Show-Me Institute
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REPORT

February 2020

LOCAL INCOME TAXES

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KEY TAKEAWAYS

- According to available data, the United States has 4,964 local income tax jurisdictions spanning 17 states, with wide-ranging rates, application, and implementation. Though this number seems high, most cities and counties, including most of the country's largest cities, do not have local income taxes.
- Missouri's two local income tax jurisdictions, Kansas City and the City of St. Louis, have earnings taxes of one percent on residents and workers. Renewal of these taxes is voted on every five years.
- Economic theory tells us that income taxes are distortionary, lowering the reward received by working and reducing personal money available for spending and investment. Research shows that state and local income taxes have negative effects on economic and population growth.
- Missouri's earnings taxes have additional negative effects because they are easily avoidable, do not have exemptions for low-income workers, and create an environment of unequal treatment.

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INTRODUCTION

In addition to the familiar federal and state income taxes that governments impose to raise revenue, some cities, counties, and school districts also levy their own income taxes. The Tax Foundation released publications on local income taxes in 2011 and 2019.[1] The purpose of this report is to summarize the Tax Foundation's data from 2019 and then narrow the focus to Missouri. This report will cover the history and current state of the earnings taxes in St. Louis and Kansas City and will summarize previous research on the effects of earnings taxes on economic growth.

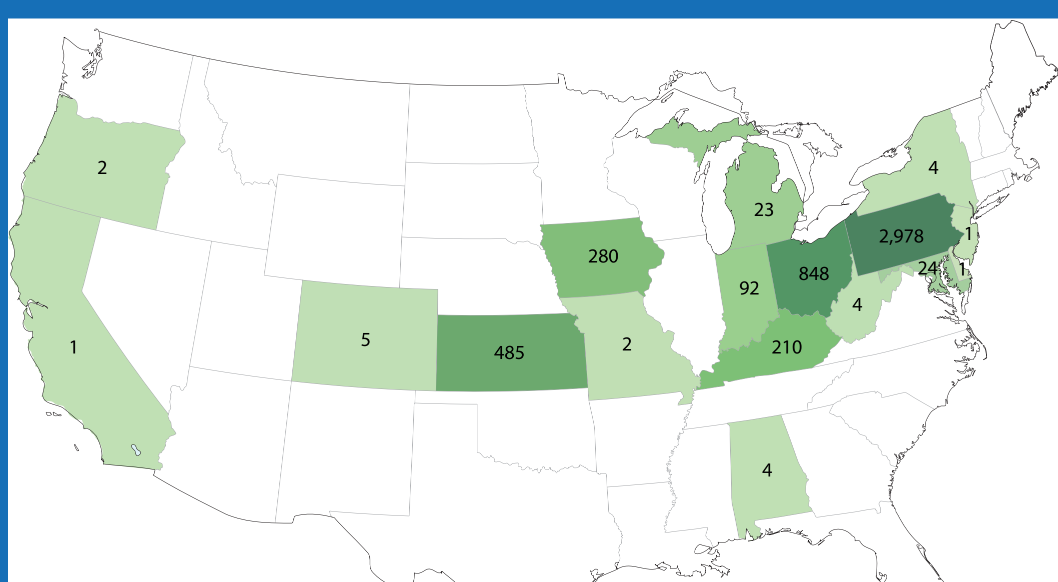
The term "local income tax" is adopted from the Tax Foundation, which gives a brief description of local income taxes in its 2019 publication:

> *Local income taxes appear under a variety of designations: wage taxes, income taxes, payroll taxes, local service taxes, and occupational privilege taxes. They are generally paid by the employee but withheld by the employer, although in some cases . . . they are paid directly by the employer. Some are imposed as a percentage of salaries and wages, while others are stated as a percentage of federal or state tax, and still others are flat amounts charged to all workers.*[2]

The ways in which these taxes are implemented vary throughout the country. As described above, there are differences in name, calculation, and application. Some jurisdictions have exemptions for low-income workers or implement a threshold for when the tax takes effect. For example, Glendale, Colorado, applies the tax only to those who earn more than $750 per month. However, most jurisdictions do not have exemptions and tax the first dollar earned. Local income taxes normally apply to residents of the jurisdiction and nonresidents who work within the jurisdiction, but there may be different rates for residents and nonresidents. Revenue from these taxes goes to the local jurisdiction.

Local income taxes were first implemented during the Great Depression, when foreclosures made property taxes an unreliable source of revenue for local governments.[3] These taxes continued to gain popularity as commuting costs decreased, making it easy for people to live in the suburbs and work in the city, again decreasing city revenues from property taxes. Philadelphia adopted the first local income tax in 1939, and the use of this tax spread to surrounding states, with Missouri enacting its first earnings tax in 1948.[4]

Map 1:
Number of Local Income Tax Jurisdictions by State, 2019



Data from Tax Foundation.

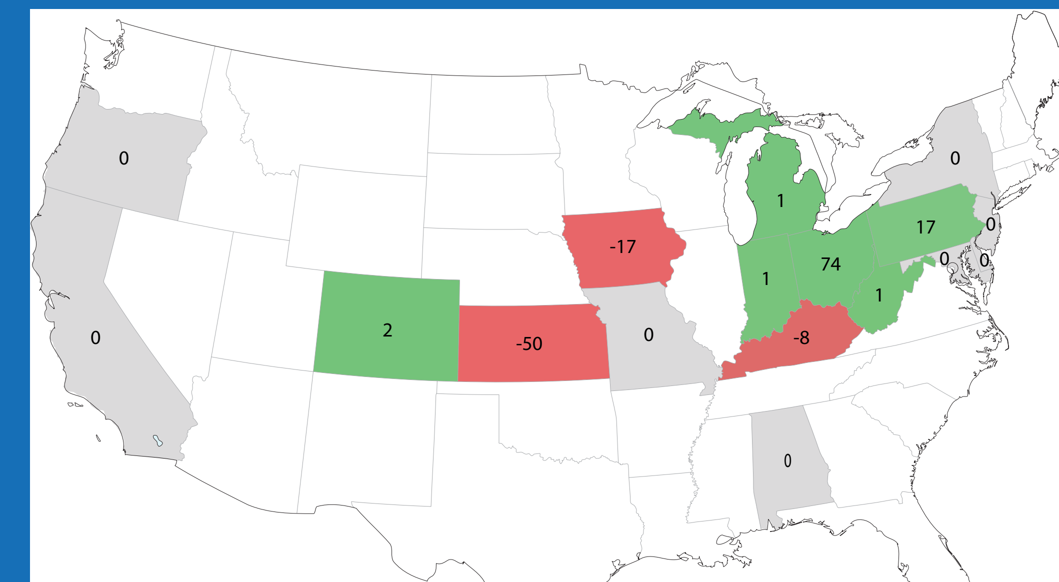
LOCAL INCOME TAXES ELSEWHERE IN THE UNITED STATES[5]

Seventeen states have jurisdictions with local income taxes. Most are located within the Rust Belt region of the country. The Tax Foundation reported 4,964 jurisdictions across the country with local income taxes in 2019. Map 1 shows the number of jurisdictions in each state. Note that most cities and counties, including most of the country's largest cities, do not have local income taxes.

The Tax Foundation published a similar report on local income taxes in 2011. Map 2 shows the changes in the number of jurisdictions with local income taxes in each state from 2011 to 2019. States that are red with a negative number show a decrease in the number of taxing jurisdictions from 2011 to 2019. Conversely, states in green show an increase in the number of jurisdictions. States that are gray had no change in the number of jurisdictions. In total, there was an increase from 4,943 reported jurisdictions in 2011 to 4,964 reported jurisdictions in 2019.* The Tax Foundation did not release a full dataset for all states in its 2011 report, so changes over time for specific jurisdictions in Iowa, Kansas, Ohio, and Pennsylvania cannot be determined. However, an interactive map showing changes in the tax rates from 2011 to 2019 for individual jurisdictions in the other 13 states can be found at https://tabsoft.co/36ibuVI.

The taxing jurisdictions are normally defined by city, county, or school district. Most states have only a handful of jurisdictions with local income taxes, but there are exceptions. Every county in Indiana and Maryland has a local income tax, and Pennsylvania has 2,978 jurisdictions with these taxes. Some specifics for each state are listed in Table 1, followed by a summary description of the local income taxes in each state. In Table 1, there are a few empty cells under "Tax Information" because the amount of variety in the local taxes for these states makes it difficult to provide summary information. An interactive map that also relays this information can be found at https://tabsoft.co/36kCHr3.

Map 2:
Change in the Number of Jurisdictions from 2011 to 2019 by State



Data from Tax Foundation.

LOCAL INCOME TAXES BY STATE

Alabama: Alabama has four earnings tax jurisdictions: Bessemer, Birmingham, Gadsden, and Macon County. In these areas, workers pay an occupational licensing fee that ranges from 1 percent to 2 percent of total earnings.

California: San Francisco has a payroll tax of 0.38 percent for residents and nonresidents.

*Differences between the 2011 and 2019 data sets suggest that some municipalities that had local taxes in 2011 no longer do in 2019. However, we were unable to confirm the circumstances surrounding each jurisdictional change, so changes may represent repeals of the taxes, consolidation of jurisdictions, data inconsistencies or other circumstances.

Table 1:
Local Income Taxes, 2019

State	Number of Jurisdictions	Rate Range	Tax Information
Alabama	4	1%–2%	Earnings tax
California	1	0.38%	Payroll tax
Colorado	5	$2.00–$5.75	Paid per month by employees and employers
Delaware	1	1.25%	Earnings tax
Indiana	92	0.35%–3.38%	Of taxable income
Iowa	280	1%–20%	Of state income tax liability
Kansas	485	0.13%–2.25%	On interest and dividends
Kentucky	210	0.0033%–2.5% or lump-sum payment	
Maryland	24	1.75%–3.2%	Of taxable income
Michigan	23	1%–2.4%	Earnings tax
Missouri	2	1%	Earnings tax
New Jersey	1	1%	Payroll tax
New York	4	0.11%–0.34% 0.11%–0.34%	Payroll tax
		3.078%–3.876%	Earnings tax
		16.75%	Of state income tax liability
		2.00%	Payroll tax
Ohio	848	0.25%–3%	
Oregon	2	0.74%–0.76%	Payroll tax
Pennsylvania	2978	0.312%–2.75% and lump-sum payment	
West Virginia	4	$2–$10	Paid per week or pay period by employees

Source: Data from Tax Foundation.

Colorado: Aurora, Denver, Glendale, Greenwood Village, and Sheridan have local income taxes that are called Occupational Privilege Taxes. These are lump-sum taxes that apply to employers and employees whose earnings are above a certain threshold. The employee pays between $2 and $5.75 per month, and the employer pays between $2 and $5 per month per taxable employee, depending on the city.

Delaware: In Delaware, one city (Wilmington) has an earnings tax. Wilmington residents pay a 1.25 percent flat tax on all income and net profits of businesses.

Indiana: All of Indiana's 92 counties have local income taxes, so all residents of Indiana pay this type of tax. The rates range from 0.35 percent to 3.38 percent. Indiana has imposed different rates for residents and nonresidents in the past, but recently the rates have been the same.

Iowa: Iowa has 1 county and 279 school districts with local income taxes. Appanoose County has a 1 percent income tax for residents and nonresidents that is called the Emergency Medical Services Tax. The school districts have local income surtaxes applied as a percentage of state income tax liability with rates ranging from 1 percent to 20 percent.

Kansas: There are 485 jurisdictions with local income taxes in Kansas. These taxes apply only to income from interest and dividends and not to income from working. Rates are 2.25 percent or less on interest and dividends.

Kentucky: Kentucky has 210 jurisdictions that tax income. These jurisdictions include cities, counties, and school districts, and the taxes apply only to residents. Some jurisdictions require lump-sum payments while others have rates up to 2.5 percent.

Maryland: All of Maryland's 24 counties have local income taxes. The tax rate depends on where an employee lives, not where they work. The tax rates range from 1.75 percent to 3.2 percent of taxable income. People who work in Maryland but do not live there pay a 1.75 percent tax on their taxable income.

Michigan: Michigan has 23 cities with local income taxes imposed on those who work within the city limits. The nonresident rate is half the resident rate. Of these cities, 19 have a resident rate of 1 percent and 4 cities have higher rates (up to 2.4 percent).

Missouri: The City of St. Louis and Kansas City are the only jurisdictions in Missouri with earnings taxes. Both cities collect 1 percent of total income from residents, as well as from nonresidents who work in the city. Both cities also collect 1 percent of net profits from businesses in the city, and St. Louis collects a 0.5 percent payroll tax.

New Jersey: Newark has a payroll tax, so it applies directly to employers and not employees. Employers in Newark pay a 1 percent tax on total payroll.

New York: New York has 3 jurisdictions with local taxes. The Metropolitan Commuter District imposes a mobility tax on employers in the district, which includes New York City's 5 boroughs and 7 surrounding counties. This local payroll tax applies only to employers whose payroll expenses exceed $312,500 each quarter and it is a progressive tax, meaning that the rate increases as payroll expenses increase. The lowest rate is 0.11 percent of payroll expenses, and the highest rate is 0.34 percent. New York City imposes a progressive local income tax based on taxable income; the lowest rate is 3.078 percent and the highest rate is 3.876 percent. Yonkers levies a local tax of 16.75 percent of state income tax liability for residents, meaning that they pay the city an amount equal to 16.75 percent of what they pay for state income tax. Nonresidents who work in Yonkers also must pay a 0.5 percent tax on earnings. There is also a New York–New Jersey Waterfront payroll tax of 2 percent for employees of the Port Authority.

Ohio: Ohio has 848 jurisdictions with local income taxes, including 649 cities with rates ranging from 0.5 percent to 3 percent. In addition, 199 school districts impose a local income tax, with rates ranging from 0.25 percent to 2 percent. The city taxes apply to residents and nonresidents who work in the cities. The school district taxes apply only to residents.

Oregon: The Tri-County Metropolitan Transportation District and the Lane County Mass Transit District levy payroll taxes on employers within the districts. These rates are approximately 0.7 percent of gross taxable payroll.

Pennsylvania: Pennsylvania has 2,978 local income tax jurisdictions, the largest number of any state. These jurisdictions include municipalities and school districts. Nonresidents are only responsible for paying the municipality-imposed tax while residents may be responsible for both. Rates do not exceed 2.75 percent and there is often an additional lump-sum tax that does not exceed $52 annually.

West Virginia: West Virginia has 4 cities with local income taxes: Charleston, Huntington, Parkersburg, and Weirton. These taxes are lump-sum payments paid per week by employees of the cities. The fees range from $2 to $5 per week.

THE EARNINGS TAX IN MISSOURI

Missouri authorized a temporary earnings tax for St. Louis in 1948. The temporary tax rate was 0.5 percent of employee income and employer profits. The earnings tax was made permanent by a vote in 1954 and was raised to 1 percent in 1959. St. Louis also has a 0.5 percent payroll expense tax, so businesses in the city pay a tax equal to 0.5 percent of all wages paid.[6] However, businesses can get an earnings tax credit equal to 20 percent of their payroll expense tax amount, so they do not necessarily pay the full 1 percent tax on profits on top of the 0.5 percent tax on payroll.[7]

Kansas City has a similar story. In 1963, Kansas City voters approved a 0.5 percent earnings tax. In 1970, voters increased the tax to 1 percent of employee income and employer profits.[8] St. Louis and Kansas City are the only jurisdictions in Missouri with earnings taxes, and as of 2010 are the only jurisdictions in Missouri that may have such taxes.

In 2010, Missourians approved the Missouri Earnings Tax

Act, which prohibits local tax authorities from enacting any new earnings taxes and requires voters in current earnings tax cities to vote to renew them every 5 years. Under this act, St. Louis and Kansas City can keep their earnings taxes, but they must be renewed every 5 years by voters. If the earnings tax is not renewed, it will be phased out over ten years with the tax rate decreasing by 0.1 percent each year.[9]

The first vote to decide whether to keep the earnings tax, called a retention vote, was in 2011. The vote passed with 78 percent voter approval in Kansas City and 88 percent voter approval in St. Louis. The next retention vote took place in 2016, and voters decided to keep the tax with 77 percent approval in Kansas City and 72 percent approval in St. Louis.[10]

Neither the St. Louis earning tax nor its counterpart in Kansas City includes an exemption for low-income workers. The same rate of 1 percent applies to residents and nonresidents. Collected revenues go into a general fund for the city. St. Louis brought in $218.3 million in revenue from the earnings tax in 2018, which was 35.18 percent of the city's general revenue.[11] Kansas City brought in $241.7 million, or 33.72 percent of general revenue from the tax in 2018.[12]

The commonly cited rationale for local income taxes is that they replace or supplement other revenue sources, like property, business, sales, and tourist taxes, to increase revenue for local governments. They can also extend further than some of these taxes by applying to non-residents. Certainly, the earnings tax brings in a lot of revenue.[13] But at what cost?

Effects on Growth

Economic theory tells us that taxes are distortionary; an increased price changes consumer behavior. Taxes lower the amount of money available for spending and investing, the two activities that drive economic growth. Income taxes create a disincentive to earn taxable income because the more money you make, the more money you pay. Accordingly, theory would suggest that income taxes have negative effects on growth.

Missouri's economic growth has been very slow in recent years. Missouri ranked 44th of 50 states in real GDP growth from 2008 to 2018,[14] and a report by Rik W. Hafer and William H. Rogers shows that Missouri has been underperforming in economic growth for almost 50 years.[15] Missouri is not a low income-tax state, and researchers have often called for a reduction or elimination of the state income tax in order to stimulate economic growth.[16] Several studies exploring the negative effects of state income taxes on growth are listed in Table 2.

Like state income taxes, the earnings tax disincentivizes earning income and reduces private saving and investment by taking money from workers. At the same time, these taxes are easier to avoid than state income taxes. People and businesses can vote with their feet by leaving high-tax areas in favor of low-tax areas.[17] Accordingly, local income taxes make cities that have them less competitive than their counterparts that don't. People want to go where they can receive the highest after-tax return on their labor, and businesses in Kansas City and St. Louis can immediately get a higher return if they move outside of city limits. As shown in an analysis by Michael Podgursky and Nick Pretnar, the St. Louis and Kansas City metro areas have had slower growth rates from 2001 to 2013 when compared to other, similar cities, and the Missouri portions of these areas performed worse than the Illinois and Kansas portions.[18] The research cited in Table 3 suggests that the earnings tax played a role in these slow levels of growth.

Other Negative Effects

Looking specifically at the earnings taxes in St. Louis city and Kansas City, there are negative effects outside of economic growth. The existence of earnings taxes often leads to unequal treatment with regard to the tax. Specifically, the government makes special deals with large businesses to incentivize them to stay or expand in the taxed jurisdiction. For example, St. Louis city has cooperation agreements with some large companies, such as Polsinelli Shughart, PC, that provide earnings and payroll tax reimbursements. The government gives these companies money, the amount of which is determined by earnings and payroll tax revenue, to help cover the costs of expansion, relocation, or other improvement acts.[19]

Table 2:
State Income Tax Research

Study	Sample	Years of Data	Findings
"Tax Avoidance and the Deadweight Loss of the Income Tax" (Feldstein, 1999)[20]			• The deadweight loss of income taxes is even larger than commonly thought because of tax avoidance.
"The Robust Relationship Between Taxes and U.S. State Income Growth" (Reed, 2008)[21]	48 continental states	1970–1999	• A 1 percentage point increase in tax burden over a 5-year period is associated with 1.37 percent lower per capita personal income growth during that period, where tax burden is the ratio of state and local tax revenues to personal income. • It's estimated that a state with a 1 percentage point higher tax burden than another state has real per capita personal income growth that is 0.90 percent lower in subsequent 5-year periods.
"Income Taxes vs. Sales Taxes: A Welfare Comparison" (Casteel and Haslag, 2010)[22]	Missouri		• The state economy would realize faster growth if the income tax were replaced by a revenue-neutral, broad-based sales tax. • A person would need an 8.7 percent increase in consumption under the income tax policy to keep welfare the same as under the sales tax policy.
"What is the Evidence on Taxes and Growth?" (McBride, 2012)[23]	26 empirical studies	1983–2012	• Provides a literature of 26 empirical studies on taxes and economic growth. • All but 3 of the studies find a negative effect of taxes on growth.
"Weak Economic Growth in Missouri's Largest Cities is Holding Down Statewide Growth." (Podgursky and Pretnar, 2016)[24]	United States metropolitan statistical areas as reported by the Bureau of Economic Analysis	2001–2013	• St. Louis and Kansas City metro areas have had slower growth rates when compared to other cities. • The Missouri portions of the St. Louis and Kansas City metro areas performed worse in terms of average annual GDP growth than the Illinois and Kansas portions.
"Tax Reform and Interstate Migration" (Edwards, 2018)[25]	All 50 states	2016	• 600,000 people moved, on net, from the 25 highest-tax states to the 25 lowest-tax states. • 24 of the 25 highest-tax states had net out-migration while 17 of the 25 lowest-tax states had net in-migration. • The zero-income-tax states are a net migration draw, particularly for high earners.
"Personal Income Taxes and Labor Downskilling: Evidence from 27 Million Job Postings" (Campello, Gao, and Xu, 2019)[26]	United States counties near a state border where one of the states had a change in its income tax.	2010–2017	• For a given county, a 1-standard-deviation increase in personal income tax rates is associated with a 0.8% drop in total labor force, a 1.1% decline in number of workers employed, and a 1% decline in average earnings.

Table 3:
Earnings Tax Research

Study	Sample	Years of Data	Findings
"How an Earnings Tax Harms Cities like Saint Louis and Kansas City" (Haslag 2006)[27]	Kansas City, Springfield, and St. Louis Metropolitan Statistical Areas	1969–2002	• The earnings tax cities (Kansas City and St. Louis) had higher suburban-to-city growth ratios than Springfield, a similar city without an earnings tax. • Springfield had higher overall percentage change in real personal income than the earnings tax cities.
	101 cities throughout the country, including 23 cities with earnings taxes	1990–2000	• A city with a 1 percent higher local income tax rate will have a 5 percent lower ratio of city-to-MSA per capita income. This suggests that people move outside of cities to avoid local income taxes.
"New Evidence of the Effects of City Earnings Taxes on Growth" (Wall 2011)[28]	176 cities from 8 states that have at least 1 city with an earnings tax. 21 cities with earnings taxes	1990–2000	• A 1 percentage point increase in the earnings tax rate was associated with a 3.04 percentage point lower population growth rate and a 2.32 percentage point lower employment growth rate. • Earnings taxes were associated with faster population growth in other cities that did not levy such taxes within the same metro area.
"Updated Estimates of the Effects of City Earnings Taxes on Growth" (Wall 2014)[29]	185 cities from 9 states that have at least 1 city with an earnings tax. 79 cities with earnings taxes	2000–2010	• Each 1 percentage point increase in the earnings tax rate is associated with a 4.2 percentage point decrease in the population growth rate. • The presence of earnings taxes is associated with slightly higher population growth in the non-tax metro areas of the cities.

As a result, some businesses do not pay the full tax while others do. These reimbursements show that the city recognizes that businesses are negatively influenced by the earnings tax in the city. If city policymakers believe that the earnings tax is such a vital part of the city economy, then why doesn't everyone pay it? Or, conversely, if the earnings tax is pushing businesses away, then why does it still exist? Overall, the earnings tax and associated special deals make the economic environment unequal.

As previously mentioned, most earnings tax jurisdictions do not have exemptions for low-income workers. Missouri fits into this category; the City of St. Louis and Kansas City earnings taxes apply to the first dollar earned without considering whether the worker is at or below the poverty line. The taxes have a regressive impact on disposable income because the tax takes a higher percentage of a low-income earner's disposable income than it takes from a high-income earner.

The research presented here shows the several negative effects of earnings taxes. Perhaps most important are the negative effects on population and economic growth. A city's survival depends on growth, so it may be time to reevaluate what these cities are willing to give up in exchange for some tax revenue.

What Can Be Done in Missouri?

The obvious way to eliminate the negative effects of Missouri's earnings tax is to eliminate the tax. Jurisdictions would be more competitive and experience more economic growth without the tax. In Missouri, voters could decide not to renew the earnings tax, and it would be phased out over 10 years. Those 10 years would give the cities time to make changes to their budget priorities and revenue strategies. This could start a serious discussion about wasteful spending and cronyism in general.

CONCLUSION

The publications presented and referenced in this report provide useful research on the economic effects of local income taxes, but there is room for further research. Data may suggest that taxes make people move,[30] but to see if an earnings tax has that effect, more extensive work needs to be done to try to isolate the effects of an earnings tax on city populations. Quality of education, weather in January, crime rates, and housing prices are just a few of many things that may also affect where a person decides to live, and therefore must be controlled for in further research. Additionally, previous work done on the effects of state income taxes could be emulated to capture local income tax effects and there is an opportunity to expand on the Haslag and Wall papers presented in this report. Further research on local income taxes will provide a more complete picture of their effects.

Whether adding a new tax burden to city residents in the middle of last century made sense at the time or not, we now know that local income taxes have harmful effects on the economies of cities that have them. Throughout the country, these local taxes are disincentivizing work and distorting economic growth, so cities should consider carefully whether their local income taxes are sensible.

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ENDNOTES

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