously lowers the costs from the tax break that were being imposed on everyone else. These costs could be reduced in many ways. In terms of the TCJA, the government traded a higher tax rate for the taxpayers who formerly had a special interest tax deduction for lower marginal tax rates for the majority of taxpayers. From an economic impact perspective, tax reforms that broaden the tax base and lower marginal tax rates improve overall economic incentives. The result is faster economic growth. From this perspective, the SALT deduction is an impediment to faster growth, and limiting/eliminating the deduction improves growth, rather than constraining it.

The spending of the federal government is another important consideration. To the extent that total spending of the federal government is not constrained by the SALT deduction, a likely outcome, then the SALT deduction requires taxes to be higher than elsewhere in the economy, or higher deficits will be incurred. Regardless of whether it is higher taxes or higher debt, an offsetting cost has been imposed on the economy that weakens economic growth and lowers broad-based prosperity. Consequently, on net, the SALT deduction worsens economic disincentives, and eliminating (or constraining) the deduction can improve overall economic incentives.

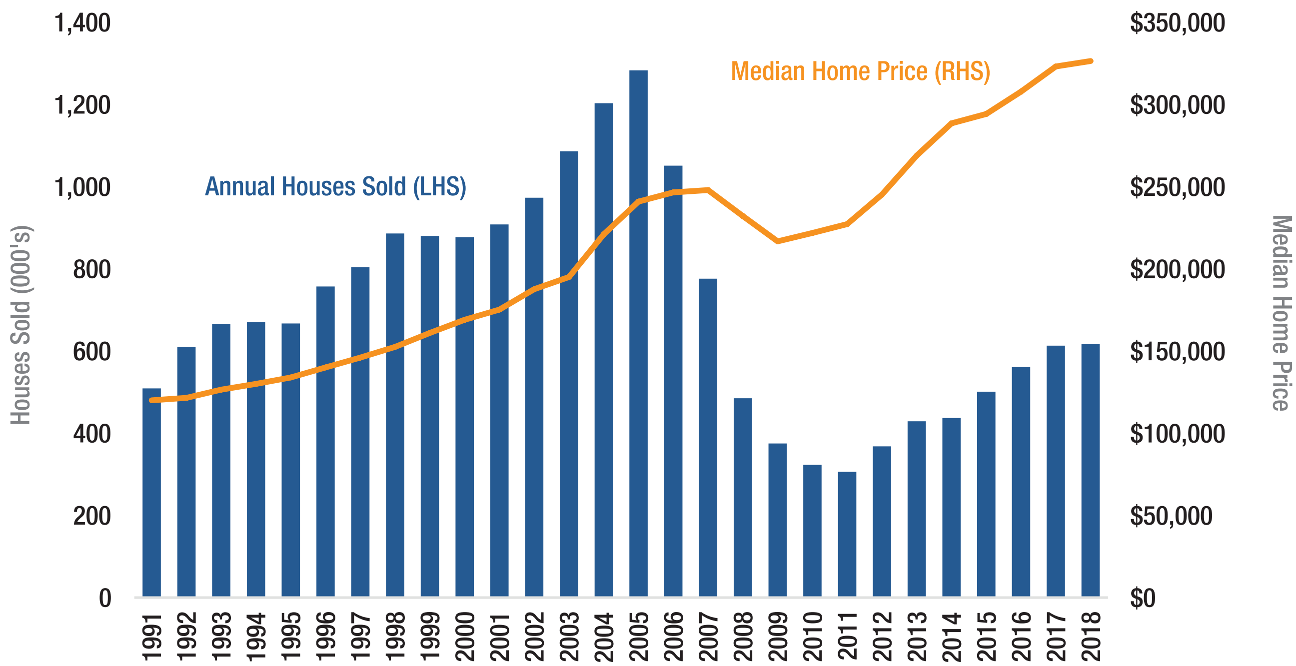
The SALT tax deduction incents homeownership

Another argument made in favor of the SALT deduction is that without it, housing values will fall.[15] These claims are not consistent with the actual experience following implementation of the TCJA. As the *Washington Post* documented in 2019,

> by all indications, there have been no widespread decreases in home values. The Case-Shiller home-price index, which tracks price movements, has documented a modest slowing in the pace of increases recently but has recorded no net declines.
>
> NAR's own data indicate that although sales of existing homes slumped in the final quarter of 2018 as interest rates increased, they have rebounded since then. In February, sales rose nearly 12 percent — the largest month-over-month gain since December 2015. Median home prices in February rose by 3.6 percent from the year earlier to $249,500, the 84th straight month of year-over-year gains.[16]

The U.S. Census data on home prices and values confirm these observations, see Figure 1. Figure 1 presents the total new homes sold in the U.S. each year between 1991 and 2018, as well as the median U.S. home price for that year. While the large swings in the U.S. home market are evident in Figure 1, there clearly was not an unprecedented change in either home sales or home prices in 2018 – the first year following implementation of the SALT deduction cap.

FIGURE 1:
U.S. New Home Sales and Median Home Prices
Annual Data | 1991 - 2018



Source: U.S. Census

While there has been no aggregate effect, capping the SALT deduction does appear to have geographical impacts. As described by the *Washington Post*,

> Where you can see ripples is in the upper brackets in high-tax areas.
>
> Mark Fleming, chief economist for First American Financial, says a new crop of home buyers is emerging: "Tax refugees." These are owners who are fed up with high taxes — now no longer deductible beyond $10,000 — and are heading to more tax-friendly locales. In the process, they may be creating "greater demand in the high end of lower-cost real estate markets," Fleming says.
>
> Realty agents in Florida, which has no state income tax, confirm the trend. Brian Walsh, a Redfin agent in Tampa, says he is seeing an influx of generally affluent clients who tell him they are abandoning areas with high taxes to buy homes in Tampa and St. Petersburg. He quoted one client who said, "I am so excited to be in a state with no income tax!" Recent refugees that Walsh has encountered come from places such as New York, the Washington area, Chicago and Denver, he told me.[17]

The fact that there are geographical impacts is not unexpected since the geographical distribution of the SALT deduction was clustered in the high-tax states. However, as the quote emphasizes, the losses in the high-tax states are offset with gains in lower-tax states.

One valid argument in favor of the SALT deduction, which is not often raised, arises if federal tax rates were once again raised to excessive levels. For instance, the top marginal tax rate between 1951 and 1964 was 91 or 92 percent. If such a tax rate were imposed in combination with California's current top income tax rate of 13 percent, then without the SALT deduction, the total marginal tax rate for residents of California would exceed 100 percent – a ludicrous marginal tax rate. These benefits are theoretical at current federal tax rates, however, and fail to outweigh the costs imposed by the SALT deduction.

The Costs of the SALT Deduction

While the arguments for the SALT deduction are unpersuasive, there are many sound arguments against the SALT deduction, which is why capping the SALT deduction was a net improvement to federal tax policy.

The SALT Deduction Narrows the Tax Base and Imposes Costs on Other Taxpayers

An efficient tax system levies a simple flat tax with the lowest possible tax rate on the broadest possible tax base. The current U.S. tax system violates this principle in many ways, which is why scrubbing the tax system of the largest offenders meaningfully improves it. As part of this effort, tax deductions that unnecessarily narrow the tax base for the benefit of special interests must be eliminated.

> "The SALT deduction is the epitome of a special interest tax break. It benefits the few (in this case, high-income taxpayers in high-tax states) at the expense of the many, and makes the objective of implementing a broader, flatter tax system more difficult.

As described above, the SALT deduction is the epitome of a special interest tax break. It benefits the few (in this case, high-income taxpayers in high-tax states) at the expense of the many, and makes the objective of implementing a broader, flatter tax system more difficult. Beyond making it more difficult to implement a more pro-growth tax system, the SALT deduction also imposes costs on the taxpayers who do not benefit from the special interest tax break.

For example, the persistent, and growing, federal deficits support the contention that the intended amount of federal spending is not influenced by the existence of the SALT deduction. It follows that the SALT deduction is not lowering the overall tax burden created by the federal government. It is simply transferring that burden to other taxpayers through a combination of higher debt costs and higher than necessary taxes on other taxpayers, particularly taxpayers in lower-taxed states.

There are also material geographical consequences from the SALT deduction. It is upper-income taxpayers in six states – California, New York, New Jersey, Illinois, Texas, and Pennsylvania – who primarily benefit from the deduction. As the Tax Foundation noted, taxpayers in these six states "claimed more than half (51.6 percent) of the value of all SALT deductions nationwide. California alone was responsible for 20.7 percent of all SALT deductions."[18]

It is difficult to justify why average taxpayers across the country should bear higher tax rates, or pay higher costs associated with the federal debt, in order to offset the high state and local government costs high-tax states impose on wealthy taxpayers.

The SALT Deduction Encourages Excessive State and Local Government Spending

The SALT deduction artificially reduces the costs on states and localities from imposing higher taxes. When the cost of any activity is reduced, more of that activity is expected. By muting the costs of state and local taxes, the SALT deduction encourages high-tax state and local governments to increase the size of government.

Perhaps even more problematic, due to the shifting of the federal tax costs, residents of lower-taxed states are forced to subsidize the costs of more government spending in the higher-taxed states. Due to the combined impact from these incentives (e.g. being forced to cover the costs of higher-taxed states and having the opportunity get their own spending subsidized), the SALT deduction encourages lower-taxed states to tax and spend more as well.

The SALT Deduction Weakens the Benefits from Fiscal Federalism

As U.S. Supreme Court Justice Louis Brandeis noted, the states are critical "laboratories of democracy", which means that each state is free to experiment with alternative public policies without imposing risks on the rest of the country. This structure empowers states to implement different fiscal philosophies.

Some states impose high taxes and spend a relatively large share of state income, while other states impose low taxes and spend a relatively small share of state income. The different approaches to governing allow families to choose those states with the combination of policies that best fit their desires. Just as important, the consequences from alternative approaches provide lessons for the entire country, not just the state that implemented the reforms.

If allowed to work, the federalist approach results in a more vibrant democracy that encourages the most effective political and economic policies to be implemented in all of the states. By encouraging all states to increase the amount of state and local spending, the SALT deduction creates a governing bias that reduces the benefits from the federalist system.

The SALT Deduction Creates Inconsistencies Between Different State and Local Revenue Sources

The SALT deduction creates a fundamental inconsistency in the tax treatment of alternative state and local revenues. While state and local governments levy all types of taxes and fees, these are not their only sources of revenue. The federal government also funds a large portion of state and local government budgets.

According to the latest State and Local Government Finances data from the U.S. Census, the federal government funded $690.2 billion of the $3.4 trillion combined state and local budgets in 2016.[19] This means that 20.3 percent of total state and local government spending was raised through the federal tax system. From the federal government's point of view, out of the $3.9 trillion federal budget in 2016, 17.9-cents out of every dollar was spent funding state and local government programs. And, the federal government's share of state and local budgets has been growing over time.

This situation creates a contradiction. If taxpayers deserve to deduct their state tax revenues from their federal tax burden, then they deserve to deduct all of their tax dollars supporting state government goods and services. All federal funds spent by the states are not eligible for federal tax deductibility, of course, because it obviously makes no sense to give taxpayers a federal income tax deduction on the portion of their federal taxes spent by state and local governments. Thus, the SALT deduction creates a problem of inconsistent tax treatment across state and local government revenue sources.

Quantifying the Costs and Benefits of the SALT Deduction

The SALT deduction effectively reduces the marginal tax rate of those taxpayers who are able to take advantage of the deduction – but these benefits are narrowly applied. California, with its highest in the nation top marginal tax rate exemplifies how large these benefits can be – and how the benefits are increased when states levy higher tax rates.

> "If taxpayers deserve to deduct their state tax revenues from their federal tax burden, then they deserve to deduct all of their tax dollars supporting state government goods and services.

To demonstrate these benefits, Table 1 estimates the alternative tax burden for ten hypothetical taxpayers who are assumed to be filing their return jointly as a married couple. For readability purposes, only the final estimated tax burden is presented for the tax burden calculations. The full calculations for each table are presented in the Appendix. These calculations are simplifications of the actual tax burdens, and do not attempt to account for payroll taxes, other potential tax credits, deductions, or potential subsidies. As such, the purpose is to provide a basis from which to judge the SALT deduction's impact on marginal and average tax rates for the combined state and federal income tax burden for taxpayers living in a high-tax state (i.e. California) compared to taxpayers living in lower-tax state (i.e. Indiana).

Due to California's steeply progressive tax system, a couple with a $50,000 taxable income would pay 2.0 percent of their income ($1,019) in California state taxes, while a couple with a $1.5 million taxable income would pay 10.7 percent of their income ($159,942) in California state taxes. Couples earning $100,000, $200,000, and $500,000 would owe 4.0 percent, 6.6 percent, and 8.2 percent of their taxable incomes to the California state government, respectively.

By definition, all taxpayers in Indiana would pay 3.23 percent of their taxable income to the state, which leads to tax payments of $1,615, $3,230, $6,460, $16,150, and $48,450 for the families with taxable incomes between $50,000 and $1.5 million, respectively.

TABLE 1

State Income Taxes Owed for Hypothetical Taxpayers with Taxable Incomes of $50,000, $100,000, $200,000, $500,000, and $1,500,000 Taxpayers Filing Married, Jointly

	STATE INCOME TAXES OWED BY ALTERNATIVE TAXABLE INCOME				
	$50,000	$100,000	$200,000	$500,000	$1.5 MILLION
California					
Total Income Tax paid	$1,019	$3,965	$13,107	$41,007	$159,942
Average Tax Rate	2.0%	4.0%	6.6%	8.2%	10.7%
Indiana					
Total Income Tax paid	$1,615	$3,230	$6,460	$16,150	$48,450
Average Tax Rate	3.23%	3.23%	3.23%	3.23%	3.23%

Source: Author calculations based on 2019 tax rates and thresholds as reported by the Tax Foundation.

If no SALT deduction existed, then the state tax payments could not be deducted from the taxpayer's federal income taxes, implying that in addition to their state taxes, the couples would owe the same federal taxes equal to 11.2 percent of their income ($5,612), 13.7 percent of their income ($13,717), 18.2 percent of their income ($36,349), 25.1 percent of their income ($125,387), and 32.9 percent of their income ($493,140) for the families with taxable incomes between $50,000 and $1.5 million, respectively, see Table 2.

TABLE 2

Federal Income Taxes Owed for Hypothetical Taxpayers with Taxable Incomes of $50,000, $100,000, $200,000, $500,000, and $1,500,000 Excluding SALT Deduction Taxpayers Filing Married, Jointly

	FEDERAL INCOME TAXES OWED BY ALTERNATIVE TAXABLE INCOME				
	$50,000	$100,000	$200,000	$500,000	$1.5 MILLION
Total Income Tax paid	$5,612	$13,717	$36,349	$125,387	$493,140
Average Tax Rate	11.2%	13.7%	18.2%	25.1%	32.9%

Source: Author calculations based on 2019 tax rates and thresholds as reported by the Tax Foundation.

Without the SALT deduction, Californians bear the full costs of their state income taxes, and Indianans bear the full cost of their state income taxes. Further, all residents with the same taxable income must pay the same federal income tax costs. As Table 3 illustrates, without a SALT deduction, residents in California pay a higher federal and state income tax burden on most of the income levels examined, except for the couples with $50,000 in taxable income. Since California levies a higher sales tax rate, these burdens cannot be interpreted as California having a lower marginal tax rate than Indiana. The calculation only means that California has a lower marginal and average income tax rate between these two couples.

TABLE 3

Average Tax Rates and After-tax Income (Federal and State Income Taxes) for Hypothetical Taxpayers with Taxable Incomes of $50,000, $100,000, $200,000, $500,000, and $1,500,000
Taxpayers Filing Married, Jointly
Excluding SALT Deduction

	FEDERAL AND STATE INCOME TAXES OWED BY ALTERNATIVE TAXABLE INCOME				
	$50,000	$100,000	$200,000	$500,000	$1.5 MILLION
California					
After-tax Income	$43,369	$82,318	$150,544	$333,606	$846,918
Average Tax Rate	13.3%	17.7%	24.7%	33.3%	43.5%
Indiana					
After-tax Income	$42,773	$83,053	$157,191	$358,463	$958,410
Average Tax Rate	14.5%	16.9%	21.4%	28.3%	36.1%

Source: Author calculations based on 2019 tax rates and thresholds as reported by the Tax Foundation.

Compared to these after-tax and average tax rates, Tables 4 and 5 demonstrate that the SALT deduction meaningfully changes the size and relative share of the federal taxes these families paid because the tax deduction's value increases as a taxpayer's income increases and as the state tax burden increases. This means that the value of the deduction is much larger for the upper-income California taxpayers relative to lower-income California and all Indiana taxpayers. The changed burden is visible in both reduced dollar costs and in terms of the percentage reduction in the average and marginal tax burdens.

For example, in California, the SALT deduction reduced the average tax rate for the couple with a taxable income of $500,000 by 2.9 percentage points, adding $14,352 to their after-tax income. For the richest couple examined, earning a taxable income of $1.5 million, the SALT deduction decreased their average tax rate by 3.9 percentage points, increasing their after-tax income by $59,178, see Table 5. The comparative benefits for the Indiana households with the same incomes are much smaller – the SALT deduction reduced the average tax rate for the Indiana couple with a taxable income of $500,000 and $1.5 million by 1.1 percentage points and 1.2 percentage points, adding $5,653 and $17,927 to their taxable income, respectively.

TABLE 4

Average Tax Rates and After-tax Income (Federal and State Income Taxes) for Hypothetical Taxpayers with Taxable Incomes of $50,000, $100,000, $200,000, $500,000, and $1,500,000
Taxpayers Filing Married, Jointly
Including SALT Deduction

	FEDERAL AND STATE INCOME TAXES OWED BY ALTERNATIVE TAXABLE INCOME				
	$50,000	$100,000	$200,000	$500,000	$1.5 MILLION
California					
After-tax Income	$43,491	$83,190	$153,690	$347,959	$906,097
Average Tax Rate	13.0%	16.8%	23.2%	30.4%	39.6%
Indiana					
After-tax Income	$42,967	$83,764	$158,741	$364,116	$976,337
Average Tax Rate	14.1%	16.2%	20.6%	27.2%	34.9%

Source: Author calculations based on 2019 tax rates and thresholds as reported by the Tax Foundation.

TABLE 5

Change in Average Tax Rates and After-tax Income (Federal and State Taxes) for Hypothetical Taxpayers with Taxable Incomes of $50,000, $100,000, $200,000, $500,000, and $1,500,000
Taxpayers Filing Married, Jointly
Including SALT Deduction

	CHANGE IN FEDERAL AND STATE INCOME TAXES OWED BY ALTERNATIVE TAXABLE INCOME				
	$50,000	$100,000	$200,000	$500,000	$1.5 MILLION
California					
Change in After-tax Income	$122	$872	$3,146	$14,352	$59,178
Change in Average Tax Rate	-0.2%	-0.9%	-1.6%	-2.9%	-3.9%
Indiana					
Change in After-tax Income	$194	$711	$1,550	$5,653	$17,927
Change in Average Tax Rate	-0.4%	-0.7%	-0.8%	-1.1%	-1.2%

Source: Author calculations based on Tax Foundation data.

These comparisons illustrate why it is the upper-income taxpayers who benefit from the deduction. Tables 4 and 5 also illustrate that the SALT deduction would only reduce the tax payments for the taxpayers with $50,000 in taxable income by $122 and $194 in California and Indiana, respectively. Compared to the standard deduction of $24,000, lower- and middle-income taxpayers are not, on average, benefiting from the SALT deduction.

The SALT deduction also impacts taxpayers' marginal tax rates, which are compared in Table 6. The marginal tax rate refers to the amount of tax payments owed for an additional amount of income earned. Marginal tax rates help determine the incentives for productive activities. Table 6 estimates the marginal after-tax income and marginal tax rates facing taxpayers in California (representing the impact on high-tax states) compared to Indiana (representing the impact on low-tax states) under two-scenarios: (1) excluding the impacts from the SALT deduction; and (2) including the impacts from the SALT deduction. Table 6 once again shows that the SALT deduction is more valuable to higher-income taxpayers than lower-income taxpayers, and that California households benefit more than Indiana households.

TABLE 6
After-tax Income and Marginal Tax Rate for an Additional $10,000 in Income for Hypothetical Taxpayers with Taxable Incomes of $50,000, $100,000, $200,000, $500,000, and $1,500,000 With and Without the SALT Deduction California Compared to Indiana

	CALIFORNIA					INDIANA				
	$50,000	$100,000	$200,000	$500,000	$1.5 MILLION	$50,000	$100,000	$200,000	$500,000	$1.5 MILLION
After-tax Income excl. SALT Deduction	$8,400	$7,000	$6,670	$5,570	$4,970	$8,477	$7,477	$7,277	$6,177	$5,977
Marginal Tax Rate	16.0%	30.0%	33.3%	44.3%	50.3%	15.2%	25.2%	27.2%	38.2%	40.2%
After-tax Income incl. SALT Deduction	$8,448	$7,176	$6,893	$5,896	$5,462	$8,516	$7,548	$7,355	$6,290	$6,097
Marginal Tax Rate	15.5%	28.2%	31.1%	41.0%	45.4%	14.8%	24.5%	26.5%	37.1%	39.0%

Source: Author calculations based on Tax Foundation data.

In California, the SALT deduction reduces the marginal tax rate by 3.3 percentage points for taxpayers with a $500,000 taxable income and 4.9 percentage points for taxpayers with a $1.5 million taxable income. The savings are much smaller in Indiana, however – the SALT deduction provides a 1.1 percentage point reduction in the marginal tax rate for taxpayers with $500,000 in taxable income, and a 1.2 percentage point reduction for taxpayers with a $1.5 million taxable income.

By closing the gap between the marginal tax rates in the high-tax state (California) and the marginal tax rate in the low-tax state (Indiana), the SALT deduction mutes the disincentives created by excessively high state and local taxes. If California's state taxes were not subsidized by the federal government (e.g. taxpayers from all other states), then families could face a marginal tax rate in excess of 50 percent. With the subsidy, those families face a 45 percent marginal lower tax rate. While still a disincentive to engaging in economic activity in California, the SALT deduction reduces the disincentive by 10.8 percent. Muting the disincentive allows California (as well as any other states that wish to spend more money) to grow the size of government without bearing the full consequences of the actions.

These hypothetical taxpayers also provide perspective on how, without spending control, the SALT deduction transfers the costs of funding the federal government. Table 7 aggregates the total federal tax payments for the ten taxpayers (five hypothetical taxpayers in California and five hypothetical taxpayers in Indiana) both excluding the SALT deduction and including the SALT deduction. Overall federal revenues are $103,705 smaller with the SALT deduction then without the SALT deduction, causing the government to run a larger deficit. The reduced tax burden on California taxpayers account for 75 percent of this revenue decline – once again illustrating the disproportionate benefits the SALT deduction provides high-tax states.

TABLE 7
The SALT Deduction Impact on Total Revenues for Ten Hypothetical Taxpayers

	FEDERAL TAX BURDEN		
	EXCLUDING SALT DEDUCTION	INCLUDING SALT DEDUCTION	DIFFERENCE
California	$674,205	$596,534	-$77,671
Indiana	$674,205	$648,171	-$26,034
Total	$1,348,410	$1,244,705	-$103,705

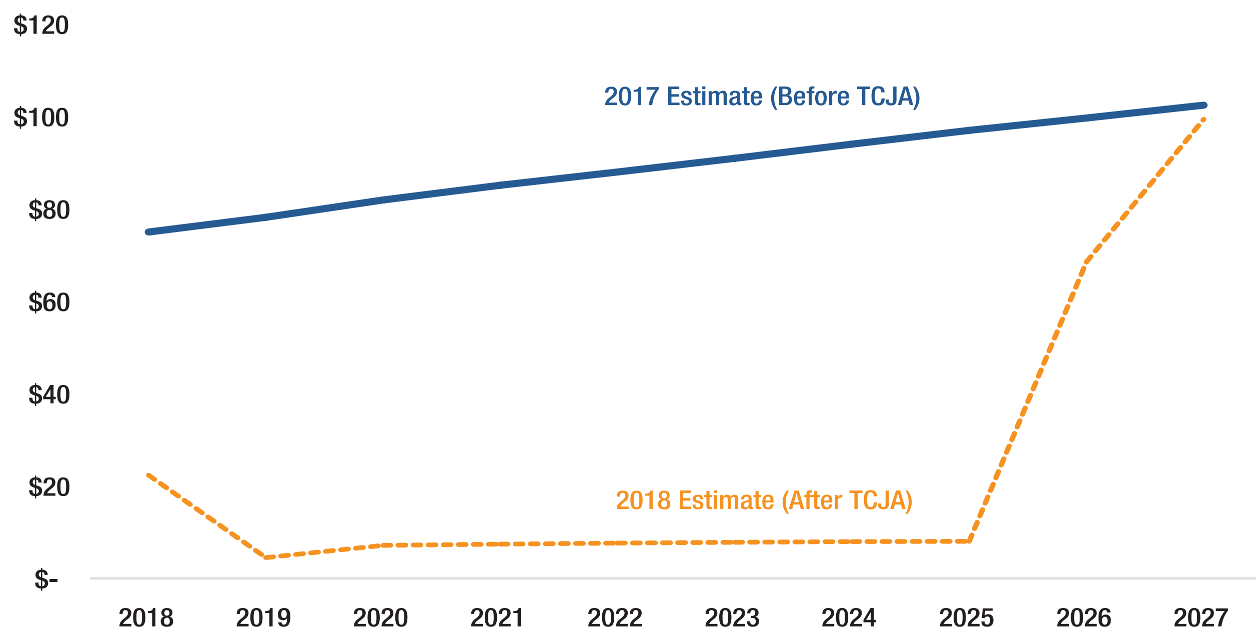
Source: Author calculations.

Since the federal government now has a deficit that is $103,705 larger, and based on the assumption that the government will not cut spending by an equal amount, then either tax rates will need to be increased to offset these lost revenues or the government will need to borrow more money. Regardless of whether the government raises taxes or borrows money (e.g. diverts investment resources away from the private sector), the SALT deduction has not lowered the overall tax burden on the economy. Further, if this burden is equally shared across all taxpayers, then each taxpayer is responsible for an additional $10,371 in government spending. As Table 5 illustrates, this additional burden is higher than the value of the SALT deduction for all taxpayers except those with $1.5 million in taxable income, and the California taxpayer with $500,000 in taxable income. The large reductions in the tax burdens are, consequently, enabled by the higher costs imposed on all other taxpayers.

The TCJA: A Case Study Illustrating the Benefits from Limiting the SALT Deduction

As Table 7 illustrated, the SALT tax preferences reduce the burden on high-income taxpayers in the high-tax states by shifting that burden onto others. The Treasury Department produces an annual publication that estimates the revenue loss associated with different tax expenditures, which can be viewed as a proxy for the size of the burden that was shifted.[20] According to the 2017 estimates of tax expenditures (prior to the passage of the TCJA), the value of the 2018 state and local tax expenditures was $75.0 billion, see Figure 2. Capping the deduction meaningfully lowered these expenditures, as the 2018 estimates of tax expenditures (after the passage of the TCJA) illustrated. Prior to the cap, the value of the tax break was estimated to grow 6.2 percent a year reaching $129.0 billion by 2027. Since the cap is currently designed to expire in 2025, the 2018 estimates show that the value of the cap will “spring back” to the previous expected path. However, the large gap in expenditures between 2018 and 2025 illustrate the large reduction in this special interest tax break.

FIGURE 2
Estimated Value of State and Local Tax Deduction 2018 through 2027 | Before and After the TCJA



Source: Author calculations.

Based on the average interest rate costs for the U.S. Treasury as of May 31, 2019 (2.593 percent), the present value of the estimated tax breaks between 2018 and 2027 as of the 2017 estimates was $892.2 billion compared to $240.7 billion as of the 2018 estimates. This reduction means the SALT cap enabled $651.5 billion of special interest tax breaks to be reallocated into broad-based marginal tax rate reductions, which is precisely what the TCJA did. The TCJA implemented broad-based tax rate reductions in corporate and individual income tax rates. Replacing lower marginal tax rates for a special interest group with broad-based tax rate reductions improves overall economic incentives.

These benefits can be visualized by comparing the combined impact on average and marginal tax rates from the lower marginal tax rates but capped SALT deduction to the average and marginal tax rates that existed prior to the TCJA. Again, California is used as a proxy for the high-tax states and Indiana is used as a proxy for the low-tax states. Unlike the previous series of tables, which examined the impact of the SALT deduction given the current tax rates, this analysis examines how the TCJA has changed the average and marginal tax rates. These calculations are a simplification and, as before, do not account for any other potential taxes, credits or deductions.

Based on the California and Indiana state personal income taxes paid detailed in Table 1, Table 8 estimates the total federal income taxes paid, the total state plus federal income taxes paid, and the marginal tax rates (state plus federal) prior to the TCJA reforms.

Comparing the average federal income tax rates for Californians versus Indianans in Table 8 illustrates that prior to the TCJA, the SALT deduction allowed California taxpayers, who had higher state income tax liabilities, to have lower federal income tax liabilities. Figure 3 graphically compares these tax rates.

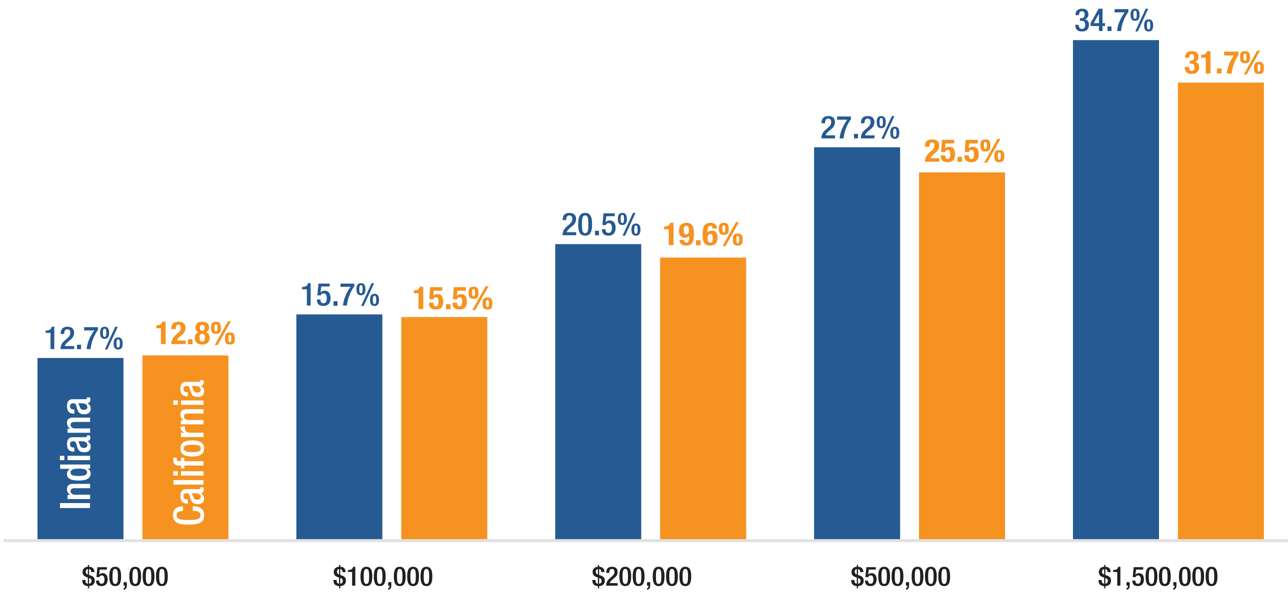
TABLE 8
California and Indiana Income Taxes Owed for Hypothetical Taxpayers with Taxable Incomes of $50,000, $100,000, $200,000, $500,000, and $1,500,000 Prior to the Tax Cuts and Jobs Act of 2017 Taxpayers Filing Married, Jointly

	TAXES OWED BY ALTERNATIVE TAXABLE INCOME				
	$50,000	$100,000	$200,000	$500,000	$1.5 MILLION
California					
Total Federal Income Tax paid	$6,415	$15,486	$39,215	$127,531	$475,894
Average Tax Rate	12.8%	15.5%	19.6%	25.5%	31.7%
Total California & Federal Income Tax paid	$7,434	$19,451	$52,321	$168,537	$635,836
Average Tax Rate	14.9%	19.5%	26.2%	33.7%	42.4%
Marginal Tax Rate	17.0%	31.0%	34.7%	41.0%	47.6%
Indiana					
Total Federal Income Tax paid	$6,325	$15,670	$41,076	$136,231	$520,045
Average Tax Rate	12.7%	15.7%	20.5%	27.2%	34.7%
Total Indiana & Federal Income Tax paid	$7,940	$18,900	$47,536	$152,381	$568,495
Average Tax Rate	15.9%	18.9%	23.8%	30.5%	37.9%
Marginal Tax Rate	17.7%	27.4%	30.3%	37.1%	41.6%

Source: Author calculations based on Tax Foundation data.

FIGURE 3

Average Federal Tax Rates in California and Indiana Prior to the Tax Cuts and Jobs Act of 2017 for Hypothetical Taxpayers, Taxpayers Filing Married, Jointly



Source: Author calculations based on Tax Foundation data.

Other than the taxpayers with $50,000 in taxable income, the SALT deduction has allowed California taxpayers to lower their average tax payments relative to Indiana taxpayers. These impacts are more pronounced for the two upper-income taxpayers in the example, particularly because the couples with a $50,000 taxable income would likely be better off filing under the standard deduction rather than itemizing. While the subsidization at the federal level was not large enough, however, to fully offset the higher state income tax burdens, these calculations demonstrate how the SALT deduction inequitably shifted the tax burden between different taxpayers with the same taxable income.

Table 9 estimates the total federal income taxes paid, the total state plus federal income taxes paid, and the marginal tax rates (state plus federal) following the TCJA reforms.

TABLE 9
State and Federal Income Taxes Owed for Hypothetical Taxpayers with Taxable Incomes of $50,000, $100,000, $200,000, $500,000, and $1,500,000 Following Implementation of the Tax Cuts and Jobs Act of 2017 Taxpayers Filing Married, Jointly

	TAXES OWED BY ALTERNATIVE TAXABLE INCOME				
	$50,000	$100,000	$200,000	$500,000	$1.5 MILLION
California					
Total Federal Income Tax paid	$5,490	$12,845	$33,949	$121,887	$489,440
Average Tax Rate	11.0%	12.8%	17.0%	24.4%	32.6%
Total California & Federal Income Tax paid	$6,509	$16,810	$47,056	$162,894	$649,382
Average Tax Rate	13.0%	16.8%	23.5%	32.6%	43.3%
Marginal Tax Rate	15.5%	28.2%	33.3%	44.3%	50.3%
Indiana					
Total Federal Income Tax paid	$5,418	$13,006	$34,799	$121,887	$489,440
Average Tax Rate	10.8%	13.0%	17.4%	24.4%	32.6%
Total Indiana & Federal Income Tax paid	$7,033	$16,236	$41,259	$138,037	$537,890
Average Tax Rate	14.1%	16.2%	20.6%	27.6%	35.9%
Marginal Tax Rate	14.8%	24.5%	26.5%	38.2%	40.2%

Source: Author calculations based on Tax Foundation data.

To facilitate the comparison, Table 10 presents the marginal tax rates and average tax rates for the five hypothetical taxpayers in California and Indiana both before and after the TCJA.

TABLE 10
Marginal Tax Rates and Average Tax Rates for Ten Hypothetical Taxpayers with Taxable Incomes of $50,000, $100,000, $200,000, $500,000, and $1,500,000 Before and After Implementation of the Tax Cuts and Jobs Act of 2017 Taxpayers Filing Married, Jointly

	TAXES OWED BY ALTERNATIVE TAXABLE INCOME				
	$50,000	$100,000	$200,000	$500,000	$1.5 MILLION
California					
	Average Tax Rate				
Before TCJA	14.9%	19.5%	26.2%	33.7%	42.4%
Post TCJA	13.0%	16.8%	23.5%	32.6%	43.3%
	Marginal Tax Rate				
Before TCJA	17.0%	31.0%	34.7%	41.0%	47.6%
Post TCJA	15.5%	30.0%	33.3%	44.3%	50.3%
Indiana					
	Average Tax Rate				
Before TCJA	15.9%	18.9%	23.8%	30.5%	37.9%
Post TCJA	14.1%	16.2%	20.6%	27.6%	35.9%
	Marginal Tax Rate				
Before TCJA	17.7%	27.4%	30.3%	37.1%	41.6%
Post TCJA	14.8%	24.5%	26.5%	38.2%	40.2%

Source: Author calculations based on Tax Foundation data.

Table 10 illustrates that the TCJA meaningfully lessened the inequitable transfers between taxpayers and lowered the average- and marginal tax rates for most taxpayers. Specifically, following the tax reforms, the total tax burden and average tax rates declined for all taxpayers evaluated except the California taxpayer earning $1.5 million. Marginal tax rates declined for most taxpayers except the Indiana taxpayer with a $500,000 taxable income, and the California taxpayers with $500,000 and $1.5 million in taxable income.

While inefficiencies remain, the TCJA demonstrated that economic incentives can be broadly improved by narrowing the benefits offered by the SALT deduction. Further, the adverse consequences for those taxpayers benefiting from the deduction can be largely offset by the broad-based tax reductions. For this reason, the SALT deduction cap was a pro-growth reform that should be made permanent.

The SALT Cap Impact on High-tax States – A California Case Study

In California, the cap on the SALT deduction has been framed as a federal tax increase on Californians. State Controller Betty Yee exemplified this position when she noted in April 2019 that "as taxpayers are filing their returns this month, many of them are discovering the bite the federally imposed SALT cap is taking out of their wallet".[21]

The reality is different.

> "The majority of the total SALT deductions claimed were claimed by upper income taxpayers.

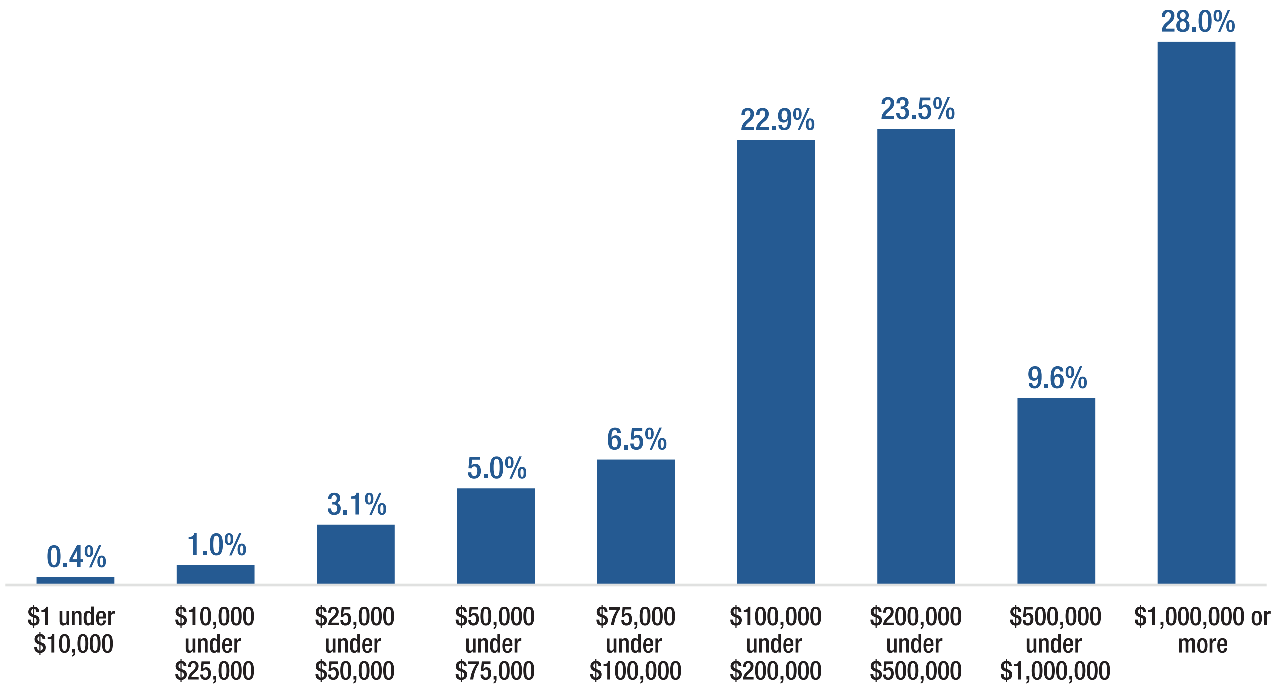
The state controller's comments would have been more accurate had she stated, "as taxpayers were filing their returns in April, many of them are discovering the bite ***California's steeply progressive and overly-burdensome state income tax*** takes out of their wallet." This is the proper way to view the SALT deduction cap – the federal government did not impose a tax increase on Californians – or high-income taxpayers in any high-taxing states. As the tax return analyses above demonstrated, trading the SALT deduction for broad-based reductions in tax rates has actually reduced the tax burden for most California taxpayers. The 2016 Statistics of Income (SOI) data reported by the IRS (latest data available) confirm the conclusion that many Californians are not paying more in taxes.[22]

In 2016, 35.1 percent of all California tax returns claimed a SALT deduction; alternatively, 64.9 percent of Californians did not claim it and will not be directly impacted by the cap. By law, taxpayers who did claim the deduction can deduct their state and local real estate tax payments, state and local personal property tax payments, and either their state and local income or sales tax payments. For Californians, the income tax deduction was by far the largest – Californians deducted $82.4 billion in state and local income taxes out of a total SALT deduction of $117.4 billion, or 70 percent of the total taxes deducted.

The majority of the total SALT deductions claimed were claimed by upper income taxpayers. As Figure 4 illustrates, 84 percent of the value of the SALT deduction claimed by Californians in 2016 were claimed by taxpayers with adjusted gross incomes (AGI) in excess of $100,000. Perhaps even more important, the average size of the deduction claimed per tax return was less than $10,000 for all taxpayers with an AGI of less than $100,000, see Figure 5. Even for taxpayers with an AGI between $75,000 and $100,000 (well above California's median household income in 2016 of $69,196),[23] the average deduction claimed per tax return was $8,111. Thus, the $10,000 SALT cap will not increase federal taxes on the majority of California taxpayers.

FIGURE 4

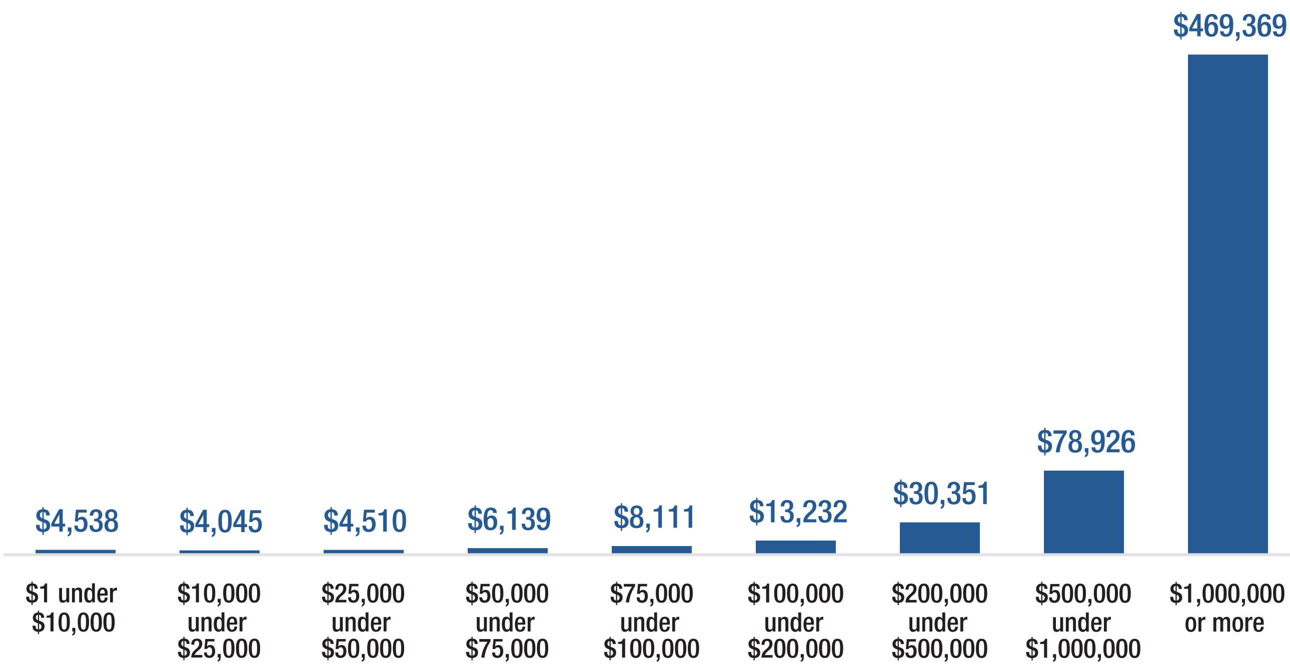
Percentage of Total Dollar Value of SALT Deduction Claimed by Size of Tax Return California Taxpayers 2016



Source: Author calculations based on IRS SOI data.

FIGURE 5

Average Size of SALT Deduction Claimed per Tax Return, by Size of Tax Return California Taxpayers 2016



Source: Author calculations based on IRS SOI data.

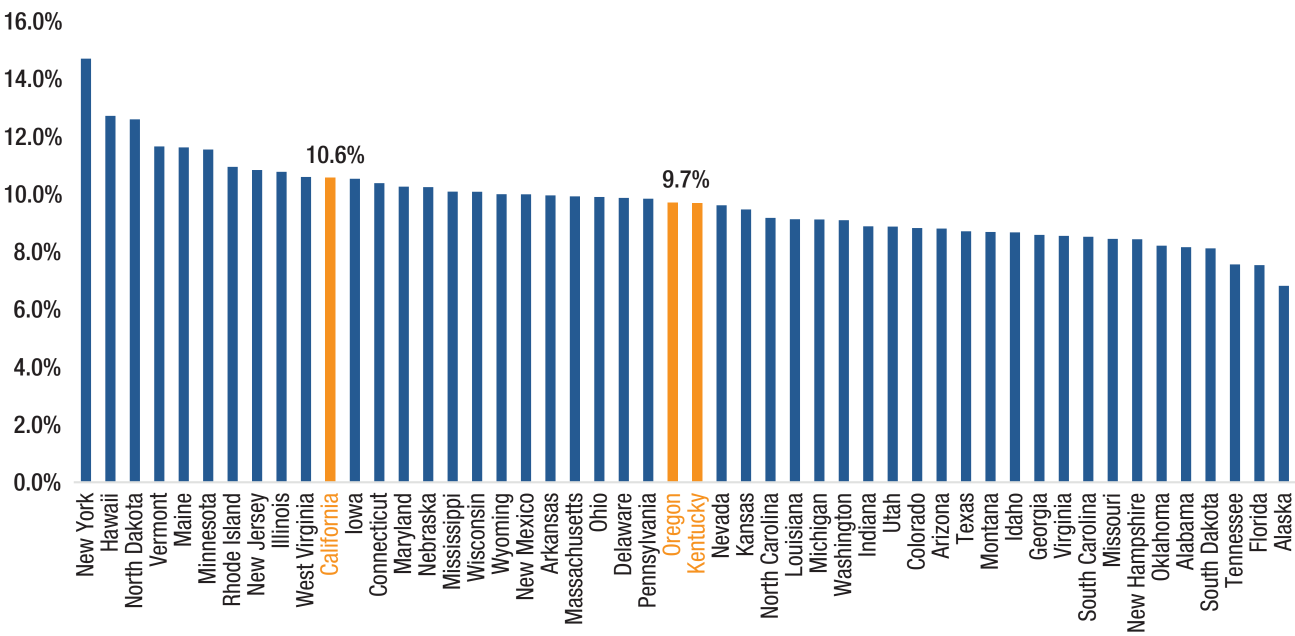
It is also important to note that 93.6 percent of all tax returns filed by Californians in 2016 had an AGI of less than $200,000. As Table 10 illustrated, the TCJA reduced the average tax rate and marginal tax rate for California households with taxable incomes of $200,000 or less on average. It is clear, consequently, that the combined policy of lower tax rates and a cap on the SALT deduction has not raised taxes on the vast majority of Californians.

Even though a majority of Californians experienced a net tax cut from the TCJA, the higher marginal and/or average tax rates for upper-income Californians is problematic. If left unaddressed, the incentive for these households to work, save, and invest in California has been diminished. The incentive to leave California and move to a more affordable state, such as Nevada or Texas, is also greater. Undoubtedly, policy changes are required to remedy this problem. The above analyses demonstrated that the SALT deduction does not eliminate the costs from California's high tax system; it simply redistributed some of those costs to residents of other states. Just as importantly, California's steeply progressive income tax system has been imposing costs on the state regardless of the generosity of the SALT deduction.

While a comprehensive evaluation of California's tax system is beyond the scope of this report, a couple of problematic trends exemplify why California's political leaders should look inward for solutions, rather than blaming the federal government for the state's confiscatory tax system.

California's excessive tax burden is readily visible by comparing its overall state and local tax burden to the burdens in other states, see Figure 6. Figure 6 compares California's state and local tax burden (the red bar) to the other 49 states. The state and local tax burden is defined as the total state and local government tax revenues as measured by the U.S. Census Bureau *2016 Annual Surveys of State and Local Government Finances*,[24] relative to each state's 2016 total personal income as measured by the Bureau of Economic Analysis.[25] As Figure 6 illustrates, while not the most heavily taxed state, (New York has this honor), California's overall state and local tax burden is 10.6 percent, or 9.1 percent higher than the median tax burden of 9.7 percent (the pink bars in Figure 6). The relative disrepair of California's infrastructure, the American Society of Civil Engineers gave California's "overall infrastructure a grade of C-", is just one indication that Californians are not receiving value for the high taxes they pay.[26]

FIGURE 6
State and Local Tax Burden by State 2016

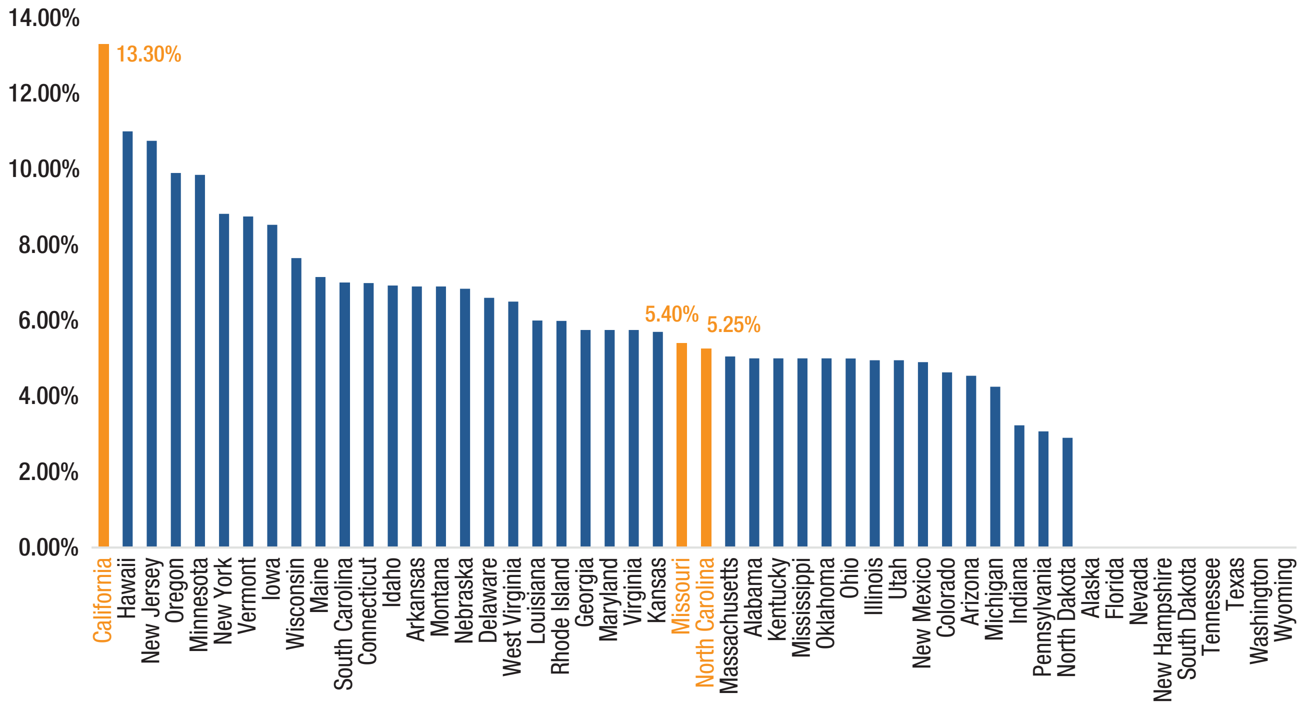


Source: Author calculations based on data from the U.S. Census, Bureau of Economic Analysis

Perhaps even more problematic, California levies the highest marginal income tax rate on personal income in the nation, see Figure 7. California's 13.3 percent marginal income tax rate is nearly three times higher than the highest marginal income tax rate levied in the states with the median top tax rate, and 21 percent higher than the marginal income tax rate in Hawaii (the state with the second highest marginal income tax rate). Steeply progressive income tax systems discourage economic growth and create excessively volatile tax revenues – revenues surge faster than income growth during periods of strong growth, and crash faster than income growth during periods of weak growth.

FIGURE 7

Highest Marginal Personal Income Tax Rates As of January 2019



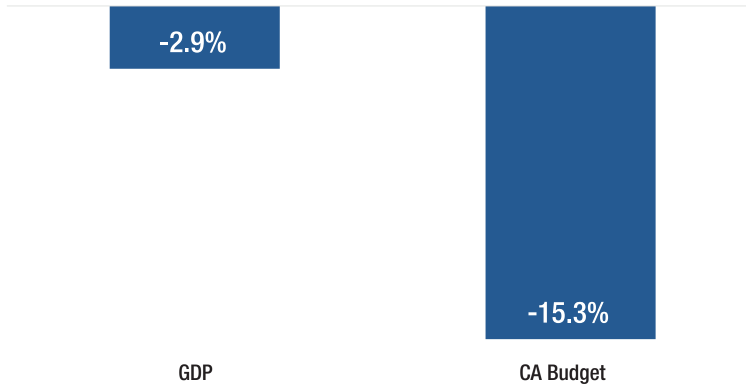
Source: Tax Foundation

State government revenues in California epitomize this revenue volatility problem. As noted by the Legislative Analyst's Office, "personal income taxes are the largest state revenue source… these taxes are much more volatile than statewide personal income. This is partly because California taxes capital gains, which are especially volatile and mainly go to high-income taxpayers who pay the highest tax rates. These taxpayers' other income also tends to be volatile."[27] Even Governor Newsom has stated that the current tax volatility "is not our friend, it is our enemy".[28] This volatility has been painstakingly evident both during and after the Great Recession. Figure 8 shows that, between FY2007-08 and FY2009-10, California's economy shrank 2.9 percent (due to the Great Recession), but the state budget declined a much larger 15.3 percent.

The volatility does not end during the good times, either. As Figure 9 illustrates, since the end of the Great Recession, the growth in California's state budget has been volatile from year to year, making it more difficult to budget. Further, the budget (+51.7 percent) has also been growing faster than the overall state economy (+49.9 percent), setting California up for another budget crisis when the next economic slowdown occurs.

FIGURE 8

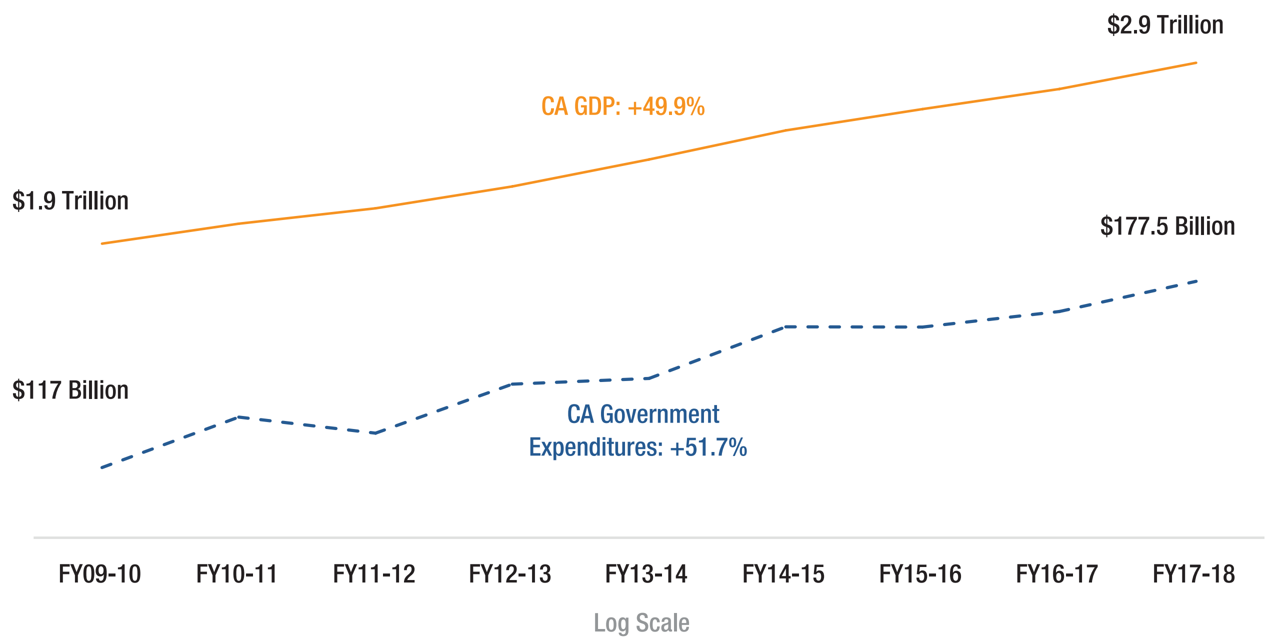
Percent Change in California's GDP Compared to Percent Change in California's State Budget FY2007-08 through FY2009-10



Source: Author calculations based on data from the U.S. Bureau of Economic Analysis and California Legislative Analyst's Office

FIGURE 9

The Growth in California's GDP Compared to the Growth in California's State Expenditures FY2009-10 through FY2017-18



Source: Author calculations based on data from the U.S. Bureau of Economic Analysis and California Legislative Analyst's Office

Reinstating the full value of the SALT deduction does not address these fundamental problems with California's tax system. In fact, all the SALT deduction cap did is lay bare the full costs imposed by California's anti-competitive tax system. It is not the responsibility of residents from Indiana or any other lower-taxed state to subsidize these costs. It is California's responsibility to fix its own tax system, and the same logic holds for New York, New Jersey, Illinois and any other high-tax state.

Conclusion: State and local taxes should not be deductible

Capping the SALT deduction raised the marginal tax rate on taxpayers, particularly in high-tax states like California. Eliminating this special interest tax deduction helped enable broad-based tax reductions that, on net, reduced the marginal tax rate and average tax burden for the majority of taxpayers. Thus, as it was implemented, the SALT cap reduced the distortions and economic costs associated with the SALT deduction, provided broad-based tax relief that offset (sometimes only partially) the increase in marginal tax rates on those taxpayers who have been benefiting from this special interest tax break.

At the state level, the SALT deduction cap exposes the anti-growth aspects of the tax system in high-tax states, such as California. Therefore, the best-policy response is to address the anti-growth aspects of these tax systems through effective tax reform. Specifically, the SALT cap creates an opportunity for comprehensive pro-growth tax reform that implements a simplified flat-tax for California.[29] It is unrealistic to anticipate that such reforms will be implemented in the near-term, however. But, without such reforms it is appropriate for California (as well as the other high-tax states) to bear the full costs of its anti-growth tax system. It is also appropriate that residents of other states do not bear higher costs because California, or any other state, decides to levy higher marginal tax rates. Therefore, limiting the state and local tax deduction is the right policy at the federal level.

More generally, the federal government should continue working toward a broader tax base and flatter tax rates, that would create a more stable tax system. These reforms should include making the cap on the SALT deduction permanent, and ideally, eliminate the policy completely.

Appendix

The following series of tables detail the specific tax revenue calculations for the estimated tax burdens, including the calculated tax burdens for infra-marginal tax rates.

TABLE A (refers to Table 1)
State Income Taxes Owed for Hypothetical Taxpayers Filing Married, Jointly

			$50,000	$100,000	$200,000	$500,000	$1,500,000
					California		
1.00%	>	$0	$170.88	$170.88	$170.88	$170.88	$170.88
2.00%	>	$17,088	$468.44	$468.44	$468.44	$468.44	$468.44
4.00%	>	$40,510	$379.60	$937.12	$937.12	$937.12	$937.12
6.00%	>	$63,938		$1,488.96	$1,488.96	$1,488.96	$1,488.96
8.00%	>	$88,754		$899.68	$1,873.28	$1,873.28	$1,873.28
9.30%	>	$112,170			$8,168.19	$36,068.19	$42,855.70
10.30%	>	$572,984					$11,802.98
11.30%	>	$687,576					$35,303.91
12.30%	>	$1,000,000					$17,953.08
13.30%	>	$1,145,960					$47,087.32
Total Income Tax paid			$1,018.92	$3,965.08	$13,106.87	$41,006.87	$159,941.67
Average Tax Rate			2.0%	4.0%	6.6%	8.2%	10.7%
					Indiana		
3.23%	>	$0	$1,615.00	$3,230.00	$6,460.00	$16,150.00	$48,450.00
Total Income Tax paid			$1,615.00	$3,230.00	$6,460.00	$16,150.00	$48,450.00
Average Tax Rate			3.23%	3.23%	3.23%	3.23%	3.23%

TABLE B (refers to Table 2)

Federal Income Taxes Owed for Hypothetical Taxpayers, Excluding SALT Deduction Taxpayers Filing Married, Jointly

		Taxes Owed by Alternative Taxable Income				
Rate	Taxable Income Over	$50,000	$100,000	$200,000	$500,000	$1,500,000
10.00%	$0	$1,940.00	$1,940.00	$1,940.00	$1,940.00	$1,940.00
12.00%	$19,400	$3,672.00	$7,146.00	$7,146.00	$7,146.00	$7,146.00
22.00%	$78,950		$4,631.00	$19,679.00	$19,679.00	$19,679.00
24.00%	$168,400			$7,584.00	$36,732.00	$36,732.00
32.00%	$321,450				$27,760.00	$27,760.00
35.00%	$408,200				$32,130.00	$71,452.50
37.00%	$612,350					$328,430.50
Total Income Tax paid		$5,612.00	$13,717.00	$36,349.00	$125,387.00	$493,140.00
Average Tax Rate		11.2%	13.7%	18.2%	25.1%	32.9%

Endnotes

1 The $10,000 cap applies to taxpayers filing as single and married jointly, and includes property taxes.

2 A link to Parts 1 through 4 of the Pacific Research Institute's *Beyond the Normal* research program can be found at: https://www.pacificresearch.org/beyond-the-new-normal-new-study-slow-economic-growth-is-not-the-new-normal-for-us-economy/. For an evaluation of the optimal size of the federal government see: Winegarden W (2018) "The 15 Percent Solution: Defining the Affordable Level of Government" *Pacific Research Institute*, May; https://www.pacificresearch.org/how-much-should-we-spend-new-pri-report-offers-the-15-solution/. For an evaluation of specific policy reforms to implement the 15 percent solution see: Winegarden W (2019) "Realizing the 15 Percent Solution: Reforms to establish a pro-growth budget" *Pacific Research Institute*, February; https://www.pacificresearch.org/wp-content/uploads/2019/02/NewNormal-2_Feb2019_Fweb.pdf.

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About the Author

Wayne Winegarden, Ph.D.

Wayne H. Winegarden, Ph.D. is a Senior Fellow in Business and Economics at the Pacific Research Institute and director of PRI's Center for Medical Economics and Innovation. He is also the Principal of Capitol Economic Advisors.

Dr. Winegarden has 25 years of business, economic, and policy experience with an expertise in applying quantitative and macroeconomic analyses to create greater insights on corporate strategy, public policy, and strategic planning. He advises clients on the economic, business, and investment implications from changes in broader macroeconomic trends and government policies. Clients have included Fortune 500 companies, financial organizations, small businesses, state legislative leaders, political candidates and trade associations.

Dr. Winegarden's columns have been published in the *Wall Street Journal, Chicago Tribune, Investor's Business Daily,* Forbes.com, and Townhall.com. He was previously economics faculty at Marymount University, has testified before the U.S. Congress, has been interviewed and quoted in such media as CNN and Bloomberg Radio, and is asked to present his research findings at policy conferences and meetings. Previously, Dr. Winegarden worked as a business economist in Hong Kong and New York City; and a policy economist for policy and trade associations in Washington D.C. Dr. Winegarden received his Ph.D. in Economics from George Mason University.

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