U.S. Municipal Bond Market

How the Dispute Over a SALT Cap Repeal is Becoming an "Economic Civil War"

Tom Kozlik
Head of Municipal Strategy & Credit
214.859.9439
tom.kozlik@hilltopsecurities.com

- New York lawmakers sent a letter to the House Speaker saying, "No SALT, no deal." They communicated that they will not support President Biden's infrastructure agenda unless it includes a repeal of the $10,000 SALT cap.
- Recent criticism focuses on the fact that the SALT deduction largely benefits high earners. The criticism is true, as the SALT deduction does mostly benefit high earners in high tax states.
- Lawmakers such as New York Governor Andrew Cuomo and Congressman Thomas Suozzi (D-NY) have argued the remote work and migration trends could drive high earners out of New York. This would effectively end up creating a tax hike on those remaining or result in cuts to services.
- Migration is occurring, but there is not enough evidence to suggest that tax policy is enough to stop or even slow it. Even if SALT is repealed, it is possible these migration patterns continue.
- We expect that if the $10,000 SALT cap is repealed, it is high earners in high tax states who would come out on top in what Gov. Cuomo calls an "Economic Civil War."

2017 SALT Cap Comes to a Head with President's 2021 Infrastructure Proposal

A controversial part of the Republicans' 2017 Tax Cuts and Jobs Act (TCJA) is coming to a head with President Biden's agenda for once-in-a-generation infrastructure legislation. Concern over the impact of the controversial tax policy limitation has worsened in recent weeks as economic activity in New York is likely to slumber longer than the rest of the country. Lawmakers are also mindful of the fact that

Lawmakers such as New York Governor Andrew Cuomo and Congressman Thomas Suozzi (D-NY) have argued the remote work and migration trends could drive high earners out of New York. This would effectively end up creating a tax hike on those remaining or result in cuts to services.

Income Distribution of SALT Deduction Benefit, 2017 and 2019

	Tax Year 2017		Tax Year 2019	
Income Class	SALT Benefit ($ billions)	Share of SALT Benefit	SALT Benefit ($ billions)	Share of SALT Benefit
Less than $10,000	<0.1	0%	<0.1	0%
$10,000-$20,000	<0.1	0%	<0.1	0%
$20,000-$30,000	<0.1	0%	<0.1	0%
$30,000-$40,000	0.1	0%	<0.1	0%
$40,000-$50,000	0.2	0%	0.1	0%
$50,000-$75,000	1.7	2%	0.7	3%
$75,000-$100,000	2.9	4%	1.5	7%
$100,000-$200,000	15.5	22%	6.8	33%
More than $200,000	49.3	71%	11.7	56%
Total	**69.7**		**20.8**	

Source: Joint Committee on Taxation and HilltopSecurities.

taxpayers, especially the 1%, are even more mobile now that COVID-19 reactions accelerated a technological shift of independence in the form of remote work. There are also potential tax revenue implications largely at stake for states such as California, Connecticut, New Jersey, and especially New York. We expect that if the $10,000 state and local tax (SALT) cap is repealed, it is high earners in high tax states who would come out on top in what New York Governor Andrew Cuomo calls an "Economic Civil War." A repeal is unlikely to slow migration, in addition, if that is truly lawmakers' key concern.

We expect that if the $10,000 state and local tax (SALT) cap is repealed, it is high earners in high tax states who would come out on top in what New York Governor Andrew Cuomo calls an "Economic Civil War."

The Democrats' victories in the Georgia run-off elections in January are what allowed the White House and Democrats in the House and Senate to ram through a sixth phase $1.9 trillion Rescue Act via the budget reconciliation process on March 11. The political circumstances also provided the backdrop by which the White House unveiled the first of two massive, multi-trillion infrastructure proposals. President Biden unveiled a preliminary outline of his American Jobs Plan on March 31.

Who would have thought, unless you have been closely watching New York politics, that New York House Democrats (all but two) would pen a letter to Speaker Nancy Pelosi arguing for a full repeal of the state and local government tax (SALT) cap only about two weeks after the president's infrastructure announcement? In the letter, New York lawmakers argued, "No SALT, no deal." In effect, they are letting the speaker know they are willing to hold the president's infrastructure agenda hostage to their SALT cap repeal demand. Lawmakers from other states may join this movement, and this week a New Jersey member of congress sent a letter to Treasury Secretary Janet Yellen stressing the importance of a SALT cap repeal. Much of the response and/or analysis of the New York (and others) lawmakers' warning to Speaker Pelosi has focused on the fact that the direct impact of the SALT deduction goes to high earners. This is true. By almost any measure, this will be true. We are, for example, showing data above from the Joint Committee on Taxation that shows the benefit goes to higher income earners. This was true before the $10,000 cap and it is true now as well.

Lawmakers from other states may join this movement, and this week a New Jersey member of congress sent a letter to Treasury Secretary Janet Yellen stressing the importance of a SALT cap repeal.

SALT Basics: What is the State and Local Tax (SALT) Deduction and SALT Cap?

The state and local tax (SALT) deduction allows select taxpayers to deduct certain taxes paid to state and local governments from their federal returns. The end impact is that taxpayers can reduce their federal income tax liability by claiming a deduction for certain state and local taxes already paid. The 2017 Tax Cuts and Jobs Act set a temporary $10,000 limit, or cap, on annual SALT deduction claims taxpayers can deduct. By limiting the amount of the SALT deduction, the SALT cap increases the tax liability of certain taxpayers and decreases it for others.

The SALT deduction allows select taxpayers to deduct certain taxes paid to state and local governments from their federal returns. The end impact is that taxpayers can reduce their federal income tax liability by claiming a deduction for certain state and local taxes already paid.

Projected Revenue Losses from the SALT Deduction ($ billions)

FY17	FY19	FY20	FY21	FY22	FY23
100.9	21.2	22.5	23.6	24.6	25.3

Source: Joint Committee on Taxation and HilltopSecurities.

Increased Mobility is Related to the Call for a Repeal to the $10,000 SALT Cap

There are some important points being missed as it relates to the SALT cap and the recent actions of the New York lawmakers. However, some critics are accusing Democratic lawmakers of conducting a misinformation campaign. We have not found this to be true, nor do we believe lawmakers are masking their intent for supporting a repeal of the SALT cap.

Some critics are accusing Democratic lawmakers of conducting a misinformation campaign. We have not found this to be true, nor do we believe lawmakers are masking their intent for supporting a repeal of the SALT cap.

An important connection that is not being made by some critics is that the high earners of New York are especially mobile now. If they leave, it could have a significant impact on those who are less mobile. This connection was highlighted by Gov. Cuomo even before COVID-19 (please see page 25 of this Jan. 2019 presentation). This connection was also highlighted by Congressman Thomas Suozzi (D-NY) in a recent Wall Street Journal article, saying in an interview, "SALT is an existential issue for us." He said higher income people will either leave the state or, if they have started working remotely since the pandemic, won't return. Please see more in a Suozzi March 30, 2021 press release. This evolving dynamic will have important policy, revenue, and credit implications for several large, mostly blue states and especially New York and New York City.

True Impact of the SALT Deduction

Let's now narrow our focus to who the SALT deduction benefits. Many in recent weeks, and even in our discussion above, have stressed that it is certain high-tax states that mostly benefit from the SALT deduction. It is more precise to highlight that it is the high earners in those high-tax states who largely would benefit from a repeal of the SALT cap. The Tax Foundation in recent Congressional testimony sharpened this explanation of the true impact on the SALT deduction.

This evolving remote work dynamic will have important policy, revenue, and credit implications for several large, mostly blue states and especially New York and New York City.

> It is too simple to say that the deduction only benefits high-tax states. It is better understood as benefiting high-income individuals, many of whom reside in high-tax jurisdictions with high housing values. Prior to the TCJA, high-tax states and localities were able to raise taxes without their taxpayers feeling the entire impact of the high tax levels. When a state or local tax was raised by $1, individuals who itemized their federal deductions would only experience a net tax increase of $0.60 to $0.90, depending on their federal marginal income tax rate. Jurisdictions with higher-income residents received more of a benefit than those with lower-income residents. The value of the deduction increased with income. In some ways, it allowed high-tax states and localities to export their tax liabilities to taxpayers in other states, particularly low-tax, low-income states.
>
> Generally, policymakers and their constituents argue for a progressive set of tax and spending policies at the federal and state levels. Higher-income individuals should be subject to higher levels of taxation to finance spending programs that benefit low- and middle-income individuals. The SALT deduction, however, distorts this preference. The SALT deduction provides a larger benefit to states with high levels of income and well-being, compared to other states.

It is more precise to highlight that it is the high earners in those high-tax states who largely would benefit from a repeal of the SALT cap.

The key policy decision at issue concerning a potential SALT cap repeal is whether the tax benefits should in fact largely flow to high earners in a select few states. A repeal of the SALT cap is unlikely to stop an exodus of high earners from those states. Therefore, federal lawmakers will have to decide if a SALT cap repeal, which costs a little over $500 billion until 2025 and effectively only benefits high income earners in select states, is worth it. A repeal of the $10,000 cap may be needed to get enough political support from Democrats in order to get the president's infrastructure package(s) through Congress, further driving up its total cost.

The key policy decision at issue concerning a potential SALT cap repeal is whether the tax benefits should in fact largely flow to high earners in a select few states.

Eliminating the SALT Deduction Cap

(Conventional revenue estimates in billions of dollars)

Year	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2019-2028
Eliminate SALT Cap	-81	-86	-90	-95	-101	-107	-113	0	0	0	-673

Source: Tax Foundation General Equilibrium Model (Oct. 2018) and HilltopSecurities.

Recent History of SALT in New York

Gov. Cuomo, State Comptroller Thomas DiNapoli, and Budget Director Robert Mujica warned, "SALT was an economic civil war" a little over a year before the COVID-19 shutdowns even began. They argued that one item in particular, which helped pay for the federal tax reform passed on Dec. 22, 2017, would be devastating to New York's, New Jersey's, Connecticut's, Massachusetts' and California's revenue bases. The policy topic they referred to was the $10,000 cap on the federal SALT deduction.

Gov. Cuomo and other state officials argued the $10,000 cap on the federal SALT deduction would be devastating to New York and other states' revenue bases.

The New York leaders indicated in a Jan. 2019 presentation, again even before COVID-19, that:

- New York is paying for tax cuts in other states (p. 22);
- SALT costs New York $14.3 billion (p. 21);
- The average New York taxpayer has SALT deductions that are more than twice the $10,000 cap (p. 23);
- SALT encourages high-income New Yorkers to move to other states. If even a small number of high-income taxpayers leave the state, it would harm state revenues (p. 25);
- Taxpayers are adjusting in response to SALT. Anecdotal evidence suggests that high income taxpayers are considering changing their residence and that financial industry firms are looking at real estate outside of New York.

It was, as Gov. Cuomo points out, mostly blue states (and especially New York) that were more severely impacted when Republican lawmakers capped the SALT deduction at the end of 2017. "If the SALT deduction were eliminated, assuming a 25% marginal tax rate, an average taxpayer in New York who currently itemizes SALT would face a tax increase of almost $5,500," a Government Finance Officers Association (GFOA) analysis reports (see p. 8). See the below table for the average SALT deduction by state before 2017. New York was over twice the cap at $22,169. The averages in Connecticut, California, and New Jersey were not quite that high, but ranged between $17,850 and $19, 664. The average of all states was just over $10,000.

NY leaders indicated SALT encourages high-income New Yorkers to move to other states. If even a small number of high-income taxpayers leave the state, it would harm state revenues.

Average SALT Deduction by State (Prior to '17 Tax Cut)

#	State	Amount	#	State	Amount	#	State	Amount
1	NY	$22,169	18	OH	$10,444	35	SC	$8,765
2	CT	$19,664	**19**	**Avg.**	**$10,233**	36	IN	$8,756
3	CA	$18,437	20	IA	$10,163	37	UT	$8,291
4	NJ	$17,850	21	NH	$10,121	38	OK	$8,201
5	DC	$16,442	22	KY	$9,955	39	TX	$7,823
6	MA	$15,571	23	HI	$9,905	40	AZ	$7,403
7	MN	$12,954	24	MO	$9,886	41	WA	$7,402
8	MD	$12,931	25	MI	$9,648	42	FL	$7,373
9	OR	$12,616	26	NC	$9,587	43	NM	$7,091
10	IL	$12,523	27	WV	$9,462	44	ND	$6,864
11	RI	$12,434	28	KS	$9,425	45	LA	$6,742
12	VT	$12,407	29	MT	$9,357	46	WY	$6,306
13	WI	$11,653	30	DE	$9,194	47	MS	$6,302
14	ME	$11,431	31	GA	$9,158	48	SD	$6,098
15	VA	$11,288	32	AR	$9,116	49	NV	$5,989
16	PA	$11,248	33	CO	$9,017	50	AL	$5,918
17	NE	$11,088	34	ID	$8,862	51	TN	$5,611
						52	AK	$4,931

Source: GFOA and HilltopSecurities.

The table shows average SALT deduction by state before 2017. New York was over twice the cap at $22,169.

Little Evidence of Millionaire Tax Flight, Pre-COVID19

For some time, policymakers, observers, and others have suspected that tax policy has had some level of impact on U.S. state-to-state migration patterns. However, prior to COVID-19 experts found that there has been a long-term decline in interstate migration, and empirical evidence has commonly shown that tax policy did not generally impact location decisions of high-income or other earners. Even in a 2016 analysis, Millionaire Migration and Taxation of the Elite: Evidence from Administrative Data, authors Stanford University and the U.S. Treasury, wrote, "The most striking finding of this research is how little elites seem willing to move to exploit tax advantages across state lines." The authors found, "millionaire tax flight is occurring, but only at the margins of statistical and socioeconomic significance." There is also not yet sufficient evidence to suggest the SALT cap is contributing to residents leaving high tax states, according to the Tax Policy Center.

Prior to COVID-19, experts found that there has been a long-term decline in interstate migration, and empirical evidence has commonly shown that tax policy did not generally impact location decisions of high-income or other earners.

Recent Migration Patterns

The truth behind the key drivers of the state-to-state migration data is hard to zero in on. What we do know is that the top two states for inbound migration in 2020 were Idaho and South Carolina (Florida was #9), according to a Tax Foundation analysis, Where Did Americans Move in 2020? The top states for outbound migration in 2020 were New Jersey, New York, Illinois, Connecticut, and California. See more, including historical patterns, at United Van Lines' National Migration Study Reveals Where and Why Americans Moved in 2020.

There is not yet sufficient evidence to suggest the SALT cap is contributing to residents leaving high tax states.

Individuals move in and out of states for a variety of reasons. Sometimes tax policy not only impacts these decisions, but tax policy can also directly dictate where job openings are located. Retirement and related demographics and weather contribute to these migration patterns as well. Remote work is also helping to reshape workers' decisions.

The top states for outbound migration in 2020 were New Jersey, New York, Illinois, Connecticut, and California.

The Post-COVID-19 Reality of Migration, Threat to New York

A commonly agreed upon consequence from COVID-19 is that it accelerated many pre-existing trends, and this is especially true as it relates to technology. Remote work has been a topic commonly referred to as one that is going to be very impactful to migration. In only a matter of weeks, many companies and regulatory authorities quickly adjusted to a work from home or remote work model because of COVID-19. An Upwork Economist Report: Remote Workers on the Move reported in October 2020 that, "anywhere from 14 to 23 million American are planning to move as a result of remote work." This is going to have a significant impact on where individuals work; where they eat lunch and dinner, and how much and where they pay their taxes.

This is such an important topic that *The Economist* included this theme, the Future of Work, as a multi-page special report in its April 10, 2021 edition. Public finance observers will be pleased to know *The Economist* indicated, "Cities will not empty." While that may be true, the impact of remote work could be significant. One of the articles, The Rise of Working From Home, in *The Economist*'s special report notes the average worker would like to work at home 50% of the time. Even if employers have their way, the work from home number will be closer to just over one day a week. Still, these scenarios are much more than the only 5% of workers who worked from home before the pandemic, according to a Pew survey. How Remote Work is Reshaping America's Urban Geography explored this important topic as well. This Financial Times article cites Redfin 2021 Q1 data showing that smaller cities are attracting migrants from places like California, New York, and Chicago among others.

Remote work has been a topic commonly referred to as one that is going to be very impactful to migration. In only a matter of weeks, many companies and regulatory authorities quickly adjusted to a work from home or remote work model because of COVID-19.

The Escape from New York Could Be Permanent This Time

The work from home trend poses a more severe threat to New York City and New York state than it does in much of the U.S. Media accounts and reports have repeatedly warned of things like, "New York is not dead, but it is on life support," like we read in this BBC article.

The revenue impact of high earners leaving creates a hole in budgets that would have to be filled either with tax increases on those who remain or cuts to service delivery. Researchers at the Manhattan Institute analyzed different scenarios where city high earners depart. In their scenario where 5% of high earners ($100k+) depart, the city could go without close to $1 billion. Results from a survey commissioned by the Manhattan Institute and conducted by the Siena College Research Institute found more than half of high-income New Yorkers are working from home, and that two-thirds of them believe that could be the new normal. The report concludes, "Of those considering leaving New York City, 30% say that the possibility of working remotely makes it more likely they will move." Even if there is a slight movement in high earners (out of state), it could have an impact on state and local finances.

The work from home trend poses a more severe threat to New York City and New York state than it does in much of the U.S.

New York City Residents to Pay Highest Rate in Nation

As part of a recent New York state budget agreement, lawmakers boosted spending by $18 billion, to $212 billion, and hiked taxes on the wealthy in order to fund the spending agenda. New York City top earners will now pay the highest combined tax rate in the nation. The tax policy moves come at an inopportune time as business leaders are faced with the potential for there to be a new normal in New York City. Assorted business leaders and companies have already left New York, with some destined for Florida or other areas of the country. This post-COVID-19 period could prove to be a difficult test for New York. New York City is very exposed to its top earners. The city's top 1% is made up of 30,000 families who earn at least $1 million a year, a combined $133 billion in income in 2018, according to the Independent Budget Office of New York. This 1% paid almost $5 billion in local income taxes, or about 42% of city income tax. Also, this top 1% paid almost as much as the bottom 90% of New Yorkers, while the top 5% earned more than the bottom 95%. As you can see, New York City is very exposed to its top earners. This exposure gets to the heart of why New York lawmakers are willing to threaten the advancement of a multi-trillion infrastructure package. We will be watching closely to see how the politics evolve related to these themes in the coming months.

Even if there is a slight movement in high earners (out of state), it could have an impact on state and local finances.

New York City is very exposed to its top earners. This exposure gets to the heart of why New York lawmakers are willing to threaten the advancement of a multi-trillion infrastructure package.

Recent HilltopSecurities Municipal Commentary

- Status of Municipal Bond-Friendly Elements and the American Jobs Plan, April 14, 2021
- We Expect a Multi-Year, But Potentially Temporary, Upswing of U.S. Municipal Credit, March 30, 2021
- Infrastructure Could Strengthen Golden Age of U.S. Public Finance, Prelim Talks to Begin, March 23, 2021

Readers may view all of the HilltopSecurities Municipal Commentary here.