

# State Payroll Taxes: A Tool for States to Circumvent the Republican Tax Plan

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# Executive Summary

The new tax law sharply limits the deduction for state and local taxes (SALT) when calculating federal taxes by capping the deduction at \$10,000. While this will not affect most taxpayers, it will affect a substantial number of taxpayers in relatively high tax states like California and New York. This paper suggests an employer-side payroll tax as a tool that states can use to shield most of the tax revenue that otherwise would have been collected through formerly deductible income or sales taxes.

The paper notes:

- The limit on deductibility seems to have been designed to punish states that tend to vote Democratic in national elections. These states have far more people who take the SALT deduction and have larger SALT deductions. Some Republican political figures have been quite open in seeing this as an attack on more liberal states that attempt to provide more services to their residents.
- While the loss of the deduction is not likely to cause higher-income residents to flee to lower-tax states, as some have claimed, it will make it more difficult politically to raise revenue for funding public services like education, health care, and housing. While even the highest tax states may not have reached the limit of their ability to tax high-income households, the loss of deductibility moves them closer to this limit.
- An employer-side payroll tax that replaces a portion of existing income or sales tax would be a way to effectively preserve the deductibility of SALT. The conventional view among economists is that an employer-side payroll tax is passed on in lower pre-tax wages. This would mean that wages would be reduced by the amount of money that workers otherwise would have paid to the state in taxes. However, workers would only pay federal taxes on their reduced wages, effectively shielding the money paid through the employer-side payroll tax from federal income taxes.
- The tax can be structured to have a zero bracket free from the tax (e.g. \$15,000 a year) and an income tax for higher-income earners and nonwage income in order to preserve the progressive structure. For example, New York, which has an income tax of 8.0 percent on higher-income taxpayers, would have an employer-side payroll tax of 5.0 percent, and then apply a 3.0 percent income tax on wage income above a \$200,000 cutoff. It would leave its current tax schedule in place on nonwage income like dividends and capital gains.
- An employer-side payroll tax would also have the benefit of shielding state taxes paid by people who do not itemize their deductions. This would be a large gain to tens of millions of middle-income taxpayers.

- An employer-side payroll tax would also shield state taxes from Social Security and Medicare taxes. This is an additional source of savings for middle-income workers, even though it is not a desirable outcome from the standpoint of supporting these programs.
- The potential savings are substantial. In the case of applying a 5.0 percent employer-side payroll tax in New York (with a \$15,000 zero bracket), a worker earning \$40,000 a year would save a total of \$340 a year between their federal income tax and Social Security and Medicare taxes. A worker earning \$80,000 a year would save more than \$1,200 a year, and a worker earning \$180,000 would save almost \$2,900 a year. The state as a whole would have savings of more than \$7 billion annually. This is money that would stay in New York and support its economy. In February 2018, New York Governor Andrew Cuomo announced a plan that allows companies in New York to impose a 5.0 percent payroll tax on wages above \$40,000. Workers at companies that participate in the plan would receive a corresponding reduction in their state income tax liability, so that their after-state-tax wage would remain the same.

It is not desirable for states to design ways to game the federal tax code. However, the Republican-led Congress clearly decided to abandon longstanding norms of fairness and equity in the way it structured the recent tax bill. It would be foolhardy for states to suffer the economic and political consequences without acting to protect the interests of their residents.

# Introduction

In addition to giving large tax cuts to corporations and high-income individuals, the recently approved tax law also includes a provision that will be a serious economic blow to more liberal states. The new tax law sharply limits the deduction for state and local taxes (SALT) when calculating federal taxes by capping the deduction at \$10,000.

This provision will lead to a substantial tax increase for many people living in states like New York and California with high-quality public services. Many homeowners in these states will reach this \$10,000 limit on property taxes alone. That means that they will lose the deduction for their state and local income taxes. That could lead to an increase in taxes of several thousand dollars annually for many middle-class families and possibly tens of thousands of dollars for higher-income households.

While most of those paying higher taxes due to this provision are going to be in the upper quintile of the income distribution, and are therefore better situated to pay higher taxes, it is important to be clear on its impact. The Republicans did not raise taxes on higher-income people in general with this provision; they raised taxes on higher-income people who live in relatively liberal states.

**Table 1** 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.

**TABLE 1**

**Tax Filers Taking the SALT Deduction in Five Most Populous Democratic and Republican States**

(percent and dollars)

	Percent Taking SALT Deduction	Average Value of Deduction
<b>Democratic States</b>		
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
<b>Republican States</b>		
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 and notes: Internal Revenue Services' Statistics on Income (Internal Revenue Service 2015).

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 uses 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.

The Republicans in Congress and the Administration were fully aware of the impact their plan would have on Democratic states. They have spoken openly 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 (WVIK 2018).

## **The Implication for Liberal States of Limiting the Deductibility of SALT**

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.

The basic logic is straightforward. Under the old tax code, high-income households were able to deduct the full amount of their state and local income tax liability from the income subject to federal

income tax.<sup>1</sup> This meant that the federal government was effectively picking up 39.6 percent (the top income tax bracket) of the taxes imposed by state and local government. This federal subsidy made it easier for state and local governments to raise taxes on high-income taxpayers since it meant that only 60 cents of every dollar collected would come out of their pockets.

Removing this subsidy will lead to two types of responses. The first is the direct political response. While most upper-income taxpayers were likely unhappy with efforts by state and local governments to get them to pay more taxes, they knew they could offset close to 40 percent of any additional tax burden through additional deductions on their federal income tax.

The new Republican tax law takes away this subsidy, which means a large effective increase in the total tax burden for these individuals. While in most cases the increased burden of state taxes will be offset by cuts in the federal income tax, the question is not one of fairness, it is one of how wealthy individuals perceive their taxes.

For example, California has a top marginal income tax rate of 13.3 percent on income over \$1 million. As a result of this rate structure, a household with a taxable income of \$2 million would be paying more than \$220,000 a year in state income taxes.<sup>2</sup> Under the old law, this tax liability was offset by savings of more than \$80,000 on federal income taxes. Since most people in this income category will hit the \$10,000 cap on SALT deductions with their property taxes alone, they will now have none of their state income tax offset by a reduced federal income tax liability.

It is difficult to believe that this will not lead this very powerful interest group to push for lower state taxes. At the very least, it will almost certainly mean much stronger resistance to any future tax increases on high-income taxpayers.

The other way in which high-income people can respond to this change in the tax code is by moving or appearing to move, to a lower tax state. (“Appearing to move” means claiming another state as a place of residence for part or all of the year in order to avoid taxation.) There are mixed findings in the research on the sensitivity of high-income people to differences in tax rates, but it clearly is not zero.<sup>3</sup>

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1 This is not the case if they are subject to the Alternative Minimum Tax.

2 The rate structure for California’s state income tax can be found at: <https://www.bankrate.com/finance/taxes/state-taxes-california.aspx>.

3 Young and Varner (2011) find relatively little evidence of an increase in mobility in New Jersey following its introduction in 2004 of a 2.6 percent “millionaires’ tax” applying to incomes over \$500,000. Varner and Young (2012) find little impact on migration of the 1.0 percentage point increase in taxes on people earning more than \$1 million in California. By contrast, Moretti and Wilson (2015) find a large effect of state income taxes on the location decisions of superstar scientists.

This change in the tax code effectively increases the difference in tax rates between states by a much larger amount than most recent changes in the tax rates states have imposed on upper-income taxpayers. For example, in 2004, New Jersey imposed a 2.6 percent millionaire's tax on incomes above \$500,000. After accounting for the deductibility on federal taxes this would have been a tax increase of 1.7 percentage points on incomes above \$500,000. In 2005, California introduced a Mental Health Services Tax of 1.0 percent on incomes above \$1 million. This would be a tax increase of 0.65 percent on incomes over \$1 million after accounting for the deductibility of the state tax.

By contrast, in the hypothetical case discussed earlier of the person earning \$2 million a year in California, the loss of the federal deduction would be equivalent to a 4.4 percentage point increase in taxes on their entire income, a 5.8 percentage point increase in taxes on their income over \$500,000, or an 8.7 percentage point increase in the tax on their income in excess of \$1 million. In short, the loss of the deductibility of SALT is a big deal for high-income taxpayers relative to recent increases in state and local income taxes. While it may not be the case that this will send them fleeing to lower tax states, there is clearly some point at which tax differentials will make a difference in the location decisions of the wealthy, and the loss of deductibility brings higher tax states closer to this point.

## Circumventing the SALT Deduction Cap with State Employer-Side Payroll Taxes

There are several ways that have been proposed for skirting 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.<sup>4</sup> For example, a state could substitute a 5.0 percent employer-side payroll tax for a 5.0 percentage point reduction in its 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 \$95,000, as the employer passes on the \$5,000 tax in the form of lower wages. Since this worker no longer has any state income

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4 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. The other 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.

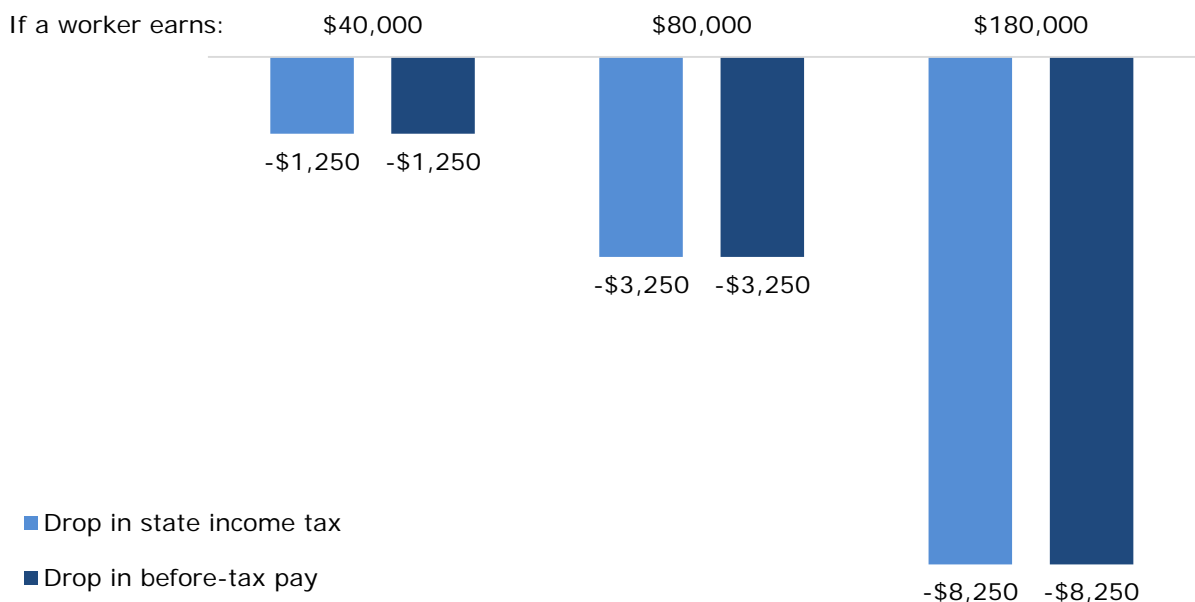


tax liability, they are in the same position after paying state taxes as they had been previously. However, the benefit is that they would only be subject to federal income taxes on the \$95,000 that shows up in their paycheck, not the \$100,000 they used to receive. This effectively preserves the deductibility of the state tax.

**Figure 1** below shows the change in state income taxes and before-tax income at three different wage levels — \$40,000, \$80,000, and \$180,000 — from substituting a 5 percent employer-side payroll tax for a 5 percent income tax. In each case, it assumed that there is a zero bracket below \$15,000 so very low-wage workers would not be subject to the payroll tax, just as they do not pay the state income tax.

**FIGURE 1**

**Drop in State Income Tax and Before-Tax Pay**



Source and notes: Author's calculations, see text.

As can be seen at each wage level, the drop in before-tax pay should be equal to the savings on state income taxes. This means that workers are not harmed by the shift in the tax burden from income taxes to an employer-side payroll tax. While this shift does not hurt them relative to their position with the state government, it does substantially lower their federal tax burden.

Going the route of an employer-side payroll tax 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 mean a substantial reduction in federal income taxes for millions of workers who had never itemized, or would no longer itemize, given the

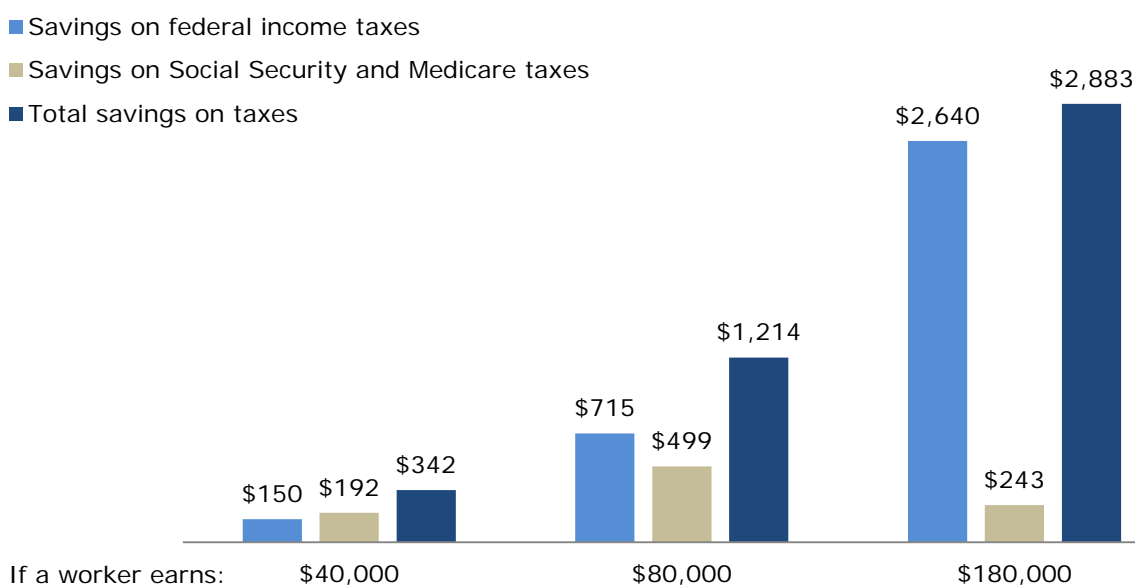
changes in the tax code. In this particular case, if the worker is in the 22 percent bracket, the savings on federal income taxes would be \$1,100 a year.

There is another benefit for a state’s workers; the lower base pay would also mean lower taxes for Social Security and Medicare. These taxes together are equal to 15.35 percent of wages.<sup>5</sup> In this case, the reduction in taxable wages associated with the payroll tax would save the worker described above another \$780 a year, bringing their total savings on federal taxes to more than \$1,900 a year.<sup>6</sup> This would be a substantial benefit to a middle-income worker.

**Figure 2** below shows the savings on income taxes and Social Security and Medicare taxes at each of these three wage levels.

**FIGURE 2**

**Tax Savings from Replacing State Income Tax with Payroll Tax**



Source and notes: Author's calculations, see text.

The worker earning \$40,000 a year would save \$150 a year on his income taxes and \$192 a year on his Social Security and Medicare taxes for a total savings of \$342. A worker earning \$80,000 a year would save \$715 a year on her income taxes and \$499 a year on her Social Security and Medicare taxes for a

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

6 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.

total savings of \$1,214. A worker earning \$180,000 a year would save \$2,640 a year on her income taxes and \$243 a year on her Social Security and Medicare taxes for a total savings of \$2,883.

The reason the savings on Social Security and Medicare taxes is so much less for a worker earning \$180,000 a year is that the Social Security tax is capped so that it doesn't apply to wage income over roughly \$130,000. This worker would only be subject to the 2.9 percent Medicare tax on her last \$50,000 in wage income.

## The Benefits to State Economies from an Employer-Side Payroll Tax

In addition to benefiting workers by reducing their federal tax liability and by putting more money in workers' pockets, an employer-side payroll tax will provide a boost to state economies. There is a substantial amount of money at stake. If this money stays in the pockets of workers in the state rather than being sent to Washington, it can provide a healthy boost to a state's economy.

**Table 2** shows the potential savings for each state based on an employer-side payroll tax in place of an existing income or sales tax of the amount indicated in Column 6. The calculations assume a 15 percent zero bracket, meaning the first \$15,000 of wage income would be exempt from the tax. The total wage income for the state is shown in Column 1, with the amount shielded under this assumption shown in Column 2. The calculations assume that the average income tax rate applied to the amount of money shielded from federal income taxes is 20 percent, as shown in Column 3. Column 4 shows the savings in Social Security and Medicare taxes, which is assumed to be 10 percent of the money shielded from federal taxes. Column 5 sums the savings on income and Social Security and Medicare taxes.

California, the state with the most at stake, had total wages of more than \$1.1 trillion in 2016. Replacing 7 percentage points of the state's income tax with a 7.0 percent employer-side payroll tax, together with a \$15,000 zero bracket, would shield \$60.4 billion from federal taxes. This would lead to savings of \$12.1 billion on federal income taxes and \$6.0 billion on Social Security and Medicare taxes, for total annual savings of \$18.1 billion. This is money that California residents will be able to spend each year, which otherwise would be paid to the federal government in taxes. This is enough to provide a noticeable boost to California's economy.

**TABLE 2****State Savings on Federal Taxes**

(millions of 2016 dollars)

	Wages and Salaries	Income Shielded	Income Tax Saved	FICA Saved	Total	Savings per Worker (dollars)	Tax Being Replaced (percentage points)
Alabama	\$90,592	\$2,413	\$362	\$241	\$603	\$299	Income, 4.00%
Alaska	\$20,529	\$0	\$0	\$0	\$0	\$0	None, 0.00%
Arizona	\$139,321	\$3,911	\$587	\$391	\$978	\$353	Income, 4.00%
Arkansas	\$53,993	\$1,934	\$290	\$193	\$484	\$385	Income, 5.50%
California	\$1,116,922	\$60,417	\$9,063	\$6,042	\$15,104	\$893	Income, 7.00%
Colorado	\$116,322	\$5,123	\$769	\$512	\$1,281	\$481	Income, 4.60%
Connecticut	\$113,106	\$5,276	\$791	\$528	\$1,319	\$786	Income, 6.00%
Delaware	\$24,677	\$893	\$134	\$89	\$223	\$492	Income, 5.00%
District of Columbia	\$69,753	\$2,314	\$347	\$231	\$578	\$729	Income, 4.00%
Florida	\$424,077	\$17,634	\$2,645	\$1,763	\$4,408	\$508	Income, 6.00%
Georgia	\$234,825	\$6,487	\$973	\$649	\$1,622	\$268	Income, 4.50%
Hawaii	\$35,884	\$1,301	\$195	\$130	\$325	\$495	Income, 5.00%
Idaho	\$29,444	\$931	\$140	\$93	\$233	\$322	Income, 5.00%
Illinois	\$355,280	\$13,227	\$1,984	\$1,323	\$3,307	\$547	Income, 5.00%
Indiana	\$142,978	\$3,070	\$461	\$307	\$768	\$245	Income, 3.20%
Iowa	\$71,817	\$3,347	\$502	\$335	\$837	\$523	Income, 7.00%
Kansas	\$67,217	\$2,298	\$345	\$230	\$575	\$405	Income, 5.00%
Kentucky	\$87,794	\$2,925	\$439	\$292	\$731	\$374	Income, 5.00%
Louisiana	\$95,621	\$3,300	\$495	\$330	\$825	\$418	Income, 5.00%
Maine	\$27,705	\$1,196	\$179	\$120	\$299	\$482	Income, 6.50%
Maryland	\$167,235	\$6,275	\$941	\$628	\$1,569	\$564	Income, 5.00%
Massachusetts	\$242,384	\$7,511	\$1,127	\$751	\$1,878	\$516	Sales, 4.00%
Michigan	\$222,823	\$6,655	\$998	\$665	\$1,664	\$377	Income, 4.25%
Minnesota	\$158,271	\$2,280	\$342	\$228	\$570	\$193	Property, 2.00%
Mississippi	\$47,323	\$1,496	\$224	\$150	\$374	\$322	Income, 5.00%
Missouri	\$138,201	\$5,212	\$782	\$521	\$1,303	\$450	Income, 5.50%
Montana	\$19,854	\$636	\$95	\$64	\$159	\$334	Income, 5.00%
Nebraska	\$47,003	\$1,575	\$236	\$158	\$394	\$381	Income, 5.00%
Nevada	\$64,404	\$1,761	\$264	\$176	\$440	\$324	Income, 4.00%
New Hampshire	\$35,731	\$1,146	\$172	\$115	\$287	\$419	Income, 4.50%
New Jersey	\$256,478	\$9,720	\$1,458	\$972	\$2,430	\$587	Income, 5.00%
New Mexico	\$37,640	\$1,747	\$262	\$175	\$437	\$516	Income, 7.00%
New York	\$639,448	\$19,844	\$2,977	\$1,984	\$4,961	\$519	Income, 4.00%
North Carolina	\$221,504	\$8,516	\$1,277	\$852	\$2,129	\$479	Income, 5.50%
North Dakota	\$21,719	\$304	\$46	\$30	\$76	\$174	Income, 2.00%
Ohio	\$270,999	\$4,510	\$676	\$451	\$1,127	\$204	Income, 2.40%
Oklahoma	\$75,614	\$1,517	\$228	\$152	\$379	\$227	Income, 3.00%
Oregon	\$96,026	\$3,386	\$508	\$339	\$847	\$449	Income, 5.00%
Pennsylvania	\$312,472	\$6,839	\$1,026	\$684	\$1,710	\$286	Income, 3.07%
Rhode Island	\$26,197	\$749	\$112	\$75	\$187	\$376	Income, 4.00%
South Carolina	\$94,249	\$4,378	\$657	\$438	\$1,094	\$518	Income, 7.00%
South Dakota	\$18,394	\$356	\$53	\$36	\$89	\$204	Sales, 3.00%
Tennessee	\$142,799	\$3,897	\$585	\$390	\$974	\$322	Sales, 4.00%
Texas	\$670,659	\$19,360	\$2,904	\$1,936	\$4,840	\$389	Sales, 4.00%
Utah	\$68,298	\$2,300	\$345	\$230	\$575	\$387	Income, 5.00%
Vermont	\$14,390	\$385	\$58	\$39	\$96	\$304	Sales, 4.00%
Virginia	\$230,876	\$9,852	\$1,478	\$985	\$2,463	\$621	Income, 5.75%
Washington	\$203,613	\$6,132	\$920	\$613	\$1,533	\$457	Sales, 4.00%
West Virginia	\$29,771	\$928	\$139	\$93	\$232	\$310	Income, 5.00%
Wisconsin	\$139,096	\$5,667	\$850	\$567	\$1,417	\$476	Income, 6.00%
Wyoming	\$13,444	\$280	\$42	\$28	\$70	\$254	Sales, 3.00%

Source and notes: Bureau of Economic Analysis, Table SA4 (BEA 2017) and state websites.

The impact is less in other states, in part because they are smaller, but also even in relative terms. Since their state tax rates are generally lower than in California, they stand to gain less from this sort of shift. Nonetheless, the savings can still be substantial. The calculations in Table 2 show that Illinois can save \$3.6 billion annually, Massachusetts can save \$2.8 billion, and New Jersey can save \$2.3 billion by substituting an employer-side payroll tax for a portion of their state income tax. There are few, if any, other policies that can bring this sort of money to a state and certainly not with the same degree of certainty.

## Issues with Switching to a Payroll Tax

The replacement of a substantial portion of current taxes with an employer-side payroll tax will inevitably involve some complications. Most immediately, it would be difficult to introduce a substantial tax all at once. Even though the payroll tax will be fully offset by lower state taxes in almost all cases, the assumption is that workers will have lower pay as a result of the tax. Many workers may resist a cut in nominal pay, even though they are receiving an equal cut in their state taxes.

To avoid this problem, it would be best if any employer-side payroll tax were phased in over two to three years. This will allow a period of time for wages to adjust to the tax. Since wages are rising on average 2.5 percent annually, few workers would be in a situation where they should see an actual cut in pay, as opposed to just a slower rate of increase. (Actually, since profit shares of income have been extraordinarily high and employers just got a large tax cut, it would be reasonable to think that many employers would absorb some of the tax increase.) This phase-in would mean 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.

There are some other issues in the mechanics of the tax that would have to be dealt with. The exact size of the zero bracket would vary across states depending on what the current tax structure looks like. Roughly 5 percent of the workforce has multiple jobs. The existence of a zero bracket would mean that the government would be missing some revenue from these workers since employers would base the tax only on the wages they pay, not the wage income the worker receives. (A worker earning \$40,000 a year from two jobs paying \$20,000 each would only have taxes paid on \$10,000 of their wage income if there is a \$15,000 zero bracket.) The loss of revenue is unfortunate in this case, but not of the same consequence of under-withholding when the worker is responsible for paying the tax. In that situation, workers are likely to face a large tax bill when they realize their employers have not

made adequate deductions. In this case, the only consequence is the state loses some amount of revenue; the worker is not liable for an employer-side payroll tax.

The tax will have a modest effect on worker's income which could affect their eligibility for benefits at both the state and federal level. States have to be mindful of this effect, but in most cases, it is likely to be positive for workers. For example, a head of household earning \$30,000 a year would see his before-tax wages fall by \$750 a year as a result of a 5 percent employer-side payroll tax with a \$15,000 zero bracket. If this person has two children, he is facing a 21.06 percent phase-out rate of the Earned Income Tax Credit (EITC). By having his income for federal tax purposes lowered by \$750, he would be able to get \$158 a year from the EITC.

This tax will also make more workers eligible for Medicaid and increase their insurance subsidies under the Affordable Care Act. On the negative side, it will also reduce the wage income that is the basis for their Social Security retirement, disability, or survivor benefits. It would be desirable if states could set up a vehicle to increase the likelihood that at least some of a workers' tax savings be used to boost retirement income.

There will undoubtedly be other issues arising with a state payroll tax, but they do not seem qualitatively more complicated than problems that already exist with state income taxes. Given the enormous potential gains to states from this switch, it is likely worth working through these problems.

# Conclusion: Employer-Side Payroll Taxes Can Protect States from the Negative Impact of SALT Limits

An employer-side payroll tax should be an effective way to shield the vast majority of 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, 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. In the past, we have seen the different levels of government working together rather than trying to improve their situation at the expense of other levels of government. However, the Republican-led Congress and White House abandoned longstanding norms of fairness, effectively declaring war on more liberal states. It would be foolhardy to pretend that nothing has changed. A state-level employer-side payroll tax gives liberal states a weapon with which to fight back. They should take it.

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