State Income Taxes Increase Government Spending and Reduce Personal Income Growth

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June 2002

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I. Introduction

Faced with a recurring state budget crisis and strong voter opposition to new tax increases, some policymakers and interest groups are calling for a complete overhaul of the Washington state tax system. High business taxes, a slumping economy and a budget shortfall have generated speculation that the current tax system can no longer pay for an expanding public sector while allowing the broader economy to prosper. One proposal being debated is the adoption of a state income tax.¹ This shift in tax policy would fundamentally alter the state’s tax structure, changing it from one that mainly taxes consumption to one that taxes productivity.

Last year the legislature created a Tax Structure Study Committee to review in detail the state’s tax structure and suggest alternatives for improving the system.² A state income tax could be among the committee’s recommendation when it releases its final report in late November.³ As this proposal is considered, it is important to analyze the experience of other states to determine if an income tax makes sense for Washington. Economic and personal income data from other states shows clearly that an income tax would have a deep and lasting effect on our state’s economy.

² The Washington Tax Structure Study Committee is a group created by the legislature to study the state’s tax structure and recommend changes. Washington Policy Center is a member of the Commission’s Advisory Group. More information can be found at http://dor.wa.gov/content/WAtaxstudy/wataxstudy.htm.
³ The enabling legislation for the Committee, ESSB 6153, does not bar consideration of an income tax or a tax increase, stating only that “Most of the alternatives … shall be revenue neutral and contain no income tax [emphasis added].”
II. The Relation Between Income Taxes, Government Spending and Personal Income Growth

Since 1967 nine states have imposed income taxes, bringing the total number of states with an income tax to 45. In seven of these nine, the rate of government spending growth increased significantly in the years following the transition. Six of the states also experienced a marked reduction in the rate of personal income growth.

A detailed study based on econometric modeling shows that over a ten-year period a state income tax in Washington would increase government spending by an inflation-adjusted $48 billion. Over the same period growth in personal income would be reduced by some $210 billion. The reduction in personal income growth would result in an average personal income of $5,740 less than what could be expected under the existing tax system. As the chart below illustrates, government spending growth increases and personal income growth slows in states that impose an income tax.

Figure 1

Our nation’s Founders understood the risks inherent in taxing income. For this reason, the Constitution was originally written to prohibit direct taxation by the federal government. In an 1895 Supreme Court case striking down a federal income tax, the Court explained that the prohibition against a direct federal income tax was intended to

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4 The nine states that most recently imposed an income tax are Connecticut, Illinois, Maine, Michigan, Nebraska, New Jersey, Ohio, Pennsylvania and Rhode Island. Alaska and Florida tax corporate income but not personal income.
6 ibid.
7 ibid.
“promote prudence and economy in expenditure.” In the Federalist Papers, Alexander Hamilton explained the reason for prohibiting an income tax: “It is a signal advantage of taxes on articles of consumption, that they contain in their own nature a security against excess.” Now that an income tax is well established at the federal level, these abiding principles underscore the importance of not compounding its inherent disadvantages by adopting it at the state level.

Current figures illustrate the strong tendency of an income tax to spur higher government spending. A comparison among states shows that those without income taxes consume a smaller portion of their citizens’ earnings and tend to be better stewards of the taxes they do collect. In states that do not have an income tax, taxes account for an average of $89 per $1,000 of household income. In contrast, the eight states with the highest income tax rates collected an average of $131 per $1,000 for government coffers.

During the 1990s people living in states without an income tax enjoyed greater personal income growth than their neighbors living in higher tax states. Personal income in Texas, for example, grew at a rate more than one third faster than in neighboring states. Personal income growth in New Hampshire outpaced that of all other New England states. Personal income in Washington state grew more than 9 percent faster than in adjacent Oregon. Nevada’s rate of personal income growth was almost double that of the nation as a whole. With the lone exception of Georgia, not one state that taxes income was able to exceed, or even match, the rate of economic growth in states with no income taxes.

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9 Hamilton goes on to explain, “If duties are too high, they lessen the consumption; the collection is eluded; and the product to the treasury is not so great as when they are confined within proper and moderate bounds. This forms a complete barrier against any material oppression of the citizens by taxes of this class, and is itself a natural limitation of the power of imposing them” The Federalist Papers, Michael Loyd Chadwick, editor, Global Affairs Publishing Company, Springfield, Virginia, 1987, Federalist Number 21, p. 107.
10 In 1913 the 13th Amendment to the Constitution was ratified, allowing the adoption of a federal income tax. The initial tax affected less than 2% of the labor force and initially the highest rate was just 7%.
III. Government Spending Growth Reduces Household Income and Growth in State GDP

As the rate of personal income growth falls and the rate of government spending increases, the portion of personal income collected to support government grows. Increasing the tax burden on the citizens and businesses of a state can have a profoundly harmful impact on economic vitality. The ten states with the lowest total state and local tax burdens enjoy stronger economic growth, a faster rise in household incomes and greater growth in gross state product than the ten states with the highest tax burden. See Figure 2.

Figure 2

![Growth of Household Income and Gross State Product in Ten Highest and Ten Lowest Tax States]

Why does personal income growth fall off and government spending increase faster in states that tax personal incomes? There are a number of reasons. Personal income growth is largely a function of market incentives. When government imposes a tax on earnings, individuals lose incentive to work harder and increase their wages. Similarly, when a share of interest earnings from savings is lost each year to taxation, individuals have less incentive to save.

Government spending tends to increase faster in states with an income tax for two primary reasons. First, the addition of an income tax simply adds one more way policymakers can incrementally increase tax revenues to fuel a faster rate of government

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13 Household Income Growth from U.S. Census Bureau Current Population Survey, Gross State Product Growth from U.S. Bureau of Economic Analysis and tax burden rankings from Tax Foundation Special Report, “America Celebrates Tax Freedom Day.” Rankings for this analysis are based on state and local tax burden. Data for the chart includes the ten states with the highest and ten states with the lowest tax burdens.
growth. With more ways to tax, citizens notice less of the impact of each incremental increase in tax rates.\textsuperscript{14} Over time, the impact of small increases combines to stifle economic growth, transferring more money out of the productive economy and into the hands of government.

Second, an income tax is not as visible to citizens as, say, a sales tax. Consumers see the effects of a sales tax every day. The tax is clearly visible when they rent a movie, go shopping or go out for a meal. As the sales tax rate increases, daily purchases immediately become more expensive. An income tax is not nearly as transparent. The tax is deducted from workers’ paychecks each month. The only time citizens may be aware of an income tax is when they carefully review a pay stub or when they complete a tax return at the end of the year. The obscure nature of an income tax increases the temptation of elected policymakers gradually to increase the tax rate with less fear of political consequences.

Provided with a new, more hidden way of raising taxes, policymakers can increase spending with a greater chance of avoiding the attention of the public. In fact, political activists who favor increased public spending may even be attracted to the stealthy nature of an income tax. Hidden taxes contribute to an uninformed citizenry and leave taxpayers vulnerable to unchecked growth in government spending.

\textbf{IV. Income Taxes Reduce State Competitiveness}

Imposition of an income tax would have wide-ranging effects on the way citizens live their lives and the way company managers run their businesses. More importantly, it would reduce the overall competitiveness of Washington state. The state’s regulatory burden already takes a heavy toll on the business climate, but lack of an income tax helps give Washington at least one competitive edge over most other states. Throughout the country, states without an income tax use that fact to attract new businesses.

The recent move of Micro-Radian Instruments Inc., a maker of laser measuring instruments, from San Marcos, California to Bellingham supports this finding. The firm plans to build a 7,000-square-foot manufacturing plant at the new location. Company managers said one of the main reasons for the move was, “Washington has no personal income tax and no corporate income tax.”\textsuperscript{15}

\textsuperscript{14} In a recent example, Seattle Mayor Greg Nickels proposed a tax he says would cost the average property owner in Seattle merely “two lattes a month.” While the incremental increase is relatively minor, the combined effect of multiple tax increases imposes a heavy burden on taxpayers and businesses. “Nickels Proposes Bigger Housing Levy,” by Jim Brunner of \textit{The Seattle Times}, April 5, 2002.

Other examples include South Dakota, where economic growth consistently outperforms that of neighboring North Dakota, which has a stifling income tax. Farther south, both Oklahoma and New Mexico are considering repealing their income taxes to compete better for businesses and jobs with their more prosperous neighbor, Texas.\textsuperscript{16} In South Carolina gubernatorial candidate Mark Sanford is proposing to eliminate that state’s income tax.\textsuperscript{17}

Maintaining Washington state’s competitive advantage is important. Many business owners say that not having an income tax is one of the few clear advantages they find to doing business in Washington. Recent studies show that complex regulations, a high business tax burden and a prevailing anti-business attitude among state regulators place the state in a decidedly unfavorable position when competing with other states in attracting new jobs and businesses.\textsuperscript{18}

V. **Other Effects of an Income Tax**

The effects of a state income tax are wide ranging and influence many actions of businesses and individuals. Along with the impacts described earlier, there are three less visible, though no less important, effects an income tax would have on the residents of Washington.

1. **Added Cost and Complexity to Individuals:** An income tax would add substantial complexity to the Washington tax code. Washington residents would have to calculate and file another tax return, in addition to the already cumbersome and frustrating requirements of the federal income tax.

2. **Added Cost and Complexity to Businesses:** The regulatory burden on businesses would also increase, requiring more paperwork for employers and an entirely new state bureaucracy for administering, collecting and enforcing the new tax. The state administrative code currently comprises more than 34,000 pages, and most business owners must comply with 58 sets of regulations enforced by 28 different local, state and federal agencies.\textsuperscript{19} A state income tax would add significantly to the amount of paperwork and record-keeping required of business owners. It would also greatly increase the number of audits and would add substantially to the enforcement costs and size of the state Department of Revenue.

\textsuperscript{17} “Sanford Tax Plan,” Sanford for Governor, Greenville, South Carolina, January 25, 2002.
3. Reduced Incentive to Work, Save and Invest: The purpose of the tax system is to raise money to pay for needed government services, not to control the lives of citizens. The tax system should exert minimal influence on the economic decisions of individuals and businesses. Changing the public revenue system to tax earnings would reduce the normal rewards that encourage people to work, save, invest and build better lives for themselves and their families.

VI. Recommendations for the Washington Tax Code

Throughout the nation different states have implemented a diversity of tax systems, providing a wealth of experience from which we can draw conclusions about the success or failure of different tax policies. In an earlier study, Washington Policy Center discussed the guiding principles for a fair and effective tax structure. Before weighing an income tax for Washington, policymakers should be familiar with these basic principles and ensure that changes in tax policy do not reduce economic opportunities for state residents.

While these guiding principles are important, there are inherent problems with any system of taxation. As Ohio University economists Richard K. Vedder and Lowell E. Gallaway wrote in a report to Congress:

“Basically, taxation reduces spending on private sector goods and services traded in the free market. The benefits of free exchange – to both the purchaser and seller – are reduced when trade is restrained by taxation. The way taxes restrain private trade varies. Income and property taxes reduce incomes to taxpayers, lowering their demand for goods and services. Sales and excise taxes increase costs to suppliers, reducing their willingness to provide goods at any given price. In any case, taxes reduce private trade.”

For this reason, it is important to create a tax code that is fair, provides needed revenue for government, will help ensure prosperous communities and a vibrant business climate. Sensible reforms of the Washington tax code can help accomplish this goal. Some reforms include:

Reduce Tax Complexity: One of the primary problems with Washington’s current tax code is the complexity and opportunity for influence created by targeted tax incentives and special interest loopholes. Rather than helping the targeted businesses or individuals, the extra paperwork, compliance requirements and constant rate changes often increase costs and limit the ability of citizens to plan for the future. To restore fairness and equality, the tax code should reduce the tax exemptions granted to special interests and move away from social engineering as a goal of tax policy.

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Reduce overall tax rates: High tax rates inhibit economic growth. The Tax Study Committee is asked to present solutions that will be revenue neutral for the state’s tax structure. Overall tax rates could be reduced by eliminating some narrow tax exemptions, while maintaining steady revenue to the public treasury. Trimming tax rates would reduce the pressure for well-positioned interests in Olympia to seek relief through special tax breaks. Lower rates and fewer special exemptions would restore a higher degree of equal treatment for all citizens under the tax system.

Restore limits on future spending growth: During the 2002 legislative session state policymakers formally ended limits on how much state government spending could grow each year. In the four legislative sessions prior to 1993 state government spending grew by an average 12.0% each biennium. Following the adoption of spending limits in 1993, growth in the cost of government slowed to an average of 8.6% per biennium.22 Today, the state government spends more than at any time in its history. Returning to reasonable budget limits would bring greater discipline to public finances, ensure that future biennial budgets are sustainable and, most importantly, serve to restore citizens’ confidence in their government.

VII. Conclusion

With the adoption of an income tax, Washington would almost certainly experience a lower rate of personal income growth and faster pace of government spending growth. Comparative research shows that states without an income tax consistently enjoy stronger economic performance than states with an income tax. In addition, the overall cost of government grows much faster in states with income taxes, increasing the relative financial burden on taxpayers.

About the Author

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Published by Washington Policy Center

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