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The SALT Deduction Cap: What Will It Mean for New England States?

Economic Perspectives on State and Local Taxes

Lincoln Institute of Land Policy, May 11, 2018

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"The SALT cap could complicate pension funding in high tax states."

Lauren Loricchio, *State Tax Notes*

"A major Wall Street credit-rating agency warned this week that federal tax changes could undermine Connecticut cities and towns' property tax receipts."

Keith Phaneuf, *The CT Mirror*

"Getting rid of [SALT] deductions...could make it harder to raise money for schools in the future."

Kim Rueben, quoted on *NPR*

Outline

- Are these outcomes likely to occur?
- What will be the impact of the SALT cap on the 6 New England states?
- Will consequences of SALT cap only be felt in high-tax states?
- Arguments for unrestricted SALT deductions
- States' attempts to "workaround" the SALT cap

How the SALT Deduction Subsidizes State Taxes and the Local Property Tax

- The SALT deduction lowers the ***tax-price*** for itemizers
- The tax-price indicates how much it costs a taxpayer to pay an extra dollar of state income tax
  - John faces a federal marginal tax rate (MTR) of 25%
  - A $100 increase in his state income taxes increases his SALT deduction by $100 and lowers his federal taxable income by $100
  - This lowers his federal income taxes by $25
  - So, the net cost to John of paying the extra $100 in state income taxes is $75 -- $100 - $25
  - Expressed as a fraction, John's tax-price = 0.75

Tax-Prices to Tax Policy

- TCJA will **increase** the tax-price of state income and sales taxes and local property taxes for many itemizers
- TCJA will **lower** federal income taxes for many taxpayers
- These changes may influence their willingness to support state and local taxes
- These changing “tax preferences” may lead to changes in state and local taxes (and spending)

Six New England Taxpayers

2017 Federal Income Tax Liabilities

Estimated 2018 Tax Liabilities

Sarah Brown
Rutland, Vermont

Sarah, 28 – School teacher, salary = $40,000

Additional income

$250 from interest

2017 Adjusted Gross Income (AGI) = $40,250

Personal exemption = $4,050

Standard deduction = $6,350

Sarah Brown
Rutland, Vermont

Regular tax	$4,011	Federal marginal tax rate = 15%
AMT	$0	**tax-price = 1.00**

Estimated 2018 tax (based on 2017 income) = $3,238

$ change in tax = -$773

% change in tax = -19.3%

2018 tax-price = 1.0

Selma and Harold Klein
Keene, New Hampshire

Selma, 68 – retired, pension = $30,000

Harold, 68 – retired, pension = $31,500

Additional income

- $4,000 from interest and dividends
- $4,500 from capital gains

2017 Adjusted Gross Income (AGI) = $70,000

Personal exemptions = $8,100

Selma and Harold Klein
Keene, New Hampshire

Itemized deductions

State income tax	$0
Property tax	$6,500
Charitable	$2,300
Mortgage interest	$7,000
Total	$15,800

Regular tax $4,861 Federal marginal tax rate = 15%

AMT $0 **tax-price** = **0.85**

Selma and Harold Klein
Keene, New Hampshire

Estimated 2018 tax (based on 2017 income) = $4,211

$ change in tax = -$650

% change in tax = -13.4%

2018 tax-price = 1.0

Melanie and John O'Neill
Providence, Rhode Island

Melanie, 42 – Nurse, salary = $40,000

John, 43 – IT technician = $45,000

Additional income

$2,000 from interest and dividends

2017 Adjusted Gross Income (AGI) = $87,000

1 school age child

Personal exemptions = $12,150

Melanie and John O'Neill
Providence, Rhode Island

Itemized deductions

State income tax	$4,245
Property tax	$4,650
Charitable	$2,000
Mortgage interest	$7,700
Total	$18,595

Regular tax $7,329 Federal marginal tax rate = 15%

Child tax credit $1,000

AMT $0 **tax-price** = **0.85**

Melanie and John O'Neill
Providence, Rhode Island

Estimated 2018 tax (based on 2017 income) = $5,089

- $ change in tax = -$1,240
- % change in tax = -19.6%

2018 tax-price = 1.0

Jane and William Walsh
Portland, Maine

Jane, 55 – teacher, salary = $60,000

William, 55 – accountant, salary = $65,000

Additional income

- $9,000 from interest and dividends
- $5,000 from capital gains

2017 Adjusted Gross Income (AGI) = $139,000

2 dependent children (in college)

Personal exemptions = $16,200

Jane and William Walsh
Portland, Maine

Itemized deductions

State income tax	$7,700
Property tax	$5,000
Charitable	$3,500
Mortgage interest	$9,925
Total	$26,125

Regular tax	$14,346	Federal marginal tax rate = 25%
AMT	$0	**tax-price** = **0.75**

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Jane and William Walsh
Portland, Maine

Estimated 2018 tax (based on 2017 income) = $15,265

$ change in tax = +$919

% change in tax = +6.4%

2018 tax-price = 1.0

Barbara and Jason Jones
New Haven, Connecticut

Jason, 45 – lawyer, salary = $130,000

Barbara, 44 – lawyer, salary = $140,000

Additional income

- $35,000 from interest and dividends
- $45,000 from capital gains

2017 Adjusted Gross Income (AGI) = $350,000

2 school age children

Barbara and Jason Jones
New Haven, Connecticut

Exemptions		$11,340
Itemized deductions		
	State income tax	$53,000
	Property tax	$18,000
	Charitable	$7,000
	Mortgage interest	$14,000
	“Limited deduction”	-$1,086
	Total	$90,914

Regular tax $49,913 Federal marginal tax rate = 28%

AMT $20,218 **tax-price** = **1.0**

Percentage of Returns Subject to AMT, 2015

	All Returns	AGI $200,000-$500,000
Connecticut	5.9%	77.4%
Maine	2.3%	70.0%
Massachusetts	5.1%	69.6%
New Hampshire	2.4%	43.0%
Rhode Island	2.9%	67.9%
Vermont	2.5%	68.6%

Barbara and Jason Jones
New Haven, Connecticut

Estimated 2018 tax (based on 2017 income) = $58,307

No longer subject to the AMT

$ change in tax = -$11,824

% change in tax = -16.9%

2018 tax-price = 1.0

Peter and Susan Smith
Lincoln, Massachusetts

Peter, 60 – Corporate manager, salary = $450,000

Susan, 59 – Engineer, salary = $250,000

Additional income

- $75,000 from interest and dividends
- $85,000 from capital gains

2017 Adjusted Gross Income (AGI) = $860,000

2 dependent children (in college)

Peter and Susan Smith
Lincoln, Massachusetts

Exemptions		$0
Itemized deductions		
	State income tax	$40,000
	Property tax	$15,000
	Charitable	$15,000
	Mortgage interest	$20,000
	"Limited deduction"	-$16,386
	Total	$73,614

Regular tax	$240,027	Federal marginal tax rate = 39.6%
AMT	$0	**tax-price = 0.604**

Peter and Susan Smith
Lincoln, Massachusetts

Estimated 2018 tax (based on 2017 income) = $225,725

$ change in tax = -$14,302

% change in tax = -6.0%

2018 tax-price = 1.0

Impact of TCJA on 6 New England Taxpayers

Taxpayers	Change in tax-price 2017	Change in tax-price 2018	% change in income tax
Brown	1	1	-19.3%
Klein	0.85	1	-13.4%
O'Neill	0.85	1	-19.6%
Walsh	0.75	1	+6.4%
Jones	1	1	-16.9%
Smith	0.604	1	-6.0%

From Changing Taxpayer Preferences to Changes in State and Local Tax Policy

- TCJA may lead many taxpayers to be less willing to pay state income taxes and local property taxes
- Political consequences:
  - More political support for state legislators who support lower taxes and/or less progressive taxes
  - More voter support for local leaders who support lower taxes and spending
  - Fewer votes in favor of tax limitation overrides, e.g. Proposition 2½
- Impacts of TCJA larger in high-income, high-tax states

Percentage of Federal Income Tax Returns by AGI Class, 2015, New England States

State	Number of Returns	Federal Adjusted Gross Income: Less than $50,000	$50,000 under $75,000	$75,000 under $100,000	$100,000 under $200,000	$200,000 under $500,000	$500,000 under $1,000,000	$1,000,000 or more
Massachusetts	3,397,110	54.1%	13.9%	9.2%	15.7%	5.7%	0.9%	0.5%
Connecticut	1,761,070	53.8%	13.7%	9.4%	15.8%	5.5%	1.1%	0.7%
New Hampshire	693,080	55.3%	14.3%	10.0%	15.5%	4.2%	0.5%	0.2%
Maine	645,690	63.2%	14.4%	9.1%	10.4%	2.4%	0.3%	0.1%
Rhode Island	527,510	60.6%	13.8%	8.9%	13.0%	3.2%	0.4%	0.2%
Vermont	326,090	62.0%	14.0%	9.2%	11.6%	2.7%	0.4%	0.2%

SOURCE: IRS, Statistics of Income Division, Individual Master File System, August 2017, and author's calculations

Average Tax-Price & Percentage Change due to TCJA New England States

State	Percent Itemizers	Average Tax-Price Wt: Tax returns	Average Tax-Price Wt: AGI	Average % Incr. in Tax-Price*
Vermont	27.3%	0.952	0.894	5% - 12%
Maine	27.7%	0.954	0.899	6% - 11%
New Hampshire	31.3%	0.942	0.874	6% - 14%
Rhode Island	32.9%	0.939	0.868	6% - 15%
Massachusetts	36.9%	0.936	0.847	7% - 18%
Connecticut	41.4%	0.927	0.828	8% - 21%

* Calculated as: (1.0 - average tax-price) / average tax-price

Average Tax Changes in 2018 due to TCJA, Individual Income Tax Provisions

State	Personal Income, 2017 (in $billions)	% of New England Total	Average Change in Federal Income Tax: Dollar Change	Average Change in Federal Income Tax: % Change
Connecticut	$251.6	27.1%	-$1,870	-5.9%
Maine	$60.2	6.5%	-$1,170	-7.8%
Massachusetts	$452.0	48.7%	-$1,790	-6.7%
New Hampshire	$77.3	8.3%	-$1,710	-8.0%
Rhode Island	$54.6	5.9%	-$1,200	-6.9%
Vermont	$31.9	3.4%	-$1,180	-7.3%

Source: Personal income data from the U.S. Bureaue of Economic Analysis. Tax change simulations represent of indiviudaul income tax provisions of the TCJA conducted by the Urban-Brookings Tax Policy Center, 2018.

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What Should New England States Expect

- Impact of TCJA likely to be muted over next couple years
  - Political and policy changes take time
  - Federal tax cuts will tend to offset reactions to higher tax-prices
- In longer run, reduced support for state income and local property taxes
  - During next recession, it will be harder to enact tax rate increases to offset inevitable tax revenue declines
  - Reduced itemization likely to put downward pressure on housing prices, making it harder to maintain property tax revenues

What Should New England States Expect

- Over time TCJA may lead to less progressive state tax systems
  - Chernick (2005) finds that increasing the number of itemizers leads to more progressive state tax systems
  - High income taxpayers will face largest increases in tax-price of state-local taxes
- May induce some high-income taxpayers in high-tax states to migrate to lower-tax states
- In Massachusetts, referenda to override Proposition 2½ are less likely to receive voter approval

Arguments for Unrestricted SALT Deduction

- SALT are involuntary payments
  - They reduce ability to pay federal taxes
  - Deduction prevents double taxation
- Compensates for higher cost of living and cost of government services in some places
- Higher tax states undertake higher level of “redistributive services”
  - They spend more on education and health care
  - Ideally we would have federal matching grants
- States with more itemizers have more progressive state and local tax systems

Attempts to "Work Around" the SALT Cap

- Taxpayers can make charitable contributions to special entities in lieu of paying state income or local property taxes
  - Has been enacted in New York; discussed in Connecticut, Rhode Island, and other states
- New York established a employer opt-in program
  - Employers pay 5% (deductible) payroll tax, and workers get a tax credit
- Problems
  - Questionable legality of charitable contributions
  - Benefits just those with high income
  - Increases tax complexity

Thank you

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