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Case Study #4: The Deduction of State and Local Income Taxes or General Sales Taxes

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These results are part of an eleven-part series, *The Economics of the Blank Slate*, created to discuss the economic effects of repealing various individual tax expenditures. In these reports, Tax Foundation economists use our macroeconomic model to answer two questions lawmakers are considering:

1. **What effect does eliminating these expenditures have on GDP, jobs, and federal revenue?**
2. **What would be the effect on GDP, jobs, and federal revenue if the static savings were used to finance tax cuts on a revenue neutral basis?**

Key Points:

Eliminating the deduction for state and local income taxes or general sales taxes would:

- Increase tax revenues by $67.7 billion on a static basis;
- Reduce GDP by $74 billion;
- Generate slightly less revenues ($50 billion) on a dynamic basis;
- Reduce employment by the equivalent of approximately 251,000 full-time workers; and
- Reduce hourly wages by 0.3 percent.

Eliminating the deduction and trading the static revenue gains for individual rate cuts would:

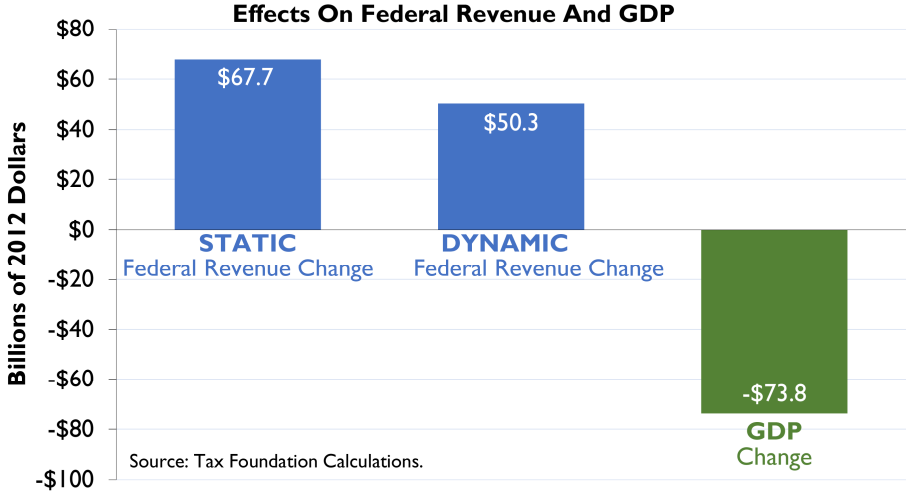
- Allow for an across-the-board rate cut of 5.8 percent;
- Boost GDP by $24 billion per year;
- Boost federal revenues by $6 billion on a dynamic basis;
- Increase employment by the equivalent of approximately 300,000 full-time workers; and
- Reduce hourly wages by 0.1 percent.

The federal individual income tax code permits taxpayers who itemize to claim a deduction for their state and local income taxes or general sales taxes. However, the deduction is controversial. Two common criticisms are that it is mostly claimed by upper-income taxpayers, and that it softens people's opposition to high taxes and wasteful spending by state and local governments because some of those taxes can be written off at the federal level. Two defenses of the deduction are that it better measures people's incomes,

recognizing that some of their income has been transferred to others, and that it provides state and local governments with an indirect subsidy that helps them to fund their operations. Nevertheless, the purpose of this case study is not to discuss the merits or demerits of the deduction but is simply to examine the growth effects if the deduction were repealed.

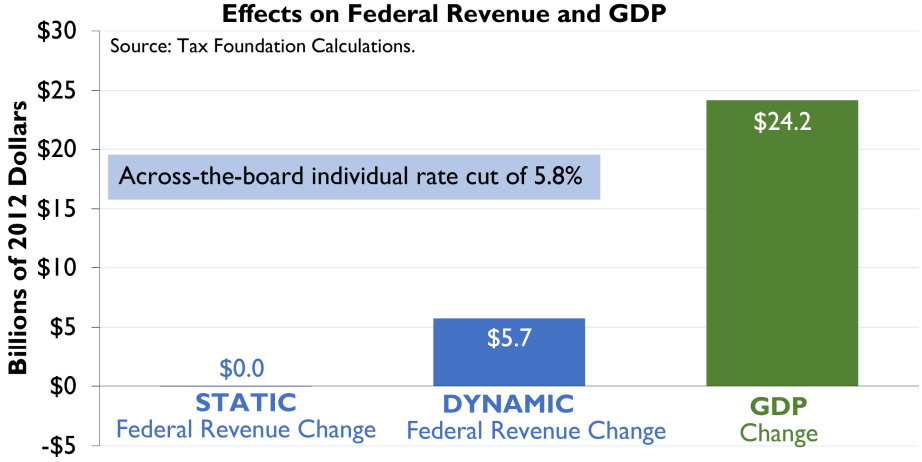
In a conventional static revenue estimate that holds the size of the economy fixed, the Tax Foundation's simulation model estimates that abolishing the federal income tax deduction for state and local income taxes or general sales taxes would have raised federal revenue by $68 billion in 2012. (See Chart 1.) This is higher than the Joint Committee on Taxation's estimate of $43.5 billion ($50.3 billion in 2013); it is unclear whether the gap occurs because the models differ in their structures, or because the JCT either has access to a larger and more complete tax sample that is not publicly available or has a different estimate of the growth of state and local taxes in recent years.[1]

Chart I. Eliminating the State and Local Income Tax Deduction
Effects On Federal Revenue And GDP



When the unrealistic static assumption is relaxed, our model predicts that ending the deduction would cause some economic harm. Losing the deduction would push some people into higher tax brackets, and the people affected would respond to the heftier marginal tax rates by working and investing less. The model estimates that when the economy has fully adjusted,

Chart 2. Using the Static Revenue Gain from Eliminating the State and Local Income Tax Deduction to Pay for an Across-the-Board Rate Cut
Effects on Federal Revenue and GDP



[1] The difference in the estimated size of the deduction would affect the level but not the pattern of the economic results of the Tax Foundation model runs.

GDP would be $74 billion lower than otherwise. Because of the negative economic feedback, the estimate of the dynamic revenue gain would be smaller than the static estimate but still appreciable at $50 billion.

If the story ended here, the outcome would be mixed: ending the deduction would produce a sizeable federal revenue gain, but for every added federal dollar, the total size of the economy would contract by more than a dollar. However, if the revenue gain were used to finance an across-the-board federal income tax rate cut, the model predicts that the economy and federal receipts would both grow modestly.[2] This can be seen in Chart 2, above. The model estimates that if the entire conventional revenue estimate were directed into a 5.8 percent across-the-board rate cut, GDP would expand by a net $24 billion and federal tax collections would increase by a net $6 billion. From a growth perspective, this is an attractive trade.

Finally, we determined the impact of these scenarios on employment and wages. We found that the elimination of the state and local income tax deduction would reduce employment by the equivalent of about 251,000 full-time workers and cut hourly wages by 0.3 percent. With the rate cut offset, employment would increase by the equivalent of about 300,000 full-time workers and hourly wages would fall by 0.1 percent.

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About the Tax Foundation
The Tax Foundation is a 501(c)(3) non-partisan, non-profit research institution founded in 1937 to educate the public on tax policy. Based in Washington, D.C., our economic and policy analysis is guided by the principles of sound tax policy: simplicity, neutrality, transparency, and stability.

[2] We assume proportional cuts in all of the ordinary income tax bracket rates but no cuts in the lower tax rates on capital gains and qualified dividends.