Bond Case Briefs

Municipal Finance Law Since 1971

Congress Can Help State and Local Governments Prepare for a Rainy Day Without Repealing the SALT Cap.

With Joe Biden in the White House and narrow control of the Congress, Democrats are likely to try to restore the full state and local tax (SALT) deduction, capped through 2025 at $10,000 per year. But if lawmakers really want to assist state and local governments, rather than cutting federal income taxes for mostly high-income households, we suggest a SALT substitute.

Although we have disagreed on the value of the SALT deduction, we agree on an alternative. We'd use the roughly $80 billion annual cost of restoring the full deduction to instead create a special insurance fund that would help states and localities weather recessions without mass layoffs and cuts in essential services. Repealing the SALT deduction completely could obviously fund an even larger program.

Creating a fund along these lines, which we call the State Macroeconomic Insurance Fund (SMIF), would help individual states during economic downturns and lessen the severity and duration of recessions for the whole country.

How the SALT deduction works

The Tax Cuts and Jobs Act of 2017 (TCJA) limited to $10,000 the amount of state and local taxes that households can deduct each year from their federal income tax. By also doubling the standard deduction, the TCJA dramatically reduced the number of itemizers. These provisions, like almost all of those affecting the individual income tax, are scheduled to expire after 2025.

Today, only about 11 percent of households take the SALT deduction, and most of the benefit goes to high-income households. For top-bracket taxpayers, the deduction amounts to a 37 percent federal tax subsidy for up to $10,000 of state and local taxes paid. President-elect Biden has proposed to limit the value of itemized deductions to 28 percent, but 28 percent of an uncapped SALT deduction would be worth far more than the $10,000 capped deduction for most taxpayers.

Pros and cons of the SALT deduction

There's a huge partisan divide on the SALT deduction. Most Republicans claim that it's a "blue state subsidy," that largely benefits big spending, rich states with lots of high-income taxpayers. Democrats argue that the subsidy makes it easier for states and localities to raise taxes to pay for essential public services.

They're both a bit right. The evidence suggests deductibility does make high-income people more tolerant of high state taxes. But, it's unclear how much of those higher state and local taxes are used to pay for services that benefit vulnerable populations.

Bigger problems

State and local governments are subject to a well-known one-two punch in recessions: just as revenues are falling, demand goes up for the safety net programs they provide.

Yet, because most states and localities are required to balance their books over each budget cycle, they are forced to slash spending or raise taxes during economic downturns. For instance, state and local governments have cut 1.4 million positions since the onset of the COVID-19 pandemic. Spending cuts can harm not only vulnerable populations but also the larger economy.

Rainy day funds can help, but both amassing those funds and withdrawing them can be politically risky. Managing these types of funds is complicated and the economics of how much to save during a year and when to withdraw money are far from straightforward.

Congress sometimes fills part of this fiscal gap, but not always. For example, it provided about $240 billion in state and local fiscal relief in March, but declined to include further unrestricted aid in the 11th hour compromise bill that was passed last month.

A proposal

Our alternative would use the federal revenue that would otherwise go to reinstating the full SALT deduction to create a State Macroeconomic Insurance Fund (SMIF). Accrued over nine years (the average length of the last four economic expansions) and with interest earnings, such a fund could provide nearly $1 trillion to states and local governments during a downturn.

In addition, states could be encouraged to supplement the fund by making additional premium payments to the SMIF. This might let them save beyond current political limits and help standardize rainy day fund rules. States that declined to pay these additional premiums could still participate in the SMIF but would get the smaller baseline insurance payout.

To prevent states from gaming the program, both expected contributions and recession-generated payouts would be determined by a formula with factors outside of a governor's control, such as state unemployment rates.

To prevent federal policymakers from raiding the SMIF – as they have routinely done to the Social Security trust fund – it would be treated as a "non-budgetary account" or "deposit fund." Contributions would be considered to generate outlays at the time they are made rather than when state and local government payments are dispersed. Premiums would be considered receipts and would generate an offsetting outlay for the contribution to the fund, with no net budgetary effect. This is generally the way the federal government accounts for loan guarantee programs.

Winners and losers

The SMIF would help states maintain current services in a recession and boost the economy by funding new investments in infrastructure and other projects. Some states may perceive that a program along these lines would provide less benefit than an unrestricted SALT deduction. But if the last 10 months have taught us anything, it's the value of insurance.

taxpolicycenter.org

January 14, 2021