Mountain States Policy Center

Policy Idea

The golden opportunity to lower income tax rates, boost competitiveness in Idaho and Montana

5 FACTS

1. *Both Idaho and Montana's current personal income tax rates are relatively high*
2. *Personal income tax revenue accounts for nearly half of state revenues in Idaho and nearly two-thirds in Montana*
3. *Policymakers can tie personal income tax rates to excess revenue via triggers, lowering the burden for all workers*
4. *In Idaho, every .1% of the state's income tax accounts for roughly $40 million in revenue*
5. *Idaho and Montana stand to gain from Washington state decision to adopt a capital gains income tax*

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Introduction

Over the past few years, Idaho lawmakers have twice lowered the state's income tax rate. The latest legislative action passed last September brings the Gem State's income tax to a flat rate of 5.8% for all income levels.

Like Idaho, Montana lowered its income tax from 6.9% to 6.75% in 2022.[1] Governor Greg Gianforte says there's room for an even larger reduction. He has proposed lowering the top state income tax rate to 5.9%.[2]

The reduction action in both Montana and Idaho follows a national trend of lowering state income tax rates. One of the only states not following the trend happens to be neighboring Washington, providing a golden opportunity for policymakers in Idaho and Montana to take advantage of an extraordinary policy shift and solidify their state competitiveness for decades to come.

The history of a state income tax

Idaho's income tax had a bumpy road in the beginning. It was originally adopted in 1931 and was structured like the federal income tax. Almost 30 years later, Idaho adopted the Idaho Income Tax Act, imposing a graduated rate on income and estates, while adopting a flat tax rate on corporations. The graduated individual rate reached as high as 8.5% in the 1980's and even as recently as 2015 was above 7.0%.

[1] Montana State Department of Revenue, New Income Tax Rates, January 2022, available at https://mtrevenue.gov/2022/01/10/new-individual-income-tax-rate/?utm_source=rss&utm_medium=rss&utm_campaign=new-individual-income-tax-rate

[2] Mountain States Policy Center, Gov. Gianforte: Lower Montana's income tax rate, November 2022, available at https://www.mountainstatespolicy.org/post/gov-gianforte-lower-montana-s-state-income-tax

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Idaho adopted its original income tax in 1931, while Montana adopted its income tax two years later

Idaho and Montana's income tax rates are relatively high

Idaho legislators have recently begun to lower the tax, taking it to a flat rate of 5.8% in 2022.

Montana adopted its income tax in 1933 – but it, too, changed and was challenged over time. Originally, Montana's state constitution put restrictions on property taxes. If you earned and owned your income, should it be considered property? The courts ruled the income tax was similar to an excise tax and therefore wasn't restricted. The issue was put to rest in 1972 when Montana adopted a new state constitution, giving the state powers to adopt taxes without saying which type of taxes were allowed.

Like neighboring Idaho, Montana's top income tax rate has been above 6.0% for some time, but proposals have been made to bring it to 5.9% in 2023.

Comparing income tax rates

Income tax rates in the Mountain West and the western United States vary significantly. Wyoming and Nevada do not levy income taxes, while Washington state has added a new capital gains income tax that is currently being litigated.

California has the highest income tax rates in the country. Colorado and Utah both have income taxes, but they have been gradually reduced to less than 5%.

While the reductions and focus on rates in Idaho and Montana are welcome, both states risk falling behind their neighbors if they don't take further action.

Furthermore, states across the country with personal income taxes have sought to lower the burden.

NEWEST PERSONAL STATE INCOME TAX RATES

IDAHO	5.8%
IOWA	3.9%
ARIZONA	2.5%
MISSISSIPPI	4.0%
GEORGIA	4.9%
UTAH	4.9%

OTHER PERSONAL STATE INCOME TAX RATES

MONTANA	6.5%
ALABAMA	5.0%
COLORADO	4.5%
ILLINOIS	4.9%
INDIANA	3.2%
MASSACHUSETTS	4.9%
MISSOURI	5.4%
NORTH CAROLINA	4.9%
OHIO	3.9%
NORTH DAKOTA	2.9%
OKLAHOMA	4.7%
PENNSYLVANIA	3.0%

A complete list of state income tax rates can be found here.

Case Study: Iowa

In Iowa, legislators have moved quickly to bring down tax rates in a time of economic pain. Iowa's Governor recently signed into law tax cuts that

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lowered the state rate of as high as 8.98% to a flat rate of 3.9%. The move amounts to a $2 billion tax cut for Iowans.

The rate will be brought down over time and will eventually reach 3.9% by 2026. Iowa's income tax was previously a cumbersome mess with nine individual brackets and a corporate income tax of 12%.[3]

Case Study: Mississippi

Numerous states have sought to lower their personal income tax rates, including Arizona, Mississippi, Iowa and Georgia

In its latest legislative session, the state of Mississippi decided to reduce its income tax to a flat rate. The Mississippi Tax Freedom Act of 2022 was originally introduced with the goal of eliminating the state's income tax. In the end, the Mississippi Legislature approved a reduction of the state's top income tax rate of five percent to a flat, marginal rate of just four percent. The first $18,000 for a single tax filer would be exempt from any state income tax.[4]

The phased-in cut will take full effect over the next four years. It would be the lowest tax bracket of any southern neighbor and one of the lowest in the country.

Both Louisiana and Arkansas have also lowered their top brackets in the past two years.

Case Study: Arizona

In Arizona, lawmakers have passed a tax reform package that flattens the state's income tax to 2.5% - for all residents and income levels. It is the lowest state income tax rate in the country. Previously, the state had four income tax brackets with a top marginal rate of 4.5%.[5]

Personal income taxes make up 44% of state revenue in Idaho and 65% in Montana

Reviewing state tax revenues

Both Idaho and Montana rely heavily on state income taxes for revenue to fund state government.

In the Gem State, personal income taxes account for roughly 44% of the state's general fund, while sales taxes bring in the largest other portion – 42.7%.[6] Corporate income taxes make up just 5.6%. A variety of other taxes make up the remaining portion. In total, Idahoans contribute $2.319 billion in income tax revenue each year. Idaho does not have a state property tax.

[3] Tax Foundation, Iowa enacts sweeping tax reform, by Jared Walczak, March 2022, available at https://taxfoundation.org/iowa-tax- reform/
[4] Mississippi Today, Lawmakers reach deal to cut but not eliminate income tax, by Bobby Harrison, March 26, 2022, available at https://mississippitoday.org/2022/03/26/mississippi-income-tax-cut-agreement/
[5] Office of Governor Doug Ducey, Arizona, How does Arizona's new tax cut benefit you?, June 2021, available at https://azgovernor.gov/governor/news/2021/06/how-does-arizonas-new-tax-cut-benefit-you
[6] Idaho state budget information, 2023, available at https://legislature.idaho.gov/wp-content/uploads/budget/highlights/SINEDieBudgetPacket.pdf

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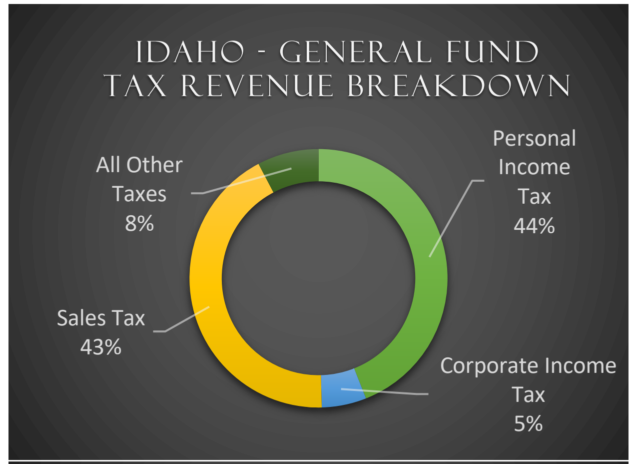
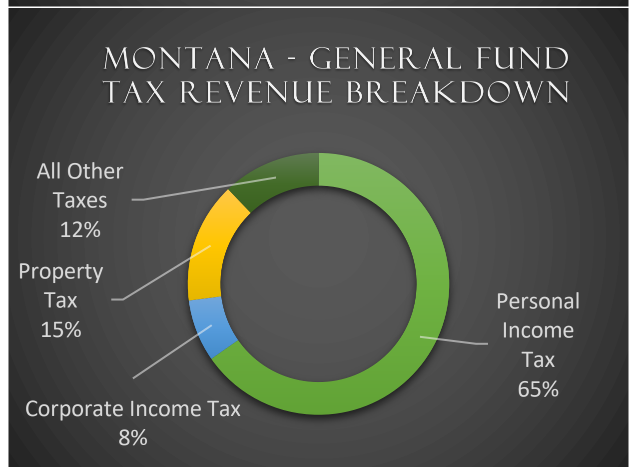
Completely eliminating a state's income tax would require a broader conversation about the state's tax structure

One option available for lawmakers to reduce the burden is to tie income tax rates to state revenues via a trigger

Meantime, in the Treasure State, personal income taxes make up 57% of the state's general fund.[7] State property taxes in Montana make up the largest other portion, at 13%. Meantime, corporate income taxes make up just 6.7%. Montana does not have a state sales tax. In total, Montanans pay $1.515 billion in income taxes each two-year budget cycle.





For both states, eliminating the state income tax would be impossible without a broader conversation about changing the state's overall tax structure. However, policymakers can still aim to reduce the burden.

Tying sustained revenue growth to rate reductions

Legislators in Montana and Idaho are debating how to spend surplus revenue in the coming years. Montana has close to two billion in excess revenue, while Idaho has roughly $1.5 billion left after its special session tax adjustments in September. Working families are sending more dollars to Helena and Boise, and as each state grows, it is not surprising to see revenue increases.

State tax revenue estimates are not perfect and can fluctuate. However, policymakers should ensure each state is not *overtaxing* its citizens. Montana has 63% more revenue than it needs to fulfill its budget obligations. Idaho has roughly 34% more tax revenue than called for in its budget.

So how can lawmakers ensure the tax burden remains low, and a state is not over collecting? One option is to tie the state's income tax rate to excess revenue via a trigger.

As the Tax Foundation reports[8]:

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[7] Montana state budget information, 2023, available at https://budget.mt.gov/Budgets/HistoricalBudgets/2023Budget_GovernorBullock
[8] Tax Foundation, Designing tax triggers: lessons from the states, available at https://taxfoundation.org/designing-tax-triggers-lessons-states/?fbclid=IwAR2h9kD4V6mkBQQ2cbxl3RU0ZJl574Tf-fSYLuePYGUZMAvzlRuDOMpaWRI

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In Idaho, every .1% of the state's income tax accounts for roughly $40 million in revenue

Adopting a tax revenue trigger would eliminate the need for special sessions or frequent state rebate checks

> *"When North Carolina legislators committed to comprehensive tax reform in 2013, they broadened tax bases and eliminated exemptions to fund rate reductions—but then turned to "tax triggers" to implement a schedule of further rate cuts, as revenue permitted, in subsequent years.*
>
> *Seeking a lower individual income tax rate, Massachusetts policymakers opted for a gradual phase-in of rate cuts, proceeding only when revenue growth was more than sufficient to absorb the rate change."*

In Idaho, personal income taxes account for $2.319 billion of the state's yearly revenue – or roughly $40 million per .1% of the 5.8% rate. Policymakers could design a trigger that would automatically reduce the 5.8% based on the amount of excess, sustained revenue reported in the state's frequent revenue forecasts. For example:

$40 million in excess, sustained revenue	**=**	**.1% of the current income tax rate**	**=**	**Reduction to 5.7%** (New income tax rate)
$200 million in excess, sustained revenue	**=**	**.5% of the current income tax rate**	**=**	**Reduction to 5.3%** (New income tax rate)
$400 million in excess, sustained revenue	**=**	**1.0% of the current income tax rate**	**=**	**Reduction to 4.8%** (New income tax rate)

There would be no need for special sessions of the legislature or one-time tax rebate checks that show government has over-collected. The reduction would happen automatically.

Montana lawmakers could consider a similar formula.

The exact revenue percentage over expectations, the period of time required to make sure it is consistent, and the corresponding income tax rate reduction would all need to be set by lawmakers.

But adopting this type of policy would send a clear message that Idaho will continue to lower the income tax burden it is placing on families and businesses. And the more the economy booms, the lower the rate.

As the Tax Foundation notes, "tax triggers can help ensure revenue stability and limit the uncertainty associated with changes to the tax code

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while providing an efficient way for states to dedicate some portion of revenue growth to tax relief."[9]

Golden opportunity, thanks to a neighbor

There is another reason for Idaho and Montana policymakers to consider further reductions or elimination of their personal income tax rates – the action of a neighbor. Washington state lawmakers have passed a new 7% income tax on capital gains income. For a state previously with no income tax, this is a dramatic policy change.

Idaho, Montana stand to gain from Washington state decision to adopt a capital gains income tax

The new Washington state income tax is being reviewed in court and a ruling later this year is expected. If the new Washington income tax is upheld, expect the exodus to begin shortly thereafter. The Washington state Department of Commerce has admitted numerous times that having no state income tax is a huge competitive advantage for the Evergreen state.[10] That advantage would shift to other states.

Business leaders who chose Washington state for its tax climate say just the talk of a new income tax is hurting. Tanium CEO Orion Hindawi says:[11]

> *"This is becoming a huge PR issue for Washington state even though nothing has substantively changed. It's not just who are we losing who's not coming, it's also who are we losing who's currently here that won't stay. People need to be fully aware, there are a lot of people who currently call themselves Seattle residents or Washington residents, who don't have to be tomorrow."*

If citizens and businesses in the Evergreen State wake up tomorrow with a new Washington state income tax, where will they go? They likely won't be choosing a state that has an income tax at or above 6%. But Nevada, Texas and Florida are options.

Why not Idaho and Montana? State policymakers can be preparing now by showing their commitment to lowering the income tax rates in their states. And if the Washington courts do rule in favor of an income tax, Idaho and Montana can be waiting with open arms.

Is Florida the model?

[9] Ibid
[10] https://www.washingtonpolicy.org/publications/detail/wa-department-of-commerce-no-state-income-tax-is-great-marketing-for-washington?fbclid=IwAR11qbKz3djSHfNO9bvRcOrKut4Pom_EFAzRbLuwmK331XGxOiDbIb24fTU
[11] Washington Policy Center, Tech CEO: Capital gains tax talk costing Washington, available at https://www.washingtonpolicy.org/publications/detail/tech-ceo-capital-gains-tax-talk-costing-wa-jobs?fbclid=IwAR0vf0ARWFcaESOjn-TuGBmigYnvJ7UU0RmoNS_HJ5MaRVilkD0jRH6ZYyw

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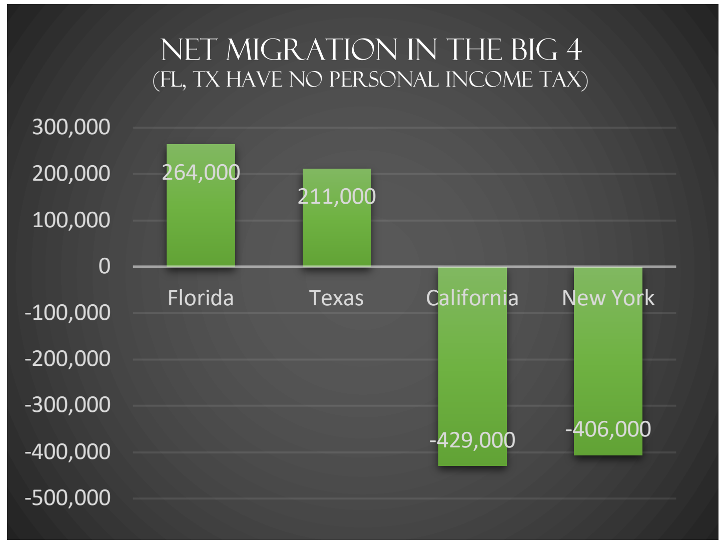
Florida's tax model may be informative to policymakers – the state has no personal income tax and no income tax on small businesses, but does have an income tax on corporations that do business in Florida

Further reducing a state's income tax can boost the economy and the state's credit ratings

Florida's red-hot economy and tax structure may be one to emulate. The Sunshine State is the fastest-growing, according to new U.S. Census figures.[12] The job market in Florida is booming, thanks to a low-tax, low-regulation environment.



Florida's tax model is unique. It doesn't impose a personal income tax, but corporations that do business in Florida are subject to a 5.5% income tax. Small businesses considered LLC's, sole proprietorships and S corporations are not subject to any income tax.[13] The state also has a 6% sales tax. This structure may be informative to policymakers in the Mountain States.

How rate reductions could help the economy and state credit ratings

Economic analyses have found that tax cuts – specifically income tax cuts – are likely to immediately boost gross domestic product (GDP).

Karel Mertens and Morten Ravn with the American Economic Review found that progressivity of an income tax hurts economic growth. Idaho lawmakers have already addressed this issue by flattening the state's income tax rate.[14]

But Mertens and Ravn further found "a 1 percentage point cut in the average personal income tax rate raises real GDP per capita by 1.4 percent in the first quarter and by up to 1.8 percent after three quarters."

Meantime, it is worth noting that states that rely heavily on income taxes to support government revenue can find themselves on a roller coaster ride during inevitable economic downturns. This is because layoffs can crash a state's income tax revenue, while sales taxes are more likely to be reliable. This is confirmed by credit agencies across the country, including Standard and Poor's (S&P), which says, "s*ales tax-based revenue*

[12] U.S. Census, Florida fastest-growing state for first time since 1957, available at https://www.census.gov/library/stories/2022/12/florida-fastest-growing-state.html
[13] Investopedia, Taxes in Florida: The Basics, available at https://www.investopedia.com/articles/personal-finance/101315/taxes-florida-small-businesses-basics.asp#:~:text=Florida%20is%20a%20tax%2Dfriendly,to%20a%205.5%25%20income%20tax
[14] Tax Foundation, Evidence of Taxes and Growth, 2012, available at https://taxfoundation.org/what-evidence-taxes-and-growth/

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structure… has demonstrated less sensitivity to economic cycles than income tax-reliant states."[15]

While no revenue source is immune to economic waves, graduated and capital gains income taxes are the most volatile taxes.[16]

Conclusion

Rarely do policymakers get such an enormous opportunity to take advantage of surging tax revenues, a neighboring state's folly, and the economic environment to lower the tax burden in their states and bring more stability to government revenues. While Idaho and Montana lawmakers should be congratulated for looking at ways to lower their state income tax rates, more work is needed.

Well-designed triggers limit volatility and unpredictability associated with changes to revenue codes

How can lawmakers ensure the tax burden remains low, and a state is not over collecting? One option is to tie the state's income tax rate to excess revenue via a trigger. In other words, the more the state has in surplus, the lower the rate will go.

As the Tax Foundation points out, "well-designed triggers limit the volatility and unpredictability associated with any change to revenue codes and can be a valuable tool for states seeking to balance the economic impetus for tax reform with a governmental need for revenue predictability."

Adding urgency to the conversation is what is unfolding in Washington state. While policymakers there have passed the state's first income tax (on capital gains income), courts are reviewing the law's constitutionality. If it is upheld, businesses and high-income earners will be interested in moving to other states – bringing additional tax revenue and jobs with them. Idaho and Montana should be ready to welcome them with open arms, and lower rates, in the coming months and years. A revenue trigger that would lock in place income tax reductions is a good place to start.

Nothing in this publication shall be construed as an attempt to aid or hinder the passage of any legislation.

[15] S&P Global Ratings, State of Washington Appropriations, General Obligation, July 11, 2022, available at https://www.tre.wa.gov/wp-content/uploads/2023AT-SP-2022.07.11-Report.pdf
[16] Tax Foundation, Income taxes are more volatile than sales taxes during an economic contraction, by Jared Walczak, March 17, 2020, available at https://taxfoundation.org/income-taxes-are-more-volatile-than-sales-taxes-during-recession/