

# SALT, Subsidies, and Subnational Spending

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*Historically, the Internal Revenue Code has permitted itemizing taxpayers to deduct state and local tax (SALT) payments on their federal tax returns. While this SALT deduction has been adjusted and refined over the years, it has been a mainstay of the federal tax code. As of December 2017, taxpayers were entitled to deduct the full amount of state and local property tax payments, as well as their choice of either state and local income taxes or sales taxes. The Tax Cuts and Jobs Act of 2017 (TCJA) dramatically altered this provision by setting a \$10,000 limit on the amount a taxpayer may deduct from her federal taxable income to account for all state and local tax payments. This \$10,000 cap on SALT deductibility is scheduled to expire on December 31, 2025, by which point Congress will likely readdress this issue.*

*This Note proposes that the next iteration of the SALT deduction scheme should allow for full deductibility of state taxes, while retaining a cap on the deductibility of local taxes. This distinction between the treatment of state and local taxes would reflect the relative advantages of public administration at the state level. State-level funding and provision of public services strikes the optimal balance between the competing goals of local administration and redistributive spending. Instituting full state tax deductibility would incentivize a shift in the funding and provision of redistributive federal programs to the state level, and would further the goals of state autonomy and policy innovation. Moreover, reducing or eliminating local tax deductibility would increase the internal policy consistency of the Internal Revenue Code, mitigate the regressive nature of the SALT deduction, and help reduce residential income segregation.*

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## I. INTRODUCTION

The Tax Cuts and Jobs Act of 2017 (TCJA),<sup>1</sup> signed into law by President Donald Trump, instituted a substantial policy change in the federal government's treatment of taxpayers' state and local tax (SALT) payments. Historically, Section 164 of the Internal Revenue Code (IRC) permitted taxpayers to deduct<sup>2</sup> the full amount of certain enumerated SALT payments<sup>3</sup> on their federal tax returns as an itemized deduction.<sup>4</sup> After the signing of the TCJA, taxpayers may only deduct, as an itemized deduction, up to a maximum of \$10,000 from their federal taxable income to account for enumerated SALT payments.<sup>5</sup> However, this \$10,000 cap on SALT deductibility is scheduled to expire on December 31, 2025, at which point the SALT deduction will revert to being uncapped.<sup>6</sup> This Note addresses the future of the SALT deduction by providing a set of recommendations to Congress on the provision's next iteration.

Arguments for and against this \$10,000 cap abound, and are often informed by political and geographic affiliations. Proponents of the SALT deduction cap (the cap) argue that it is needed to reduce the impact of other revenue-reducing changes to the IRC implemented in the TCJA, including lower marginal tax rates<sup>7</sup> across brackets, an expanded standard deduction, and accelerated

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1. Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017).

2. A tax deduction lowers a taxpayer's tax burden by decreasing their taxable income. For example, if a taxpayer has \$100,000 in income and qualifies for \$25,000 in deductions, they are subject to tax on only \$75,000 of income, as opposed to \$100,000.

3. I.R.C. §§ 164(a)(1)–(6). Enumerated categories of deductible state and local taxes include real property taxes, personal property taxes, and either income or sales taxes (up to the taxpayer's discretion).

4. I.R.C. § 164. Taxpayers have a choice between taking the standard deduction — which the TCJA set at \$12,000 for single taxpayers and \$24,000 for a married couple filing jointly — or the sum of their itemized deductions (the total amount of which depends on taxpayer-specific circumstances, but which tends to be higher for higher-income taxpayers). I.R.C. § 63. Common itemized deductions include the SALT deduction, home mortgage interest deduction, and charitable contribution deduction. Generally, taxpayers choose to itemize deductions only if the sum of their itemized deductions exceeds the standard deduction they would otherwise receive.

5. Tax Cuts and Jobs Act § 11042(a) (codified as amended at I.R.C. § 164(b)(6) (2018)).

6. *Id.*

7. A marginal tax rate is the tax rate assessed on a taxpayer's additional dollar of income. This is a feature of a progressive taxation scheme in which income beyond certain threshold dollar amounts is taxed at progressively higher rates. For a more detailed explanation, see Alicia Tuovila, *Marginal Tax Rate Definition*, INVESTOPEDIA (May 5, 2020), <https://www.investopedia.com/terms/m/marginaltaxrate.asp> [<https://perma.cc/73ZR-X3V5>].

depreciation.<sup>8</sup> Moreover, they argue that an unlimited SALT deduction acts as a subsidy to high-tax states and to well-off, itemizing taxpayers<sup>9</sup> within these states.<sup>10</sup> Opponents of the cap view the policy as a form of political retribution leveled at the liberal, Democratic-leaning — and often high-tax — states that voted against Donald Trump in the 2016 election.<sup>11</sup> They also argue that the SALT deduction cap was intended to fund tax cuts for corporations and the wealthy at the expense of the middle class in high-cost states,<sup>12</sup> and to coerce high-tax states into lowering their tax rates.<sup>13</sup> While a federal judge found the coercion argument unpersuasive as a constitutional matter,<sup>14</sup> it may carry weight in the

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8. See I.R.C. §§ 63, 164; Nicole Kaeding, *Testimony Before the House Ways and Means Select Revenue Measures Subcommittee*, TAX FOUND. (June 25, 2019), <https://taxfoundation.org/salt-deduction-cap-testimony-2019/> [<https://perma.cc/T3MG-RV35>] (“Limiting the SALT deduction helped finance broader tax reforms . . . within the TCJA.”).

9. Itemizing taxpayers are those who choose to take itemized deductions, rather than the standard deduction. I.R.C. §§ 63(c)(7)–(e) (2018). High-income taxpayers are far more likely to itemize than low-income taxpayers. See Erica York, *Who Benefits from Itemized Deductions?*, TAX FOUND. (Mar. 7, 2019), <https://taxfoundation.org/itemized-deduction-benefit/> [<https://perma.cc/CNH2-CVA9>] (“The percentage of taxpayers who itemize increases as we move up the income scale.”). For a more detailed explanation of how the SALT deduction subsidizes high-tax states and well-off itemizing taxpayers within these states, see *infra* note 56 and Part II.C.

10. See Erik M. Jensen, *Four States Challenge the Cap on SALT Deductions*, 36 J. TAX’N INVS. 51, 52–53 (2019); Gladriel Shobe, *Disaggregating the State and Local Tax Deduction*, 35 VA. TAX. REV. 327, 375 (2016); Kirk J. Stark, *Fiscal Federalism and Tax Progressivity: Should the Federal Income Tax Encourage State and Local Redistribution?*, 51 UCLA L. REV. 1389, 1414 (2004); 1 U.S. DEP’T OF TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT, at x, 78, 80 (1984).

11. See Governor Cuomo and Attorney General James Announce Filing of Appeal in Multi-State Lawsuit Against Trump Administration’s SALT Reform, N.Y. STATE (Nov. 26, 2019), <https://www.governor.ny.gov/news/governor-cuomo-and-attorney-general-james-announce-filing-appeal-multi-state-lawsuit-against> [<https://perma.cc/P896-4C6H>] (New York Governor Andrew Cuomo: “The Trump Administration’s SALT policy is retribution politics — plain and simple[.]” (internal quotation marks omitted)).

12. See Cory Booker, Opinion, *Trump’s Unfair Tax Plan Will Harm Average New Jerseyans*, NJ.COM (Nov. 2, 2017), <https://www.nj.com/opinion/2017/11/booker-trumps-tax-plan-will-harm-new-jerseyans-ops.html> [<https://perma.cc/VT84-WXB7>] (“[Ensuring] that New Jersey families and homeowners aren’t made to shoulder the burden of a massive tax giveaway to the very richest corporations and individuals in this country[.] . . . begins with stopping schemes like eliminating the state and local tax deduction[.]”).

13. See Mnuchin Fires Warning Shot to High-Tax States: Get Control of Your Budgets, FOX BUS. (Nov. 9, 2017), <https://www.foxbusiness.com/politics/mnuchin-fires-warning-shot-to-high-tax-states-get-control-of-your-budgets> [<https://perma.cc/ERS2-U7YZ>] (Mnuchin: “I do hope that this sends a message to the state governments that, perhaps, they should try to get their budgets in line[.]” (internal quotation marks omitted)); Complaint ¶ 16, *New York v. Mnuchin*, 408 F. Supp. 3d 399 (S.D.N.Y. 2019) (No. 18-cv-6427).

14. *Mnuchin*, 408 F. Supp. 3d at 416, 423 (“The States have cited no constitutional principle that would bar Congress from exercising its otherwise plenary power to impose an

policy arena as an assault on a longstanding tenet of fiscal federalism, namely that SALT should be fully deductible.<sup>15</sup>

The SALT deduction cap was met with backlash from officials in liberal-leaning, high-tax states.<sup>16</sup> Some states have attempted legislative workarounds to mitigate the cap's effect.<sup>17</sup> Several states even banded together to file an unsuccessful lawsuit against the Trump administration challenging the constitutionality of the cap.<sup>18</sup> Voters in these states were also displeased, ousting several Republican congressional incumbents in the 2018 mid-term elections.<sup>19</sup> According to the Tax Policy Center, Democrats performed disproportionately well in districts in which a large percentage of taxpayers typically claim the SALT deduction.<sup>20</sup>

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income tax without a limitless SALT deduction. . . . Because the States have failed to plausibly allege that the cap, more so than any other major federal initiative, meaningfully constrains [states'] decision-making process, this Court has no basis for concluding that the SALT cap is unconstitutionally coercive.”); Alak Mehta, *Salty About the SALT Deduction Cap, Blue States File Suit in New York v. Mnuchin*, J.L. & SOC. PROBS.: COMMON L. BLOG (Nov. 20, 2019), <http://jlsplaw.columbia.edu/2019/11/20/salty-about-the-salt-deduction-cap-blue-states-file-suit-in-new-york-v-mnuchin/> [<https://perma.cc/PM3R-BD9W>]; *infra* text accompanying note 80.

15. Fiscal federalism refers to taxation and spending by states in a federal system. See William B. Barker, *The Tax Cuts and Jobs Act of 2017: The SALT Deduction, Tax Competition, and Double Taxation*, 56 SAN DIEGO L. REV. 73, 81 (2019).

16. See N.Y. STATE, *supra* note 11 (New York Governor Andrew Cuomo: “The Trump Administration’s SALT policy is retribution politics — plain and simple[.] . . . New York is already the nation’s leader in sending more tax dollars to Washington than we get back every year, and we will not allow this administration to pick the pockets of hard-working New Yorkers to fund tax cuts for corporations and send even more money to red states.” (internal quotation marks omitted)); *ICYMI: Attorney General Grewal Continues Fight to Protect New Jersey Taxpayers from Cap on SALT Deduction*, N.J. OFF. ATTY GEN. (Nov. 26, 2019), <https://www.nj.gov/governor/news/news/562019/approved/20191126c.shtml> [<https://perma.cc/SGT9-64HK>] (New Jersey Governor Phil Murphy: “The Trump Administration continues to use the IRS as a political weapon which affects thousands of hard-working residents of New Jersey and similar states[.] . . . My Administration remains committed to finding solutions for homeowners wrongly targeted by the federal tax law that limited SALT deductions and exploring all possible avenues to restore full deductibility for our residents.” (internal quotation marks omitted)).

17. See Emily Berg, Comment, *Just A Pinch of Salt Is Not Enough*, 92 TEMP. L. REV. 445, 459–68 (2020).

18. See Complaint, *Mnuchin*, 408 F. Supp. 3d 399 (No. 18-cv-6427); *Mnuchin*, 408 F. Supp. 3d at 423.

19. See *Congressional Districts Ranked by Percentage of Returns with State and Local Tax Deduction, 2014 and 2016*, TAX POLY CTR. (June 13, 2017), <https://www.taxpolicycenter.org/statistics/congressional-districts-ranked-percentage-returns-state-and-local-tax-deduction-2014-and> [<https://perma.cc/AL6Q-RAL5>]; *U.S. House Election Results 2018*, N.Y. TIMES (May 15, 2019), <https://www.nytimes.com/interactive/2018/11/06/us/elections/results-house-elections.html> [<https://perma.cc/77L2-W9QT>].

20. See Noah Zwiefel, *Did SALT-y Voters Punish Republicans in 2018?*, TAX POLY CTR. (Oct. 8, 2019), <https://www.taxpolicycenter.org/taxvox/did-salt-y-voters-punish-republicans-2018> [<https://perma.cc/4WQ4-7Q48>].

The cap is expected to have substantial economic impact in high-tax states and municipalities.<sup>21</sup> Most saliently, it has reduced property values in areas with high property taxes by as much as ten percent.<sup>22</sup> Since a substantial amount of homeowners' wealth is tied up in their homes, a decline in home values reduces the equity they have available to finance retirement and college tuition as well as the amount of disposable income available to spend on goods and services, which has its own ripple effects in the local economy.<sup>23</sup> Even more significantly, the cap decreases the value of the SALT deduction's subsidy to state and local governments, making it harder for them to maintain their fiscal policies.<sup>24</sup> The SALT deduction had previously served as a subsidy to states and municipalities by allowing them to charge higher tax rates than they could absent the deduction; the cap reduced the amount of this subsidy.<sup>25</sup>

This Note proposes that the next iteration of the SALT deduction should treat state and local taxes differently. More specifically, this Note argues that the cap should be lifted for state tax deductibility, but retained in some capacity for local tax deductibility. The rationale for this proposed distinction is grounded in the propositions that states are better suited than localities to

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21. See Complaint ¶¶ 10–15, *Mnuchin*, 408 F. Supp. 3d 399 (No. 18-cv-6427).

22. See Jonathan D. Salant & Samantha Marcus, *Your N.J. Home is Worth Less Than It Should Be, Thanks to the Trump Tax Law*, NJ.COM (Oct. 13, 2019), <https://www.nj.com/politics/2019/10/your-nj-home-is-worth-less-than-it-should-be-thanks-to-the-trump-tax-law.html> [<https://perma.cc/C3AE-6LS3>]; Moody's Analytics, *Home Price Impact of Tax Cuts and Jobs Act of 2017*, PROPUBLICA (Oct. 2019), <https://www.propublica.org/datastore/dataset/home-price-impact-of-tax-cuts-and-jobs-act-of-2017> [<https://perma.cc/HM5V-MHV9>]. Since the cap prevents many property owners in high-tax areas from fully deducting their property tax payments from their federal taxable income, these owners now pay more annually in federal taxes. To make up for this increase in federal taxes, potential homebuyers are now willing to pay less upfront, reducing property values.

23. See Complaint ¶ 14, *Mnuchin*, 408 F. Supp. 3d 399 (No. 18-cv-6427).

24. Even if state and local tax rates remain unchanged, the SALT deduction cap increases itemizing taxpayers' tax burden, as it limits their ability to fully deduct state and local tax payments from their federal taxable income. Moreover, this enlarged burden on itemizing taxpayers also hinders the ability of states and localities to maintain or increase their tax rates (and thus, revenue) due to the risk of taxpayer flight to jurisdictions with less burdensome tax rates. Put simply, allowing an itemizing taxpayer to deduct their SALT payments is economically equivalent to a decrease in the state or local tax rate. This decrease allows subnational governments to charge more than they otherwise could. For a more detailed explanation, see Martin Feldstein & Gilbert Metcalf, *The Effect of Federal Tax Deductibility on State and Local Taxes and Spending*, 95 J. POL. ECON. 710, 712 (1987). See also Gladriel Shobe, *Subsidizing Economic Segregation*, 11 U.C. IRVINE L. REV. (forthcoming) (manuscript at 25), <https://ssrn.com/abstract=3548290> [<https://perma.cc/ABD3-PYXQ>]; Complaint ¶ 15, *Mnuchin*, 408 F. Supp. 3d 399 (No. 18-cv-6427).

25. See Shobe, *supra* note 24 (manuscript at 25).

provide public goods and services that benefit taxpayers across the economic spectrum, and are better suited than the federal government at tailoring programs to local conditions. Expanding state tax deductibility will incentivize the funding and provision of redistributive programs at the state level, and will further the goals of state autonomy and policy innovation. Moreover, maintaining or reducing local tax deductibility will increase the internal policy consistency of the Internal Revenue Code, mitigate the regressive nature of the SALT deduction, and help reduce economic segregation. While Professor Gladriel Shobe has made a similar proposal in her literature,<sup>26</sup> this Note builds on her arguments in significant ways and also raises new ones. Most saliently, this Note adds onto Professor Shobe's work by comparing the SALT deduction to alternative means of federal subsidies.

Part II of this Note discusses the history of the state and local tax deduction, its various iterations, and policy debates surrounding the provision. Part III provides an overview of state and local taxation and spending, including differences between the types of taxes levied and the types of services provided by state versus local governments. Part IV outlines the policy rationale for this Note's proposed distinction between state and local tax deductibility. It uses arguments discussed in Part II to support the proposition that state taxes should be more deductible than local taxes. Part V discusses the ideal form of a SALT deduction, comparing it to alternative methods of subsidies to state and local governments. This Note proposes that the SALT deduction should allow for full deductibility of state taxes, but impose a cap on local tax deductibility. Further, it concludes that direct grants should be used in conjunction with the SALT deduction, and that tax credits are a promising alternative to SALT deductibility.

## II. HISTORY OF THE STATE AND LOCAL TAX DEDUCTION (IRC § 164)

This Part traces the historical development of the state and local tax deduction codified in section 164 of the IRC and summarizes the policy arguments and debates surrounding the deduction. Part II.A provides an overview of the history of the SALT deduction, including the legislative history of both enacted amendments

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26. See Shobe, *supra* note 10.

and unenacted proposals. Part II.B discusses scholarly arguments in favor of a SALT deduction, while Part II.C discusses scholarly arguments against a SALT deduction.

#### A. HISTORICAL DEVELOPMENT OF THE SALT DEDUCTION

The modern federal income tax was introduced in 1913.<sup>27</sup> In the initial iteration of the IRC, all state and local taxes,<sup>28</sup> apart from those assessed against local benefits,<sup>29</sup> were deductible from taxpayers' federal taxable income.<sup>30</sup> While the provision was amended in the following decades, it retained its general structure of allowing complete SALT deductibility unless an exception was specifically enumerated.<sup>31</sup>

As part of the Revenue Act of 1964, Congress inverted the structure of the SALT deduction to its present-day form. Now, the provision specifically enumerates the types of state and local taxes that are deductible and disallows a deduction for all others.<sup>32</sup> Deductible SALT taxes enumerated in the 1964 act included: (1) state and local real property taxes; (2) state and local personal property taxes; (3) state and local income, war profits, and excess profits taxes; (4) state and local general sales taxes; and (5) state and local taxes on the sale of motor fuels.<sup>33</sup> The House Ways and Means Committee argued that the federal government should allow deductions for all three major sources of state and local government revenue — property, income, and general sales taxes — to avoid distortions in state fiscal policy away from nondeductible sources of tax revenue and toward deductible sources.<sup>34</sup> However, the Committee reasoned that this approach was not necessary when it

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27. See Act of Oct. 3, 1913, ch. 16, § 2(A), 38 Stat. 114, 166 (1913).

28. Local taxes were defined to encompass county, municipal, and school taxes. See Act of Oct. 3, 1913, ch. 16, § 2(B), 38 Stat. at 167.

29. A tax is considered assessed against local benefits when the property subject to the tax is limited to property benefited. For example, a tax on real property imposed to pay for a sidewalk improvement directly benefitting that piece of real property would be considered a tax assessed against a local benefit (assuming the tax does not exceed the benefit inuring to the property). See 26 C.F.R. § 1.164-4 (2020).

30. See Act of Oct. 3, 1913, ch. 16, § 2(B), 38 Stat. at 167; Barker, *supra* note 15, at 76.

31. See Shobe, *supra* note 10, at 338.

32. *Id.*; Revenue Act of 1964, Pub. L. No. 88-272, § 207(a), 78 Stat. 19, 40 (1964) (codified as amended at I.R.C. § 164(a) (2018)); Barker, *supra* note 15, at 76.

33. See Revenue Act of 1964 § 207(a) (codified as amended at I.R.C. § 164(a) (1964)); Barker, *supra* note 15, at 76.

34. H.R. REP. NO. 88-749 (1963), *reprinted in* 1964 U.S.C.C.A.N. 1313.

came to other types of state and local taxes due to their lesser importance in raising revenue, as well as administrability concerns.<sup>35</sup>

In the Tax Reform Act of 1986, Congress enacted a substantial change to section 164 by eliminating the deduction for state and local sales taxes.<sup>36</sup> The legislative history notes that Congress eliminated this deduction as part of its overall strategy of broadening the tax base<sup>37</sup> and lowering tax rates.<sup>38</sup> Congress also believed that disallowing this deduction would improve the consistency of federal tax policy, as certain kinds of state and local sales taxes, such as those levied on utility services, sales of alcoholic beverages, and wholesalers, were already nondeductible.<sup>39</sup> Moreover, at the time, less than one-quarter of sales taxes paid by individuals were claimed as itemized deductions, compared to more than one-half of income taxes.<sup>40</sup> Thus, Congress believed that disallowing this deduction for sales taxes would not substantially incentivize state and local governments to shift away from the sales tax as a revenue source.<sup>41</sup>

As part of the discussion surrounding the Tax Reform Act of 1986, politicians, officials, and economists made several arguments about the SALT deduction. Notably, the Treasury Department proposed a complete repeal of the deduction, arguing that the federal government should not subsidize state and local services that primarily benefit residents of that jurisdiction — just as it does not subsidize personal consumption.<sup>42</sup> Instead, the Treasury Department argued, the federal government should remain neutral toward state and local taxation.<sup>43</sup> In its report to the president, the Treasury Department noted that the SALT deduction

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35. *Id.*

36. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 134(a)(1), 100 Stat. 2085, 2116 (1988) (codified as amended at I.R.C. § 164(a)).

37. Broadening the tax base means subjecting more gross income to taxation. This can be implemented by curbing deductions and exclusions to gross income, as well as by limiting tax credits.

38. H.R. REP. NO. 99-3838, at 47 (1986). By eliminating this deduction, Congress increased the tax base. Because tax revenue equals tax base multiplied by tax rate, Congress would theoretically now be able to raise the same amount of tax revenue even while lowering tax rates.

39. *Id.*

40. *Id.*

41. *Id.*

42. 1 U.S. DEP'T OF TREASURY, *supra* note 10, at 78. An analogous subsidy of personal consumption would entail a deduction for all personal expenditures. This would substantially reduce the federal tax base. For more on this, see *infra* Part IV.A.

43. 1 U.S. DEP'T OF TREASURY, *supra* note 10, at 78.



reduced federal income tax revenue by \$30 billion in 1982 — an amount approximately equivalent to the revenue loss that would result from an overall 10% reduction in individual income tax rates.<sup>44</sup> It argued that “[f]ederal support of this magnitude can be defended only if there is reason to believe that the subsidized activities would otherwise be carried on at too low a level<sup>45</sup> and if the present tax deduction is an efficient form of subsidy.”<sup>46</sup> The Treasury Department found neither of these conditions to exist.<sup>47</sup> First, it claimed that there was no evidence that state and local expenditures have such strong spillover effects<sup>48</sup> that they would be under-provided in the absence of a SALT deduction.<sup>49</sup> Second, it argued that the SALT deduction is an inefficient subsidy because the deduction benefits only the minority of taxpayers who itemize and disproportionately benefits high-income individuals and communities.<sup>50</sup> Instead, the Department supported direct grants-in-aid<sup>51</sup> as a more efficient and cost-effective form of subsidy.<sup>52</sup>

The Treasury Department also unsuccessfully argued that different sources of state and local tax revenue — sales, income, and property taxes — should be treated similarly for the purposes of the deduction because “the degree of reliance on these three tax

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44. *Id.* But see Feldstein & Metcalf, *supra* note 24, at 726–27 (“The research presented here implies that eliminating deductibility might not produce anything like the amount of additional revenue that the Treasury predicted and might actually cause a fall in total tax revenue.”).

45. To clarify, the Treasury Department is arguing here that the SALT deduction should exist only if state and local taxation (and thus spending) would otherwise be carried on at less than an optimal level. How the Treasury Department would assess when state and local taxation is carried on at “too low a level” seems to be based purely on the potential presence of spillover benefits, rather than a normative judgment on the role of state and local government in providing public goods and services. For more on spillovers, see *infra* note 48.

46. 1 U.S. DEPT OF TREASURY, *supra* note 10, at 78.

47. *Id.*

48. Spillovers occur when persons outside of a taxing jurisdiction receive benefits they did not pay for. See Shobe, *supra* note 10, at 371. Expenditures with spillover benefits are likely to be under-provided because those within the jurisdiction are reluctant to fund benefits flowing to those residing outside the jurisdiction. See Richard Briffault, *The Local Government Boundary Problem in Metropolitan Areas*, 48 STAN. L. REV. 1115, 1133 (1996) (“The spillover problem is more acute today because local borders frequently abut one another, and people range widely in their daily activities across multiple local boundaries.”).

49. 1 U.S. DEPT OF TREASURY, *supra* note 10, at 78.

50. *Id.* at x, 78, 80.

51. I.e. direct grants from the federal government to state and local governments.

52. 1 U.S. DEPT OF TREASURY, *supra* note 10, at 80. But see Feldstein & Metcalf, *supra* note 24, at 728–30 (illustrating how SALT deductibility may be a more cost-effective method than direct federal grants to stimulate state and local spending).

bases varies widely from state to state.”<sup>53</sup> Thus, to allow a deduction for some types of taxes but not all would unfairly benefit some states and localities over others, and distort state and local fiscal policy away from the non-deductible revenue source.<sup>54</sup>

Finally, the Treasury Department argued that because the SALT deduction leads to higher federal tax rates for all,<sup>55</sup> it only creates a net benefit for states and localities that levy above-average taxes.<sup>56</sup> In contrast, states and localities that levy below-average taxes would be worse off than they would without any SALT deduction.<sup>57</sup> Given these concerns, the Treasury Department believed that its proposed elimination of the SALT deduction would “reduce the extent to which low-tax and low-income jurisdictions indirectly subsidize high-tax and high-income jurisdictions.”<sup>58</sup>

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53. 1 U.S. DEP’T OF TREASURY, *supra* note 10, at 80. The report mentioned that five states had no general sales tax and six states had no personal income tax. *Id.*

54. *Id.* A 1987 economic study found statistical support for the conclusion that deductibility increases state and local government reliance on federally deductible revenue sources. Feldstein & Metcalf, *supra* note 24, at 731.

55. This argument assumes the federal government wishes to raise a target amount of tax revenue. Thus, since the SALT deduction reduces federal tax revenue, the federal government must compensate by increasing federal tax rates.

56. 1 U.S. DEP’T OF TREASURY, *supra* note 10, at 80. This argument is grounded in two key impacts of the SALT deduction. First, the deduction leads to higher federal income tax rates across the United States (assuming a target amount of tax revenue), as described *supra* note 55. Second, the SALT deduction benefits high-tax states and localities more than low-tax states and localities. Here is the reasoning behind this second impact: By allowing itemizing taxpayers to deduct their SALT payments from their federal taxable income, the SALT deduction effectively subsidizes these taxpayers by reducing their federal tax burden. Because (1) taxpayers in high-tax jurisdictions are more likely to itemize than taxpayers in low-tax jurisdictions (for whom the standard deduction is more likely to exceed the sum of their itemized deductions due to lower SALT payments); and (2) the amount of the subsidy to itemizing taxpayers increases with the amount of their SALT payments (which are likely higher in high-tax jurisdictions), the SALT deduction’s subsidy of itemizing taxpayers will be greater in high-tax jurisdictions than in low-tax jurisdictions. Now, the last bit: By disproportionately benefitting itemizing taxpayers in high-tax jurisdictions, the SALT deduction disproportionately benefits high-tax jurisdictions themselves by allowing them to levy taxes without their itemizing residents feeling the full economic burden of the taxes (due to the subsidy). *See supra* note 24 and accompanying text. So, if the SALT deduction increases federal income tax rates for all but disproportionately benefits high-tax jurisdictions, then high-tax jurisdictions are likely to see a net benefit and low-tax jurisdictions are likely to see a net disadvantage.

57. *See* explanation *supra* note 56.

58. 1 U.S. DEP’T OF TREASURY, *supra* note 10, at 81. The federal grants-in-aid system, through which high-tax states actually subsidize low-tax states, calls this conclusion into question. *See* ROBERT JAY DILGER & MICHAEL H. CECIRE, CONG. RSCH. SERV., FEDERAL GRANTS TO STATE AND LOCAL GOVERNMENTS: A HISTORICAL PERSPECTIVE ON CONTEMPORARY ISSUES 1 (2019), <https://fas.org/sgp/crs/misc/R40638.pdf> [<https://perma.cc/5MHG-L4BK>]; Daniel Jacob Hemel, *The Death and Life of the State and Local Tax Deduction*, 72 TAX L. REV. 151, 165 (2019) (“[S]tates whose residents benefit the most from the SALT deduction are also the states with the largest negative balance of payments with the

A May 1985 proposal from the Executive Office of the President (EOP) to Congress also argued for the complete elimination of the deduction.<sup>59</sup> This proposal echoed many of the policy reasons for the change outlined in the Treasury Department's 1984 report to the president, including fairness,<sup>60</sup> inefficiency of the existing subsidy,<sup>61</sup> and expansion of the tax base.<sup>62</sup> The proposal also rejected the argument that state and local taxes should be deductible because they are involuntary and provide no benefit to taxpayers.<sup>63</sup> In the EOP's view, state and local taxes are voluntary because taxpayers retain control over the taxes they pay through both the electoral process and their ability to move to jurisdictions with attractive tax and fiscal policies.<sup>64</sup> The EOP proposal also argued that taxpayers receive important personal benefits in return for state and local taxes, including public education and public utilities.<sup>65</sup> The EOP analogized taxation for these public benefits to personal spending to support its argument to end deductibility.<sup>66</sup>

The EOP proposal also found that SALT deductibility has only a minor impact on the level of state and local government

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federal government (i.e., the states that pay the most in federal taxes relative to the federal spending they receive."); see also Bruce J. Schulman, *Blue States Already Subsidize Red States. Now Red States Want Even More*, WASH. POST (Oct. 30, 2017), <https://www.washingtonpost.com/news/made-by-history/wp/2017/10/30/blue-states-already-subsidize-red-states-now-red-states-want-even-more/> [<https://perma.cc/AQ6G-U3K3>].

59. EXEC. OFF. OF THE PRESIDENT, THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 62–69 (1985), <https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Reform-Proposal-1985.pdf> [<https://perma.cc/NFA3-KPXA>].

60. *Id.* at 62 ("The current deduction for State and local taxes disproportionately benefits high-income taxpayers residing in high-tax States."). The report found that less than 10% of families earning less than \$20,000 per year availed themselves of the SALT deduction, compared to more than 95% of families earning more than \$100,000 per year. See *id.* at 67.

61. *Id.* at 64 ("[P]rovision of the subsidy through a deduction for State and local taxes is neither cost effective nor fair. On average, State and local governments gain less than fifty cents for every dollar of Federal revenue lost because of the deduction. Moreover, a deduction for State and local taxes provides a greater level of subsidy to high-income States and communities than to low-income States and communities.").

62. *Id.* at 63 ("The deduction for State and local taxes is one of the most serious omissions from the Federal income tax base. . . . Recovery of those revenues will permit a substantial reduction in marginal tax rates.").

63. *Id.*

64. *Id.*; see also *infra* Part IV.A and note 162 (discussing why local taxes should be considered more voluntary than state taxes). But see Brian Galle, *Federal Fairness to State Taxpayers: Irrationality, Unfunded Mandates, and the "SALT" Deduction*, 106 MICH. L. REV. 805, 851–52 (2008) (arguing that paying SALT may not be considered a freely chosen consumption choice due to frictions associated with mobility).

65. EXEC. OFF. OF THE PRESIDENT, *supra* note 59, at 63.

66. *Id.*

spending,<sup>67</sup> though this impact would vary substantially by jurisdiction depending on the concentration of itemizing taxpayers: “[T]he effect on spending for a particular State or local government would be larger than [two] percent for a high-income community and may not affect spending at all in low-income communities where few residents itemize deductions.”<sup>68</sup>

In 2004, responding to pressure from states that depended primarily on sales tax rather than income tax, Congress amended the IRC to once again allow taxpayers to deduct state and local sales taxes, but this time only as an option to do so in lieu of — rather than in addition to — deducting state and local income taxes.<sup>69</sup>

Finally, in December 2017, the TCJA introduced a \$10,000 limit on SALT deductibility that is scheduled to expire on December 31, 2025.<sup>70</sup> The initial House and Senate proposals differed substantially from the final version. The House bill would have repealed the SALT deduction for state and local income and sales taxes, and instituted a \$10,000 cap for property taxes.<sup>71</sup> The Senate blueprint would have repealed the SALT deduction entirely.<sup>72</sup> House Ways and Means Committee Chairman Kevin Brady, who represents Texas’s 8th Congressional District, championed the House Bill for “eliminating costly deductions that drive up taxes,” though he did not support complete elimination of the property tax deduction.<sup>73</sup>

67. *Id.* at 65 (“A National League of Cities study found that total State and local spending is about 2% higher because of the existence of tax deductibility.”).

68. *Id.* This disparity in induced spending between high-income and low-income communities supports this Note’s argument that state taxes — which fund public goods and services benefitting taxpayers across the economic spectrum — should be more deductible than local taxes — which often fund services benefitting primarily high-income individuals.

69. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 501(a), 118 Stat. 1418, 1520 (2004); Shobe, *supra* note 10, at 339.

70. Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 11042(a), 131 Stat. 2054, 2085 (2017) (codified as amended at I.R.C. § 164(b)(6) (2018)).

71. *See Kevin Brady Introduces Tax Cuts and Jobs Act, Receives Kudos from President Donald Trump*, U.S. CONGRESSMAN KEVIN BRADY (Nov. 3, 2017) [hereinafter *Brady Introduces*], <http://kevinbrady.house.gov/news/documentsingle.aspx?DocumentID=400863> [<https://perma.cc/QSG9-3T9V>]; Reuters, *U.S. House Will Reject Total Elimination of State and Local Tax Deductions: Brady*, CNBC (Nov. 13, 2017), <https://www.cnbc.com/2017/11/13/us-house-will-reject-total-elimination-of-state-and-local-tax-deductions-brady.html> [<https://perma.cc/3CR3-GJHT>]. As will be clarified in Parts III and IV of this Note, this proposal would have increased local tax deductibility relative to state tax deductibility — the opposite of this Note’s recommendation.

72. *See* Reuters, *supra* note 71.

73. *See Brady Introduces*, *supra* note 71. It is worth noting that, unlike most states, Texas has no state income tax. *See* TEX. CONST. art. 8, § 24-a (“The legislature may not impose a tax on the net incomes of individuals, including an individual’s share of partnership and unincorporated association income.”). As a result, Texas has higher-than-average property taxes. *See* Peter Dawson, *If You Think Texas Property Taxes are High, a New*

The House Report accompanying the initial House bill argued that the proposed change “makes the system simpler and fairer for all families and individuals, and allows for lower tax rates.”<sup>74</sup>

## B. ARGUMENTS IN FAVOR OF A SALT DEDUCTION

Proponents of a SALT deduction defend it as a constitutional requirement and a key tenet of fiscal federalism.<sup>75</sup>

There are two strains of the constitutional argument: one general and one TCJA-specific. First, proponents argue that there is an implicit constitutional limitation on the federal government’s Taxing Power<sup>76</sup> barring any cap or limitation on the SALT deduction.<sup>77</sup> This argument is grounded in the proposition that the Constitution reserves authority to states to decide whether and how much to spend on intrastate infrastructure, welfare, schooling, and other public goods and services.<sup>78</sup> Thus, any limitation on the SALT deduction should be viewed as either exceeding the scope of Congress’ Taxing Power or violating federalism principles embedded in the Constitution because such a limitation would affect state and local fiscal decisions. Second, SALT deduction supporters argue that the TCJA’s cap on the SALT deduction unconstitutionally targets and coerces high-tax states to reduce their taxation and spending levels.<sup>79</sup> Judge J. Paul Oetken tested and rejected these arguments in *New York v. Mnuchin*, in which he dismissed a constitutional challenge levied by four high-tax states — New

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*Study Shows That You’re Right on the Money*, HOUS. CHRON. (Feb. 27, 2019), <https://www.houstonchronicle.com/news/houston-texas/houston/article/Study-shows-Texas-real-estate-property-tax-rate-13649667.php> [<https://perma.cc/JP2R-K2VM>].

74. H.R. REP. NO. 115-409, at 165 (2017).

75. See, e.g., Letter from the U.S. Conf. of Mayors to U.S. Sens. & Reps., at 2 (Sept. 25, 2017), <https://www.usmayors.org/wp-content/uploads/2017/09/Mayors-Letter-on-Tax-Reform-092517-FINAL.pdf> [<https://perma.cc/T7B2-ZT8D>] (SALT as an essential tenet of fiscal federalism) [hereinafter U.S. Conf. Letter]; *infra* note 77 and accompanying text (SALT as a constitutional requirement).

76. U.S. CONST. art. I, § 8, cl. 1.

77. See *New York v. Mnuchin*, 408 F. Supp. 3d 399, 415 (S.D.N.Y. 2019); Complaint ¶¶ 1, 34–38, *Mnuchin*, 408 F. Supp. 3d 399 (No. 18-cv-6427). While no such limitation appears explicitly in the Constitution’s text, proponents argue that it can be inferred from the historical understanding surrounding the ratification of the Constitution and Sixteenth Amendment and from principles of federalism enshrined in the Constitution’s structure and embedded in the Tenth Amendment. See *id.*

78. See Complaint ¶¶ 3, 5, 44, *Mnuchin*, 408 F. Supp. 3d 399 (No. 18-cv-6427).

79. See *Mnuchin*, 408 F. Supp. 3d at 406; Complaint ¶¶ 120, 137–39, *Mnuchin*, 408 F. Supp. 3d 399 (No. 18-cv-6427).

York, Connecticut, Maryland, and New Jersey — against the U.S. Treasury Department.<sup>80</sup>

Proponents also defend the SALT deduction as promoting the goals of fiscal federalism,<sup>81</sup> including decentralization, policy diversity, and regulatory competition.<sup>82</sup> By reducing the effective burden of state and local taxation on taxpayers, the SALT deduction provides more resources for state and local governments<sup>83</sup> to experiment and compete against each other through different combinations of taxation and spending,<sup>84</sup> and incentivizes a shift in the provision of services from the federal government to state and local governments.<sup>85</sup> As Professor Daniel Hemel argues in support of the SALT deduction's stimulation of subnational taxation and spending:

State and local governments play critically important functions in our democratic system: they facilitate civic participation and self-governance; they impose checks on overreach by the federal executive, legislative, and judicial branches; and they serve as laboratories for policy experimentation with the potential for positive spillovers. They also channel resources toward investments in education and human capital that will serve the U.S. workforce well in an increasingly globalized knowledge economy. If tax policy arguments over the SALT deduction leave us somewhere close to equipoise, I would prefer to err on the side of supporting state and local

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80. *Mnuchin*, 408 F. Supp. 3d at 416, 423 (“The States have cited no constitutional principle that would bar Congress from exercising its otherwise plenary power to impose an income tax without a limitless SALT deduction. . . . Because the States have failed to plausibly allege that the cap, more so than any other major federal initiative, meaningfully constrains [states’] decision-making process, this Court has no basis for concluding that the SALT cap is unconstitutionally coercive.”). For a summary of this decision, see Mehta, *supra* note 14.

81. See U.S. Conf. Letter, *supra* note 75, at 2 (“[A]ny alterations to the deduction would upset the carefully balanced fiscal federalism that has existed since the permanent creation of the federal income tax over 100 years ago.”).

82. See Ruth Mason, *Federalism and the Taxing Power*, 99 CALIF. L. REV. 975, 1035 (2011).

83. See Hemel, *supra* note 58, at 59 (“[S]everal econometric studies find a relationship in the expected direction between the value of the SALT deduction and the amount of state and local government spending.”). See also *supra* note 24 and accompanying text for an explanation of how the SALT deduction subsidizes state and local governments.

84. See Barker, *supra* note 15, at 90 (noting that states fiscally compete against each other in two ways: increasing the supply of public benefits and lowering taxes).

85. Brian Galle, *A Republic of the Mind: Cognitive Biases, Fiscal Federalism, and Section 164 of the Tax Code*, 82 IND. L.J. 673, 675 (2007).

governments rather than discouraging subnational revenue collections and expenditures.<sup>86</sup>

In response, critics question whether state and local governments should be given this magnified role in the provision of public services or whether the federal government should instead step in to help equalize the quantity and quality of public goods and services provided across states.<sup>87</sup>

Proponents also praise the SALT deduction for being among the least restrictive forms of federal aid to the states.<sup>88</sup> As compared to the grants-in-aid system — through which the federal government often contractually requires states to implement federal policy<sup>89</sup> — the SALT deduction leaves states far freer to enact policies that differ from or conflict with federally desired policies.<sup>90</sup> In this sense, the SALT deduction is akin to a matching grant<sup>91</sup> to state and local governments that places no restrictions on how to spend the funds.<sup>92</sup> In response, critics argue that the SALT deduction is a less efficient form of subsidy to states than direct grants because it favors itemizing, high-income taxpayers and high-income communities,<sup>93</sup> and because it does not deliver money to states on a dollar-to-dollar basis.<sup>94</sup>

Other arguments supporting the deduction include claims that state and local government services create positive spillover benefits into other jurisdictions (and as such should be encouraged by

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86. Hemel, *supra* note 58, at 170.

87. For a discussion of the argument that all redistributive policies should be centralized at the national government level, see Kirk J. Stark, *supra* note 10, at 1408, and see also Galle, *supra* note 85, at 680–84.

88. Mason, *supra* note 82, at 1023.

89. The federal government does this in two primary ways: (1) by conditioning states' receipt of federal funds on the states' implementation of certain federal policy goals that the federal government either does not have the power or the political will to implement directly; and (2) by imposing restrictions on how the grant money can be spent. For a comparison of the breadth of Congress' Spending Power and Taxing Power, see generally Mason, *supra* note 82.

90. *Id.* at 1023, 1028.

91. This term is used to describe financial grants awarded by the federal government to state and local governments in a fixed ratio to the amount state and local governments spend themselves. For example, the federal government might grant \$1 to states for every \$2 they spend on mass transit investments.

92. Mason, *supra* note 82, at 1023. The mechanics of this are as follows: When a state raises its taxes to fund spending, the federal subsidy to that state also automatically grows due to the SALT deduction. *Id.*

93. 1 U.S. DEP'T OF TREASURY, *supra* note 10, at x, 78, 80.

94. Galle, *supra* note 85, at 694.

the federal government);<sup>95</sup> that a deduction encourages state and local governments to provide undersupplied public goods and services at a more optimal level;<sup>96</sup> and that the deduction is necessary to ensure that taxpayers are taxed on a proper measurement of economic income.<sup>97</sup>

### C. ARGUMENTS AGAINST A SALT DEDUCTION

Opponents of a SALT deduction criticize it as benefitting only itemizing taxpayers who tend to be well-off.<sup>98</sup> As an itemized deduction, SALT provides no direct benefit to the vast majority of taxpayers, as most take the standard deduction.<sup>99</sup> Moreover, the benefit of the deduction increases with the income of the taxpayer for two reasons: (1) They are able to deduct more due to their larger state and local tax burdens, and (2) the value of the deduction is higher for those facing higher federal marginal tax rates.<sup>100</sup> This is borne out in the data. According to the Treasury Department, households in the top 1% of income claimed over 37% of SALT deduction benefits in 2017, while households in the top 20% of income claimed over 87% of SALT deduction benefits.<sup>101</sup>

While supporters of a SALT deduction acknowledge that it exclusively benefits itemizing taxpayers and disproportionately benefits wealthier taxpayers *in the short-term*, they argue that *in the*

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95. See Shobe, *supra* note 10, at 331; Louis Kaplow, *Fiscal Federalism and the Deductibility of State and Local Taxes Under the Federal Income Tax*, 82 VA. L. REV. 413, 480–81 (1996).

96. See Shobe, *supra* note 10, at 331, 352.

97. *Id.* at 331.

98. See Jensen, *supra* note 10, at 52–53.

99. Approximately 70% of taxpayers have historically chosen to take the standard deduction, but after the TCJA's increase of the standard deduction, this figure is estimated to grow to 90% of taxpayers. See *What is the Standard Deduction?*, TAX POL'Y CTR. (May 2020), <https://www.taxpolicycenter.org/briefing-book/what-standard-deduction> [https://perma.cc/T4C8-R2WR]. Generally, taxpayers choose to itemize deductions only if the sum of their itemized deductions exceeds the standard deduction they would otherwise receive. See *supra* note 4.

100. See Shobe, *supra* note 10, at 375; Stark, *supra* note 10, at 1414. It is also worth noting that the deduction especially benefits wealthy individuals living in high-tax states and localities.

101. U.S. DEP'T OF TREASURY, OFFICE OF TAX ANALYSIS, DISTRIBUTION TABLE 2017 004C, SHARE OF TAX BENEFITS OF SELECTED INDIVIDUAL INCOME TAX EXPENDITURES BY INCOME CLASS (Mar. 30, 2016), <https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/Selected-Credits-Deductionsand-Exclusions-2017.pdf> [https://perma.cc/6UWL-87SL].



*long-run* it stimulates progressive taxation<sup>102</sup> at the state and local level by reducing the effective burden of state and local taxation.<sup>103</sup> A 2011 economic study found that SALT deductibility does indeed have these offsetting effects: “On the one hand, the [SALT] deduction disproportionately benefits high bracket taxpayers. On the other hand, deductibility appears to lead to a greater reliance on progressive income taxes at the state and local level. . . .”<sup>104</sup> Because the SALT deduction reduces the effective cost of state and local taxation of high-bracket itemizers more than low-bracket itemizers,<sup>105</sup> it incentivizes state and local governments to structure their own tax systems in a more progressive way, so as to shift more of the tax burden onto higher-income individuals.<sup>106</sup> In this sense, the SALT deduction does benefit lower-income, non-itemizing taxpayers, albeit indirectly through its impact on state fiscal decisions.<sup>107</sup>

Opponents further criticize the SALT deduction for unjustifiably subsidizing state and local governments that choose to levy high taxes and provide more services.<sup>108</sup> Such critics argue that, while states and localities should be free to tax and spend as they wish, the federal government should not preference certain state fiscal decisions through such a subsidy.<sup>109</sup> One scholar has gone further, arguing that, by subsidizing states, the deduction reduces the quality of state governance.<sup>110</sup> In response, supporters of a SALT deduction argue that the federal government should

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102. In progressive taxation schemes, high-income (i.e. high-bracket) taxpayers are taxed at higher rates than low-income (i.e., low-bracket) taxpayers. In concert with public welfare programs, progressive taxation serves to redistribute income from high-income to low-income households. See Julia Kagan, *Progressive Tax*, INVESTOPEDIA (July 19, 2020), <https://www.investopedia.com/terms/p/progressivetax.asp> [<https://perma.cc/X6FL-9RDS>].

103. See Gilbert E. Metcalf, *Assessing the Federal Deduction for State and Local Tax Payments*, 64 NAT. TAX J. 565, 588 (2011).

104. *Id.*; see also Howard Chernick, *On the Determinants of Subnational Tax Progressivity in the U.S.*, 52 NAT. TAX J. 93, 108 (2005) (“[E]liminating or curtailing the deductibility of state and local taxes would substantially reduce the progressivity of subnational tax systems.”).

105. For clarification of this point, see *supra* note 100 and accompanying text, and note 24.

106. See Hemel, *supra* note 58, at 158.

107. *Id.*

108. See *supra* Part II.A.

109. See *id.*

110. Galle, *supra* note 85, at 696. Professor Galle argues that, by lightening taxpayers’ tax burden, the SALT deduction disincentivizes interstate mobility. This diminished mobility, he believes, reduces the quality of state governance compared to an ideal market in which “taxpayers will flee inefficient or corrupt governments for those that deliver similar sets of services with less waste.” *Id.*

encourage services to be provided at the state and local level, rather than at the federal level. They point to the extensive grants-in-aid system,<sup>111</sup> through which the federal government provides a tremendous amount of direct aid to states — often with conditions and restrictions attached — to argue that the SALT subsidy would incentivize the funding and provision of these programs at the state and local level.<sup>112</sup> SALT deduction supporters also point out that while the SALT deduction does subsidize high-tax states, these states already subsidize low-tax states through federal taxation and spending.<sup>113</sup> So, they argue, it is unpersuasive to disparage the SALT deduction as a subsidy flowing from low-tax to high-tax states given the reality that high-tax states tend to have the largest negative balance of payments<sup>114</sup> with the federal government.<sup>115</sup>

Further, critics argue that payment of state and local taxes for public goods and services is akin to personal consumption, and thus does not merit a deduction.<sup>116</sup> Just as payment for a television or a haircut would not qualify for a deduction, payment for transportation infrastructure and public education should also not be deductible; all of these expenditures directly benefit the taxpayer. In response, proponents argue that since SALT is not a freely chosen consumption choice due to constraints on mobility, SALT payments cannot be properly analogized to private consumption.<sup>117</sup>

As is now clear, a host of discordant policy arguments surround the SALT deduction. Proponents believe that the SALT deduction's subsidy of subnational governments provides these governments greater fiscal capacity to tax and provide services for their residents. This, in turn, promotes key values of federalism, including policy diversity and local administration. Opponents believe that the SALT deduction primarily benefits high-income taxpayers

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111. See DILGER & CECIRE, *supra* note 58, at 1 (“In [Fiscal Year 2019], the federal government is expected to provide state and local governments about \$750 billion in federal grants encompassing a wide range of public policy areas, such as health care, transportation, income security, education, job training, social services, community development, and environmental protection. Federal grants account for just under one-third of total state government funding[.]”).

112. See Galle, *supra* note 85, at 675; Mason, *supra* note 82, at 1023.

113. See Hemel, *supra* note 58, at 164–65.

114. Put differently, high-tax states tend to receive less in federal spending than their residents pay in federal tax.

115. See Hemel, *supra* note 58, at 158, 164–65.

116. Shobe, *supra* note 10, at 331; see also Galle, *supra* note 64, at 808.

117. Galle, *supra* note 64, at 805.

and high-tax jurisdictions, unjustifiably incentivizes subnational governments to increase taxation, and corrodes the federal tax base.

### III. OVERVIEW OF STATE AND LOCAL TAXATION AND SPENDING

This Part discusses the types of taxes levied and types of services provided by state and local governments, and their implications for the SALT deduction. Part III.A explains how local governments tend to rely on property taxes for revenue, while state governments tend to rely on income and sales taxes for revenue.<sup>118</sup> Part III.A concludes that IRC section 164's preferential treatment of property taxes, in addition to local tax deductibility on state tax returns, provides local governments greater benefit than state governments receive.

Part III.B discusses differences in state and local government spending activities, noting that state governments tend to be more redistributive<sup>119</sup> than local governments.<sup>120</sup> States spend on public goods and services benefitting a broad, diverse group of citizens, including those who pay little to no taxes.<sup>121</sup> Local governments, in contrast, spend on public goods and services benefitting those in a smaller, more socioeconomically homogeneous geographic area.<sup>122</sup> Due to the reality of income stratification between municipalities,<sup>123</sup> local government spending is likelier to provide greater

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118. See Shobe, *supra* note 10, at 344.

119. This Note uses the term “redistributive” to describe systems of tax and spending that transfer wealth from higher-income, wealthier households to lower-income, lower-wealth households. In such systems, wealthier taxpayers fund a high percentage of the cost of public goods and services, but do not receive a share of the benefit commensurate with this percentage. The more redistributive the system, the greater this disparity between taxes paid and benefit received.

120. See Shobe, *supra* note 10, at 342–43.

121. See *id.* at 347.

122. *Id.*

123. See Shobe, *supra* note 24 (manuscript at 9–10) (describing how economic segregation among localities has grown since the 1970s). One major reason for this income stratification is exclusionary behavior by local governments. For instance, local governments can use zoning mechanisms to exclude affordable housing units, and thus low-income individuals. See Shobe, *supra* note 10, at 356. Examples of such mechanisms include minimum lot size requirements, minimum square footage requirements, and single residence per-lot requirements (i.e., bans on multifamily residential units). See Elliott Anne Rigsby, *Understanding Exclusionary Zoning and Its Impact on Concentrated Property*, CENTURY FOUND. (June 23, 2016), <https://tcf.org/content/facts/understanding-exclusionary-zoning-impact-concentrated-poverty/> [<https://perma.cc/4QPW-25VB>].

net benefit<sup>124</sup> to the taxpayer funding that spending than state government spending, which often benefits those paying little to no taxes.<sup>125</sup> Thus, local tax deductibility — which subsidizes local governments — confers a greater benefit on wealthier, itemizing taxpayers than state tax deductibility.<sup>126</sup>

#### A. STATE VS. LOCAL GOVERNMENT TAXATION

While the composition of revenue sources varies by state and municipality, the general pattern is that property constitutes the primary tax base for local governments, while income and sales are the main tax bases for state governments.<sup>127</sup> This feature makes local taxes more deductible than state taxes due to the Internal Revenue Code's differential treatment of these revenue sources.<sup>128</sup>

State governments raise revenue primarily through sales taxes and individual income taxes.<sup>129</sup> These two sources combine to account for over 80% of all state tax revenue.<sup>130</sup> Overall, state tax revenue constitutes approximately two-thirds of total state revenue, with the other one-third primarily composed of grants from the federal government.<sup>131</sup>

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124. “Net benefit,” as used in this Note, refers to how much a taxpayer receives for what she is paying in taxes. It can be understood as a return on investment. For example, if Taxpayer A pays \$50 in local taxes and \$100 in state taxes, and receives \$45 worth of benefit from local spending and \$50 worth of benefit from state spending, his “net benefit” is greater from local spending than it is from state spending.

125. See Peter Mieszkowski & Edwin S. Mills, *The Causes of Metropolitan Suburbanization*, 7 J. ECON. PERSP. 135, 137 (1993) (“By residing in income-stratified communities, the affluent avoid local redistributive taxes.”). If incomes were as widely dispersed within a local jurisdiction as they are within an entire state, then it is possible that state and local government spending would provide equal net benefit to the taxpayer funding that spending.

126. Shobe, *supra* note 10, at 351.

127. *Id.* at 344.

128. The current iteration of the Internal Revenue Code allows taxpayers to deduct property taxes plus the taxpayers' choice of either income or sales taxes — up to a maximum of \$10,000. I.R.C. § 164. Given state governments' reliance on income and sales taxes (only one of which is deductible) and local governments' reliance on property taxes (which is always deductible), local governments currently receive preferential treatment under this provision.

129. See Shobe, *supra* note 10, at 344.

130. *Id.* It is worth noting that New Hampshire lacks both a sales tax and income tax, instead relying primarily on a state property tax for revenue. See N.H. ASSESSING STANDARDS BD., UNDERSTANDING NH PROPERTY TAXES: THE OFFICIAL NEW HAMPSHIRE ASSESSING REFERENCE MANUAL, at 1-1 (3d ed. 2019), <https://www.revenue.nh.gov/mun-prop/property/documents/asb-manual.pdf> [<https://perma.cc/3NPU-LTG6>].

131. See Shobe, *supra* note 10, at 343.

In contrast, local governments raise revenue primarily through property taxes.<sup>132</sup> Approximately 74% of total local government tax revenue is derived from property taxes, while sales and income taxes comprise only 21% of local government tax revenue.<sup>133</sup> Local government tax revenue constitutes approximately two-thirds of total local taxes and fees, with the other one-third primarily composed of grants from state governments.<sup>134</sup>

Given the Internal Revenue Code's preferential treatment of property taxes over income and sales taxes, local governments receive a relatively greater subsidy under the current SALT deduction scheme than do state governments.<sup>135</sup> Moreover, local governments receive another important benefit under the current tax regime. Since states generally model their tax systems on the federal tax scheme (although not required), local taxes are generally deductible against *state* taxable income on state tax returns.<sup>136</sup> So, in effect, local tax payments can be deducted twice (against federal and state taxable income), while state tax payments can only be deducted once (against federal taxable income).<sup>137</sup> This double deduction translates to an additional subsidy for local government activities.

## B. STATE VS. LOCAL GOVERNMENT SPENDING

State and local governments both spend on public goods and services benefitting residents of their respective geographic footprints. However, while state populations tend to be socioeconomically diverse, local government populations tend to be socioeconomically homogeneous due to the reality of income stratification between local jurisdictions.<sup>138</sup> Accordingly, local government spending is likelier to provide greater net benefit to the local

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132. *Id.* at 344.

133. *Id.*

134. *Id.* at 343.

135. *See supra* note 128.

136. *See Shobe, supra* note 10, at 341.

137. *Id.* at 341–42.

138. *See Shobe, supra* note 24 (manuscript at 10–11) (“[Since the 1970s,] lower-income households have become more likely to live in localities with other low-income households, and high-income households have become more likely to live in localities with other high-income households. Economic segregation is the most pronounced among the relatively wealthy, who are more segregated than lower-income families. The increase in the number of wealthy localities has led to an increase in the number of localities that are composed almost exclusively of relatively wealthy families, and these localities almost always have superior local public goods and services.”).

taxpayers who directly fund that spending than state government spending, which often benefits those paying little to no taxes as well. Thus, local tax deductibility that subsidizes local governments confers a greater benefit on wealthier, itemizing taxpayers than state tax deductibility.

The largest categories of state government expenditures are social services<sup>139</sup> (32% of total state government direct expenditures), higher education (15%), and transportation (7%).<sup>140</sup> States also spend a great deal of money in the form of intergovernmental grants to local governments, primarily to ensure an adequate baseline of funding for primary and secondary education in each locality.<sup>141</sup> Since primary and secondary education funding occurs primarily at the local level via property taxes, states view this type of redistribution as necessary to ensure adequate educational quality across the state.<sup>142</sup> In contrast, the largest categories of local spending are primary and secondary education (34% of total local government direct expenditures), utilities (11%), and police and fire protection (8%).<sup>143</sup>

The aforementioned categories of state and local spending reveal that state governments tend to spend in a redistributive manner benefitting citizens across the socioeconomic spectrum, while local governments tend to spend in a manner that is likely to directly benefit the socioeconomically stratified group of taxpayers within their jurisdiction.<sup>144</sup> Whereas local governments spend on primary and secondary education for children within their jurisdiction, state governments spend on redistributive, equalizing education grants.<sup>145</sup> Local governments fund police and fire protection, utilities, and parks and recreation upkeep — all of which directly benefit local taxpayers — while state governments fund public welfare programs that benefit residents across the state, many

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139. Examples include cash assistance, housing assistance, health spending, food assistance. *Id.* at 350.

140. *Id.* at 348–49.

141. *Id.* The Government Accountability Office estimated that 73% of the \$446 billion of intergovernmental transfers from state to local governments in 2009 was spent on education, amounting to about \$327 billion. See *About InterGovernmental Revenue*, U.S. GOV'T ACCOUNTABILITY OFF., [https://www.gao.gov/fiscal\\_outlook/state\\_local\\_fiscal\\_model/interactive\\_graphic/about\\_intergovernmental\\_revenue](https://www.gao.gov/fiscal_outlook/state_local_fiscal_model/interactive_graphic/about_intergovernmental_revenue) [https://perma.cc/ND32-9B3V].

142. Shobe, *supra* note 10, at 349.

143. *Id.* at 348.

144. *Id.* at 351.

145. *Id.* at 348–49.

of whom pay little to no taxes.<sup>146</sup> Since wealthier, itemizing taxpayers tend to cluster together in local jurisdictions,<sup>147</sup> they likely receive a greater net benefit from local taxation and spending — and by extension, local tax deductibility — than they do from state taxation and spending — and by extension, state tax deductibility.

Looking beyond the data, there are three interrelated reasons why redistribution is likely to continue happening at the state level, rather than at the local level. First, due to lower costs associated with intra-state moves than inter-state moves,<sup>148</sup> as well as a wider selection of local jurisdictions, wealthy taxpayers are better *able* to move away from redistributive local jurisdictions to economically homogenous local jurisdictions than the parallel move away from redistributive states.<sup>149</sup> Second, wealthy taxpayers *desire* to move to economically homogeneous local jurisdictions because they will benefit from high-quality public goods and services at a relatively low tax rate — as few tax dollars are redistributed to the benefit of less wealthy residents.<sup>150</sup> Among these public goods and services, the most salient pull factor is school quality.<sup>151</sup> Third, while redistributive local jurisdictions cannot force wealthy taxpayers to stay, economically homogeneous local jurisdictions can keep less wealthy taxpayers out through exclusionary zoning mechanisms, thus stunting any possibility of redistribution.<sup>152</sup> Local governments use these tools to exclude residents who are expected to consume more in public goods and services than they would fund via taxes.<sup>153</sup> Because these mechanisms are unavailable to state governments, local jurisdictions are likely to continue to be far more economically homogenous than states as a whole.

This Part underscores two key conclusions. First, IRC section 164's preferential treatment of property taxes — local governments' primary revenue source — confers greater benefit on local

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146. *Id.* at 348, 350–51.

147. *See supra* note 138.

148. *See infra* note 162 and accompanying text.

149. *See Shobe, supra* note 10, at 367.

150. *See Shobe, supra* note 24 (manuscript at 12–13).

151. *See id.* (manuscript at 13–14) (describing how school quality appears to influence households' decisions to sort into economically homogeneous localities more than any other factor).

152. *See supra* note 123.

153. *See Shobe, supra* note 10, at 368. For a more detailed discussion on how local fiscal concerns motivate exclusionary zoning that, in turn, leads to income stratification, see Note, *Making Mixed-Income Communities Possible: Tax Base Sharing and Class Desegregation*, 114 HARV. L. REV. 1575, 1577–85 (2001).

governments than state governments. Second, local tax deductibility confers a greater benefit on high-income, itemizing taxpayers than state tax deductibility. This is because state spending tends to benefit a socioeconomically diverse population pool, whereas local government spending tends to benefit a socioeconomically homogeneous pool. Put simply, state governments are more redistributive than local governments. This has significant implications for future SALT reform proposals.

#### IV. POLICY RATIONALE FOR THE DISTINCTION BETWEEN STATE AND LOCAL TAX DEDUCTIBILITY

This Part argues that the federal government should treat state and local taxes independently, rather than as a single unit, for the purposes of a SALT deduction. More specifically, state taxes should be more deductible than local taxes, as policy justifications for the deduction apply more strongly to state taxes than local taxes.<sup>154</sup>

Each subpart in this Part discusses a different line of argument supporting the proposition that state taxes should be more deductible than local taxes. Part IV.A argues that since local government spending is akin to personal spending — which is rightly nondeductible — local taxes should also be nondeductible, or at least less deductible. Part IV.B makes the case that state government expenditures should be subsidized through state tax deductibility because state spending can often substitute for federal spending, while adding the benefits of more localized administration and policy diversity. Part IV.C argues that because local tax deductibility benefits the wealthy more than state tax deductibility does, local taxes should be less deductible than state taxes from a redistributive perspective. Part IV.D points out that this recommended policy approach is likely to be politically popular as well.

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154. For an overview of the legislative history of the SALT deduction and common arguments made in favor of and against it, see *supra* Part II.



### A. LOCAL GOVERNMENT SPENDING IS AKIN TO PERSONAL SPENDING

It is a fundamental tenet of the IRC that personal expenses are not deductible.<sup>155</sup> If personal expenses were deductible and thus omitted from the taxable income base, the federal government would have to dramatically increase tax rates to raise the same amount of revenue.<sup>156</sup>

As discussed in Part III.B, local government spending is likelier to provide greater net benefit to the taxpayer funding that spending than state government spending, which tends to be more redistributive.<sup>157</sup> Direct benefits provided by local government spending include primary and secondary education, utility service, police and fire protection, and parks and recreation.<sup>158</sup>

This close relationship between taxes paid and benefits received more closely resembles the structure of ordinary personal consumption than that of state or federal taxation, where the benefits tend to be far more dispersed, particularly among those paying little to nothing in taxes.<sup>159</sup> A taxpayer paying local taxes in return for a direct benefit is economically similar to a consumer purchasing a good or service that confers a direct benefit.<sup>160</sup> Further, like personal spending but unlike state or federal spending, local government spending can be described as an actively chosen consumption choice due to taxpayers' greater ability to move between local jurisdictions than between state or federal jurisdictions, as well as their greater knowledge of local government benefits.<sup>161</sup> It is far

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155. See I.R.C. § 262 (2018) (“Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.”); Shobe, *supra* note 10, at 358.

156. Tax revenue can be described as the tax base multiplied by the tax rate. If the tax base decreases, the tax rate must be increased to maintain the same level of tax revenue. See Julia Kagan, *Tax Base*, INVESTOPEDIA (June 5, 2020), <https://www.investopedia.com/terms/t/taxbase.asp> [<https://perma.cc/R2D4-6YLJ>] (“To calculate the total tax liability, you must multiply the tax base by the tax rate[.]”).

157. See Shobe, *supra* note 10, at 358.

158. See *supra* Part III.B.

159. See *supra* Part III.

160. See Shobe, *supra* note 10, at 358. In theory, according to this analogy, taxpayers should be allowed a deduction for the difference between taxes paid and local government benefits received — if the former is greater than the latter. However, administrability issues arising from the difficulty of quantifying the amount of “benefit” counsel in favor of a bright-line deduction rule. See *id.* at 360.

161. See Shobe, *supra* note 10, at 360–63; Galle, *supra* note 64, at 824–30. It is worth noting that high-income taxpayers likely have greater ease of mobility than low-income

less of a mental, emotional, and financial burden for a family to move to a nearby locality with a preferable fiscal regime than to move to another state or country for the same reason.<sup>162</sup> Moreover, taxpayers tend to have more information on local spending — particularly school quality — than state spending.<sup>163</sup>

From a policy perspective, these considerations favor reducing or eliminating local tax deductibility. Recall that the Treasury Department, in its 1984 report to the President, argued that because state and local taxes fund services directly benefitting state and local taxpayers, the SALT deduction as a whole is no more justifiable than a deduction for all private spending.<sup>164</sup> However, as discussed, this argument applies much more strongly to local taxes than state taxes, as local tax payments are far more likely to fund services benefitting that taxpayer than state tax payments, and are far more likely to be a freely chosen consumption choice.

Further, given the similarity between local government spending and personal spending, locally provided benefits are more likely to be provided at an optimal level than state-provided benefits.<sup>165</sup> Because taxpayers see the close connection between local taxes paid and benefits received (as they do with private consumption and its benefits), they are more likely to be willing to pay these taxes to support local public goods and services.<sup>166</sup> However, because state taxes are more likely to be spent in a redistributive manner, taxpayers may not be as willing to pay these taxes to support sufficient state public goods and services.<sup>167</sup> Even the 1984 Treasury Department, which argued for a complete repeal of the SALT deduction, conceded that the deduction could be justified

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taxpayers, as they possess greater financial resources and are less likely to be impeded by exclusionary zoning measures.

162. See Shobe, *supra* note 10, at 362–63. Examples of financial costs associated with moving between jurisdictions include costs of physically moving belongings, time costs associated with seeking employment and finding a new residence, and childcare costs (especially if family or friends had been providing childcare in the taxpayer's previous location). Non-financial costs may include discomfort caused by unfamiliarity, and reduced proximity to family, friends, and desired recreational opportunities. *Id.* at 362. All of these costs are more pronounced for moves between states and nations than moves between local jurisdictions within a state. *Id.* at 363, 365.

163. *Id.* at 363–65.

164. See *supra* Part II.A; 1 U.S. DEP'T OF TREASURY, *supra* note 10, at 78.

165. See Shobe, *supra* note 10, at 353–54.

166. See *id.*; see also WILLIAM A. FISCHER, THE HOMEVOTER HYPOTHESIS: HOW HOME VALUES INFLUENCE LOCAL GOVERNMENT TAXATION, SCHOOL FINANCE, AND LAND-USE POLICIES 4 (2001) (describing how homeowners pay close attention to local taxation and spending policies due to their direct impact on home values).

167. See Shobe, *supra* note 10, at 353–54.

“only if there is reason to believe that the subsidized activities would otherwise be carried on at too low a level. . . .”<sup>168</sup> The redistributive nature of state government spending provides such a reason.

#### B. STATE GOVERNMENT EXPENDITURES ARE A PREFERABLE SUBSTITUTE TO FEDERAL GOVERNMENT EXPENDITURES

If local government expenditures are properly analogized to personal expenses, state government expenditures can be properly analogized to federal government expenditures.<sup>169</sup> Similar to the federal government, state governments spend in a redistributive manner in which well-off taxpayers often do not receive a benefit commensurate with their state tax payments.<sup>170</sup> Given this similarity, along with the benefits of more localized administration<sup>171</sup> and state autonomy, the federal government should incentivize state provision of goods and services through a magnified deduction for state tax payments. Currently, the federal government furthers its redistributive goals largely through mammoth grants-in-aid to state governments.<sup>172</sup> A broader state tax deduction would help encourage the funding of redistributive programs currently funded through such grants-in-aid to the state level — incentivizing more progressive state taxation schemes in the process.<sup>173</sup> At the very least, reverting the state tax deduction to the pre-TCJA status quo will help prevent further fiscal centralization at the national level.

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168. See *supra* note 45 and accompanying text; 1 U.S. DEPT OF TREASURY, *supra* note 10, at 78.

169. See Shobe, *supra* note 10, at 374 (“[S]tate expenditures are similar in many aspects to the types of items funded by the federal government and therefore may serve as a substitute for federal spending.”).

170. See *id.*; *supra* Part III.B.

171. Scholars describe such benefits through the principle of subsidiarity — that taxes should be assessed by the lowest level of government capable of effectively providing a good or service. For a more detailed discussion on the benefits of subsidiarity, see Shobe, *supra* note 10, at 354–55.

172. See DILGER & CECIRE, *supra* note 58, at 1 (“In [Fiscal Year 2019], the federal government is expected to provide state and local governments about \$750 billion in federal grants encompassing a wide range of public policy areas, such as health care, transportation, income security, education, job training, social services, community development, and environmental protection. Federal grants account for just under one-third of total state government funding[.]”).

173. See *supra* Part II.C for a discussion of how the SALT deduction stimulates more progressive state and local tax regimes.

Before delving into how an expanded state tax deduction might help shift redistributive federal programs to the state level and why this shift is desirable, it is worth briefly discussing why governments should perform a redistributive function at all. While this Note cannot begin to present and analyze all the justifications and criticisms of redistribution proposed in the academic literature and public policy arena, this paragraph highlights a few. Redistribution has been justified as part of a society's moral imperative to improve the conditions of its worst-off members.<sup>174</sup> It has also been justified under the economic principle of diminishing marginal utility: because the value of an additional dollar to an individual declines as the number of dollars she owns increases, the government should redistribute money from the wealthy to the poor to maximize societal happiness.<sup>175</sup> Moreover, redistribution may lead to greater occupational and geographic mobility, improving the economy as a whole.<sup>176</sup> Meanwhile, critics posit that it is morally impermissible to compel redistribution through compulsory taxation,<sup>177</sup> and that redistribution destroys people's incentives to work, invest, and generate output.<sup>178</sup>

Shifting back from redistribution theory to this section's primary argument: in the current redistribution system, the federal government provides grants-in-aid to states, which then use that grant money to help fund a wide array of public goods and services.<sup>179</sup> The flow of money often looks like this: taxpayer → federal government → state government → taxpayer or public good. Examples of this phenomenon include Medicaid,<sup>180</sup> Temporary

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174. See generally JOHN RAWLS, *A THEORY OF JUSTICE* (1971).

175. See, e.g., Sarah Lawsky, *On the Edge: Declining Marginal Utility and Tax Policy*, 95 MINN. L. REV. 904, 906–07 n.14 (2011) (providing a list of tax law articles that reach policy recommendations based on an assumption of diminishing marginal utility).

176. See Adriana Kugler, *The Impact of Tax and Transfer Programs on Risk-Taking Behavior and Labor Mobility*, CTR. FOR AM. PROGRESS (Dec. 4, 2013), <https://www.american-progress.org/issues/economy/reports/2013/12/04/80370/the-impact-of-redistributive-tax-and-transfer-programs-on-risk-taking-behavior-and-labor-mobility/> [https://perma.cc/R7WX-Y9Z3].

177. See Barry Christian, *Redistribution*, STAN. ENCYCLOPEDIA PHIL. (Spring 2018), <https://plato.stanford.edu/archives/spr2018/entries/redistribution/> [https://perma.cc/N5XL-HFY3].

178. See Richard B. McKenzie, *Taxation and Income Redistribution: An Unsympathetic Critique of Practice and Theory*, 1 CATO J. 339, 339, 355 (1981).

179. See DILGER & CECIRE, *supra* note 58, at 9.

180. *Financial Management*, MEDICAID.GOV, <https://www.medicaid.gov/medicaid/financial-management/index.html> [https://perma.cc/YW9K-BX7E] (last visited Nov. 29, 2020).

Assistance for Needy Families (TANF),<sup>181</sup> and highway funding.<sup>182</sup> By subsidizing state governments, an increased deduction for state taxes would likely incentivize state governments to spend more on such goods and services, thus reducing the amount needed from the federal government.<sup>183</sup> In effect, this deduction would encourage a shift in the provision of some of these programs to the state level.<sup>184</sup> Moreover, as discussed in Part II.B, state tax deductibility would provide states greater autonomy than grants-in-aid, which often come attached with restrictive conditions.<sup>185</sup>

However, this argument is also open to criticism. First, it may not be desirable to shift the provision of public goods and services from the federal to the state level. Professor Kirk Stark, for instance, argues that redistributive policies should be centralized at the highest level of government to eliminate financial incentives for strategic migration.<sup>186</sup> Without such centralization, the wealthy would have incentive to escape redistribution and the poor would have incentive to take advantage of redistribution.<sup>187</sup> Stark also believes that redistribution at the state and local level is likely to create spillover benefits<sup>188</sup> for other jurisdictions, resulting in too little redistribution.<sup>189</sup> Finally, Stark argues that centralization of redistribution would create efficiencies in the provision of public goods and services that would not be achieved otherwise.<sup>190</sup>

While Stark raises several legitimate criticisms of a shift from the federal grants-in-aid system to direct state-level funding and provision of redistributive programs, he discounts several major

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181. *What is TANF?*, U.S. DEP'T OF HEALTH & HUMAN SERVS., <https://www.hhs.gov/answers/programs-for-families-and-children/what-is-tanf/index.html> [https://perma.cc/GBZ3-MY88] (last visited Nov. 29, 2020).

182. *Federal-Aid Highway Program*, FED. HIGHWAY ADMIN., U.S. DEP'T OF TRANSP., <https://www.fhwa.dot.gov/federal-aidessentials/federalaid.cfm> [https://perma.cc/7MZ3-4YXZ] (last visited Nov. 29, 2020).

183. See Galle, *supra* note 85, at 675 (acknowledging that the SALT deduction incentivizes a shift in the provision of public goods and services from the federal government to state and local governments, but argues that the deduction may be an imperfect tool for accomplishing this end).

184. See *id.*

185. See *supra* Part II.B.

186. Stark, *supra* note 10, at 1408.

187. *Id.* But see Shobe, *supra* note 10, at 365–66 (“Recent studies demonstrate[] . . . that there is very little migration of the wealthy between states as a result of tax burdens. There is also no evidence of significant tax-based migration even though there are many states from which to choose with wildly varying tax structures[.]”).

188. See Stark, *supra* note 10, at 1408. For an overview of spillovers, see *supra* note 48 and accompanying text.

189. See Stark, *supra* note 10, at 1408.

190. See *id.* at 1433.

advantages of such a shift. First, states can serve as laboratories for policy experimentation, leading to the development of innovative programs.<sup>191</sup> While federal grants-in-aid do not inherently preclude such beneficial experimentation, in practice, they are often accompanied by restrictive conditions on the acceptance and use of funds.<sup>192</sup> Second, state and local governments are better at responding to taxpayers' policy preferences because each voter has more influence and each representative represents fewer citizens.<sup>193</sup> Third, due to this responsiveness, taxpayers may identify more strongly with state and local governments and thus be more willing to pay taxes and comply with tax law.<sup>194</sup> Scholars have described such benefits of local administration through the principle of subsidiarity — that taxation should occur at the lowest level of government capable of effectively providing a good or service.<sup>195</sup>

Another line of arguments against broadening the state tax deduction concerns not the desirability of a shift in taxation and spending from the federal to the state level, but rather the efficacy of a state tax deduction in accomplishing this end. The efficacy argument takes two major forms. First, even if a state tax deduction does subsidize state government spending, it is unclear whether states would actually choose to spend more on public programs.<sup>196</sup> Second, it is possible that if some states choose to fund programs that the federal government finds desirable, but other states choose not to fund such programs, the federal government might simply “bail out” the latter group of states by providing the funds itself through grants-in-aid. If this were the case, states might be much less likely to choose to fund programs themselves. This can be described as a moral hazard problem.

In response to the first criticism, it is of course possible that states might choose to maintain the same taxation and spending

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191. One example of this phenomenon is the Affordable Care Act, modeled off of a Massachusetts state program. See Edmund Andrews, *Steven Callender: How to Make States “Laboratories of Democracy”*, STAN. GRADUATE SCH. BUS.: INSIGHTS BY STAN. BUS. (May 19, 2015), <https://www.gsb.stanford.edu/insights/steven-callender-how-make-states-laboratories-democracy> [<https://perma.cc/545R-U5RS>].

192. See *supra* note 89; Mason, *supra* note 82, at 1028.

193. See Shobe, *supra* note 10, at 354–55.

194. See *id.* at 355.

195. See *id.* at 354–55.

196. For example, some states refused to expand Medicaid, even though states were only expected to provide a small fraction of the funding. See Phil McCausland, *Residents Suffer as Mississippi and 13 Other States Debate Medicaid Expansion*, NBC NEWS (Nov. 4, 2019), <https://www.nbcnews.com/news/us-news/residents-suffer-mississippi-13-other-states-debate-medicaid-expansion-n1075661> [[perma.cc/22BS-Z59H](https://perma.cc/22BS-Z59H)].

policies regardless of the presence of a state tax deduction. However, such states would essentially be turning down free funds and indirectly subsidizing higher-tax states who do take advantage of such a federal subsidy.<sup>197</sup> Moreover, Professor Gilbert Metcalf has found empirical support for the proposition that SALT deductibility increases state and local spending out of own-source revenue.<sup>198</sup>

The presence of the “bail out” problem described in the second criticism depends on federal policy decisions. Certainly, if the federal government chooses to provide grants-in-aid for desired programs, states will be disincentivized from funding these programs themselves. However, this problem can be mitigated if the federal government limits its aid to matching grants<sup>199</sup> or to a certain percentage of the program’s cost, and reserves such grants only for the most important of programs. Such a system would place fiscal pressure, and thus political pressure, on a state to partially fund the desired program, thus sparing the federal government from bearing the full cost. If a state chooses not to fund the federally desired program due to a lack of resources — as opposed to a lack of political will — the federal government could consider a system of variable matching grants, in which the federal government provides larger matching grants for states with a smaller tax base. An alternative solution — more stick than carrot — might be to impose an automatic tax on residents of the non-funding state. This additional federal tax revenue could be put in a lockbox to be used exclusively to fund the federally desired program in the state at issue.<sup>200</sup>

### C. LOCAL TAX DEDUCTIBILITY BENEFITS THE WEALTHY MORE THAN STATE TAX DEDUCTIBILITY

As explained in Part II.C *supra*, the financial benefits of the SALT deduction primarily accrue to wealthy taxpayers, making

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197. This argument was made in the Treasury Department’s 1984 report to the president, as discussed in Part II.A. See 1 U.S. DEPT OF TREASURY, *supra* note 10, at 80–81.

198. See Metcalf, *supra* note 103, at 588.

199. See *supra* note 91.

200. This approach may face constitutional issues, particularly regarding the Uniformity Clause and coercion. However, precedent favors broad federal latitude on both of these issues. See *United States v. Ptasynski*, 462 U.S. 74, 84 (1983) (unanimously holding that an exemption for Alaskan oil from the Crude Oil Windfall Profits Tax Act of 1980 did not violate the Uniformity Clause); *South Dakota v. Dole*, 483 U.S. 203, 206 (1987) (allowing Congress to condition grants to states on state implementation of policies falling outside of Congress’s enumerated powers).

the federal tax code less progressive.<sup>201</sup> While this is the case for both state and local taxes, deductibility of local taxes benefits the wealthy more than deductibility of state taxes because of the redistributive nature of state taxes.<sup>202</sup> Deductibility of local taxes confers two substantial benefits on wealthy taxpayers: (1) a deduction and (2) direct benefits from local spending subsidized by the deduction.<sup>203</sup> However, deductibility for state taxes only confers the benefit of a deduction, as the induced state spending is likely to primarily consist of redistributive spending that does not directly benefit wealthy taxpayers.<sup>204</sup> Thus, the regressive nature of the SALT deduction is more pronounced for a local tax deduction than a state tax deduction.<sup>205</sup>

Further, eliminating or reducing the deduction for local taxes might help mitigate income stratification between local jurisdictions.<sup>206</sup> An elimination or reduction in local tax deductibility would decrease the subsidy flowing to economically homogeneous localities.<sup>207</sup> In response, local governments might be pushed to merge or consolidate services with neighboring localities to reduce their operating costs.<sup>208</sup> This, in turn, might lead to greater economic diversity within local jurisdictions.<sup>209</sup>

More importantly, by reducing the subsidy flowing to economically homogeneous local jurisdictions, a reduction in local tax

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201. See *supra* Part II.A.

202. See Shobe, *supra* note 10, at 376.

203. For a discussion of how local government spending tends to directly benefit taxpayers funding that spending, see *supra* Part III.B. See also Shobe, *supra* note 24 (manuscript at 31) (“[T]he local tax deduction disproportionately subsidizes wealthy localities . . . and wealthy taxpayers who live in those wealthy, economically segregated localities [who] can keep that subsidy for themselves due to minimal redistribution within economically homogeneous localities.”).

204. See *supra* Part III.

205. See Shobe, *supra* note 10, at 376.

206. See *supra* note 138 and accompanying text.

207. See *supra* note 24.

208. A panel of tax experts and lawmakers in New Jersey has recently proposed mandating such municipal mergers for towns with populations less than 5,000 to reduce costs. See Max Cohen, *Is Time Up for Tiny Towns in New Jersey? Some Say Mergers Would Save Money and Lower Taxes, but Skeptics Disagree*, PHILA. INQUIRER (July 3, 2018), [https://www.inquirer.com/philly/news/new\\_jersey/consolidation-new-jersey-small-town-taxes-municipal-mergers-20180703.html](https://www.inquirer.com/philly/news/new_jersey/consolidation-new-jersey-small-town-taxes-municipal-mergers-20180703.html) [<https://perma.cc/Q6K6-BMPY>]; Stephen Stirling, *Merging 191 of N.J.'s Smallest Towns? It's on the Table. Here's Which Ones Would Get the Ax*, N.J.COM (June 21, 2018), [https://www.nj.com/data/2018/06/merging\\_191\\_of\\_njs\\_smallest\\_towns\\_its\\_on\\_the\\_table\\_heres\\_which\\_ones\\_would\\_get\\_the\\_ax.html](https://www.nj.com/data/2018/06/merging_191_of_njs_smallest_towns_its_on_the_table_heres_which_ones_would_get_the_ax.html) [[perma.cc/CEZ6-GP3N](https://perma.cc/CEZ6-GP3N)].

209. For a related discussion on how regionalizing local property taxes would promote socioeconomic integration, see Note, *supra* note 153, at 1577–85.



deductibility would also reduce the incentive for the wealthy to congregate in such jurisdictions.<sup>210</sup> As described earlier, wealthy taxpayers seek out economically homogeneous local jurisdictions to benefit from high-quality public goods and services at a relatively low tax rate.<sup>211</sup> A reduction in local tax deductibility — and its corresponding subsidy to local governments and their denizens — would force these taxpayers to pay more in taxes for the same quality of goods and services. This, in turn, would reduce the draw of these localities to wealthy taxpayers, and thus engender economic diversity at the local level.<sup>212</sup>

#### D. GREATER DEDUCTIBILITY FOR STATE TAXES THAN LOCAL TAXES IS LIKELY TO BE POLITICALLY POPULAR

While the previous subparts provided theoretical and empirical justification for greater state tax deductibility than local tax deductibility, this subpart argues that such a distinction is likely to be politically popular as well. Liberal-leaning taxpayers would support it because it encourages states to provide important public goods and services like education, infrastructure, and welfare through a more progressive taxation scheme, and mitigates the regressive nature of the current SALT deduction. Conservative-leaning taxpayers would support it because it reduces the size and role of the federal government — particularly agencies whose *raison d'être* is doling out grants to states — and furthers goals of state autonomy, state policy innovation, and localized administration.

#### V. WHAT FORM SHOULD THE SALT DEDUCTION TAKE?

Thus far, this Note has provided theoretical, empirical, and pragmatic justifications for the proposition that state taxes should

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210. See Shobe, *supra* note 24 (manuscript at 33) (“Because the local tax deduction allows relatively wealthy localities to provide better goods and services at a cheaper cost than they could in the absence of the deduction, the deduction changes the cost/benefit analysis in favor of those localities for those who can afford to choose to live there.”).

211. See *supra* Part III.B.

212. For a more complete discussion of the relationship between the local tax deduction and economic segregation, see Shobe, *supra* note 24 (manuscript at 32–36). For a discussion of the harms caused by economic segregation, see Shobe, *supra* note 24 (manuscript at 15–23).

be more deductible than local taxes. However, it has not yet discussed the ideal form of such a deduction scheme. More broadly, it has not yet addressed whether a SALT deduction is even the best means of subsidizing state and local governments — as compared to direct grants or tax credits. This Part is dedicated to addressing these questions. Part V.A discusses the ideal form of a SALT deduction scheme, including the specific ways in which state and local taxes should be treated differently and whether the SALT deduction should be itemized or above-the-line.<sup>213</sup> Part V.B discusses the merits and drawbacks of alternative and supplementary methods of subsidies to state governments.

#### A. HOW SHOULD THE SALT DEDUCTION BE ALTERED TO ALLOW FOR GREATER DEDUCTIBILITY OF STATE TAXES THAN LOCAL TAXES?

There are four primary means by which the SALT deduction can be altered to allow for greater deductibility of state taxes than local taxes — two targeting a type of tax, and two targeting the level of government.

The first approach to amending the SALT deduction would disallow or limit the deduction for property taxes, the primary revenue source for local governments.<sup>214</sup> To further target this change at local governments, the revised statute could specifically disallow or limit the deduction for *local* property taxes, as opposed to *all* property taxes. The primary benefit of this approach is simplicity of statutory drafting. All it would require is a basic change to the language of section 164 of the Internal Revenue Code, either eliminating (local) property taxes from the list of enumerated deductible taxes in section 164(a) or putting a cap on the deductibility of (local) property taxes.<sup>215</sup> The primary downside of this approach is that local governments would be able to evade the policy's intended effect by shifting their revenue source away from a property tax and toward an income or sales tax.<sup>216</sup> Moreover, this approach

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213. An above-the-line deduction would allow *all* taxpayers — not just itemizing taxpayers — to deduct a specified amount from their taxable income. For a list of above-the-line deductions, see I.R.C. § 62 (2018).

214. See *supra* Part III.A.

215. See I.R.C. § 164(a) (2018).

216. Note that similar arguments about distortionary effects were made by the House Ways and Means Committee about the Revenue Act of 1964 and the Treasury Department about the Tax Reform Act of 1986. See *supra* Part II.A.

would disproportionately hurt taxpayers residing in property tax-reliant local jurisdictions without any legitimate policy justification for such disparate treatment.

The second approach would maintain or increase the deductibility of income and sales taxes, the primary revenue source for state governments.<sup>217</sup> To ensure that this change is targeted at state governments, the revised statute could specifically maintain or increase the deduction for *state* income and sales taxes, as opposed to *local* income and sales taxes. Perhaps the easiest way of increasing deductibility would be to revert to the pre-1986 version of the SALT deduction, in which both income and sales taxes were fully deductible, as opposed to merely the taxpayer's choice of one or the other.<sup>218</sup> The primary benefit of this approach is, again, simplicity of statutory drafting. It merely requires a basic amendment to the language of section 164, eliminating the taxpayer choice provided in section 164(b)(5)(A) and adding sales taxes (or specifically, statewide sales taxes) to the enumerated list of deductible taxes in section 164(a).<sup>219</sup> The primary downsides of this approach are the administrative complexity associated with estimating sales tax payments<sup>220</sup> and the distortionary effect it would have on state government fiscal decisions.<sup>221</sup>

The third method would be to disallow or limit a deduction for all local taxes. The primary benefits of this approach are that it would not distort local government fiscal decisions toward or away from a specific type of tax, and it would not inequitably affect certain taxpayers based on their local government's choice of tax type. It would also be relatively easy to draft such a change to section 164; either the word "local" could be eliminated from the provision or a cap — either by percentage or dollar amount — could be imposed on the deductibility of local taxes.<sup>222</sup> Moreover, this approach would also likely limit or eliminate the deductibility of local taxes against state taxable income, as state tax schemes are generally modeled off of the federal tax scheme.<sup>223</sup>

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217. See *supra* Part III.A.

218. See Revenue Act of 1964, Pub. L. No. 88-272, § 207(a), 78 Stat. 19, 40 (1964) (codified as amended at I.R.C. § 164(a) (2018)).

219. See I.R.C. § 164 (2018).

220. See Shobe, *supra* note 10, at 383.

221. Those state governments that do rely on property taxes as a revenue source would be incentivized to shift toward using an income or sales tax, thus distorting their fiscal decisions.

222. See I.R.C. § 164 (2018).

223. See *supra* Part III.A.

The primary weakness of this approach is that it would hurt large municipalities that are state-like in their economic heterogeneity and redistributive spending activities. Large cities spend far more on redistributive expenditures per capita than suburban municipalities.<sup>224</sup> Moreover, a class of spending that may not be redistributive in a socioeconomically homogeneous suburban community is likely to be redistributive in a socioeconomically diverse large city. Education spending is a prime example.<sup>225</sup> In a wealthy suburb, many families may be funding close to the cost of their children's education via taxes, making education spending non-redistributive. However, in a socioeconomically diverse city where some families do not have sufficient income to fund the cost of their children's education via taxes, education spending is more redistributive.

The fourth method would be to maintain or increase the deductibility of all state taxes. The primary benefits of this approach are similar to those of the third approach: simplicity of statutory drafting, lack of distortion of state fiscal decisions toward or away from a specific type of tax, and consistent treatment of taxpayers residing in local jurisdictions that are reliant on different types of tax. The primary downside of this approach would be the administrative complexity associated with estimating sales tax payments.

It is worth mentioning that deductibility can be increased — as proposed in the second and fourth methods of reforming SALT — by making the deduction above-the-line,<sup>226</sup> rather than itemized. Post-TCJA, only 10% of American households are expected to itemize;<sup>227</sup> making the deduction above-the-line would greatly expand the pool of taxpayers benefitting from the deduction. While this approach should be considered, it is not the optimal means of reforming SALT for a couple of reasons. First, the standard deduction is best understood as a floor for itemized deductions for low-income taxpayers whose itemized deductions would otherwise be

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224. See Steven G. Craig et al., *Why Do Big Cities Redistribute Income Out of Own Source Revenue?* 2 (Univ. of Hous. Working Paper, 2014), [https://www.uh.edu/~kohlhase/CraigKohlhaseCityRedist\\_WP\\_Dec\\_2014.pdf](https://www.uh.edu/~kohlhase/CraigKohlhaseCityRedist_WP_Dec_2014.pdf) [<https://perma.cc/WF33-NREB>] (“The 53 largest cities spend over \$137 per capita [on redistributive expenditure] in real terms, and New York City spent \$1,750 per capita, while suburbs of these same large cities on average spend \$36 per capita on redistributive expenditure.”).

225. See RUSSELL SAGE FOUND., *DUAL CITY: RESTRUCTURING NEW YORK* 108 (John H. Mollenkopf & Manuel Castells eds., 1992) (discussing the redistributive impact of public education spending in New York City).

226. See *supra* note 213.

227. See *What is the Standard Deduction?*, *supra* note 99.

of relatively small amounts.<sup>228</sup> This perspective helps mitigate the seemingly inequitable effects of maintaining SALT as an itemized deduction. Put differently, the reason itemized deductions do not benefit low-income taxpayers is because the standard deduction provides an *even greater* benefit. Second, and more importantly, keeping SALT as an itemized deduction incentivizes more progressive state taxation.<sup>229</sup> Because an itemized SALT deduction disproportionately benefits wealthier taxpayers, state and local governments have an incentive to structure their own tax systems in a more progressive way, so as to shift more of the burden onto higher-income taxpayers.<sup>230</sup>

The ideal SALT deduction reform should look like a combination of the third and fourth methods discussed in order to limit distortion of state and local fiscal decisions toward or away from certain types of tax. More specifically, the reformed deduction should allow taxpayers to fully deduct all state *and* local taxes, including both sales and income taxes, as the benefits associated with increased state tax deductibility and reduced distortionary impact outweigh the costs associated with estimating sales tax payments. To limit local tax deductibility, the reformed deduction should institute a cap on local tax deductibility, similar to the TCJA's cap on all SALT deductibility.<sup>231</sup> Capping, rather than eliminating, the local tax deduction strikes the proper balance. It reduces local tax deductibility while mitigating the reform's negative impact on state-like municipalities and relatively less wealthy itemizing taxpayers, who will still be able to deduct a substantial portion of their local tax payments under this scheme.

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228. See *supra* note 4.

229. See *supra* Part II.C.

230. *Id.* For an empirical demonstration of this relationship, see Chernick, *supra* note 104.

231. This proposal requires only a couple basic amendments to the current version of section 164. First, the revision should eliminate the taxpayer choice provided in section 164(b)(5)(A) and add state and local sales taxes to the enumerated list of deductible taxes in section 164(a). Next, the cap in section 164(b)(6)(B) should be modified to state that “the aggregate amount of local real property taxes, local personal property taxes, local income, war profits, and excess profits taxes, and local sales taxes taken into account under subsection (a) for any taxable year shall not exceed [a specified cap amount].”

## B. IS A DEDUCTION THE OPTIMAL FORM OF FEDERAL SUBSIDY TO STATE AND LOCAL GOVERNMENTS?

This Note has made the case that SALT reform should make state taxes more deductible than local taxes and has discussed the optimal way to institute such reform. However, the question remains whether SALT deductibility is the best means of subsidizing subnational governments. This Part addresses the merits and drawbacks of SALT deductibility as a method of providing subsidies to subnational governments, as compared to two alternative methods: direct subsidies and tax credits. It concludes that direct grants should be used in conjunction with SALT deductibility, and that tax credits are a promising, but understudied, alternative to SALT deductibility.

### 1. *SALT Deductibility vs. Direct Subsidies*

Various scholars and institutions have argued that the SALT deduction should be eliminated in favor of direct subsidies to state and local governments. As discussed in Part II.A *supra*, the Treasury Department advocated for direct federal outlays as a more efficient and cost-effective form of subsidy.<sup>232</sup> Professor Brian Galle points out that direct grants may be a more efficient form of subsidy because a deduction “does not necessarily deliver money to states on a dollar-for-dollar basis[.]”<sup>233</sup> Rather, the magnitude of the deduction’s subsidy depends on state and local government fiscal policies.<sup>234</sup> Professor Louis Kaplow notes that direct subsidies are preferable to deductibility for three main reasons: (1) direct subsidies are less regressive than deductions, which favor high-income taxpayers; (2) direct subsidies are better able to target certain activities deemed more deserving of a federal subsidy; and (3) direct subsidies allow for greater transparency and accountability than deductibility, which is a more opaque form of subsidy.<sup>235</sup> Additionally, unlike the SALT deduction, direct subsidies do not favor jurisdictions more capable of and more willing to impose higher taxes on their taxpayers.<sup>236</sup>

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232. See 1 U.S. DEP’T OF TREASURY, *supra* note 10, at 80.

233. Galle, *supra* note 85, at 694.

234. *Id.*

235. See Kaplow, *supra* note 95, at 484–86.

236. See *supra* Part II.C.

Other scholars disagree, arguing that SALT deductibility is preferable to direct aid as a form of subsidy. Professor Ruth Mason has praised the SALT deduction for being a less restrictive form of federal aid to states than direct grants that often come with strings attached.<sup>237</sup> Mason notes that the SALT deduction gives states more latitude to enact policies different from or at odds with federally desired policies, thus advancing goals of state autonomy and innovation.<sup>238</sup> While a matching grant system with no conditions or restrictions would have the same effect from the federal government's perspective,<sup>239</sup> it is unlikely that the federal government would agree to this approach given its broad power to advance federal goals through conditional grants.<sup>240</sup> Professors Daniel Hemel and Gilbert Metcalf note that SALT deductibility encourages more progressive state and local taxation schemes.<sup>241</sup> Direct subsidies would not have this effect. And Professors Feldstein, Metcalf, and Galle have theorized that SALT deductibility may actually be a more cost-effective and efficient method of stimulating state and local spending than direct federal grants.<sup>242</sup>

Amidst this debate on the merits of deductibility vis-à-vis direct subsidies, there seems to be a basic consensus on a few points. Deductibility gives state and local governments greater policy autonomy than direct subsidies,<sup>243</sup> while direct subsidies allow the federal government to target the subsidies at state and local government activities it deems more deserving.<sup>244</sup> Deductibility has a more regressive effect than direct subsidies,<sup>245</sup> but incentivizes more progressive state and local taxation schemes.<sup>246</sup> And lastly, while deductibility favors jurisdictions more capable of and more

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237. See Mason, *supra* note 82, at 1023.

238. *Id.* at 1028.

239. See *supra* note 92.

240. See, e.g., *South Dakota v. Dole*, 483 U.S. 203, 206 (1987) (allowing Congress to condition grants to states upon state implementation of policies falling outside of Congress's enumerated powers).

241. Hemel, *supra* note 58, at 158; Metcalf, *supra* note 103, at 588.

242. See Feldstein & Metcalf, *supra* note 24, at 728–30; Galle, *supra* note 85, at 694 (suggesting that, due to cognitive biases, the SALT deduction could make voters in net-payer states — i.e., states with a negative balance of payments with the federal government — more willing to shoulder their role as net-payers).

243. See Mason, *supra* note 82, at 1023, 1028.

244. See *supra* note 89 and accompanying text. The federal government may want to target subsidies at state and local government programs that are redistributive or that have positive spillover effects, as opposed to those that are more akin to personal consumption.

245. See 1 U.S. DEP'T OF TREASURY, *supra* note 10, at 78, 80.

246. See Hemel, *supra* note 58, at 161; Metcalf, *supra* note 103, at 588; *supra* text accompanying note 241.

willing to impose high taxes on their taxpayers,<sup>247</sup> direct subsidies can target state and local governments with lesser fiscal capacity.

Despite disagreements in the literature, it is clear that both a SALT deduction and direct subsidies should have a place in the federal government's toolbox. Direct subsidies are the optimal tool to make up for the shortcomings of SALT deductibility as a federal subsidy. Direct conditional grants should be used to ensure funding for programs that the federal government deems of the utmost importance or that require multi-state cooperation.

However, such conditional grants to states should be used sparingly in order to remain consistent with the goals of state autonomy discussed in this Note. Although such direct grants will disincentivize states from funding some programs themselves, the federal government can utilize a matching grant system to encourage states to provide partial funding.<sup>248</sup> Moreover, conditional grants to large, state-like municipalities may help mitigate the harm that reduced local tax deductibility will impose on these local governments. Direct subsidies are also necessary to ensure that state governments with less fiscal capacity are able to adequately provide for their citizens. This supplementary support could take the form of variable matching grants, in which the federal government provides larger matching grants for states with less fiscal capacity. It could also take the form of direct grants, perhaps similar to the fiscal equalization regimes common in other countries.<sup>249</sup>

## 2. *SALT Deductibility vs. SALT Tax Credits*

While the academic literature has not devoted much attention to the merits of tax credits<sup>250</sup> as a replacement for SALT

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247. See *supra* note 56 and accompanying text.

248. See *supra* note 91; *supra* text accompanying note 199.

249. See Kirk J. Stark, *Rich States, Poor States: Assessing the Design and Effect of a U.S. Fiscal Equalization Regime*, 63 TAX L. REV. 957, 957 (2010) ("Australia, Canada, Germany, India, South Africa, and numerous other federations throughout the world have in place a complex system of 'equalization grants' whereby the central government makes fiscal transfers to ensure that resources available to state or provincial governments do not exhibit significant variation. . . . For example, § 36 of the Canadian Constitution envisions federal equalization policies designed 'to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.'").

250. Tax credits directly offset a taxpayer's tax burden. For example, a tax credit of \$100 allows a taxpayer to subtract \$100 from their total tax liability. This is distinct from a deduction, which indirectly reduces a taxpayer's tax burden by decreasing their taxable income. See *supra* note 2.



deductibility, there is evidence that tax credits may be a promising alternative, mitigating some of the issues of deductibility. Mechanically speaking, a SALT tax credit would consist of a federal tax credit — equal to all or some portion of the taxpayer’s state and/or local tax burden — that would be used to offset the taxpayer’s federal tax liability.

Economist Gilbert Metcalf found that replacing the SALT deduction with a 15% tax credit,<sup>251</sup> available to both itemizers and non-itemizers, would reduce the regressive impact of the SALT deduction — as its direct benefit would accrue to all, rather than just to itemizing taxpayers — while still encouraging progressive taxation schemes at the state and local level.<sup>252</sup> Such a 15% SALT tax credit may be a better method of subsidy to subnational governments than deductibility. However, there are ways to mitigate the regressive impact of the SALT deduction, even while retaining its general structure as an itemized deduction. For instance, president-elect Joe Biden has proposed capping the tax benefit of itemized deductions to 28% for those earning more than \$400,000.<sup>253</sup> Under this policy, assuming a 35% marginal tax rate, taxpayers earning above that threshold would see their federal tax liability reduced by [SALT x 28%], as opposed to [SALT x 35%]; this is functionally equivalent to a 28% tax credit.<sup>254</sup>

Professor William Barker has recently suggested replacing the SALT deduction with a federal tax credit for state tax payments, limited to a percentage of the taxpayer’s federal tax liability.<sup>255</sup> In this system, a taxpayer may theoretically receive a federal tax credit equal to the full amount of her state tax liability, as long as the credit amount doesn’t exceed a percentage of her federal tax liability.<sup>256</sup> An alternative to this approach would be a tax credit for state taxes limited to a maximum dollar amount.

While a SALT tax credit would require a more dramatic change to section 164 than this Note’s proposal in Part V.A, and thus may be less politically viable, it may be a preferable alternative.

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251. See Metcalf, *supra* note 103, at 572 (“In effect this allows all taxpayers to deduct their state and local taxes as if they were in the 15 percent tax bracket.”).

252. See *id.* at 588.

253. See Garrett Watson, Huaqun Li & Taylor LaJoie, *Details and Analysis of Democratic Presidential Nominee Joe Biden’s Tax Plan*, TAX FOUND. (Oct. 22, 2020), <https://tax-foundation.org/joe-biden-tax-plan-2020/> [<https://perma.cc/5H4D-MD84>].

254. See *id.*

255. See Barker, *supra* note 15, at 104.

256. See *id.*

Further economic literature on a SALT tax credit would be beneficial to providing a more comprehensive understanding of its benefits and drawbacks.

## VI. CONCLUSION

While the SALT deduction has taken different forms over the years, it has long been a mainstay of the federal tax code and a foundational principle of fiscal federalism. It should continue to exist. However, it should be modified to account for important differences between state and local governments, and should be considered in the broader context of the grants-in-aid system.

This Note argues that the next iteration of the SALT deduction should allow for full deductibility of all statewide taxes, while retaining a cap on local tax deductibility. Increasing state tax deductibility will help promote competing goals of local administration and redistributive spending, and further goals of state autonomy and policy innovation. Maintaining, as opposed to increasing, local tax deductibility will help reduce the regressivity of the SALT deduction and promote economically heterogeneous communities. Maintaining, as opposed to eliminating, local tax deductibility will mitigate the potential harm to large, redistributive local governments and to relatively less wealthy itemizing taxpayers. Such a reform to the SALT deduction may be politically feasible as well. Further, this Note compares SALT deductibility to two alternative methods of federal subsidies to states — direct grants and federal tax credits — concluding that direct grants should be used in conjunction with SALT deductibility, and that tax credits are a promising, and potentially preferable, alternative to SALT deductibility.