The State of State (and Local) Tax Policy

Q. How do state and local individual income taxes work?

A. Forty-one states and the District of Columbia levy broad-based taxes on individual income. New Hampshire and Tennessee tax only individual income from dividends and interest. Seven states do not tax individual income of any kind. Local governments in 13 states levy some type of tax on income in addition to the state income tax.

State governments collected $344 billion from individual income taxes in 2016, or 27 percent of state own-source general revenue (table 1). "Own-source" revenue excludes intergovernmental transfers. Local governments—mostly concentrated in Maryland, New York, Ohio, and Pennsylvania—collected just $33 billion from individual income taxes, or 3 percent of their own-source general revenue. (Census includes the District of Columbia's revenue in the local total.)

TABLE 1

State and Local Individual Income Tax Revenue
2016

	Revenue (billions)	Percentage of own-source general revenue
State and local	$376	16%
State	$344	27%
Local	$33	3%

Source: Urban-Brookings Tax Policy Center, "State and Local Finance Initiative Data Query System."

Note: Own-source general revenue does not include intergovernmental transfers.

Forty-one states and the District of Columbia levy a broad-based individual income tax. New Hampshire taxes only interest and dividends, and Tennessee taxes only bond interest and stock dividends. (Tennessee is phasing its tax out and will completely eliminate it in 2022.) Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not have a state individual income tax.

For combined state and local revenue, Maryland relied the most on the individual income tax in 2016, with the tax accounting for 29 percent of its revenue. The District of Columbia and nine states—California, Connecticut, Kentucky, Massachusetts, Minnesota, Montana, New York, Oregon, and Virginia—also collected 20 percent or more of their own-source revenue from individual income taxes in 2016.

The State of State (and Local) Tax Policy

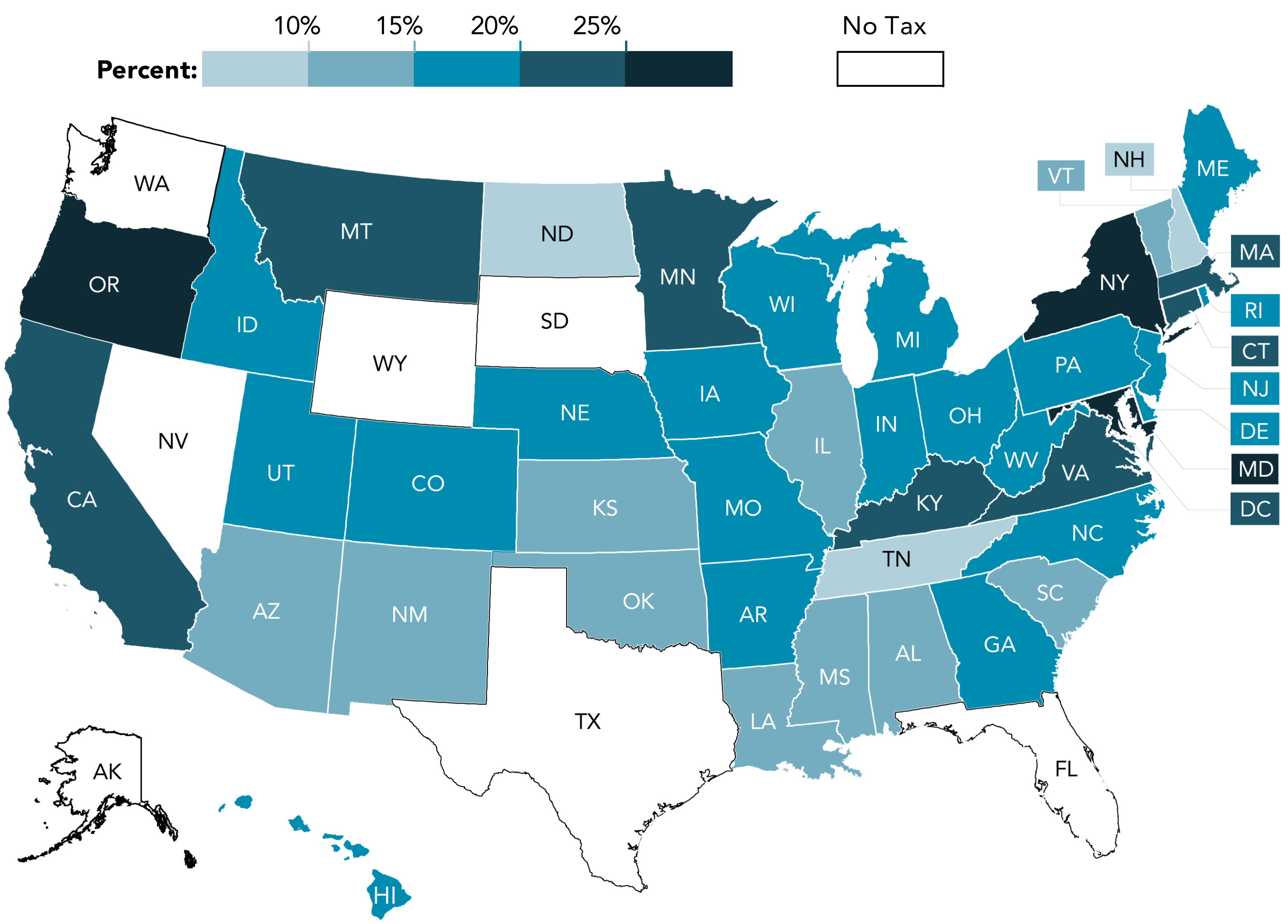
How do state and local individual income taxes work?

North Dakota's 5 percent of revenue from individual income taxes was the least of any state with a broad-based individual income tax. In every other state with a broad-based income tax, the tax provided at least 10 percent of own-source general revenue. New Hampshire and Tennessee, which levy a far more limited individual income tax, each collected about 1 percent of own-source revenue from their taxes.

FIGURE 1

Individual Income Tax as a Percentage of State and Local Own-Source General Revenue

2016



Source: Urban-Brookings Tax Policy Center, "State and Local Finance Initiative Data Query System."

Note: Own-source general revenue does not include intergovernmental transfers.

The State of State (and Local) Tax Policy

How do state and local individual income taxes work?

Local governments levy their own individual income taxes in 13 states. Localities in Indiana, Iowa, Maryland, and New York levy an individual income tax that piggybacks on the state tax. That is, local taxpayers in these states file their local tax on their state tax return and receive state deductions and exemptions when paying the local tax. Michigan localities also levy an individual income tax but use local forms and calculations.

Meanwhile, localities in Alabama, Delaware, Kansas, Kentucky, Missouri, Ohio, Oregon, and Pennsylvania levy an earnings or payroll tax. These taxes are separate from the state income tax. Earnings and payroll taxes are typically calculated as a percentage of wages, withheld by the employer (though paid by the employee) and paid by individuals who work in the taxing locality, even if the person lives in another city or state without the tax. Separately, localities in Kansas only tax interest and dividends (not wages).

In 2016, individual income taxes as a percentage of own-source local revenue ranged from less than 1 percent in Kansas and Oregon to 26 percent in Maryland. Local governments in Kentucky, Ohio, and Pennsylvania also collected more than 10 percent of own-source revenue from individual income taxes (or payroll taxes) in 2016.

WHAT INCOME IS TAXED?

The individual income tax base in most states is similar to the federal tax base. Most states start with federal adjusted gross income but a few start with federal taxable income (which is adjusted gross income minus certain deductions and exemptions). Alternatively, a handful of states use their own definition of income, but even these states rely heavily on federal rules when establishing their tax base.

Even the states that start with the federal tax base, however, often apply different rules for certain types of income. For example, unlike the federal government, states often tax municipal bond interest from securities issued outside that state, and many allow a full or partial exemption for pension income. In many states, but not all, taxpayers who itemize their federal tax deductions and claim deductions for state and local taxes cannot deduct those income taxes from their state income tax.

The 2017 Tax Cuts and Job Act created a new federal deduction for pass-through business income (income earned by sole proprietors, partnerships, and certain corporations). As such, states that use federal taxable income as their tax base had to decide whether to conform with the new federal deduction or establish separate treatment of pass-through income. For example, Idaho accepted the deduction as a part of its tax system while Oregon decoupled and rejected it. Critically, the deduction will not apply to state income taxes in states that use federal adjusted gross income, unless states pass legislation to adopt it.

Ohio already exempted a portion of pass-through business income from its income tax. Kansas exempted all pass-through income from its tax in 2012, but after budget problems it reversed course and ended the exemption in 2017.

HOW DO INDIVIDUAL INCOME TAX RATES VARY ACROSS STATES?

Most state income taxes are fairly flat, even in those states that apply graduated rates. Eight states impose a single tax rate on all income, while Hawaii has the most with 11 tax brackets. Top marginal rates for state income tax in 2018 ranged from 2.9 percent in North Dakota to 13.3 percent in California—including a 1 percent surcharge on incomes over $1 million (figure 2).

The State of State (and Local) Tax Policy

How do state and local individual income taxes work?

In some states with multiple tax brackets, the top tax bracket often begins at a low taxable income. Alabama, for example, has three rates, but the top tax bracket applies to taxable income over $3,000, making it essentially a flat tax. In other states, the difference between the lowest and the highest tax rates is small: about 2 percentage points in Arizona and Mississippi, for example.

While most states in the 1980s followed the federal government's lead in reducing the number of income tax brackets, some have increased the number of rates since then. California and New York have imposed new brackets (often called millionaire's taxes) for high-income taxpayers. California approved a millionaire's tax in 2004 that adds 1 percentage point to the rate applied to incomes over $1 million, and further increased the progressive bracket structure with another ballot measure in 2012. Similarly, New York's top tax rate of 8.82 percent applies to income above about $1 million.

At the start of 2018, California, Hawaii, Minnesota, and Oregon had top rates above 9 percent and another eight states had top income tax rates above 7 percent.

HOW DO STATES TAX CAPITAL GAINS AND LOSSES?

Eleven states and the District of Columbia treat capital gains and losses the same as under federal law. They tax all realized capital gains, allow a deduction of up to $3,000 for net capital losses, and permit taxpayers to carry over unused capital losses to subsequent years. However, most states tax capital gains at the same rate as ordinary income, while the federal government provides a preferential rate.

New Hampshire fully exempts capital gains, and Tennessee taxes only capital gains from the sale of mutual fund shares. Arizona exempts 25 percent of long-term capital gains, and New Mexico exempts 50 percent. Massachusetts has its own system for taxing capital gains, while Hawaii has an alternative capital gains tax. Pennsylvania and Alabama only allow losses to be deducted in the year that they are incurred, while New Jersey does not allow losses to be deducted from ordinary income.

The remaining 25 states that tax income generally follow the federal treatment of capital gains, with the exception of various state-specific exclusions and deductions.

HOW DO STATES TAX INCOME EARNED IN OTHER JURISDICTIONS?

A state income tax is generally imposed by the state in which the income is earned and not the state where the earner lives. Some states, however, have entered into reciprocity agreements with other states that allow outside income to be taxed in the state of residence. For example, Maryland's reciprocity agreement with DC allows Maryland to tax income earned in the District by a Maryland resident. As of 2010, 15 states and DC had adopted reciprocity agreements with specific states. Typically, these are states with major employers close to the border and large commuter flows in both directions.

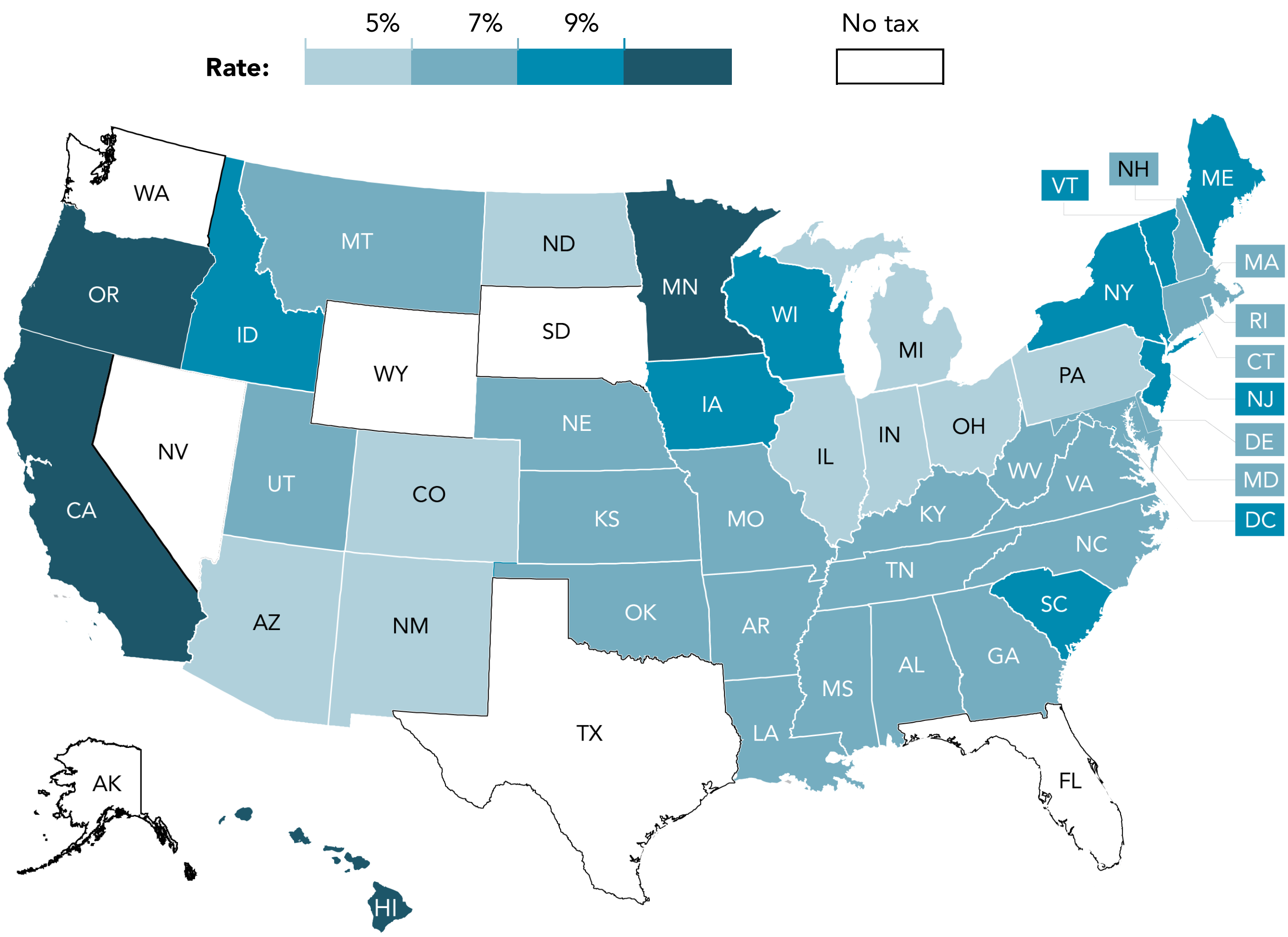
The State of State (and Local) Tax Policy

How do state and local individual income taxes work?

FIGURE 2

Top State Individual Income Tax Rates

2018



Source: Federation of Tax Administrators, "State Individual Income Taxes (Tax Rates for Tax Year 2018—as of January 1, 2018)."

The State of State (and Local) Tax Policy

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Data Sources

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Further Reading

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