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The Effect of Personal Income Tax Rates on Individual and Business Decisions – A Review of the Evidence

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International Studies Program
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Executive Summary

Federal and state governments frequently use progressive personal income tax (PIT) rate structures to try to address concerns about income inequality. However, there is considerable evidence that high state PIT rates have a negative effect on business and individual decisions that negatively affect state growth rates. Indeed, the evidence shows that individuals and capital are mobile and move in response to differences in state tax rates. Therefore, it does not require a 'leap of faith' to believe that lower state PIT rates benefit an economy in terms of growth in employment and per capita incomes. Nor are proposals to cut PIT rates on high income households simply a 'give away to the rich', which is a criticism often leveled at such proposals. Rather, the benefits of robust economic growth are broadly shared throughout the income distribution, not just at the top of it. In fact, there is substantial evidence that economic growth reduces the rate of poverty.

There is a broad consensus among economists [see, for example, Harberger (1962), Mieskowski (1967), and McClure (1970)] that taxes do not necessarily stick where they are legally placed. For example, the PIT is legally assessed on individual or household income, but the story does not stop there. Individuals may respond to high PIT rates by reducing their work effort, migrating to low tax states, and/or undertaking other behaviors to reduce their PIT liabilities. In such cases, firms may have to compensate their employees for higher taxes by offering them higher pre-tax wages. In this manner, the PIT may be shifted, in full or in part, on to employers. If individuals are able to shift the PIT, in full or part, onto their employers, then many individual and business decisions may be influenced by PIT rate differentials among the states. Indeed, the effect of PIT rates on wages is a double edged sword. If employees pay the PIT, then individuals may pursue higher after-tax wages by moving to low tax states. On the

other hand, if individuals are compensated for higher taxes by receiving higher pre-tax wages, then corporations may choose to invest in low tax states because pre-tax wages are lower in those states.

Gyourko and Tracy (1989), Wallace (1993), and Feldstein and Vaillant (1994) report evidence that differences in state PIT rates are an important determinant of differences in pre-tax wage differences. This finding is very important because there is a considerable body of evidence that pre-tax wages figure prominently in plant and facilities location decisions. Hekman (1982), Papke (1991), Coughlin, Terza, and Arromdee (1991), and Gius and Frese (2002) find that high state PIT rates have a negative effect on the plant and facilities location decision, foreign direct investment, capital investment, and firm location. Finally, Helms (1985), Becsi (1996) and others report evidence that high state PIT rates slow the growth of state employment and personal income.

Economists who have studied the effects of taxes on family owned businesses find that high PIT rates discourage entrepreneurs from investing in new capital equipment and, conversely, that reducing taxes encourages new investment. At higher PIT rates, hiring employees can become a less attractive proposition as a higher fraction of any additional income that a new hire might generate for the business is taxed and diverted to the government. Finally, investment also promotes small business growth, since how much a worker can produce for a company depends on the amount and quality of the equipment that the worker has to work with. That is why when low PIT rates spur a business to make new capital investments in software, computers, or machinery, for example, that company's workers become more productive, causing the company to grow.

Wallace (2002) and Vedder (2003) examine the effect of state PIT rates on state-to-state migration behavior. Vedder (2003) reports that low tax states gained 2.05 million people in terms of net domestic migration, while high tax states lost 890,000, from 1990 to 1999. From 2000 to 2002, low tax states gained 729,000, and high tax states lost 371,000 in net domestic migration. In short, high state personal income taxes result in the high-income retirees moving to states with a low or even no personal income tax. The flight of high income households, particularly the high-income retirees, may negatively affect charitable giving in a state.

Finally, recent studies examine the effect of PIT rates on reported taxable income, which encompasses a wide variety of economic decisions, including wage-and-salary income, interest and dividend income, and net business income. A large number of studies show that personal income tax rates have a negative and economically significant effect on reported taxable income.

In summary, there is a large body of evidence that high state PIT rates have a negative effect on business and individual decisions and thus slow the growth of state employment and personal income. Consequently, states must use care in setting PIT rates to make sure that they are not out of line with those of their neighbors and other competitor states.

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The Effect of Personal Income Tax Rates on Individual and Business Decisions – A Review of the Evidence

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1. Introduction

An important goal of a state's economic policy is to create an attractive place to do business and well paying jobs for the future so that Rhode Island's talented and well educated youth choose to pursue careers at home rather than in neighboring states. As discussed in greater detail below, high state PIT rates make it more difficult for a state to achieve this objective. Federal and state governments frequently use progressive personal income tax (PIT) rate structures to address concerns about income inequality. However, the ability of state governments to do so may be limited because high PIT rates may adversely affect business location decisions, work effort, the form of compensation (e.g., fringe benefits, stock options,

etc.), capital investment, and economic growth. The purpose of this study is to review the evidence regarding the effect of high state PIT rates on business and individual decisions. Before proceeding with a review of this evidence, we briefly review current trends in the top federal and state PIT rates.

2. Recent Trends in Top Federal and State Personal Income Tax Rates

The top U.S. federal PIT rate has declined from 70 percent in 1980 to the current top rate of 35 percent.[1] This trend reflects, in part, the growing consensus among economists that high PIT rates slow economic growth. During this same period, state income tax progressivity decreased, too [see Scott and Triest, 1993], and this trend appears to be continuing. Table 1 provides a summary of recent changes to top state PIT rates. Table 1 shows that four states decreased their top PIT rate during 2004 and 2005. Specifically, Montana decreased its top rate from 11.0 percent to 6.9 percent. Nebraska and New Mexico decreased their top rates from 6.8 percent to 6.5 and 5.3 percent, respectively, and Ohio decreased its top rate from 7.5 to 7.2 percent.[2]

Table 2 provides detailed information on actual and proposed changes to the top PIT rates among the states over the past five years. In 2006, for example, New York, Pennsylvania, and Utah are reportedly considering proposals to reduce their top PIT rates. In the case of Pennsylvania, the Governor vetoed a proposed gradual reduction in the top rate to 2.98 percent, and Utah is considering reducing its top PIT rate from 7 percent to 4.9 percent. Thus, states are continuing to consider and enact decreases in their top PIT rates.

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[1] The Economic Recovery Act of 1981 reduced the top federal individual income tax rate from 70 percent to 50 percent, and the Tax Reform Act of 1986 further cut the rate from 50 percent to 28 percent. Subsequently, the top federal individual income tax rate was increased to 33 percent in 1991, further increased to 39.6 percent in 1993, and decreased to the current rate of 35 percent.

[2] Between 2004 and 2005, only one state – California – increased its top personal income tax rate, from 9.3 to 10.3 percent.

Concern among state policy-makers regarding the effect of high state PIT rates on economic growth is not misplaced. As discussed in greater detail below, the relationship between taxes and economic growth does not require a 'leap of faith', as some would have it. Rather there is substantial empirical evidence that high state PIT rates slow economic growth. Table 3 shows that Rhode Island's average top PIT rate was nearly double that of her neighboring states, and, during the same period, Rhode Island's economy substantially under performed the economies of her neighbors, as measured by the average growth rate in real per capita income and the average poverty rate.

Another criticism often leveled at proposals to cut PIT rates on high income households is that it is a 'give away to the rich', however, there is substantial evidence that economic growth is an effective anti-poverty policy. Figure 1 shows the relationship between the national growth rate in gross domestic product (GDP) and the poverty rate in the U.S. over the past two decades. Examination of Figure 1 shows that the poverty rate decreases during periods of robust economic growth, as in the economic booms of the mid-1980's and mid-1990's, and the poverty rate increases during periods of economic contraction. We contend that decreasing a state's top PIT rate benefits a state's economy by stimulating growth in employment and per capita incomes, which, in turn, reduces the poverty rate. In other words, the benefits of robust economic growth are broadly shared throughout the income distribution, not just at the top of it. The evidence shows that individuals and capital are mobile and move in response to state tax rate differentials. Thus, states must use care in setting their PIT rates to make sure that they are not out of line with those of their neighbors and other competitor states.

3. The Effect of State PIT Rates on Pre-tax Wages

There is a broad consensus among economists [see, for example, Harberger (1962), Mieskowski (1967), and McClure (1970)] that taxes do not necessarily stick where they are legally placed. For example, the PIT is legally assessed on individual or household income, but the story does not stop there. Individuals may respond to high PIT rates by reducing their work effort, migrating to low tax states, and/or undertaking other behaviors to reduce their PIT liabilities. In such cases, firms may have to compensate their employees for higher taxes by offering them higher pre-tax wages. In this manner, the PIT may be shifted, in full or in part, onto employers. If individuals are able to shift the PIT, in full or part, onto their employers, then many individual and business decisions may be influenced by PIT rate differentials among the states. Because wage differentials among the states figure prominently in business decisions, we begin by examining the evidence regarding the PIT rate differentials on net-of-tax wage differentials among the states.

In one of the first studies of the effect of PIT rates on wages, Gyourko and Tracy (1989) examine whether differences in fiscal conditions among metropolitan areas generate wage differentials. They find that differences in state PIT rates are an important determinant of wage differentials across cities. Wallace (1993) also explores the effect of PIT tax rate differentials on wages by using data from the Current Population Survey. She finds that in 25 percent of the cases studied, the state PIT is not borne by employees, while in 75 percent of the cases employees bear the entire burden of the tax. More specifically, she finds that relatively low skilled groups (service occupation, production, machine operators, transportation) do not bear the entire burden of the tax in traditional manufacturing industries (durable goods and transportation) and service industries (retail, financial services, and wholesale). In more highly skilled

occupations, (executive, administrative, managerial, technicians, administrative support, and research and development), particularly in service industries, individuals are often compensated for tax increases. Feldstein and Vaillant (1994) also provide empirical evidence that employees are compensated for differences in state PIT rates through higher pre-tax wages. Their estimates suggest that high state PIT rates result in high pre-tax wages, and vice versa, low state PIT rates result in low pre-tax wages.

In short, the effect of PIT rates on wages is a double edged sword. If employees pay the PIT, then individuals may pursue higher after-tax wages by moving to low tax states. On the other hand, if individuals are compensated for higher taxes by receiving higher pre-tax wages, then corporations may choose to invest in low tax states because pre-tax wages are lower in those states.

4. The Effect of State PIT Rates on Business Location Decisions

Since differences in state PIT rates affect pre-tax wages and the after-tax return on capital investment, differences in state PIT rates may be an important determinant of plant and facilities location decisions, firm births, and incremental firm investment. As discussed above, differences in state PIT rates play a critical role in determining interstate differences in pre-tax wages. Furthermore, there appears to be a consensus in the literature that differences in state pre-tax wages are an important determinant of the location of plant and facilities. This, in turn, implies that state PIT rates influence the location of plants and facilities through their effect on pre-tax wages.

Hekman (1982) conducted a survey with business executives of 204 firms in North Carolina, South Carolina, and Virginia. The executives are asked to rate 19 business location factors and 12 quality of life factors. Hekman finds that the most important location factors are state and

local industrial climate, labor productivity, transportation, availability of industrial sites, and the cost of employees and construction. Moreover, he finds that quality of life factors are important, specifically the quality of the education system, the cost of living, housing, quality of the environment, and personal taxes. They conclude that traditional concerns in industrial location are access to labor, transportation, markets, and raw materials, but now consideration is given to local and state tax systems, education, the industrial climate, and the skills of the workforce.

Papke (1991) reports evidence that the level of state wages plays an important role in manufacturing location decisions. The finding that state wages adversely affect plant and facilities location decisions is significant because of the evidence that state PIT rates influence interstate wage differentials. Thus, to the extent that state PIT rates account for differences in pre-tax wages among the states, Papke's findings suggest that high state PIT rates play an important and negative effect on plant and facilities location decisions.

Coughlin, Terza, and Arromdee (1991) find that states with higher pre-tax wage rates deter foreign direct investment (FDI). According to their estimates, high state PIT rates have a substantial and negative effect on the ability of a state to attract FDI because higher PIT rates result in higher pre-tax wages. Similarly, Gius and Frese (2002) examine the effect of state PIT rates on firm location. They find that a state's PIT rate has a negative and economically significant effect on firm location. They hypothesize that the impact of high PIT rates on the manager's and/or owner's income plays a large role in their decision-making regarding firm location. It also may be the case that high PIT rates increase pre-tax wages, and a state's pre-tax wage rate figures prominently in firm location decisions.

5. The Effect of State PIT Rates on State Growth Rates

Since higher state PIT rates result in higher pre-tax wages which, in turn, influence firm location decisions, it is reasonable to ask whether state PIT rates influence state growth rates. The literature on the effect of state PIT rate differentials employs several measures of state economic growth, including changes in state per capita income levels and employment growth. There is considerable evidence that high state PIT rates adversely affect the growth of state employment and per capita income.

Wasylenko (1988) finds that higher pre-tax wages have the largest effect on employment growth in the various industries, though the magnitude of the effect varies by industry. He also reports that progressivity of the PIT also has a negative effect on total non-agricultural employment and wholesale trade employment. Wasylenko and McGuire (1985) find that higher wages, utility prices, PIT rates, and increases in the overall level of taxation discourage employment growth in several industries. In short, they conclude that total employment growth is slower in states where the overall tax effort is growing relative to that in other states.[3] They also report evidence that state PIT rates have relatively important negative effects on employment growth for three industries: wholesale trade, retail trade, and financial services.

Plaut and Pluta (1983) examine aggregate manufacturing growth for 48 states between 1967 and 1972 and 1972 and 1977. They examine the effect of taxes on the change in employment, real value added, and real capital stock. They find that adverse business climate rank and high overall tax effort in a state tend to slow employment growth.

Helms (1985) reports evidence that state tax burdens significantly reduce state growth rates. Similarly, in a study for the Federal Reserve Bank of Atlanta, Bartik (1992) concludes that taxes

[3] State tax effort is the ratio of total state tax revenues and aggregate personal income in the state.

have quite large and significant effects on economic activity. Of the 57 interregional studies reviewed, 70 percent report at least one statistically significant negative effect of taxes on one measure of economic activity such as employment, output, or business investment. Finally, Becsi (1996) examines data for the period beginning in 1960 to 1992 and finds that high state PIT rates and high overall tax levels are associated with slower state economic growth.

6. The Effect of PIT Rates on Entrepreneurship and Small Business Growth

The Small Business Survival Index (SBSI) ranks the policy environment for entrepreneurship among the states. There are 26 measures included in the SBSI (2005). The top PIT rate is included in the SBSI index because income tax rates affect individual economic decision making in important ways. A high PIT rate increases the costs of working, saving, investing, and risk taking. PIT rates vary among states, therefore impacting crucial economic decisions and activities. In fact, the PIT impacts business far more than generally assumed because roughly 90 percent of businesses file taxes as individuals (e.g. sole proprietorship, partnership and S-corps) and therefore pay PIT rather than corporate income taxes. According to the 2005 state rankings, where a rank of 1 indicates the friendliest environment for entrepreneurship, Rhode Island was 48th, almost the least friendly state to small business survival after California and Maine.

The Joint Economic Committee (2003) finds that taxpayers in the highest federal income tax bracket are not just highly-paid executives or people living off of investment income; rather, they are often small business owners. Small businesses generally pay income tax through the individual income tax system, not the corporate income tax system. Sole proprietorships, partnerships, and S-corporations are the three main organizational forms chosen by small business owners.

Economists who study the effects of taxes on sole proprietorships find that high PIT rates discourage entrepreneurs from investing in new capital equipment and, conversely, that reducing taxes encourages new investment. At higher PIT rates, hiring employees can become a less attractive proposition as a higher fraction of any additional income that a new hire might generate for the business is taxed and diverted to the federal government. Finally, investment also promotes small business growth, since how much a worker can produce for a company depends on the amount and quality of the equipment that the worker has to work with. That is why when low PIT rates spur business to make new capital investments in software, computers, or machinery, for example, that company's workers become more productive, causing the company to grow.

Hodge and Moody (2004) point out that an extraordinarily high proportion of high-income taxpayers have some form of business income and as their incomes rise, so too does the likelihood that they have business activity. It turns out that 74 percent of the top 1 percent of income earners report business activity on their personal tax returns. These groups break down as follows: 68 percent of those with incomes between $317,000 and $499,999 report business activity; 77 percent between $500,000 and $999,999; and 83 percent with incomes of $1 million or more.

We proceed below by summarizing the evidence of PIT rates on small business hiring, investment, and growth.

Carroll, Holtz-Eakin, Rider, and Rosen (2000a) investigate the effect of entrepreneurs' personal taxes on their use of employees by analyzing the tax returns of sole proprietors before and after the Tax Reform Act of 1986. Their estimates show that a 10 percent decrease in the PIT rate would increase the median wage bill of entrepreneurs by 3 to 4 percent. Based on their

estimates, when a sole proprietor's PIT rate goes up, the probability that he or she employs one or more workers goes down. Further, conditional on employing workers, increases in PIT rates decrease the rate of growth of such firms' wage bills.

Carroll, Holtz-Eakin, Rider, and Rosen (2000b) also analyze the effect of personal income taxes on investment by entrepreneurs. More specifically, they use a large sample of federal individual tax returns filed by sole proprietors and the large tax rate reductions associated with the Tax Reform Act of 1986 (TRA86) to gauge the effect of income taxes on investment. They find that an increase in a sole proprietor's income tax rate increases the proportion of sole proprietors that make investment in capital assets. Their estimates suggest that a five-percentage-point increase in the PIT rate would decrease the proportion of entrepreneurs who make new capital investments by 10.4 percent. Further, such a tax increase would decrease average capital outlays by 9.9 percent. In other words, PIT rates have a substantial effect on investment by entrepreneurs in plant, facilities, and equipment.

Carroll, Holtz-Eakin, Rider, and Rosen (2000c) also investigate the effect of entrepreneurs' personal income tax situations on the growth rates of their enterprises. Their estimates suggest that decreasing a sole proprietor's personal income tax from 50 percent to 33 percent would lead to a 28 percent increase in pre-tax income. They conclude that changes in entrepreneurs' income tax rates have a significant impact on the growth of their enterprises. This is consistent with the view that raising income tax rates discourages the growth of small business.

Additionally, Bruce and Gurley (2005) find that increasing PIT rates on small business decreases entrepreneurial entry; increases exit from entrepreneurship; and shortens the duration of entrepreneurial ventures. The specific findings include the following. A PIT rate increase of 1 percent on entrepreneurial income decreases the probability of entrepreneurial entry by 1.42

percent for single filers and 2.0 percent for married filers. A PIT rate increase of 1 percent on entrepreneurial income increases the probability of exiting entrepreneurial activity by 17.32 percent for single filers and by 7.81 percent for married filers. A PIT rate increase of 1 percent on entrepreneurial income shortens the duration of entrepreneurial activity by 32.5 percent for single filers and 44.8 percent for married filers. Finally, Gentry and Hubbard (2000) examine entry into self-employment, and find that the probability of entry increases when tax rates are less progressive.

Power and Rider (2002) examine the effect of PIT rates on retirement savings of the self-employed. The Federal Tax Code provides for two types of retirement savings plans for the self-employed, the Keogh plan (i.e. tax-deferred retirement savings plans for people who are self-employed) and Simplified Employee Pension Plans (SEPs). They use a sample of 5,344 returns of sole proprietors constructed from the Statistics of Income individual income tax files for tax years 1985, 1989 and 1993. They find that PIT rates have a substantial effect on both the decision to contribute to a tax deferred savings plan and the amount contributed by the self-employed.

7. The Effect of PIT Rates on Interstate Migration

Wallace (2002) considers the effect of state individual income taxes on state-to-state migration behavior. She finds that in certain areas of the country, higher wages in part compensate individuals for higher income taxes. Income differentials by themselves are not the driving factors in individual-level migration. In the Northeast, however, she finds that PIT rates play an important role in interstate migration.

Vedder (2003) reports that low tax states gained 2.05 million people in terms of net domestic migration, while high tax states lost 890,000, from 1990 to 1999. This pattern continued in the

post-1990s. From 2000 to 2002, low tax states gained 729,000, and high tax states lost 371,000 in net domestic migration. Vedder also observes that the migration into states without income taxes was impressive – as was the out-migration from high-tax states. Based on his statistical analysis of the data on interstate migration, he concludes that high taxes in general are perceived as lowering the quality of life in a locality, leading to out-migration. In addition, Vedder points out that vast literature shows that high taxation leads to reduced economic growth.

Slemrod and Bakija (2004) suggest that high-income retirees change their state of residence to avoid paying high state taxes. They conclude that high personal income taxes and property taxes levied by states lead upper-bracket taxpayers to move to states with lower, less progressive tax rates.

The evidence of net out-migration of high income individuals due to high PIT rates bodes ill for the vitality of a state's economy. People subject to the top PIT rate are among the most highly productive people and contribute to the dynamism of a state's economy. Consequently, state's with high top PIT rates relative to neighboring and competitor states risk a brain drain. Such states are less attractive locations for business investment, results in a smaller tax base which puts pressure on a state's budget, and may result in less charitable giving in the state, especially in the case of high-income retirees leaving a state for tax reasons.

8. Evidence from Taxpayer Reports of Individual Taxable Income

Thus far, we have reviewed the evidence of PIT rates on individual decisions, including work effort, small business decisions, and the form of compensation (e.g., fringe benefits). A recent literature attempts to estimate the effect of PIT rates on all of these activities taken as a whole rather than separately. This literature looks at the effect of PIT rates on income from all taxable sources (i.e., wages and salary, dividends and interest, and net business income).

Lindsey (1985) examines the effect of PIT rates on high-income individuals. He finds that some components of income are more sensitive to changes in the tax rates than others. For example, PIT rates have a very strong effect on business income, while the effect on wages is smaller but still substantial. Feldstein (1995) also estimates the effect of PIT rates on income from all taxable sources. Like Lindsey (1985), He finds that changes in tax rates during this period had a substantial effect on reported taxable income.

Goolsbee (2000) examines the responsiveness of income from all taxable sources (i.e., wages and salary, dividends and interest, and net business income) to changes in PIT rates using detailed compensation data on several thousand corporate executives from 1991 to 1995. He divides executives into groups with incomes between $275,000 and $500,000 per year, $500,000 and $1,000,000 per year, and $1,000,000 and greater per year. He finds that those making more than $1 million per year are particularly responsive to changes in PIT rates.

According to Feldstein (1999), a 10 percent increase in the combined federal and state PIT rate results in a $78 loss to the economy for every $100 of additional tax revenue. Using more sophisticated estimates of the increase in income tax revenue from a 10 percent rate increase that account for economic behavior, Feldstein finds that the harm to the economy of a 10 percent rate increase is substantially greater than the benefit in terms of increased tax revenue. In one set of estimates, he finds that the cost to the economy is $2.06 for every dollar of additional revenue.

Auten and Carroll (1999) also gauge the effect of tax rates on individual behavior by examining changes in income from all taxable sources during the 1980s, but they have access to superior data and use more sophisticated statistical techniques. More specifically, they report an

estimated tax price elasticity of 0.54, meaning that a 10 percent increase in the combined federal and state income tax rate would result in a 3.8 percent decrease in reported taxable income.[4]

While this estimate may strike some as rather modest, it masks considerable variation in the elasticity by occupation. Auten and Carroll report estimated effects by occupation. These estimates vary between -0.19 for lawyers and -2.37 for investors. The elasticity for investors implies that a 10 percent increase in the combined federal and state PIT rates would result in an approximately 16 percent decrease in income from all taxable sources. This is a very substantial response by an important group of people that presumably have an important influence on economic growth.

9. Conclusions

There is a large body of evidence that shows that high state PIT rates have a negative effect on business and individual decisions and thus slow the growth of employment and per capita income in a state. At the individual level, personal income taxes influence work effort and state-to-state migration. At the firm level, the evidence suggests that state PIT rates influence business location decisions and entrepreneurs' decisions to grow their firms by hiring employees and investing in plant, facilities, and equipment. Thus, decreasing PIT rates, particularly if they are significantly higher than those in neighboring and other competitor states, leads to growth in employment and per capita income. Economic growth, in turn, helps to reduce the poverty rate. In short, it does not require a 'leap of faith' to believe that the benefits of decreasing the PIT rate

[4] This calculation assumes a combined federal and state individual income tax rate of 41.435 percent. This rate corresponds to the combined rate for taxpayers residing in Rhode Island and facing the state's top individual tax rate in 2005 of 9.9 percent. This estimate of the combined rate accounts for the deductibility of state income taxes or 41.435 percent equals [0.35 + (1-0.35)*0.099]*100. A ten percent reduction in this combined rate corresponds to an approximately 7 percent increase in the tax price, where the tax price is 1.0 minus the tax rate. Unless specified otherwise, all interpretations of elasticities are based on these assumptions regarding the change in the initial tax-price (7 percent) and the corresponding change in the combined federal and state rate (10 percent).

on high income individuals are broadly shared throughout the income distribution. Indeed, the evidence shows that states with lower PIT rates enjoy higher growth in employment and real per capita income.

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Index Tables

Table 1. Top Personal Income Tax (PIT) Rates in the 50 States in 2004 and 2005

State	Top PIT Rates 2004	Top PIT Rates 2005	State	Top PIT Rates 2004	Top PIT Rates 2005
Alabama	5.0	5.0	**Montana**	**11.0**	**6.9**
Alaska	-	-	**Nebraska**	**6.8**	**6.5**
Arizona	5.0	5.0	Nevada	-	-
Arkansas	7.0	7.0	New Hampshire	5.0	5.0
California	**9.3**	**10.3**	New Jersey	9.0	9.0
Colorado	4.6	4.6	**New Mexico**	**6.8**	**5.7**
Connecticut	5.0	5.0	New York	7.7	7.7
Delaware	6.0	6.0	North Carolina	8.3	8.3
Florida	-	-	North Dakota	5.5	5.5
Georgia	6.0	6.0	**Ohio**	**7.5**	**7.2**
Hawaii	8.3	8.3	Oklahoma	6.7	6.7
Idaho	7.8	7.8	Oregon	9.0	9.0
Illinois	3.0	3.0	Pennsylvania	3.1	3.1
Indiana	3.4	3.4	**Rhode Island**	**9.9**	**9.9**
Iowa	9.0	9.0	South Carolina	7.0	7.0
Kansas	6.5	6.5	South Dakota	-	-
Kentucky	6.0	6.0	Tennessee	6.0	6.0
Louisiana	6.0	6.0	Texas	-	-
Maine	8.5	8.5	Utah	7.0	7.0
Maryland	4.8	4.8	Vermont	9.5	9.5
Massachusetts	5.3	5.3	Virginia	5.8	5.8
Michigan	3.9	3.9	Washington	-	-
Minnesota	7.9	7.9	West Virginia	6.5	6.5
Mississippi	5.0	5.0	Wisconsin	6.8	6.8
Missouri	6.0	6.0	Wyoming	-	-

Source: Facts and Figures on Government Finance

Notes: Rhode Island has the second highest top PIT rate among the states. Montana, Nebraska, New Mexico, and Ohio recently cut their top PIT rates. New York, Pennsylvania, and Utah are considering cutting their top PIT rates. Only California has increased their top PIT rate over the past two years.

Table 2. A Summary of Recent Trends in State Personal Income Tax Rates

State	Date of Release	Text
Colorado	January, 2005	The Colorado Governor proposed the cut in the individual income tax rate from the current 4.63% to 4.5%.
Delaware	January, 2004	The Republicans in the Delaware General Assembly announced a proposal that would roll-back personal income tax rates by 6.3% across all tax brackets. The top rate would drop from 5.95% to 5.58%.
Illinois	January, 2004	The Illinois Governor proposed doubling the state's personal income tax rate from the current 3 percent to 6 percent for people earning more than $250,000.
Iowa	March, 2005	The chair of the Iowa House and Means Committee proposed to eliminate the state individual income tax in cities within five miles of the state line.
Massachusetts	November, 2000	The Massachusetts voters approved a cut in the state income tax rate from 5.75% to 5% over the next three years.
Montana	April, 2003	In tax year 2005, Montana will reduce the top PIT rate from 11 to 6.9 percent.
New Mexico	April, 2005	New Mexico Governor has signed into law a measure that will lower the top PIT rate from 6% to 5.3% in January 2006 and 4.9% in 2008.

Table 2. A Summary of Recent Trends in State Personal Income Tax Rates (Continued)

State	Date of Release	Text
New Mexico	October, 2005	New Mexico Governor signed the law under which the top marginal income tax rate will drop from 6% to 5.7% in the 2005 tax year and will go to 5.3% in January 2006. The previous implementation schedule had called for the top marginal rate to decline to 5.8% in 2006 and then to 5.3% in 2007.
New York	January, 2006	The New York Governor released his executive budget proposal for fiscal 2007 which includes, among other measures, the reduction of the top personal income tax rate from 6.85% to 6.75% and increase the income level at which the top rate begins, beginning in 2007.
Pennsylvania	May, 2003	The Pennsylvania Governor has proposed raising the state's personal income tax from 2.8% to 3.75% in order to replace with state grants up to $1.3 billion generated by school property taxes.
	October, 2003	The Pennsylvania House approved Governor’s proposal to raise the state's personal income tax rate from 2.8% to 3.25% on January 1, 2004 and to subsequently revert to a permanent 3.1% rate July 1, 2004.
	January, 2006	The Pennsylvania Governor vetoed the bill for a graduated reduction in Pennsylvania's personal income tax rate, from 3.07% to 3.03% in 2007 and to 2.98% in 2008. The bill was approved by the Senate in November, 2005.

Table 2. A Summary of Recent Trends in State Personal Income Tax Rates (Continued)

State	Date of Release	Text
Utah	October, 2005	The Utah Governor proposed a single state individual income tax rate of 5% and elimination of deductions for home mortgage interest.
	January, 2006	The Utah House Revenue and Taxation Committee has approved the bill which would reduce the top personal income tax rate from 7% to 6.4%.
Utah	February, 2006	The Utah Senate Revenue and Taxation Committee endorsed an income tax reform plan that would replace the state's current system with a single-rate tax and few deductions. The bill next goes before the full Senate. The bill would lower the current top rate of 7% (paid by two-thirds of filers) to 4.9%. The fiscal note prepared by the Office of Legislative Research and General Counsel indicates that this measure would result in revenue losses of $15 million in fiscal 2007, $59 million in fiscal 2008, and $63 million in fiscal 2009. The measure would allow a credit for home mortgage interest and charitable giving, but it would eliminate a number of other credits. The bill also would eliminate the 50% deduction for federal taxes paid.

Source: Various issues of *State Tax Notes*.

Table 3. Average Top PIT Rates, Growth in Per Capita Income, and Poverty Rate for Selected States in New England from 1980 to 2000

State	Average top PIT rate from 1980 to 2000 (percent)	Average annual growth rate in real per capita income from 1980 to 2000 (percent)	Average annual poverty rate between 1980 to 2000 (percent)
Connecticut	5.8	2.3	8.0
Massachusetts	5.4	2.6	9.3
New Hampshire	5.0	2.4	5.9
Rhode Island	10.6	1.8	10.1
Unweighted average	6.7	2.3	8.3

Sources: "Facts and Figures on Government Finance"; BEA, and Census Bureau.

Note: Among neighboring states, Rhode Island has the highest average top PIT rate (10.6%) between 1980 and 2000, the lowest average growth rate in real per capita income (1.8%), and the highest average poverty rate (10.1%) during the same period.

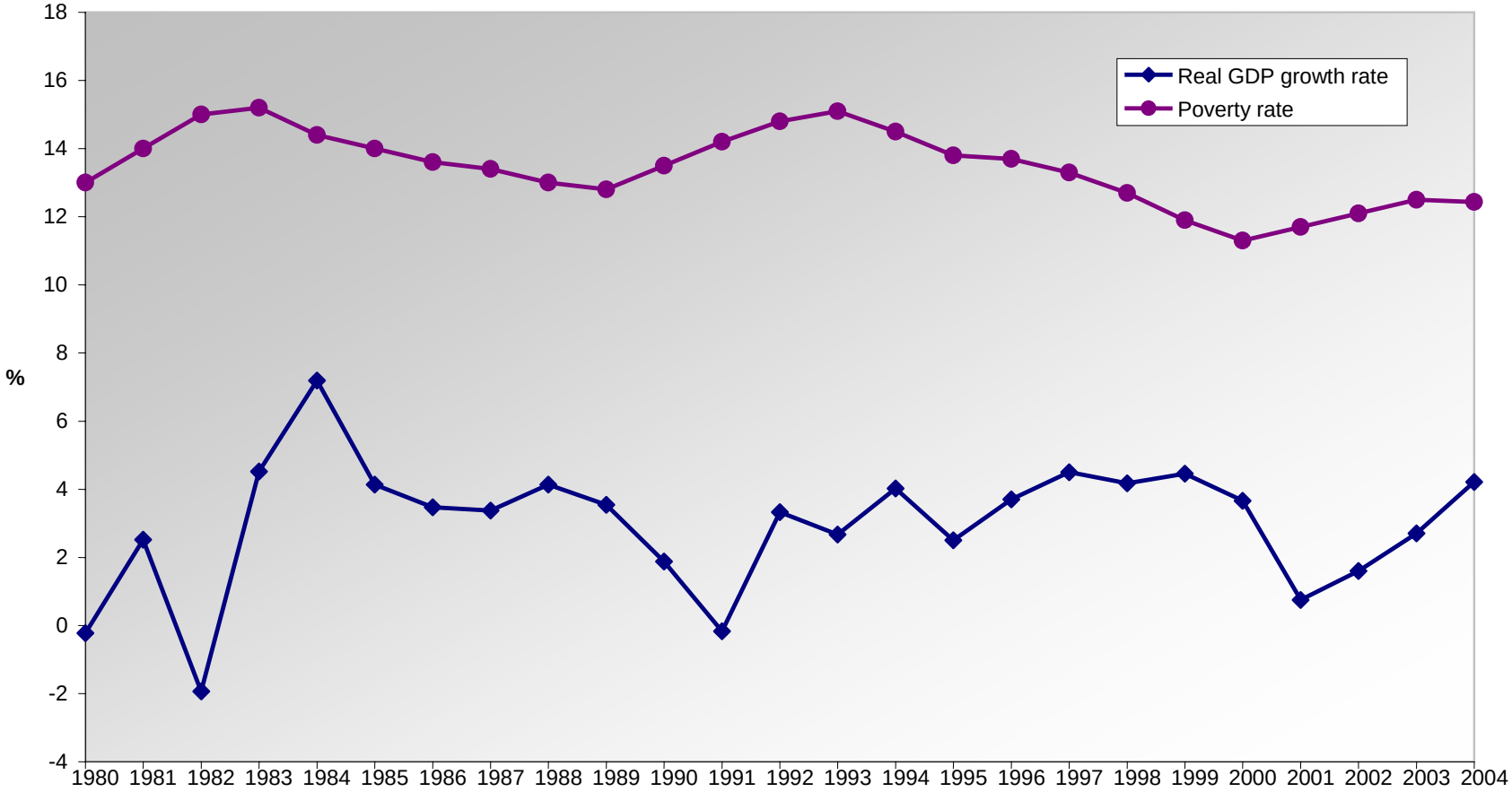
Table 4. Comparison of Personal Income Tax Structures for Selected States

State	Tax Base	Standard Deduction	Exemption for dependents	Maximum Rate (percent)	Taxable Incomes Over	Number of tax brackets
1, California	FAGI[3]	$174	$272	10.30	$1,000,000	7
2. Connecticut	FAGI[3]	$25,250	$0	5.00	$10,000	2
3. Delaware	FAGI[3]	$220	$110	5.95	$60,000	6
4. Maine	FAGI[3]	$5,700	$2,850	8.50	$17,700	4
5. Maryland	FAGI[3]	$4,800	$2,400	4.75	$3,000	4
6. Massachusetts	FAGI[3]	$7,150	$1,000	5.30/ 12.00[1,2]	$0	1
7. Montana	FAGI[3]	$3,800	$3,800	6.90	$13,900	7
8. New Hampshire	Interest and dividends only	$4,800	n.a.	5.00	$0	1
9. New Jersey	SGI	$2,000	$1,500	8.97	$500,000	6
10. New York	FAGI[3]	n.a.	$1,000	7.70	$500,000	7
11. Oregon	FAGI[3]	$308	$154	9.00	$6,500	3
12. Pennsylvania	STI[4]	n.a.	n.a.	3.07[2]	$0	1
13. Rhode Island	FAGI[3]	$6,400	$3,200	9.90	$326,4ss50	5
14. Vermont	FTI[5]	$6,400	$3,200	9.50	$326,450	5

Source: Facts and Figures on Government Finances, The Tax Foundation.

Notes:
[1] The 12 percent rate applies to short-term capital gains, long- and short-term capital gains on collectibles, and pre-1996 installment sales classified as capital gain income for Massachusetts purposes.
[2] Flat rate.
[3] FAGI: Federal Adjusted Gross Income.
[4] STI: State Taxable Income.
[5] FTI: Federal Taxable Income.

Figure 1. Real GDP Growth and the Poverty Rate in the U.S. (1980-2004)



*Real GDP in chained 2000 dollars

Source: Bureau of Economic Analysis; US Census Bureau

Notes: During periods of robust growth from 1982 to 1989 and 1992 to 2000, the poverty rate decreased. This shows that a policy of cutting top PIT rates to stimulate economic growth has a favorable impact on a state's poverty rate.