

# BACKGROUND

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## Why Tax Reform Should Eliminate State and Local Tax Deductions

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### Abstract

*The state and local tax and municipal bond interest deductions encourage higher taxes and debt by state and local governments. By requiring higher federal marginal tax rates to replace lost revenue, the state and local tax deduction further severs the link between taxes paid and services received, forcing all federal taxpayers to pay, in part, for services provided to residents of other states. Moreover, the deduction on interest from state and local bonds distorts infrastructure spending decisions and makes it easier for states to accumulate debt, which could harm state economies and result in requests for federal bailouts. Both Republicans in Congress and President Trump have released frameworks for pro-growth tax reform that would significantly reduce marginal tax rates and get rid of many existing deductions and loopholes in the current system. We estimate that by replacing the state and local tax and bond interest deductions with a revenue-neutral and distribution-neutral reduction in marginal tax rates, policymakers could reduce federal tax rates by as much as 16.4 percent and an average of 7.3 percent. Alternatively, without maintaining distributional neutrality and instead focusing on middle-class tax cuts only, marginal income tax rates for the three middle-income brackets could decline by an average of 13.3 percent.*

Under federal tax law, individuals may deduct the income and property taxes that they pay to their state and local governments, as well as any interest they receive from owning state or local bonds, from their total income when filing their federal taxes. In recent years, individuals have been allowed to choose between deducting their income tax or sales taxes.<sup>1</sup> Because federal tax

### KEY POINTS

- Current policy, which allows taxpayers who itemize their deductions to deduct most of their state and local taxes (SALT), makes it easier for states to raise taxes, and shifts the burden of state spending to federal taxpayers.
- Eliminating the SALT deductions means that policymakers would have an additional \$1.7 trillion in 10-year tax revenues, potentially reducing marginal tax rates by as much as 16.4 percent and by an average of 7.3 percent.
- Implementation of SALT provision also creates taxpayer fairness, as taxpayers in low-tax states currently pay significantly more in federal taxes than taxpayers with identical incomes who live in high-tax states.
- Eliminating these deductions would provide a significant tax cut to the 70 percent of taxpayers who do not itemize their deductions. It would also benefit many of the 30 percent who do itemize, because the lower rates and higher standard deduction would more than compensate for these lost deductions.

This paper, in its entirety, can be found at <http://report.heritage.org/bg3256>

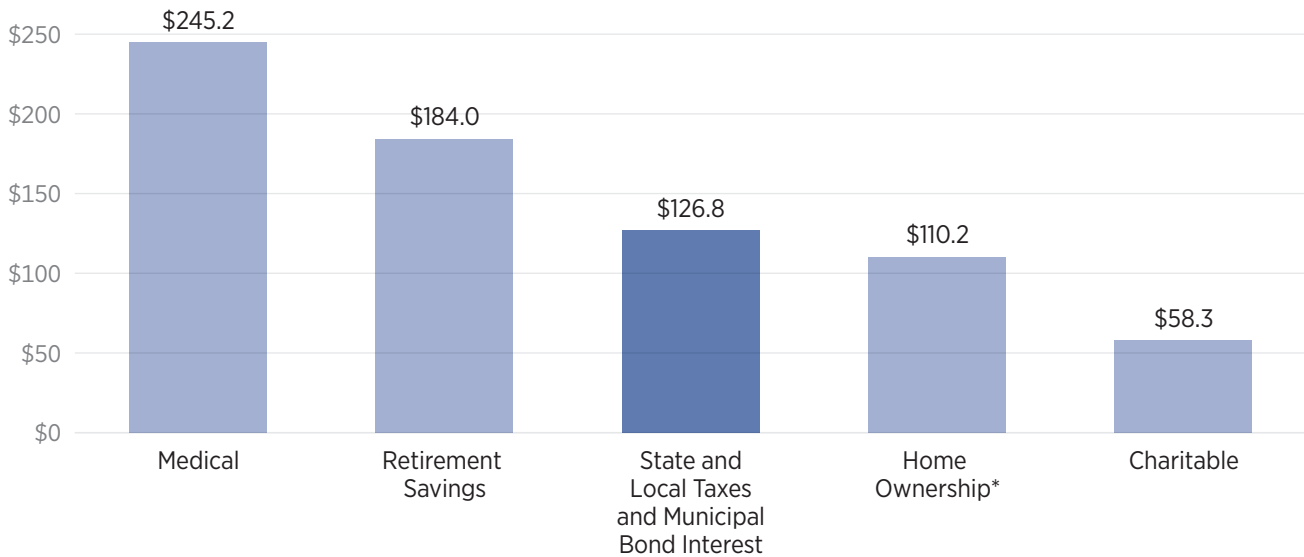
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CHART 1

## Major Tax Preference Items

FOR 2017, IN BILLIONS OF DOLLARS



**NOTE:** \*Home ownership includes the value of the mortgage interest deduction and capital gains exclusion.

**SOURCE:** U.S. Department of the Treasury, Tax Expenditures, Table 3, "Income Tax Expenditures Ranked by Total Fiscal Year 2017-2026 Revenue Effect," <https://www.treasury.gov/resource-center/tax-policy/Documents/Tax-Expenditures-FY2017.pdf> (accessed October 6, 2017).

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deductions effectively spread the costs of these deductions across all taxpayers in the form of higher federal tax rates, the state and local tax deduction results in federal taxpayers in low-tax, low-debt states subsidizing taxpayers in high-tax, high-debt states. Distributional impacts within states results in low-income residents subsidizing high-income residents as a result of these deductions.

If the state and local tax and bond interest deductions were eliminated, federal income tax rates could be reduced by as much as 16.4 percent. Ending the federal subsidy of state and local taxes and debt would help to improve the fiscal discipline and economic efficiency of state and local governments because taxpayers would no longer receive a refund for part of the taxes they paid to their state or locality. Instead, they would pay the full cost of the services they received. Additionally, municipal bond investors would no longer receive a subsidy on top of the

interest earned from their municipal bonds, so state and local government budgets would have to reflect the full cost of any accumulated debt.

### Economics of the Deductions

Tax deductions reduce the tax base and thus require higher marginal tax rates to maintain the same level of tax revenue. Ideally, deductions should be kept to a minimum after the appropriate tax base has been established. Yet the U.S. tax code is littered with numerous deductions and exemptions. The federal deductions for state and local taxes and municipal bond interest turn high-tax and high-debt states as well as high-income taxpayers into those special interests.

Since state and local taxes reduce individuals' after-tax income, it may make sense to exclude the income used to pay those taxes from federal taxation. But this was when state and local governments

1. Since 2004, taxpayers have been allowed to choose between deducting their state and local income taxes or their state and local sales taxes.

TABLE 1

## State and Local Tax Deductions, by State

STATE AND LOCAL TAX DEDUCTIONS AS A PERCENT OF FEDERAL ADJUSTED GROSS INCOME

Rank	Amount	Rank	Amount	Rank	Amount			
1	New York	8.94%	18	Georgia	4.82%	35	Kansas	3.69%
2	New Jersey	8.53%	19	Nebraska	4.76%	36	Indiana	3.49%
3	Connecticut	8.15%	20	Ohio	4.64%	37	Arizona	3.42%
4	California	7.73%	21	Iowa	4.63%	38	Oklahoma	3.12%
5	Maryland	7.60%	22	Kentucky	4.63%	39	West Virginia	3.01%
6	Oregon	6.91%	23	North Carolina	4.60%	40	Mississippi	3.00%
7	D.C.	6.73%	24	Utah	4.47%	41	Washington	2.87%
8	Rhode Island	6.31%	25	Hawaii	4.44%	42	Alabama	2.73%
9	Massachusetts	6.25%	26	Delaware	4.44%	43	Louisiana	2.60%
10	Minnesota	6.12%	27	Montana	4.41%	44	Florida	2.52%
11	New Mexico	6.12%	28	Idaho	4.31%	45	Texas	2.49%
12	Illinois	5.93%	29	New Hampshire	4.25%	46	Nevada	2.39%
13	Wisconsin	5.87%	30	Missouri	4.24%	47	Tennessee	1.87%
14	Vermont	5.52%	31	Michigan	4.21%	48	North Dakota	1.61%
15	Maine	5.50%	32	South Carolina	4.18%	49	Wyoming	1.58%
16	Virginia	5.46%	33	Colorado	3.91%	50	South Dakota	1.58%
17	Pennsylvania	4.82%	34	Arkansas	3.70%	51	Alaska	1.50%

**SOURCE:** Authors' calculations based on data from the U.S. Treasury, Statistics of Income for 2014, Historic Table 2, "Individual Income and Tax Data, by State and Size of Adjusted Gross Income," <https://www.irs.gov/uac/soi-tax-stats-historic-table-2> (accessed June 20, 2017).

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provided the majority of services and collected the majority of taxes. The reverse is true today as the federal government collects over 50 percent more in revenues than state and local governments combined.<sup>2</sup> As the primary revenue collector, the federal government should not exempt any levels of taxation. Moreover, the tax deduction allows states to raise taxes higher than they otherwise would and encourages governments to provide services that are more appropriately left to the private sector. The tax deduction also has significant perverse distributional impacts, redistributing income from the poor to the rich, and from people in low-tax states to people in high-tax states.

### Size of State and Local Tax and Municipal Bond Interest Deductions

The deductions for state and local taxes and

municipal bond interest remain some of the largest deductions in the federal tax code. According to The Heritage Foundation's Individual Income Tax Model (HFIITM), the state and local tax and municipal bond interest deductions will reduce federal tax revenues by an estimated \$128 billion in 2017, rising to \$207 billion by 2026, for a total of \$1.669 trillion over 10 years. This makes these state deductions among the largest "tax preference" items.

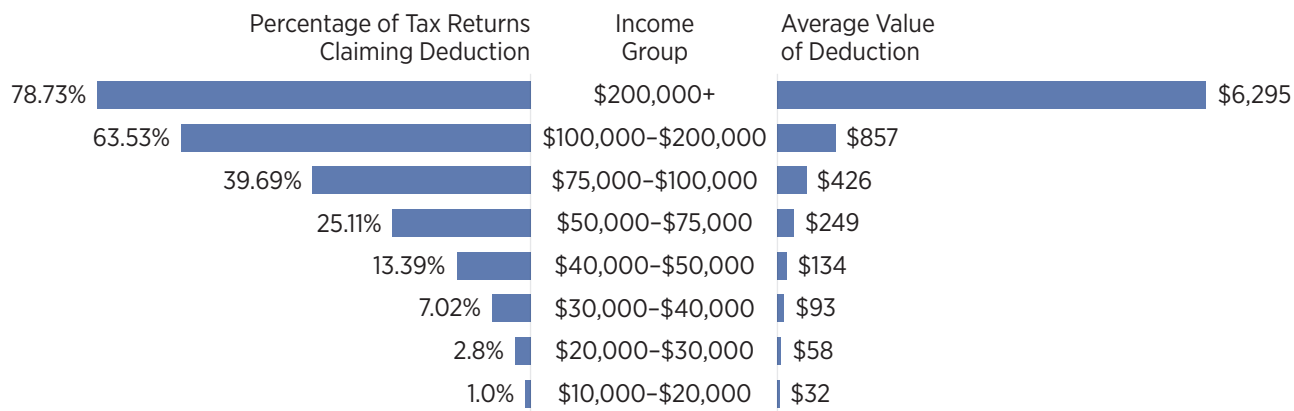
### Beneficiaries of State and Local Deductions

**States with High Taxes.** States with higher income and property taxes receive the greatest benefit from the state and local tax deduction. Seven states receive 53 percent of the value of the state and local tax deduction: California, Connecticut, Illinois, Maryland, Massachusetts, New Jersey, and New

2. Tax Policy Center, "What Is the Breakdown of Revenues Among Federal, State, and Local Governments," *Briefing Book*, <http://www.taxpolicycenter.org/briefing-book/what-breakdown-tax-revenues-among-federal-state-and-local-governments> (accessed September 28, 2017).

CHART 2

## Upper-Income Earners Benefit Most from State and Local Tax Deduction



**SOURCE:** Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2016–2020, Table 3, “Distribution by Income Class of Selected Individual Tax Expenditure Items, at 2017 Rates and 2016 Income Levels,” January 30, 2017, <https://www.jct.gov/publications.html?func=startdown&id=4971> (accessed October 6, 2017).

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York.<sup>3</sup> On average, taxpayers who itemize in those states deduct 7.6 percent of their income in state and local taxes, compared to 4.2 percent of income among other taxpayers who itemize in all other states.<sup>4</sup>

The state and local tax deduction effectively reduces states’ marginal tax rates, allowing them to collect higher taxes while pushing some of the burden from their own taxpayers to taxpayers in other states. For example, the State of California has a top marginal tax rate of 13.3 percent for its highest-income earners, but the state and local tax deduction reduces this to an effective tax rate of 8.0 percent. This is because the federal government effectively reimburses California’s highest-income state taxpayers 40 cents of each dollar they pay in state taxes. Thus, while California’s government keeps every dollar of state tax revenue, only part of that revenue comes from California resi-

dents. The rest comes from the federal government in the form of reduced federal tax receipts.

**Higher-Income Taxpayers and Itemizers.** The deduction for state and local taxes creates winners and losers within states. Higher-income taxpayers win; lower-income taxpayers lose.

The state and local tax deduction is available only to taxpayers who itemize their deductions: for 2017, single taxpayers with more than \$6,350 in total deductions and married taxpayers with more than \$12,700 in deductions. Thus, more than 70 percent of all taxpayers receive no benefit from the state and local tax deduction. Those who receive no benefit tend to have lower incomes. Only 20 percent of taxpayers making less than \$50,000 itemize their deductions, compared with 93 percent of taxpayers who have incomes of \$200,000 or more.<sup>5</sup>

3. Authors’ calculations based on data from the U.S. Department of the Treasury, *Statistics of Income for 2014*, Historic Table 2, “Individual Income and Tax Data, by State and Size of Adjusted Gross Income,” <https://www.irs.gov/uac/soi-tax-stats-historic-table-2> (accessed October 6, 2017). Taxpayers in those seven states made up only 30 percent of the population in 2014, compared to claiming 53 percent of the state and local tax deductions. U.S. Census Bureau, “Annual Estimates of the Resident Population for the United States, Regions, States, and Puerto Rico: April 1, 2010 to July 1, 2016,” <https://www.census.gov/data/tables/2016/demo/popest/state-total.html> (accessed September 11, 2017).

4. U.S. Census Bureau, “Annual Estimates of the Resident Population for the United States, Regions, States, and Puerto Rico: April 1, 2010 to July 1, 2016.”

5. Authors’ calculations based on the most recent Statistics of Income data from the Internal Revenue Service. See Table 2, “Individual Income and Tax Data, by State and Size of Adjusted Gross Income, Tax Year 2014,” <https://www.irs.gov/statistics/soi-tax-stats-historic-table-2> (accessed July 15, 2017).

TABLE 2

## Municipal Bonds Provide Largest Subsidies to Top-Income Investors

Tax Bracket	Sample Corporate Bond Rate	Comparable Municipal Bond Rate	Size of Subsidy
0%	5%	5.00%	-1.40%
10%	5%	4.50%	-0.90%
15%	5%	4.25%	-0.65%
25%	5%	3.75%	-0.15%
28%	5%	3.60%	0%
33%	5%	3.35%	0.25%
35%	5%	3.25%	0.35%
39.6%	5%	3.02%	0.58%

**NOTE:** The subsidy is the difference between the comparable municipal bond rate and 3.6 percent, which is an example of where municipal governments may set their bond rates to attract a sufficient number of investors.

**SOURCE:** Authors' calculations based on federal marginal income tax rates and a sample corporate bond rate of 5 percent.

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The distribution of the *value* of the state and local tax deduction is even more skewed than that of those claiming it. According to a 2013 report by the Congressional Budget Office (CBO), 80 percent of the value of the state and local tax deduction goes to the top 20 percent of taxpayers.<sup>6</sup> This is because higher-income individuals not only pay more state and local taxes, but also face higher marginal tax rates at the federal level. A \$10,000 deduction for a middle-income family facing a top federal income tax rate of 15 percent produces a \$1,500 reduction in their federal taxes while a \$10,000 deduction for a high-income family that faces a 39.6 percent federal income tax rate nets them \$3,960.

**High-Debt State and Local Governments.** The deduction for municipal bond interest drives down the cost of borrowing money for state and local governments. When investors do not have to pay taxes

on municipal bonds, they are willing to accept significantly lower interest rates than they would require if they were taxed on those bond purchases. Thus, state and local governments look to finance any eligible spending through municipal bonds because they can then shift a significant portion of the financing cost of that spending onto federal taxpayers (who ultimately pay higher rates in the long run as a result of the lost revenues from the deduction) and it allows them to shift the burden of current spending onto future taxpayers and lawmakers.

Excessive debt financing has been a prime source of municipal bankruptcies across the country. Mounting municipal bankruptcies will certainly place pressure on Congress for a federal bailout. Already, Congress intervened in the debt-ridden and economically depressed territory of Puerto Rico in 2016. Although Congress stopped short of providing cash outright to Puerto Rico, it violated the rule of law by revoking bondholders' rights to due process and by providing a super-bankruptcy process that the law explicitly prohibited for Puerto Rico.<sup>7</sup>

**High-Income Investors.** Like the state and local tax deduction, the municipal bond interest deduction is more valuable to high-income taxpayers who face higher marginal tax rates. Thus, the municipal bond deduction effectively shuts low-income and middle-income investors out of the municipal bond market. Because of the higher value of the deduction to high-income investors, municipalities can reduce interest rates to a level at which it does not make economic sense for low-income investors to purchase them.

If the going rate for a corporate taxable bond is 5 percent, the equivalent rate for a tax-free municipal bond varies between 3 percent and 5 percent, depending on a taxpayer's marginal tax rate. For example, if a taxpayer in the 39.6 percent bracket purchases a private bond that pays 5 percent interest, he has to pay 2 percent of that interest in federal taxes (2 percent = the 39.6 percent tax rate times the 5 percent interest payment), leaving only 3 percent as after-tax income. However, a taxpayer in the 10 percent bracket would only have to pay 0.5 percent of that interest in federal taxes (0.5 percent = the 10 percent tax rate times the 5 percent interest payment), leaving 4.5 percent as income.

6. Congressional Budget Office, "The Distribution of Major Tax Expenditures in the Individual Income Tax System," May 2013, [http://www.cbo.gov/sites/default/files/cbofiles/attachments/43768\\_DistributionTaxExpenditures.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/43768_DistributionTaxExpenditures.pdf) (accessed October 6, 2017).

7. Rachel Greszler and Salim Furth, "Congress Aims to Give Debt-Ridden Puerto Rico a Free Pass as Long as Obama Wants," *The Daily Signal*, May 20, 2016, <http://dailysignal.com/2016/05/20/congress-aims-to-give-debt-ridden-puerto-rico-a-free-pass-as-long-as-obama-wants/>.

Since state and local governments want to attract more than just investors in the top marginal tax bracket, they have to pay a rate higher than 3 percent (e.g., 3.5 percent or 3.75 percent). This means that investors in the top marginal brackets receive higher interest payments than they require to get them to purchase municipal bonds. Instead of the subsidy going to state and local governments for infrastructure and investment, then, a sizeable portion goes to high-income investors. The CBO estimated that 20 percent of the value of municipal bond deduction goes to high-income households;<sup>8</sup> another study estimated that a significantly higher portion—about 70 percent to 90 percent—goes to high-income households.<sup>9</sup>

### Tax Deduction Subjects Federal Tax Revenues to the Whim of State Governments

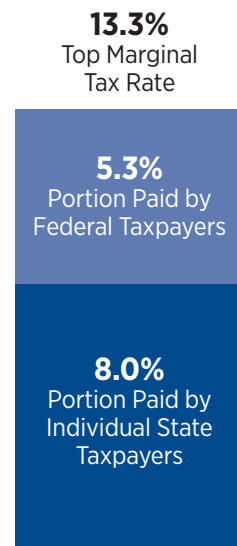
Dependence on state tax policy leaves the federal government with less control over its collection of taxes. By allowing individuals to deduct the taxes paid to their state and local governments, federal revenues become contingent on states' level of taxation and debt issuance. If states raise taxes or issue more debt (particularly at higher interest rates), individuals deduct more in state and local taxes and interest and federal tax revenues decline. On the other hand, if states lower their taxes or reduce their debts (or interest rates fall), individual deductions decline and federal tax revenues rise.

For example, Illinois' recent temporary tax increase, contained in Illinois' Taxpayer Accountability and Budget Stabilization Act, are estimated to have generated an additional \$25.7 billion in tax revenues for the state between 2011 and 2014.<sup>10</sup> However, those same tax increases directly reduced federal tax revenues. Although the exact amount by which federal revenues declined is unknown, it was almost certainly billions of dollars.<sup>11</sup>

CHART 3

### Breakdown of California's Top Marginal Tax Rate

A significant portion of California's top marginal rate of 13.3 percent is effectively paid by federal taxpayers because of the state and local tax deduction.



SOURCE: Authors' calculations based on top federal and California income tax rates.

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### Municipal Bond Interest Deduction Distorts Infrastructure Investment Decisions

The municipal bond interest deduction has long been cited as necessary for state and local governments to invest in infrastructure. However, the exemption can encourage inefficient and excessive levels of infrastructure and other spending by allowing states to issue more debt at a lower cost than they would otherwise.

8. Congressional Budget Office, "Subsidizing Infrastructure Investment with Tax-Preferred Bonds," 2009, <https://www.cbo.gov/sites/default/files/111th-congress-2009-2010/reports/10-26-taxpreferredbonds.pdf> (accessed October 6, 2017).

9. Calvin H. Johnson, "Repeal Tax Exemption for Municipal Bonds," *Tax Notes*, 2007, <https://law.utexas.edu/faculty/calvinjohnson/repeal-exempt-muni-bonds.pdf> (accessed October 6, 2017).

10. Benjamin VanMetre, "Illinois' Temporary Tax Hike: \$18 Billion Later," Illinois Policy Institute, *Policy Point*, September 17, 2013, <https://www.illinoispolicy.org/policy-points/illinois-temporary-tax-hike-18-billion-later/> (accessed October 6, 2017).

11. If the entire tax increase had been achieved by raising taxes on those facing the highest federal tax rate of 39.6 percent, the estimated \$25.7 billion in additional state tax revenues would have reduced federal tax revenues by \$10.2 billion. At a 15 percent marginal tax rate and all \$25.7 billion subject to the deduction, Illinois' recent tax hike would have reduced federal tax revenues by \$3.9 billion.

Because local governments do not bear the full borrowing costs for infrastructure projects financed by municipal bonds, this federal preference incentivizes localities not only to overspend on infrastructure but also to fund projects whose total costs (some of which are not borne by the locality) outweigh their benefits.<sup>12</sup> Voters tend to view municipal bond financing as “free money” for infrastructure, despite high levels of local debt that foist the financial burden of projects on future generations. In the 2016 election, voters approved 86 percent of municipal bond issuances for transportation infrastructure projects, whereas just 7 percent of measures to increase gas taxes to pay for such projects succeeded.<sup>13</sup>

The exemption leads taxpayers and local governments to subsidize private projects under the guise of generating economic development or other questionable justifications. For example, 36 professional sports stadiums received tax-exempt municipal bond financing since 2000, amounting to a \$3.2 billion subsidy to the issuers and \$3.7 billion in lost federal revenues.<sup>14</sup> Despite justifications that the projects contribute to economic growth, numerous studies have shown that publically funded sports stadiums have no significantly positive, and often a negative, economic effect for metropolitan areas.<sup>15</sup> Overall, of the

\$430 billion in municipal bonds issued in 2014, 19 percent (\$82 billion) were for private activities.<sup>16</sup>

Furthermore, the tax exemption for municipal bonds discourages private infrastructure investment, which produces numerous benefits for users and governments, such as improved infrastructure management, fewer project delays, increased economic efficiency, and mitigation of taxpayer risk.<sup>17</sup> The municipal bond deductions create an artificial inequity that leads local officials and detractors of private infrastructure to incorrectly declare that government can deliver an infrastructure asset more affordably because of lower financing costs, and thus cuts off opportunities for some private infrastructure projects.

This preference has left America far behind other nations (almost all of which do not have similar tax exemptions) when it comes to the provision of private infrastructure.<sup>18</sup> For example, the U.S. has just one private airport,<sup>19</sup> whereas partially or completely privatized airports serve nearly 75 percent of European commercial air traffic.<sup>20</sup> While private investment in surface transportation is growing in the U.S., the majority of large private highway projects take place elsewhere.<sup>21</sup> Private infrastructure investment around the globe, especially in Europe, Canada, and Australia, continues to outpace that of the U.S.<sup>22</sup>

12. Scott Greenberg, “Reexamining the Tax Exemption of Municipal Bond Interest,” Tax Foundation *Fiscal Fact* No. 520, July 21, 2016, <https://taxfoundation.org/reexamining-tax-exemption-municipal-bond-interest> (accessed October 6, 2017).
13. Ann Henebery and Emily Han, “Transportation Ballot Measures Recap,” Eno Center for Transportation, *Eno Transportation Weekly*, December 12, 2016, <https://www.enotrans.org/article/transportation-ballot-measures-recap/> (accessed October 6, 2017).
14. Ted Gayer, Austin Drukker, and Alexander Gold, “Tax-Exempt Municipal Bonds and the Financing of Professional Sports Stadiums,” Brookings Institution, September 2016, [https://www.brookings.edu/wp-content/uploads/2016/09/gayerdrukkergold\\_stadiumsubsidies\\_090816.pdf](https://www.brookings.edu/wp-content/uploads/2016/09/gayerdrukkergold_stadiumsubsidies_090816.pdf) (accessed October 6, 2017).
15. See, for example, Dennis Coates, “Growth Effects of Sports Franchises, Stadiums, and Arenas: 15 Years Later,” Mercatus Center *Working Paper*, September 2015, <https://www.mercatus.org/system/files/Coates-Sports-Franchises.pdf> (accessed October 6, 2017).
16. Internal Revenue Service, Statistics of Income, “Municipal Bonds, 2014,” <https://www.irs.gov/pub/irs-soi/2014municipalbondsonesheet.pdf> (accessed October 6, 2017).
17. Robert Poole, Jr. and Austill Stuart, “Federal Barriers to Private Capital Investment in U.S. Infrastructure,” Reason Foundation *Policy Brief* No. 138, January 2017, [http://reason.org/files/federal\\_barriers\\_to\\_private\\_capital\\_investment.pdf](http://reason.org/files/federal_barriers_to_private_capital_investment.pdf) (accessed October 6, 2017).
18. There are many additional governmental obstacles to private infrastructure investment. See: Michael Sargent and Nicolas D. Loris, “Driving Investment, Fueling Growth: How Strategic Reforms Can Generate \$1.1 Trillion in Infrastructure Investment,” Heritage Foundation *Background* No. 3209, May 8, 2017, [http://www.heritage.org/sites/default/files/2017-05/BG3209\\_0.pdf](http://www.heritage.org/sites/default/files/2017-05/BG3209_0.pdf).
19. The Luis Muñoz Marín International Airport in San Juan, Puerto Rico, was privatized via a federally approved long-term lease in 2013.
20. Michael Sargent, “End of the Runway: Rethinking the Airport Improvement Program and the Federal Role in Airport Funding,” Heritage Foundation *Background* No. 3170, November 23, 2016, <http://www.heritage.org/transportation/report/end-the-runway-rethinking-the-airport-improvement-program-and-the-federal>.
21. Robert W. Poole, Jr., ed., “Annual Privatization Report 2016: Surface Transportation,” Leonard Gilroy, Reason Foundation, August 2016, <http://reason.org/files/apr-2016-surface-transportation.pdf> (accessed October 6, 2017).
22. Chris Edwards, “Encouraging Private Infrastructure Investment,” testimony to the Joint Economic Committee, U.S. Congress, July 24, 2013, <https://www.downsizinggovernment.org/encouraging-private-infrastructure-investment> (accessed October 6, 2017).

## Eliminating the State and Local Tax Deduction

The Heritage Foundation's Center for Data Analysis estimated the static impact on federal tax revenues of eliminating the state and local tax deduction and municipal bond deduction using the HFIITM. The HFIITM estimates the static impact of changes in federal-tax policy on the overall revenues and distribution of federal taxes. A detailed documentation of the HFIITM can be found in the Appendix.

We estimate that eliminating the state and local tax deduction would increase federal income tax revenues by about 7.4 percent (\$1.669 trillion) over the next 10 years (2017–2026). The Treasury Department estimates a very similar revenue effect of \$1.692 trillion over the same period.<sup>23</sup>

### Replacing the Deduction with Reduced Rates.

The purpose of eliminating the state and local tax and municipal bond interest deductions is not to generate new federal tax revenues, but to rid the tax code of inefficient policies. Thus, Congress should offset the removal of any deductions with a reduction in marginal tax rates. Our first simulation uses the revenues from eliminating the state and local tax and municipal bond interest deductions to lower rates in a way that maintains both revenue neutrality and distributional neutrality with the current tax code. Based on the results, revenue neutrality in the final year (2026) is maintained within 0.08 percent of the current baseline revenues and distributional neutrality is within an average of 0.07 percentage points of current baseline tax shares.<sup>24</sup>

In our revenue-neutral and distribution-neutral rate-reduction scenario, the largest tax reductions would go to the 25 percent and 28 percent tax brackets, which would decline by 12.1 percent and 16.4 percent,

respectively (to 21.97 percent and 23.42 percent). The 15 percent and upper-income rates would all decline between 3.1 percent and 7.2 percent.

We also analyzed a revenue-neutral scenario focused on reducing tax rates for middle-income individuals and families by reducing the 15 percent, 25 percent, and 28 percent tax rates.<sup>25</sup> Focusing on these three rates allowed for reductions ranging from 10.7 percent to 16.0 percent. The 15 percent, 25 percent, and 28 percent rates fell to 13 percent, 21 percent, and 25 percent, respectively.

Although we did not dynamically model the macroeconomic effects of replacing the state and local tax and municipal bond interest deductions with lower marginal income-tax rates, such a policy could generate positive macroeconomic impacts. The state and local tax and municipal-bond interest deductions encourage adverse economic policies at the state level and unjust subsidies, so eliminating them could reduce the negative effects of bad state policies and investment-market disruptions. If accompanied by more efficient state tax-and-spending policies, replacing the state and local tax and municipal bond interest deductions with lower federal tax rates would spur economic growth.

## The Potential Impact on State Policies

Eliminating the state and local tax deduction could increase accountability in state governance and reduce wasteful spending.

Without the federal government picking up a piece of their state and local tax burden, many taxpayers would face a significantly higher effective state tax burden that could drive some individuals and small businesses (that file taxes as individuals as opposed to corporations) out of high-tax states

23. U.S. Department of the Treasury, *Tax Expenditures*, Table 3, "Income Tax Expenditures Ranked by Total Fiscal Year 2017–2026 Revenue Effect," <https://www.treasury.gov/resource-center/tax-policy/Documents/Tax-Expenditures-FY2017.pdf> (accessed October 6, 2017). Line items included for elimination are: deductibility of nonbusiness state and local taxes other than on owner-occupied homes; deductibility of state and local property tax on owner-occupied homes; and exclusion of interest on public-purpose state and local bonds. For a similar analysis looking only at the impact of repealing state and local deductions, see Rachel Greszler and Kevin D. Dayaratna, PhD, "Time to End the Federal Subsidy for High-Tax States," Heritage Foundation *Background* No. 2999, March 26, 2015, <http://www.heritage.org/taxes/report/time-end-the-federal-subsidy-high-tax-states>.

24. We then compared the revenues and distribution (measured by the percent of total tax burden paid by each of 12 separate income groups) of current tax policy to that with no state and local deduction and lower marginal rates in the final year of the estimates (2026). Through multiple iterations of changes in marginal rates, we achieved a new set of marginal tax rates that are both revenue-neutral and distribution-neutral compared to current tax law. Revenues are within \$13.6 billion or 0.06 percent of the baseline over the 2017–2026 period and the average change in each of the 12 income brackets' share of the total tax burden is 0.09 percentage points. (The share for most income brackets changes by less than 0.03 percentage points and the largest is 0.5 percentage points for the highest-income bracket that pays 52.2 percent of all taxes.)

25. This middle-class tax-cut simulation is revenue-neutral over the 2017–2026 period within 0.5 percent of current baseline tax revenues.



TABLE 3

### Eliminating State and Local Tax and Municipal Bond Deductions Allows Revenue- and Distribution-Neutral Reduced Tax Rates

Regular Marginal Tax Rates		
Current	New	Percent Change
10%	10.0%	0.0%
15%	14.5%	-3.1%
25%	22.0%	-12.1%
28%	23.4%	-16.4%
33%	30.8%	-6.8%
35%	32.5%	-7.2%
39.6%	37.5%	-5.3%

#### Capital Gains and Dividends Marginal Tax Rates

Current	New	Percent Change
15%	14.0%	-6.6%
20%	18.1%	-9.4%
23.8%	21.9%	-7.9%

**NOTE:** These rates achieve revenue-neutrality within 0.06 percent of the current law baseline revenues and distributional neutrality within an average of 0.09 percentage points of the current baseline tax shares.

**SOURCE:** Estimated marginal rates were calculated using the Heritage Foundation Individual Tax Simulation Model.

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and into low-tax states. This competition in state taxation would benefit individuals and businesses because it would make states more accountable for all of the tax revenue they collect.

Increased accountability would lead to more equitable and efficient taxation at both the state and federal level. Absent the deduction, taxes would be distributed more equitably according to services received. When faced with the full cost of services received, taxpayers would likely demand fewer services and a more efficient allocation of their tax dollars, leading to a more optimal overall level of taxation.

TABLE 4

### How Eliminating the State and Local Tax and Municipal Bond Deductions Could Be Used for Revenue-Neutral Middle-Class Tax Cuts

Current	New	Change
10%	10%	0%
15%	13%	-13.3%
25%	21%	-16.0%
28%	25%	-10.7%
33%	33%	0%
35%	35%	0%
39.6%	39.6%	0%

**NOTE:** These rates achieve revenue-neutrality within 0.5 percent of the current baseline over the 2017–2026 period.

**SOURCE:** Estimated marginal rates were calculated using the Heritage Foundation Individual Tax Simulation Model.

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Eliminating the municipal bond interest deduction would force state and local governments to pick up the full tab of their infrastructure spending (including some private infrastructure projects), instead of allowing them to pass a significant portion on to federal taxpayers. This would help prevent infrastructure spending in which the benefits do not outweigh the costs and it would significantly reduce the practice of turning private infrastructure projects into public ones. Removing the deduction would also encourage more private investment and also level the playing field for the municipal bond market by removing regressive subsidies that disproportionately benefit wealthy investors.<sup>26</sup> This could help prevent state and local governments from incurring excessive and unnecessary debts that are increasingly contributing to municipal bankruptcies across the U.S.

#### The Effect on Individuals

Eliminating the deduction may seem like an increase in federal taxes (or an increase in effective state taxes) for anyone who claims the state and

26. Sargent and Loris, “Driving Investment, Fueling Growth.”

local tax deduction, but in fact, it could reduce many of these taxpayers' federal-tax liabilities. If coupled with a corresponding revenue-neutral and distribution-neutral reduction in federal marginal tax rates, more than 70 percent of taxpayers who do not itemize would face lower combined federal and state income-tax burdens. Additionally, some taxpayers who itemize but who have relatively lower incomes or live in lower-tax states would also experience a tax cut.

In addition to the immediate change in federal tax liabilities, eliminating the state and local tax deduction could cause state and local governments to reduce their taxes as residents would be more likely to push back against high levels of taxes and services if they had to pay the full freight.

### **End the Subsidy for High-Tax and High-Debt States**

An appropriate tax base makes most tax deductions and exclusions inefficient because they require higher marginal-tax rates. The state and local tax deduction fits this description because it supports high levels of taxation and inefficient and waste-

ful government spending. Furthermore, it subjects federal-tax revenues to the whim of state governments, while benefiting wealthy taxpayers and high-tax states. Meanwhile, the municipal-bond interest deduction encourages inefficient and often excessive levels of infrastructure and publicly supported private investments and it unjustly subsidizes high-income taxpayers.

Eliminating the state and local tax and municipal bond interest deductions would encourage a more efficient tax system, and a corresponding reduction in marginal federal income-tax rates could boost economic growth. As Congress and the President work to achieve pro-growth tax reform, eliminating the state and local tax and municipal bond interest deductions should be at the top of the to-do list.

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## Appendix

The Heritage Foundation’s Individual Income Tax Model (HFIITM) is a statistical microsimulation model coded in MATLAB used for forecasting the revenue effects of tax policy reforms and their various manifestations. The model uses data from the 2007 Statistics of Income Public Use Tax File from the Internal Revenue Service.<sup>27</sup> This stratified sample of the American population consists of approximately 143,142 tax-filing records. The data blur certain information, such as state of residency, for high-income tax filers (those with adjusted gross incomes over \$200,000).

The model and data are based on the IRS’s 2007 Form 1040 and include most variables, or lines, contained in this form. Some lines are excluded from the IRS dataset and therefore cannot be disaggregated within the model.

To establish a base-case scenario, the HFIITM model generates an independent and identically distributed random sample from the original 2007 dataset and uses this random sample to “age” each observation of data in subsequent years through 2026. The sample from the original 2007 data is used to generate subsequent observations of data for 2008, and then the 2008 data are used to generate 2009 data, and the process continues.

Each random sample consists of one million observations. Each time an alternative scenario is tested or “scored” by the model, a new base-case scenario is developed. Due to the large sample size of one million observations, the base-case scenario does not differ significantly from one run to another.

The aging of the data from 2007 to 2026 includes targeted aging based on actual data available from

the IRS through 2012 and applied growth rates. For nearly all variables, additional aggregate IRS data from 2012 are used to apply a steady growth rate between 2007 and 2012. Beyond 2012, variables are grown according to what are deemed appropriate growth rates.

For example, variables related to income are grown according to presumed income-growth rates, and education-related and health-related tax components are grown according to their estimated cost growth. The tax parameters for 2015 and beyond are adjusted for inflation and income as determined by current tax law. Aggregate revenues are computed using the law of large numbers, which states that for a sufficiently large sample size, the mean of a random sample converges to the population mean.<sup>28</sup>

Although cyclical growth is expected, the HFIITM—like most other microsimulation models—does not attempt to model such cyclical growth. Instead, the HFIITM assumes steady state growth. Because of this assumption of steady state growth, additional aggregate data from 2012 were used to adjust the growth rates of most variables between 2007 and 2012. Without this adjustment, the estimated growth rates create significantly higher values for many of the variables than actually occurred.

The first simulation using the HFIITM ran a baseline scenario based on current policy and juxtaposed this against an alternative scenario that eliminates state and local tax deductions for years 2017 through 2026. The differences between the two scenarios are based on comparing overall revenues after refunds and credits.

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27. Internal Revenue Service, “2007 Statistics of Income Public Use Tax File.”

28. George Casella and Roger L. Berger, *Statistical Inference*, 2nd ed. (Pacific Grove, CA: Duxbury, 2002). p. 235.