The Tax Reform Act: Impact of the SALT Deduction on Real Estate

The Cost of Local Public Services (CLPS)

There are a number of ways in which the costs to households of having their State or Local Government spend 1$ actually is less than the dollar spent. For example, the Federal government has policies that reimburse local governments with some percentage of what they spend on school lunches, highways, law enforcement training… Because the magnitude of these grants is based on a fraction of local effort - they make local spending appear cheaper in the eyes of local voters. This in turn tends to increase the amount spent in total (grant + local effort) on such programs. One-minus-the grant rate is often called the Cost of Local Public Services (CLPS).

There is no end to economic studies demonstrating the stimulating impact of such “matching grant” programs. If higher level governments want lower level governments to spend more in total on a particular service – they enact a matching grant program. This stands in contrast to programs which simply provide a fixed dollar amount of aid per capita, per pupil, or per patient. If higher level governments simply want to ease the financial burden of local services – they can provide these so called “block grants”. This type of grant mostly reduces local effort (and taxes) as grant dollars are simply substituted for local effort.

The SALT deduction

The SALT deduction works just like a matching grant. Not only does it ease the burden of state and local taxes, it actually encourages government spending by reducing the cost to local constituents of a dollar spent on those services. Eliminating the deduction increases the CLPS – and rather than stimulating local spending on public services it will dampen, or hinder local spending.

The effect of eliminating the SALT deduction will be felt strongest in cities and town that are populated mostly by home owners and not renters since landlords will continue to deduct property taxes as a business expense. It will hurt suburbs more than central cities and also will be felt most in higher income communities where the value of the deduction is larger because voters are in higher income tax brackets. In effect towns receiving the largest benefit from the SALT deduction will now suffer relative to those whose benefit has been less.

There is also a literature in economics that suggests increases in the CLPS - and the consequent reductions in local public service outlays - can only lower house prices. The magnitude of this “capitalization” effect however, is open to some debate. Again this will felt the most in communities where the deduction is currently worth the most.

In the US, State and Local governments are in charge of providing and funding primary and secondary schools, infrastructure, and public safety. Eliminating the deduction ultimately will reduce spending on these services – in the aggregate. It is somewhat ironic that many in Congress believe there currently is a need to improve such services in order to make the US more productive, more competitive and to grow the economy. Eliminating SALT could have exactly the reverse effect.