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FISCAL FACT

Top Marginal Effective Tax Rates By State under Rival Tax Plans from Congressional Democrats and Republicans

By Gerald Prante

Introduction

One of biggest news stories across the nation is what Congress should do about the expiring Bush-era tax cuts. Should they be extended for everyone as Republicans favor? Or should they be extended for everyone except those at the top of the income spectrum, as Democrats (including the President) favor? The debate is ever-focused on this top 2-3 percent of the income spectrum.

The most clear-cut distinction between the Republican and Democratic plans is how high the top ordinary tax rates should be. The Democratic plan calls for allowing the top two ordinary tax rates to rise from their 2010 levels of 33 percent and 35 percent to their scheduled 2011 levels of 36 percent and 39.6 percent, respectively. The Republican plan calls for extending the lower 2010 levels.

The two parties' tax plans also differ on what tax rates should be imposed on capital gains and dividends of high-income people, as well as over whether we should restore the limitations on itemized deductions, which over the phase-out range, impose an implicit 1 percentage point surtax on adjusted gross income.

The Costs and Benefits of Higher Tax Rates on High-Income Taxpayers

Empirical evidence tends to suggest that raising marginal tax rates on those at the top of the income spectrum is one of the most economically inefficient ways of raising tax revenue due to the higher sensitivities to taxation among those at the top, along with the fact that as statutory rates rise, the deadweight loss of taxation rises more quickly.[1]

Most public finance economists would agree that, in a relative sense, the sensitivities of labor to higher taxes are greatest at the high end of the income spectrum (along with second earners).

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[1] For a good overview of this issue, see "What Does the Taxable Income Elasticity Say About Dynamic Responses to Tax Changes?" by Carroll and Hrung at http://ideas.repec.org/a/aea/aecrev/v95y2005i2p426-431.html or "The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review" by Saez, Slemrod and Giertz at http://elsa.berkeley.edu/~saez/saez-slemrod-giertzJEL09elasticity.pdf.

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However, the absolute level of sensitivity is still subject to empirical debate. Also part of any debate relating to taxes on high-income earners is the impact on income inequality and the cost of financing any tax cuts. For example, if high-income taxpayers believe that a current tax cut will merely be financed by future tax increases, the beneficial effect of the current tax cut may be minimal, assuming those taxpayers are rational and forward-looking.

In this Tax Foundation Fiscal Fact, we do not undertake a full study of the costs and benefits of higher tax rates on high-income taxpayers; rather, we merely measure how high marginal effective tax rates would actually be under the two main tax plans before Congress: (1) the Republican plan which would merely extend 2010 tax law, and (2) the Democrat plan which would extend 2010 tax law with some exceptions, most notably allowing the top two tax rates to climb back to 36% and 39.6% from their 2010 levels of 33% and 35%.

Results

Table 1 presents top marginal effective tax rates (METRs) for high-income taxpayers by state for these two policy scenarios. The numbers in the table were calculated by adding $1 to self-employment labor income and then calculating the net change in payroll taxes,[2] state and local income taxes (accounting for any federal deductibility) and the federal income tax (accounting for any state and local income tax deductibility). Due to deductibility, phase-outs of itemized deductions at both the federal and state/local levels, and the deductibility of one-half of self-employment tax, the total rate is not merely the sum of the payroll tax rate, the top state rate, and the top federal rate.

Overall, the disparity between the two policies is approximately 5-6 percentage points. Under the Democratic plan, marginal effective tax rates on some high-income taxpayers in New York City would exceed 50 percent. That would be the highest in the nation and the only place above 50 percent. The lowest top marginal effective tax rate on labor income under the Democratic plan, 42.94 percent, would be in those states that have no state income tax.

Three important cautions before citing information in this table:

(1) A top marginal effective tax rate of 50 percent does not mean that 50 percent of one's entire income is taken in taxes. It simply means that any *additional* income that the person earns would be taxed at a 50 percent rate. For example, even though Bill Gates would likely face these top marginal tax rates, Gates's first $16,000 is still taxed at a rate of 10 percent by the federal income tax.

(2) The tax rates given here only count income taxes, so states that rely heavily on sales taxes instead of income taxes show a lower top rate. That does not mean that sales taxes don't diminish the purchasing power one gets from earning an additional dollar of income, thereby reducing the incentive to earn that additional dollar of income.

(3) By top marginal effective tax rates, we are referring to the METRs faced by the highest income earners on their self-employment income. This is not equal to the highest possible marginal effective tax rate that a taxpayer could face. For example, in certain circumstances within the federal tax code, it is possible that one's marginal effective tax rate could exceed 100 percent over a given income range. Also, METRs faced by some EITC recipients can be very high over certain ranges, especially

[2] We omit the Social Security portion of payroll taxes, leaving only the 2.9% Medicare portion because all taxpayers under consideration are above the wage threshold.

if one adds the implicit "income tax" that these same low-income people pay through means-testing of government transfer programs.

Table 1
Top Marginal Effective Tax Rates on Self-Employment Income by State, 2011

State	Top METR (Congressional Democrats' Plan)	Rank*	Top METR (Congressional Republicans' Plan)	Rank*
Alabama	44.90%	40	39.41%	40
Alaska	42.94%	44	37.21%	44
Arizona	45.72%	36	40.12%	37
Arkansas	47.60%	11	42.08%	14
California	49.37%	2	44.14%	2
Colorado	45.78%	35	40.18%	35
Connecticut	46.81%	20	41.38%	19
Delaware	47.30%	15	41.77%	15
District of Columbia	48.16%	(8)	42.66%	(8)
Florida	42.94%	44	37.21%	44
Georgia	46.62%	23	41.06%	24
Hawaii	49.69%	1	44.26%	1
Idaho	47.73%	9	42.21%	9
Illinois	44.72%	41	39.13%	41
Indiana	45.65%	37	40.13%	36
Iowa	46.51%	25	41.21%	22
Kansas	46.90%	19	41.35%	21
Kentucky	47.09%	18	41.54%	18
Louisiana	45.22%	39	39.76%	39
Maine	48.16%	7	42.66%	7
Maryland	48.60%	4	43.13%	4
Massachusetts	46.09%	29	40.61%	29
Michigan	45.79%	34	40.28%	34
Minnesota	47.76%	8	42.24%	8
Mississippi	46.01%	30	40.42%	30
Missouri	46.69%	22	41.13%	23
Montana	46.62%	23	41.06%	24
Nebraska	47.14%	17	41.60%	17
Nevada	42.94%	44	37.21%	44
New Hampshire	42.94%	42	37.21%	42
New Jersey	48.33%	6	43.02%	5
New Mexico	45.94%	31	40.35%	32
New York (non-NYC)	48.44%	5	42.96%	6
New York City	50.68%	(1)	45.30%	(1)
North Carolina	47.69%	10	42.18%	11
North Dakota	45.92%	32	40.33%	33
Ohio	47.57%	12	42.19%	10

Oklahoma	**46.31%**	**27**	**40.74%**	**27**
Oregon	**47.35%**	**14**	**42.14%**	**13**
Pennsylvania	**45.51%**	**38**	**39.98%**	**38**
Rhode Island	**46.21%**	**28**	**40.74%**	**27**
South Carolina	**47.23%**	**16**	**41.70%**	**16**
South Dakota	**42.94%**	**44**	**37.21%**	**44**
Tennessee	**42.94%**	**42**	**37.21%**	**42**
Texas	**42.94%**	**44**	**37.21%**	**44**
Utah	**45.92%**	**33**	**40.42%**	**30**
Vermont	**48.77%**	**3**	**43.30%**	**3**
Virginia	**46.47%**	**26**	**40.90%**	**26**
Washington	**42.94%**	**44**	**37.21%**	**44**
West Virginia	**46.81%**	**20**	**41.38%**	**19**
Wisconsin	**47.55%**	**13**	**42.18%**	**11**
Wyoming	**42.94%**	**44**	**37.21%**	**44**

Notes:

(1) State rank does not include D.C. or New York City, but ranks cited in ( ) for D.C. and New York City are those ranks they would have if ranked against other states.

(2) At the very high end, in those states with a state income tax rate that is less than 3 percent (including those with no income tax), the implicit surtax resulting from the limitation on itemized deductions would cease, thereby reducing the state's marginal effective tax rate by about 1 percentage point.

(3) New Hampshire and Tennessee do not tax labor income, thereby their state tax rates for the purposes of this table are zero. (They do levy taxes on investment income derived from interest and dividends, but those do not affect this table. This report has been updated to reflect this as the initial report included New Hampshire and Tennessee state income tax rates.)

Source: Tax Foundation calculations

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