THE BROOKINGS INSTITUTION
BROOKINGS CAFETERIA PODCAST

ENDING THE STATE AND LOCAL TAXES (SALT) DEDUCTION

Washington, D.C.
Friday, October 22, 2021

PARTICIPANTS:

FRED DEWS
Multimedia Project Manager
The Brookings Institution

RICHARD V. REEVES
John C. and Nancy D. Whitehead Chair
Senior Fellow, Economic Studies
Director, Future of the Middle Class Initiative
The Brookings Institution

DAVID WESSEL
Director, Hutchins Center on Fiscal and Monetary Policy
Senior Fellow, Economic Studies
The Brookings Institution

* * * * *

DEWS: Welcome to the Brookings Cafeteria, the podcast about ideas and the experts who have them. I'm Fred Dews.

Millions of American taxpayers itemize their deductions, one of which is for state and local taxes, or the SALT deduction. Most of these filers are at the upper end of the income distribution and live in high-income urban areas. On this episode, Senior Fellow Richard Reeves, director of the Future of the Middle Class Initiative at Brookings, says the SALT deduction mostly benefits the wealthiest taxpayers, gives little or no benefit to the middle class, and should be eliminated entirely. He also talks about the unusual politics of the debate in Washington, where Democratic leaders are calling for repeal of the SALT deduction CAP put in place in the 2017 tax law, championed by congressional Republicans.

Also on this episode, David Wessel, senior fellow and director of the Hutchins Center on Fiscal and Monetary Policy at Brookings, explains why inflation is back, why it's different this time, and what the Federal Reserve can do about it.

You can follow the Brookings Podcast Network on twitter @policypodcasts to get information about and links to all our shows including Dollar and Sense: The Brookings Trade Podcast, The Current, and our events podcast.

First up, here's David Wessel with his Economic Update.

WESSEL: I'm David Wessel and this is my economic update.

Inflation is back after a decade in which the word "inflation" rarely made the front pages and inflation was consistently BELOW the Fed's two percent target. Consumer prices have risen 5.4 percent in the past 12 months, in part because of soaring energy prices. but the Consumer Price Index, excluding volatile food and energy prices, is up 4 percent in the past year. Used car prices are up nearly 25 percent.

What's going on here?

A surge in consumer demand as the restraints of the pandemic ease is hitting the economy at a time when for all sorts of reasons the supply of goods and services can't increase fast enough, because of cutbacks in production earlier in the pandemic that are hard to reverse quickly; because of kinks in global supply chains; because of bottlenecks in key sectors of the economy, including the ports where imports arrive; because prices of many commodities are rising—oil prices have doubled in the past year and so has the price of coffee on world markets; and because a lot of workers who left the job market during the pandemic are staying on the sidelines, forcing employers who need to hire to raise wages in some sectors.

Although rising prices indicate that much of the U.S. economy is recovering vigorously from the COVID recession, and that's good, the burst of inflation is unwelcome. People generally don't like inflation, particularly when, as is the case for many Americans now, their wages aren't increasing as fast as the prices of the goods and services they buy.

Fed Chair Jay Powell told us that the increase in inflation was going to be temporary—transitory was the word of choice—but he now says that the spurt of inflation is going to continue "longer than we had thought." The International Monetary Fund recently said that it anticipates the inflation rate will return to pre-pandemic levels, but not until mid-2022, and it cautioned that there is a lot of uncertainty about that.

There's a lot going on here, but one big issue is this: While the forces that are pushing up prices right now may be temporary and could abate as producers and businesses adjust, the longer they go on the more businesses and consumers and investors will see this uptick in inflation as likely to be long-lived, and they'll begin to react accordingly. Or, as central bankers put it, inflation expectations may become unanchored. In other words, anticipation of higher inflation in the future will become self-fulfilling.

The standard remedy for this would be for the Fed to curtail its bond-buying and raise interest rates, and it is moving gingerly in that direction. On one hand, it doesn't want to overreact by raising interest rates soon and disrupting the welcome decline in unemployment only to discover that the inflation fires have burned themselves out in six or nine months. On the other hand, the Fed has been surprised by the breadth and persistence of price increases and Fed officials insist they don't want today's price hikes to produce an increase in the inflation expectations

Of course, the Fed often has to make tough decisions amid uncertainty—that's the job after all. But this episode differs from those it has confronted in the past couple of decades. It isn't dealing with what was once called "stagflation"—that's a mix of low growth and high inflation. It isn't confronting a simple narrow supply shock like a spurt in oil prices. It isn't rescuing the economy as it did in 2008 and '09 from a collapse of housing prices and financial crisis. It isn't confronting weak consumer demand coinciding with cuts in federal spending as was the case in 2011 and 2013. It's dealing with this new situation as implements a new framework for monetary policy, one that was written at a time when Fed officials worried about too little—not too much—inflation.

DEWS: You can listen to more from David Wessel on our SoundCloud channel. And now, here's my interview with Richard Reeves.

Richard, welcome back to the Cafeteria podcast.

REEVES: Thank you for having me back, Fred.

DEWS: It's great to see you again. And as I've mentioned in the intro, I've asked you here to talk about the SALT deduction in the tax law, the state and local taxes deduction. Can you first talk about your interest in this? You've written a lot of pieces on the Brookings website about this, so give our listeners a sense of why you are so interested in this topic.

REEVES: Well, it's one of those weird elements in the U.S. tax code where you get deductions for various things. So, we all know about mortgage interest deduction, et cetera. And this one is a deduction that allows you to set your state and local taxes, hence SALT, that's what we're referring to there, against your federal tax bill. And so, it means that you can, if you're paying lots of taxes in a wealthy suburb of Maryland or New Jersey, then you're going to do very well out of this deduction. It's been around for a long time and it's very valuable to those particular people.

And I became interested in it partly because what we saw was that when President Trump reduced the value of the deduction in his 2017 tax bill, it was Democrats who were most up in arms about it. So, what he did was, he said, you can only claim up to $10,000 worth of the deduction against your federal tax bill. And so what that meant was the top 1 percent in particular who were claiming way more than ten thousand—I mean you're paying a lot more than ten thousand in property taxes and state taxes if you live in a mansion in a New York suburb, right? So, suddenly they lost a huge amount of value. So it was a significant tax rise for that group.

But those people are also Democrats, disproportionately, the people who live in high tax areas of our biggest cities are disproportionately Democrats. And so what you saw was people like Chuck Schumer, Nancy Pelosi, and others who live in those areas really leading the charge against this. And so there's this odd sight of Democrats becoming really, really passionate about bringing back, in full, this tax break, which disproportionately helps people at the very top of the income distribution.

So, if you're being unkind, you'd use words like "hypocrisy." Certainly, I think it exposes the tension in egalitarian enterprise here, and the tension between sort of wanting to do the right thing for the most powerful people in your constituency and wanting to do the right thing more generally.

And so, I guess I just became interested and a little bit annoyed that it wasn't getting enough attention. My fear was that, because it's a bit esoteric—like, what is SALT, and does it really matter? And it's like a weird thing—that it would actually happen and without there being much public debate about the real tradeoffs here. And so, that led me to write the pieces for Brookings, plus opinion pieces for the New York Times, and elsewhere. And actually The New York Times, along with The Washington Post and the Boston Globe have now will come out very strongly against what the Democrats say they want to do, which is to restore some of the value of it. And so, which is a move in position for the New York Times, for example. So, there has been a bit of a shift in opinion here. And I guess my main role here was to sort of bring it into the clear light of day. If you're going to argue for this, you got to argue for it in the open.

DEWS: There are a lot of great charts that demonstrate that inequity in who benefits most from the SALT deduction in a lot of the pieces that you've written with Chris Pulliam. I'll put links to all those in our show notes. And I do want to get to the politics in a few minutes because it's so fascinating. First, I'd like to ask you about some of the arguments for the SALT deduction. One argument for it is that it allows state and local governments more tax flexibility to raise revenue and thus manage programs and policies in their own jurisdictions. What's your take on that view?

REEVES: Well, it's true in the sense that, like, if you make it cheaper for states and local governments to raise taxes, then it's easier for them to raise taxes, and it is cheaper for them to do that because they can raise my taxes. So, I'm a classic case, I live in Montgomery County, Maryland, so, high tax area of a high tax state. Then of course, it's easier for Maryland or for Montgomery County to tax me more heavily if they know that I'm going to be able to get a third of that back from the federal government. So what's happening is the federal government is subsidizing the taxes of the people in those high tax areas. It's a very inefficient, weird roundabout way to subsidize it. That's part of my criticism.

But I think that the argument against that is that there are better ways to subsidize states to do it than through a regressive tax cut to the rich people who happen to live in their area. It's also worth noting that there are lots of federal government systems around the world, and the U.S. is the only one that offers this kind of deduction to states and local governments. And so, you know, other countries like Canada with federal systems sort of manage it. And so, yes, of course, it makes it easier to raise those taxes. But that's not a very good argument in favor of such an odd and regressive tax break.

If you really want to help New York to spend more money on its K-12 schools for its poorest kids, then there are better ways to do that—through grants—than by giving rich New Yorkers a tax break in the hope that that will allow New York to tax the rich New Yorkers more in the hope that that money will get to the K-12 schools that serve the poorest kids in New York. How about just giving more money to the poorest kids in New York? Right? That would strike me as a much more direct way of doing it. Doing it through the SALT deduction is a bit like saying it's possible to get into your house by going around the back into the backyard, climbing up the drainpipe and climbing in through your bedroom window. Of course it's possible, but it's easier to go through the front door.

DEWS: It sounds vastly complicated and quite circular. Can you put some numbers to that regressive nature? You talk a lot about income quintiles in all of your research, and you've also talked about the top 1 percent. What kinds of numbers are we talking here?

REEVES: So, this cap was put in place to just say it, so you can only claim up to ten thousand dollars, and that really did reduce its value to the richest. So, the easiest way I think to put this is to say, well, what would the result be were that to be repealed? So, let's say we would repeal what President Trump did in 2017—which actually will happen automatically in 2025 when it expires unless something changes—and who would benefit from that? Who would benefit from just repealing what President Trump did? No cap at all, just get rid of the cap. And we can get into alternatives, but that is definitely where the argument started. Well, that would give the top 1 percent an average tax cut of $35,000 a year, and it would give the middle 60 percent a tax cut of about $37 a year. So, it's not that there'd be nothing in the middle, but it's infinitesimally small to the middle, almost a little bit. Ninety-five percent of the benefit would go to the top 20 percent, and a huge proportion of that goes to the top 1 percent. But that's like, that's not a bug, that's a feature. It's designed to help people with high tax bills. And so of course, it's going to help the richest, and it particularly helps, to take the cap away all together really helps top 1 percent.

One of the ironies here that Chris Pulliam really helped me to understand, of course, is that if the Democrats raise the top rate of income tax, it makes the SALT deduction even more regressive because it means you can set even more, it means you're getting even more benefits if you raise it to say 40 percent, means that you're getting 40 percent benefit back from the SALT. So, you're literally chasing your tail because it gets more regressive and more and more expensive. So, you can't buy a family Kentucky Fried meal for the value of the tax cut to the middle class, but you can buy quite a lot with the $35,000 it will be worth to the top 1 percent.

DEWS: This might get us into the politics of it, but it seems that even if the value of it is as small, as you said on average $37 a year for the middle 60 percent of the income distribution—so not the top 20, not the bottom 20—that's not nothing. And then as you get a little bit higher towards the top quintile of income, maybe that figure jumps to $100 a year, $200 a year, then it seems to me, then, in the politics of it, those are the kind of people, so maybe the not the upper middle class are where politicians are saying, you know, we want to put that money back in our constituents' hands, 200, 300, 400 dollars, that's not nothing.

REEVES: Yes, that's right. And if you if you look at the group below the top 1 percent, but in the top 20 percent, so between the 81st and 99th percentiles, the value to that group is $1,365. Right. So one and a half thousand dollars in round terms to that group, who are not in the top 1 percent, so they're not upper class and not the richest. But they're in the upper middle class. They're the group that I've written about in my previous work, right, "Dream Hoarders." And that's a non-trivial amount of money for some people, particularly those near the edge. So the question then becomes, is that the best way to help that group? Well the irony is that we're looking for ways to tax the top 20 percent more. My own view for what it's worth is we can't raise the money we need from just the top 1 percent. And the top 20 percent haven't seen quite the same income gains as the top 1 percent, but they've seen significant income gains. And so this is a group of people who, they're well into six-figure incomes, and they've done pretty well in the last 20 years. So, these are upper middle-class professionals. Maybe they're not making the half million dollars or whatever, just to get into the top 1 percent, but they're certainly not struggling.

So, the question I think is not would it be valuable to some of those people? Of course it would. The question is, are they the priority for a tax cut? This is a tax cut that we're talking about now. Given where we are, what happened in 2017, do we want to give the people at the top a tax cut? And I think if you frame it that way, most people would probably answer no, particularly when it's expensive, and we're talking about 80 billion dollars a year. And so that's a lot of money. And here we see this huge fight over how can we get this bill through? And it seems to me that this was probably not the top priority. This is not the group who you most need to spend your money on. It's not that they won't get some value from it, but for my money, I'd be much more interested in the people at the bottom half of the distribution.

DEWS: So, back to the politics of it, as you mentioned Chuck Schumer, Nancy Pelosi a few minutes ago, leaders of their parties in the House and the Senate. They criticized the 2017 tax bill overall as pro-rich and as a "gut punch" to the middle class. Yet they also insisted and keep insisting on eliminating the SALT cap. Do you think their politics are misaligned here?

REEVES: I think there's a misalignment between their politics and their policy. And so I think that it's a fair criticism of the Trump tax bill and one that I myself wrote about it, which is that it was pretty regressive, and that most of the benefit from the 2017 tax bill went to the top, went to the top 1 percent and the top 20 percent. That's true. Now that was a whole bill. And here I should say I'm drawing on the work of our colleagues in the Tax Policy Center, and please check out their numbers, they are the best numbers on all of these things. And so what they found was if you took the Trump tax bill as a whole, about 21 percent of the benefit went to the top 1 percent of the of the distribution, right? So that was heavily regressive.

But take repeal of the SALT cap just as a single issue. Fifty-seven percent of the benefit of that move would go to the top 1 percent. So, taken as an individual item, repeal of the SALT cap would give three times as much benefit as the Trump tax bill did the top 1 percent, not in absolute terms, of course, but relatively speaking. And so in that sense, it's three times as regressive a move individually as the Trump tax bill was as a whole.

And so at that point, you think, well, what's happening here? And that's why I think many, many politicians actually across the political spectrum, from Congresswoman Ocasio-Cortez in the House to Michael Bennet in the Senate, have strongly come out against their colleagues and said we should keep the cap in place because they can look at the numbers and they can say this is not a great use of taxpayers money to be giving the money away to the people at the top. And particularly on a policy that's worth saying, Fred, that just doesn't appear to be very effective. It's not the best way to help these states, and it distorts housing markets a little bit, too, not as much as the mortgage interest deduction, but to the extent it makes it cheaper for people to live in expensive houses. Let's get Jenny Schuetz on, and I'm pretty sure that she'll explain to me that that would mean that you're incentivizing people to buy more expensive houses, which is not good for the housing market. So it's distortionary, it's regressive, and it's expensive. Other than that, it's a great policy. And so it's being driven beyond political calculations.

DEWS: Jenny Schuetz and also Bill Gale, who's called for abolishing the mortgage tax deduction entirely.

REEVES: I'm with him and I would abolish the SALT deduction as well. And by the way, the 529 college savings accounts, which also provoked people like Chris Van Hollen and Nancy Pelosi to be up in arms because it affected their upper middle-class constituents.

DEWS: So, even though the deduction is demonstrably not to the benefit of the middle class generally and lower income groups, I mean, why do you think this tax break remains so popular in Congress among so many Democrats? I mean, there's even a SALT Caucus.

REEVES: There is there is a SALT Caucus, yeah, that's when you know that the argument had been flushed out into the open when some Democrats had to caucus around it. And those Democrats are almost entirely from congressional districts where the impact of the introduction of the cap was felt most strongly. And so to that extent, they are being representatives, they are representing the affluent people that live in their districts. But I think that's the main reason is that people feel in those sorts of districts and those members of Congress in particular, they feel as if the introduction of the cap was politically motivated. It was precision targeted to hit coastal, liberal, coastal rich Liberal Democrats. I mean, just like in that sense it was a precision guided missile in the Trump tax bill, and it's seen as such. And so I actually don't think for a moment that President

Trump or the people who were working under him were motivated by a desire for a cleaner and better and fairer tax system. They were politically motivated, but it was one of the arguments Chris Pulliam and I've been making is that sometimes you get good policy from bad motives. And the other way round. And you should judge it on its policy. But I think that's wise because it's probably upset a lot of their loudest constituents as well.

DEWS: Yeah, that's a pretty typical phenomenon in Washington politics, is whoever shouts loudest gets the most attention. But let's talk about policy solutions because that's what we're all about here. This debate on the SALT deduction comes up as part of President Biden's, well, it was three point five trillion Build Back Better bill, I'm not sure where it stands now. And you and Christopher Pulliam have looked at two options on the table: repeal the cap for two years or lift the cap entirely over ten years. What's your assessment of those options?

REEVES: Well, those two options are both terrible. It's just a question of which is the worst way to go here. So, I have to have this ascending order of awfulness when I think about this. I mean, ideally, we would just get rid of the deduction altogether, find better ways to help the states. And we should get rid of it, like the mortgage interest deduction, as you just mentioned. So, we should get rid of it.

Where we are at the moment is it's a halfway house where we haven't got rid of it, but we've capped its value. So, just taking the cap off altogether, just write massive checks to the richest Americans, that's a terrible idea. I'm actually worried by the thought that what we might see is the full repeal, take the cap off, but only for a couple of years. Because then what would happen actually is, we'd have had a couple of years with the cap, then repeal it, but then it expires. So what would you, and then you have to decide whether to put it back up again. So, in other words, this thing could be kicking around as a policy debate for some time if there's a temporary here.

I fear, there could be pressure for that so that these members of Congress have got something to take back to their constituents in 2022, which is, look, I got this, got the tax break. But that's a terrible way to do tax policy, to just keep bouncing it around here and there.

And so Chris and I have made a suggestion in the spirit of compromise, which is to raise the cap to 20,000, which would pick up some of the people you were asking about before, Fred. So they're upper middle class, but they're not rich, perhaps, right? So they are the people under $200,000 in a more expensive part of town. But then phase it out over ten years, so drop it by two thousand every ten years. That would actually save against the current budget almost a trillion dollars because of this expiry of the cap in 2025. And so you could actually raise the cap for now, gradually phase it out so that people had time to get used to the fact that it was going and save a trillion dollars. And a trillion dollars actually would help right now, I think, in these debates. Given the numbers that are being involved, if you could go and say, look, here's the way to save a trillion dollars and still do something about the cap in the short term. To be clear, that's not my preferred option, my preferred option would be to phase it out from where it is now, from 10,000. But at the very least, that would put it on a glide path to removal.

And actually, one of the things about tax policy in general is it tends to be very spiky, it's very staccato. It's stop, start, repeal, etc. And I actually think what we should be doing is looking at these deductions and trying to find bipartisan agreement for a 10-year phased withdrawal. It took the UK nearly 10 years to get rid of its mortgage interest deduction, over two governments, two different governments. And so I can imagine you could get some agreement, say, okay, we're going to get rid of this, and it gives the housing market and the individuals concerned time to adjust to the fact that it's going to drop by two thousand every year. So, in the spirit of trying to be positive about this, that's a proposal we put forward.

DEWS: And I'll put a link to the show notes to that piece as well, which you and Christopher talk about those options. Richard, I want to end on an issue that you've written a lot about over your career, and that's inequality. And you've called the SALT deduction quote, "bad policy, especially at a time of rising inequality," and I know you touched on this a little bit earlier in our conversation, but can you kind of expand on the notion of the SALT deduction and its relationship to inequality?

REEVES: Sure, I actually in one of the pieces that you're going to link to, we have two charts and one chart shows who will benefit most from repealing the cap on the SALT deduction across the income quintiles, up to and including the top 1 percent, and then a chart next to it which says who has seen the most income growth over the last few decades with the same groups. A minute ago, I was just checking my numbers and I'm constantly getting the charts confused because they look exactly the same. And so the value of taking away the cap in terms of who it would go to perfectly mirrors who has been getting richer anyway.

So, if you were trying to design a policy that said, look, which income groups have been doing the best over the last few decades, how can we give them a tax cut? Lifting the deduction on SALT is perfect for that. So it's in the same way that it was precision guided in some ways politically, distributionally it's really hard to find a way to give money to the people who need it least given recent income trends, as this would do. It eerily matches the inequality trends and gives the most money to the people who've seen the most gains in recent decades. And so it's actually in flat contradiction to a tax agenda which would be about redistribution. Now, I should say that there's lots of other things that the Democrats are doing, which are, of course, very redistributive—child tax credit, which I've written positively about, and so on. So, we're talking in isolation here, but in isolation this is a policy proposal, lifting the SALT cap, which would be anti-equality in a way that is difficult to justify.

DEWS: And, Richard, this has been a fascinating conversation, in my personal life it's given me a lot to think about. I had a conversation with my spouse about the SALT deduction in our tax position and in the best tradition of Brookings scholarship you've identified a policy problem, you've brought evidence and data to bear, and you've made a really compelling argument for a policy direction. So, I really appreciate you bringing this to light and having this conversation with me.

REEVES: Well, thank you, Fred. Thank you for having me on. The thing is one of my sort of working principles as someone who is lucky enough to be towards the top of the income distribution is that unless my proposals are going to hurt me in some way or other, then they're probably not a very good idea from an egalitarian perspective. And it doesn't make me very popular. But, you know, being popular at dinner parties should never be the goal of a Brookings scholar because being an empirically based Brookings scholar rarely makes you popular at dinner parties, certainly, in the affluent parts of the cities where a lot of us live. But the truth is the truth hurts sometimes.

DEWS: Well, Richard, again, thank you for sharing with us your time and your expertise. Appreciate it.

REEVES: Thank you, Fred.

DEWS: A team of amazing colleagues makes the Brookings Cafeteria possible. My thanks go out to audio engineer Gaston Reboredo; our audio intern this semester, Nicolette Kelly; Bill Finan, director of the Brookings Institution Press, who does the book interviews; my communications colleagues Marie Wilkin, Adrianna Pita, and Chris McKenna for their collaboration. And finally, to Ian McAllister, Soren Messner-Zidell and Andrea Risotto for their guidance and support.

The Brookings Cafeteria is brought to you by the Brookings Podcast Network, which also produces Dollar & Sense, The Current, and our events podcasts. Follow us on Twitter @policypodcasts. You can listen to the Brookings Cafeteria in all the usual places and visit us online at Brookings.edu.

Until next time, I'm Fred Dews.