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Behind the Numbers: What Happens to Personal Income & Government Spending When States Adopt Income Taxes?

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A recent report by the National Taxpayers Union (NTU) tries to make the case that adoption of an income tax in New Hampshire would stunt the growth of the state's economy and cause a sharp rise in state government outlays. NTU's arguments, however, are unpersuasive.

The report's most striking—and least credible—claim is its prediction that by 2020 a New Hampshire income tax would cause state personal income to be 19 percent lower than it would otherwise be. To put this in perspective, if New Hampshire's personal income had been 19 percent lower in 1998 than it actually was, the state's ranking in per-capita personal income would have dropped 25 places—past 20 states that currently levy higher personal income taxes than the four percent rate proposed for New Hampshire. Thus, NTU predicts a truly gigantic negative impact from an income tax that, as proposed, would be lower than the income taxes of 39 of the 41 states with income taxes. Apparently, NTU believes that New Hampshire's economic health, unlike other states, is hugely dependent on the nature of its tax structure.[1] New Jersey, for example, adopted an income tax in 1976, and since then it has seen its per capita personal income ranking increase from 5th highest in 1976 to 3rd highest in 1998.

The NTU report's other principal argument is that per-capita New Hampshire state spending will be $1,870 higher in 2020 if an income tax is adopted. But this is a meaningless prediction. No one questions that state spending will be higher under any of the tax proposals before New Hampshire's legislature—because more of the costs of education would be borne by the state. The real question is whether total state and local spending (including spending by local school boards) will go up. The NTU paper chooses to avoid that question.

Certainly the availability of new tax revenues can make more public services possible. Nevertheless, adopting a personal income tax is unlikely to fundamentally change New Hampshire's low-public-spending culture. The state ranks last in public spending as a share of personal income. Whether New Hampshire's citizens will choose to always be the lowest spending state in the country remains to be seen. But

[1] The NTU report predicts that New Hampshire per capita personal income will grow by 3.5% a year in constant dollars in the absence of an income tax, and 2.5% a year with an income tax. That compares to a 1.9% annual growth rate in New Hampshire per capita personal income from 1991 to 1998, when the national per capita personal income grew at an annual rate of 1.7%. Over the next decade, the Congressional Budget Office predicts that national per capita GDP, which closely tracks personal income, will grow at a rate of 1 percent a year.

that choice is independent of the means of raising revenue.

NTU arrives at its unusual predictions by looking at the economic performance and fiscal conduct of nine states that have adopted income taxes since 1967. There are fundamental flaws in this approach, which we now address.

Most states that have adopted income taxes since 1967 have outpaced the rest of the country in terms of real income growth.

NTU's case for the economic badness of state income taxes rests entirely on its finding that six of the nine states that enacted income taxes since 1967 saw their rate of personal income growth decline after adoption of their income taxes. But the comparison is between growth from 1950 to the year of adoption of the income tax and growth after adoption. This comparison is essentially meaningless.

All six states that NTU alleges performed poorly adopted their income taxes within three years of 1970. But the average national growth rate in total personal income from 1950 through 1970 in constant dollars was 4.1 percent, compared to 2.6 percent from 1970 to 1998. Thus, it's not surprising that most states that adopted a personal income tax around 1970 had slower growth thereafter than before, since exactly the same thing happened to states that did not adopt a personal income tax. **In fact, every single state saw lower growth in per capita personal income after 1970 compared to growth over the 1950-70 period.**

The national economy faced turbulent times in the 1970s, with the OPEC oil embargo, big problems for the American auto and steel industries, stagflation, high interest rates and a sharp drop in productivity growth. It's hard to imagine that NTU has simply forgotten those well-known events. But absent such a gross oversight, one must infer that NTU believes that six state income taxes enacted between 1967 and 1971 somehow caused the nationwide economic problems of the seventies.[2] That, of course, would be a highly implausible theory.

A more meaningful comparison would be to compare growth rates in per capita personal income (in constant dollars) in states that adopted income taxes over the past three decades to the national growth rate and to growth rates in states that do not have income taxes. Such a comparison shows the following:

- Of the nine states that have adopted broad-based income taxes since 1967, six have seen higher growth in per capita personal income than the national average from the time they adopted their income taxes through 1998.
- Some of the high-performing income-tax-adopting states include: Connecticut,

[2]A total of seven states adopted income taxes between 1967 and 1971: Michigan, Illinois, Ohio, Pennsylvania, Nebraska, Rhode Island, and Maine. All but Maine failed NTU's unusual economic performance test. (Why Maine passed is not clear, since its growth rates in personal income and per capita personal income before and after adoption of its income tax in 1969 followed the national pattern).

whose annual growth rate in per-capita personal income since adoption of its income tax has risen by almost half compared to the five years before (a growth rate ranking up from 7th in the nation to 4th); New Jersey, whose per-capita personal income growth rate since adoption of its income tax in 1976 has outpaced every state without an income tax except one (New Hampshire); and Nebraska, whose per-capita personal income grew from only 87 percent of the national average before adoption of its income tax to 94 percent by 1998.

In contrast, of the nine states that still do not have broad-based income taxes, four saw lower growth in per capita personal income from 1991 to 1998 than the national average, while five saw higher growth. Notably, six of the nine states with no income tax had per capita personal incomes below the national average in 1998 (compared to five that were below average in 1991).

States adopting Income Tax (constant 98$)	Year Income Tax Enacted	Per Capita Income (PCI)						PCI as % of Natl. Average		
		Year Tax Enacted	In 1998	Annual Growth	Natl. in start year	Natl. in 1998	Natl. Ann. Growth	Year PIT Enacted	In 1998	Change
New Jersey	**1976**	$ 13,002	$ 33,953	+4.5%	$ 11,000	$ 26,482	+4.1%	118.2%	**128.2%**	**+10.0%**
Nebraska	**1967**	14,787	24,786	+1.7%	17,054	26,482	+1.4%	86.7%	**93.6%**	**+6.9%**
Connecticut	**1991**	31,978	37,700	+2.4%	23,485	26,482	+1.7%	136.2%	**142.4%**	**+6.2%**
Maine	**1969**	13,979	23,002	+1.7%	17,054	26,482	+1.5%	82.0%	**86.9%**	**+4.9%**
Pennsylvania	**1971**	15,362	26,889	+2.1%	15,454	26,482	+2.0%	99.4%	**101.5%**	**+2.1%**
Rhode Island	**1971**	15,503	26,924	+2.1%	15,454	26,482	+2.0%	100.3%	**101.7%**	**+1.4%**
Michigan	**1967**	16,886	25,979	+1.4%	17,054	26,482	+1.4%	99.0%	98.1%	–0.9%
Illinois	**1969**	19,418	28,976	+1.4%	17,054	26,482	+1.5%	113.9%	109.4%	–4.4%
Ohio	**1971**	15,734	25,239	+1.8%	15,454	26,482	+2.0%	101.8%	95.3%	–6.5%

States without Income Tax (constant 98$)	Base Year	Per Capita Income (PCI)						PCI as % of Natl. Average		
		In 1991	In 1998	Annual Growth	Natl. in 1991	Natl. in 1998	Natl. Ann. Growth	In 1991	In 1998	Change
Texas	**1991**	$ 21,524	$ 25,028	+2.2%	$ 23,485	$ 26,482	+1.7%	91.7%	94.5%	**+2.9%**
Tennessee	**1991**	20,316	23,615	+2.2%	23,485	26,482	+1.7%	86.5%	89.2%	**+2.7%**
South Dakota	**1991**	19,164	22,201	+2.1%	23,485	26,482	+1.7%	81.6%	83.8%	**+2.2%**
Washington	**1991**	24,415	28,066	+2.0%	23,485	26,482	+1.7%	104.0%	106.0%	**+2.0%**
New Hampshire	**1991**	25,599	29,219	+1.9%	23,485	26,482	+1.7%	109.0%	110.3%	**+1.3%**
Florida	**1991**	23,278	25,922	+1.5%	23,485	26,482	+1.7%	99.1%	97.9%	–1.2%
Nevada	**1991**	24,649	27,360	+1.5%	23,485	26,482	+1.7%	105.0%	103.3%	–1.6%
Wyoming	**1991**	21,959	23,225	+0.8%	23,485	26,482	+1.7%	93.5%	87.7%	–5.8%
Alaska	**1991**	25,726	25,771	+0.0%	23,485	26,482	+1.7%	109.5%	97.3%	–12.2%

There is no evidence that adoption of an income tax leads to increased government spending.

The NTU report claims that in seven of the nine states that enacted income taxes since 1967, state spending has grown at a faster rate since adoption of those income taxes than before adoption. But this is a highly misleading statistic, since it focuses only on state spending rather than total state and local outlays. Many states adopted income taxes for the express purpose of providing local property tax relief. In those states, an increase in state spending would be expected. But total government spending would not go up because combined state and local spending were unchanged.

Of course, a few states have adopted state personal income taxes with the objective of increasing revenues to pay for expanded government services. There is nothing inherently wrong with the citizens of a state choosing to do that—but it doesn't mean New Hampshire will also follow that course.

Again, let us compare the experience of states that adopted an income tax since 1967 with those that still have no income tax:

Of the nine states that adopted an income tax since 1967, five increased per capita state and local spending at a faster rate than the national average from 1991 to 1996. The other four states saw lower growth in per capital state and local spending than the national average.

#Likewise, of the nine states without an income tax, five increased per capita state and local spending at a faster rate than the national average from 1991 to 1996, while four saw lower growth.

Thus, in the 1990s, there has been little difference in state and local spending growth rates between states that have adopted an income tax and those that have not.[3]

Annual Changes in Per Capita State & Local Spending (constant dollars, fiscal years)

		1972-91	1991-96
US Average		**+1.7%**	**+1.6%**
States adopting Income Taxes Since 1967—			
	Income Tax In		
Pennsylvania	1971	+1.5%	**+2.8%**
Illinois	1969	+1.4%	**+2.4%**
Nebraska	1967	**+1.9%**	**+2.2%**
New Jersey	1976	**+2.2%**	**+2.2%**
Ohio	1971	**+2.3%**	**+2.2%**
Rhode Island	1971	**+2.6%**	+1.6%
Michigan	1967	+1.3%	+1.4%
Connecticut	1991	**+2.5%**	+0.9%
Maine	1969	**+2.3%**	+0.8%
States without Income Taxes—			
Tennessee		**+1.8%**	**+3.4%**
New Hampshire		+1.6%	**+3.2%**
Texas		**+1.8%**	**+2.7%**
South Dakota		+1.1%	**+2.5%**
Washington		+1.5%	**+2.1%**
Florida		**+2.4%**	+1.4%
Nevada		+0.8%	–0.1%
Wyoming		**+2.3%**	–0.9%
Alaska		+1.7%	–2.1%

Comparisons are from 1991 to 1996 (the latest available year) to show recent trends, and from 1972 around when many state income taxes were adopted (and data on state and local spending are available).

[3]Real economic growth, the adoption and expansion of Medicaid since the late sixties, and a variety of other factors have meant that overall state and local per capita spending has risen across the nation over the past three decades.

Conclusion: Distorted Economic Analysis from NTU

The NTU report distorts data to prove a point that is simply wrong. Forty-one states, with more than 80 percent of the nation's population, have broad-based income taxes. At any given time, some of these states have had strong economic growth and others have performed less well. Likewise, some of the nine states that choose not to impose an income tax have performed well, while some have done poorly. Any attempt to measure whether having a particular type of tax structure helps a state economically can depend heavily on the economic measures used and the time periods selected.

NTU tries to take advantage of this fact to manipulate the data towards its desired conclusion. But the truth is that there is no consistent correlation between a state's economic performance and whether it imposes an income tax—or more precisely, there is no correlation between poor performance and an income tax.

Nationally, nine of the top ten states with the highest per capita personal incomes have broad-based income taxes. New Hampshire ranks eighth highest, but it is the only state without a personal income tax to make the top-ten list.

There are states that rely heavily on income taxes, such as North Carolina and Delaware, that have had good economic growth over a long period of time by a variety of measures. States with low or no personal income taxes such as North Dakota, Alaska and Wyoming have done poorly by a number of economic measures.

Since it adopted its personal income tax, effective in 1992, Connecticut has ranked fourth among the states in real per capita personal income growth—one of the best measures of the financial well-being of the citizens of a state. In fact, Connecticut reclaimed its position of having the highest per-capita income in the country in 1996, after falling to second prior to the adoption of its income tax.

This evidence does not prove that adopting a personal income tax would be beneficial to the New Hampshire economy—although at least one study less ideologically biased than NTU's has drawn that conclusion.[4] Rather, the evidence shows that among the 41 states with broad-based personal income taxes, most of them are currently doing quite well.

An honest assessment of the data over long periods of time leads to the conclusion that the existence of a personal income tax does not adversely affect a state's economy in any significant way. This really shouldn't be surprising. After all, there are other things that are far more likely to affect business decisions, such as labor costs, proximity to markets, and the quality of the work force. The positive effects of an income tax on tax fairness and getting more bang for the buck for each dollar of tax imposed are easily measured. In contrast, allegations of purported negative effects do not withstand analysis.

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[4]Besides allowing a fairer sharing of the state tax burden, state income taxes impose a lower net burden on state taxpayers as a whole than consumption-based taxes, such as sales and excise taxes, because individuals who itemize deductions can deduct state income taxes on their federal tax returns. To a lesser, but still notable degree income taxes also usually have an advantage over property taxes in this regard, because individual income-tax-payers as a group tend to be in higher federal tax brackets than property-tax-payers.