State Individual Income Taxes

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Overview

• Why have an income tax?
• Nebraska’s income tax in brief
• Challenges and trends in income taxation
Focus on Income Tax

• 41 states plus DC levy a broad-based income tax
• Most couple closely to the Feds
  – 29 use Federal AGI as base
  – 8 use Federal Taxable Income as base
• Wages = 72.5% of FAGI (2010)
• Taxable SS = 2.3% of FAGI
• Taxable pensions/annuities = 6.7% of FAGI
• Other income = 18.5 % of FAGI
• 32.1 percent of federal filers itemize
Importance of IIT

Source: U.S. Census Government Finance Statistics
Why have an income tax?

- It is income elastic, i.e., its revenues grow in proportion to income.
- It can be progressive in its distribution of tax burdens.
- It can be relatively neutral in its effects on economic decisions, thus reducing distortions in the economy.
- Raise “enough” revenue to meet expenditure needs
- It is deductible at the federal level, thus reducing the overall burden on residents by state.
- Quick example:
- AGI = $80,000
  - Deduct state income tax = $6,000
  - So—taxable income = $74,000
- If federal tax rate = 30%
  - Federal tax after deduction = $22,200
  - Without deduction = $24,000
  - “Save” $1,800 or 30% of your state income tax
On the other hand...

- Because it is income elastic, revenues may decline during economic downturns.
- The tax may be progressive which may discourage higher-income individuals and businesses from locating in a given state.
- “Bracket creep” due to inflation results in potentially increased tax burdens with no change in real income; a progressive rate schedule may guarantee that taxes will grow faster than real income.
• The tax may be used to give special preferences to certain groups or certain income types, thus potentially disrupting the equity and efficiency advantages of the tax.

• Taxpayers may feel that compliance with the tax is cumbersome and expensive.
Income tax/Personal income

Options in a typical system

- Defining the base: largely wages in current systems, FAGI, other?
- Exemptions/deduction: how many, how large, what purpose
- Brackets and rates
- Credits
Nebraska’s Income Tax

• Coupling to Federal AGI
• Four brackets with rates from 2.46 to 6.84 percent
• Deductions and credits: standard/itemized, some capital gains, child/dependent care, EITC, elderly/disabled, angel investment, others
Nebraska relative to other states

• Average number of brackets (4.8 mean, 1 minimum, 12 max – Hawaii)

• Implicit personal exemptions – similar to the average state

• Rates – not much different than U.S. average (2.63 first rate and 6.57 top rate average)

Clawback provision—a bit more unique
• Exemptions and credits tend to be more specific by states
• Nebraska’s not out of the norm
• Overall comparisons difficult to make
• NBER Taxsim model results (2011):
  – Marginal tax rate: NE 6.49* US 4.64
  – Average tax rate (tax/income): NE 3.84 US 3.32
Issues and Trends

- Rate differentials and economic development
- Demographics
- Changing economic base
- Diversified public finances
  - Flat rates
  - Reduced profile for income tax?
Rate differentials

• Effective rates important! Considers effect of credits, exemptions, etc.

• Is economic activity affected by differences in effective tax rates?
  – Certainly—but how much difference in rate is needed and how large are the impacts?
• Economic effects:
  – If labor and capital can move, they may seek lower tax states if benefit is greater than the cost
  – “All else constant”
  – Evidence?
Individual behavior and tax rates

- Young and Varner (2005) no impact
- Davies and Pulito (2011) find an impact
- Bluestone (2007) zero income tax states, no benefit
- Very difficult to find consensus, and more issues:
  - Relatively few individuals move out of state over a lifetime
  - Mix of taxes and expenditures are important
  - Cost of living, family lifestyles, housing all important as well
• Demographics:
  – Elderly population growth
  – Affect income, sales and property tax bases
  – Less wage income, more retirement income (capital, social security, pensions)
  – States have felt pressure to reduce taxation of these forms of income
State Treatment

• 33 states (out of 42) have state tax exclusions for some combination of private, state-local or federal civilian retirement/pension income

• 21 states allow an additional senior-related tax exemption

• Other credits and allowances in a hand full of states

• Georgia’s recent change (2012):
  − Capped exemption at $65,000 (versus unlimited exemption phase in)
  − Arguments – equity, cost

• Kentucky Reform Commission recommendation: reduce pension income exemptions ($485 million per year with means testing)
  − Retiree testimony “...We make over $100,000 and don’t pay a nickel in state income taxes. That’s representation without taxation. That’s wrong.” (Goodman, p. 2)
• Michigan
  – 2011 Law retained exemptions for those born before 1946
  – Reduced exemptions for others, with target at those born after 1952
  – Notion of hold harmless of more vulnerable resonates (?)
Changing economics

• Can income tax capture where economy is headed?
  – Labor somewhat less mobile, but technology having an impact on all industry
  – Increased use of capital relative to labor
  – Health and other services
  – Where are the tax handles?
Future Role of Income Tax

- Discussion of flatter rates/broader base
  - Reduce administrative costs
  - Reduce incentives to arbitrage
  - How much is possible?
  - Lots of discussion, little action

- Large reduction/elimination of income tax
  - Consumption swap: services, rate differentials
  - Enough evidence of impact?
Resources


• R. Buschman and D. Sjoquist (  
• S. Wallace and A. Stephenson (2010), “Georgia’s Individual Income Tax: Options for Reform,” Fiscal Research Center Report No. 218, Andrew Young School, Georgia State University, Atlanta.


• D. Sjoquist, L. Wheeler, and L. Almada (2012), “Georgia’s Corporate Income Tax: A Description and Reform Options,” Fiscal Research Center Report No. 172, Andrew Young School, Georgia State University, Atlanta.