**The Massachusetts Joint Committee on Revenue**
**"Using a State Employer-Side Payroll Tax to Offset the Limit on the SALT Deduction"**

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## The Republican Tax Plan's Attack on Liberal States

While the main thrust of the Republican tax plan was to lower tax rates on high-income taxpayers through a variety of mechanisms, including a reduction in the top income tax rate, it also involved a quite explicit attack on liberal states. The decision to limit the deductibility of state and local taxes to $10,000 will have a disproportionate impact on liberal states. These states tend to have higher local property and state income taxes. This means a far higher percentage of taxpayers in these states will run up against the $10,000 limit than in more conservative states. The result is that higher-income taxpayers, who would have otherwise had their state tax burden partially defrayed by the federal income tax deduction, will instead bear the full burden themselves.

My testimony briefly shows the disproportionate impact of the restrictions on state and local tax (SALT) deductions. Then it argues as to why this is unfair, even though the most affected individuals are higher-income people who have been the biggest gainers in the economy over the last four decades. Finally, it outlines the possibility of using a state employer-side payroll tax, as a partial substitute for the income tax, as a way to preserve deductibility for most taxpayers.

## The Disproportionate Impact on Liberal States

Limiting the SALT deduction to $10,000 per return has by far the greatest impact on states that have consistently voted Democratic. This is the case both because these states tend to have higher property values and therefore higher costs of living, and also because they quite deliberately try to provide their residents with better services in the form of health care, education, and child care than conservative states. In many areas, the property tax on even middle-income houses will be large enough to fully absorb the $10,000 allowable deduction. This means that residents will not be able to deduct state income taxes against their federal income tax.

The table below shows the percent of tax filers taking the SALT deduction in the five most populous states that have consistently voted Democratic in presidential races, along with the five most populous states that have consistently voted Republican. It also shows the average value of the deduction claimed on the returns for taxpayers using the SALT deduction. The data are for the 2015 tax year, the most recent year for which data are available.

| | **Percent Taking SALT Deduction** | **Average Value of Deduction** |
|---|---|---|
| **Democratic States** | | |
| California | 34.4% | $18,439 |
| New York | 34.5% | $22,168 |
| Illinois | 31.3% | $12,521 |
| New Jersey | 41.2% | $17,852 |
| Massachusetts | 36.9% | $15,573 |
| **Republican States** | | |
| Texas | 22.8% | $7,824 |
| Georgia | 32.8% | $9,160 |
| Arizona | 28.4% | $7,404 |
| Tennessee | 19.3% | $5,611 |
| Indiana | 22.7% | $8,755 |

Source: Statistics on Income, 2015: Historic Table 2, https://www.irs.gov/statistics/soi-tax-stats-historic-table-2.

In all of the five most populous Democratic states, more than 30 percent of tax filers took advantage of the SALT, with more than 40 percent of filers in New Jersey taking advantage of this deduction. By contrast, among the five most populous states consistently voting Republican, only Georgia crossed the 30 percent threshold. The share of filers using the deduction in Indiana and Texas was less than 23 percent and it was under 20 percent in Tennessee.

In addition to the fact that a much smaller share of filers use the SALT deduction in red states than in blue states, those who do take advantage of the deduction also benefit far less on average from the deduction. Among the five most populous red states, the largest average value for the deduction was in Georgia at $9,160. In Tennessee, the average value of the deduction was just $5,600. Obviously, a relatively small share of the households in red states will be affected by a $10,000 cap on the deduction.

By contrast, in the five most populous blue states, the lowest average deduction was $12,520 in Illinois. The average deduction was $18,440 in California and $22,170 in New York. There are many households in these states who will be affected by a $10,000 cap on the deduction and will pay substantially more federal income tax as a result.[1]

The Republicans in Congress and the Administration were fully aware of the impact their plan would have on Democratic states. They openly have spoken about this limit as providing incentives for liberal states to reduce their taxes, with the implied reduction in public services that would inevitably follow. Steven Moore, a prominent Republican consultant on economic issues and campaign adviser to President Trump, argued that if Democratic states did not reduce their tax rates, then higher-income people in these states would simply move to lower tax states.[2]

Whether or not Moore's assessment of the impact of the new tax plan on population flows proves correct, there can be little doubt about the motivation for this particular provision. The Republicans wanted to make it more costly for liberal states to pursue progressive policies by providing high-quality public services to their residents. As it is structured, the tax plan will certainly have this effect.

**Limiting the State and Local Tax Deduction: Shouldn't the Wealthy Pay More?**

One of the arguments in favor of the cap on the SALT deduction is that it is aimed at overwhelmingly higher-income taxpayers, who have been the big gainers in the economy over the last four decades. Many of these taxpayers will also benefit from other provisions in the tax code, such as the reduction in the top rate from 39.6 percent to 37.0 percent, or the reduction in the tax rate on income from pass-through corporations.

While it is true that most of the people who will be affected by the limit on SALT deductibility are among the winners in the economy, this is certainly not true of many of them. Furthermore, even in the cases of very high earners, this is a tax increase that results from them living in a liberal state, not one that is based on their high income alone.

Regarding the first point, there will be many households in states like New York or California earning less than $200,000 a year who will see their $10,000 SALT deduction limit reached from property taxes alone. These people can live in houses that have current values in the range of

1 It is worth noting that these figures are for 2015. They would likely be around 10 percent higher in 2018 due to inflation and income growth.
2 See http://wvik.org/post/conservative-economist-makes-case-capping-tax-deductions-popular-blue-states#stream/0.

$700,000 to $1,000,000 (they may have paid a much lower price when they purchased the house), so their property tax burden can approach or exceed $10,000. This means that whatever they pay in state income tax will not be deductible on their federal taxes. In these states, their income tax liability could be in excess of $10,000, meaning that they will see a substantial rise in taxable income under the new law.

While these households are clearly doing better than most people in the country, few would see a two-earner, four-person household with an income of $180,000 in the New York City area as wealthy. An increase in their taxes on the order of $2,500 a year would not be inconsequential.

However, the more important point is that this is an increase that is only being levied on taxpayers in more liberal states. Even if we believe that higher-income people should be paying more money in taxes, it doesn't make sense to restrict the tax to specific groups of high-income people. It would never occur to us to impose a special tax on high-income people of Italian or French ancestry.

In this case, the tax increase on higher-income people in relatively liberal states is intended to discourage spending in areas like quality K–12 education, free college, quality child care, or other public services. This is especially important in our current political environment. Since conservatives currently control policy at the federal level and have for most of the last four decades, the possibilities for experimentation with progressive policy lie almost entirely at the state level. The Republicans hope to strangle this potential by making it too costly for liberal states to fund increased public services or possibly to even sustain current levels of funding.

In this respect, it is worth noting that the tax plan placed no limit on the charitable deduction. This means that any conservative millionaire or billionaire who decides to give a large chunk of money to a right-wing charity (e.g., The Religious School for the Advancement of White Nationalism) can still get the federal government to pick up 37 cents of every dollar they donate. Taxpayers will be on the hook for $37 million if they chose to give $100 million to this cause. However, state or local taxes used to improve the quality of education for inner city kids, or to provide child care for their parents, will not be tax deductible. This money will come 100 percent out of the pockets of people that live in liberal states. That is neither good policy, nor can it be seen as a very fair outcome.

**Fixing the SALT Deduction Cap with State Employer-Side Payroll Taxes**

There are several ways that have been proposed for working around the cap on SALT deductions, but the cleanest route is to substitute a state employer-side payroll tax for a portion of the state income tax.[3] For example, Massachusetts could substitute a 5.1 percent employer-side payroll tax for its 5.1 percent income tax on wage income. (The tax on income from capital, such as dividends and rents, could be left in place.)

The logic of this approach is that we would expect that wages would be reduced by roughly the size of the payroll tax, as employers pass on the cost of the tax in the form of lower wages. This means that someone who used to get paid $100,000 a year will instead get paid $94,900, as the employer passes on the $5,100 tax in the form of lower wages. Since this worker no longer has any state income tax liability, they are in the same position after paying state taxes as they had been previously. However, the benefit is that they would only be subject to federal income taxes on the $94,900 that shows up in their paycheck, not the $100,000 they used to receive. This effectively preserves the deductibility of the state tax.

Going this route also has the advantage of effectively extending the deduction for state taxes to all taxpayers, even those who don't itemize. In the case described above, this person would be paying less in federal income taxes as a result of the switch to the payroll tax regardless of whether they choose to itemize. This would effectively mean a substantial reduction in federal income taxes for millions of workers in the state who had never itemized, or would no longer itemize, given the changes in the tax code. In this particular case, if the worker is in the 22 percent bracket, the savings would be $1,122 a year.

There is another benefit for Massachusetts workers in going this route since the lower base pay would also mean lower taxes for Medicare and Medicaid. These taxes together are equal to 15.35 percent of wages.[4] In this case, the reduction in taxable wages associated with the payroll tax would

3 The other two routes that have been proposed are setting up state charities that would support areas like public education and health care. People could contribute to these charities and get a deduction on their federal income taxes. They would also get a 100 percent credit against their state income taxes for any contributions. Another route would be to have a state payroll tax where the money paid in the tax was 100 percent deductible from the state income tax. These routes have the advantage that they would require no change in the state income tax structure. However, both are legally questionable in a way that a state employer-side payroll tax is not.

4 The Social Security tax is capped at $128,400, but there is no limit on the wages subject to the Medicare tax.

save the worker described above another $780 a year, bringing their total savings on federal taxes to more than $1,900 a year.[5] This would be a substantial benefit to a middle-income worker.

To simplify the adjustment process, it would be best if any employer-side payroll tax were phased in over 2–3 years. While it is widely accepted among economists that employer-side taxes are passed on in wages, the adjustment is not likely to take place immediately. Also, workers will likely resent a cut in nominal pay even if it is offset by a lower tax burden. (Actually, since profit shares of income have been extraordinarily high and employers did just get a large tax cut, it would be reasonable to think that many employers would absorb some of the tax increase.) With nominal wages rising on average around 2.5 percent annually, if the payroll tax was phased in over two years it should be possible for employers to pass it on to workers by holding wages constant rather than actually cutting them. This means it would take a bit longer to fully offset the impact of the loss of the SALT deduction, but it is likely to make the transition process smoother.

**Conclusion: State Employer-Side Payroll Taxes Can Protect Massachusetts Workers from the Republican Plan**

An employer-side payroll tax should be an effective way to shield the vast majority of Massachusetts workers from the limits on the deductibility of SALT. It will not protect everyone from harm under this provision, since people with substantial capital income, and therefore substantial income tax liability on this income, will still lose the ability to deduct the full amount. But even in these cases, switching to an employer-side payroll tax is likely to benefit them since it will increase the percentage of their state taxes that can be deducted.

There is an argument that it is not desirable to have state and local governments trying to game the federal tax code. This is, in general, true. For the most part, we have seen different levels of government working together rather than trying to improve their situation at the expense of other levels of government. However, with the Republicans in Congress and the White House abandoning longstanding norms of fairness and effectively declaring war on more liberal states like Massachusetts, it would be the height of foolishness to pretend that nothing has changed. A state-level employer-side payroll tax gives Massachusetts, and other liberal states, a weapon with which to fight back. They should take it.

5 The reduction in taxable wages would mean that workers would get somewhat smaller Social Security checks when they retire. It would be desirable to have some mechanism to facilitate savings so that workers will be at least as well off in their retirement in this scenario as they had been.