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

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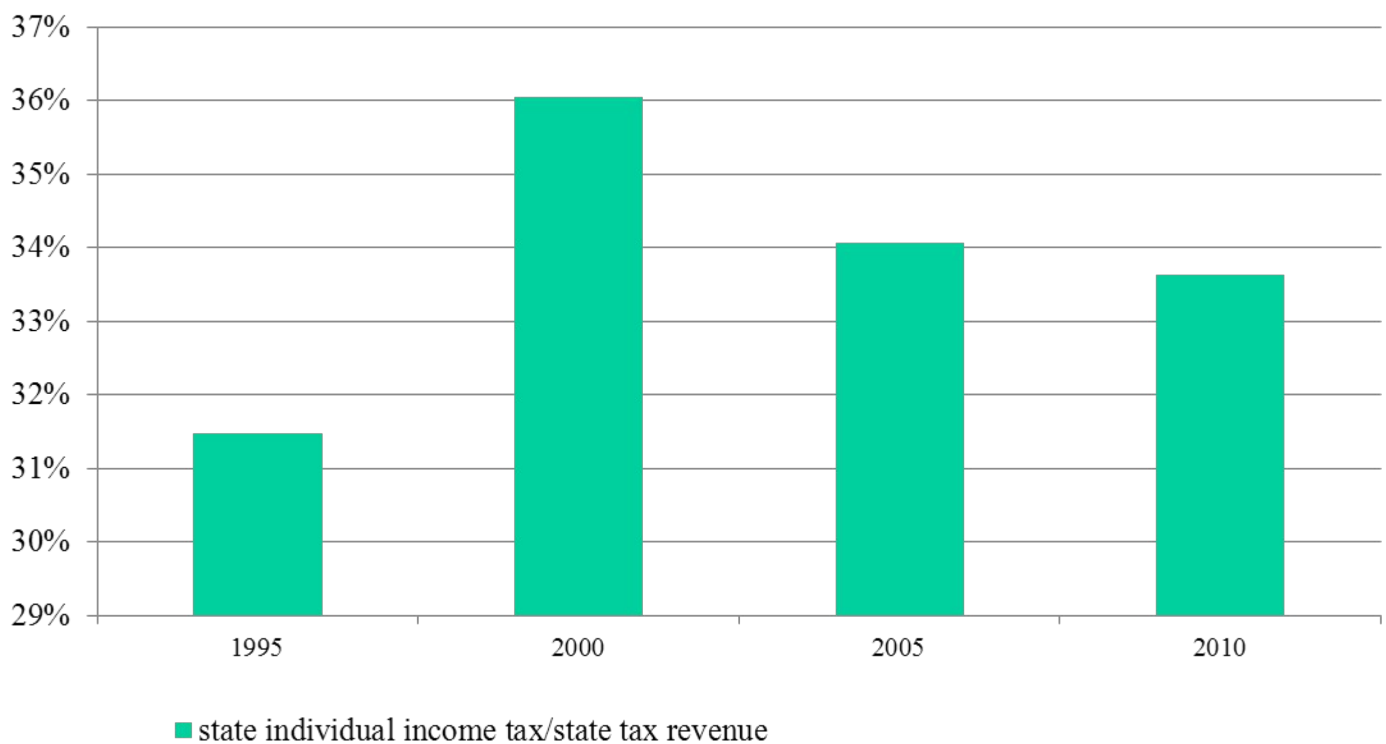
Importance of IIT



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.

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- 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

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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.

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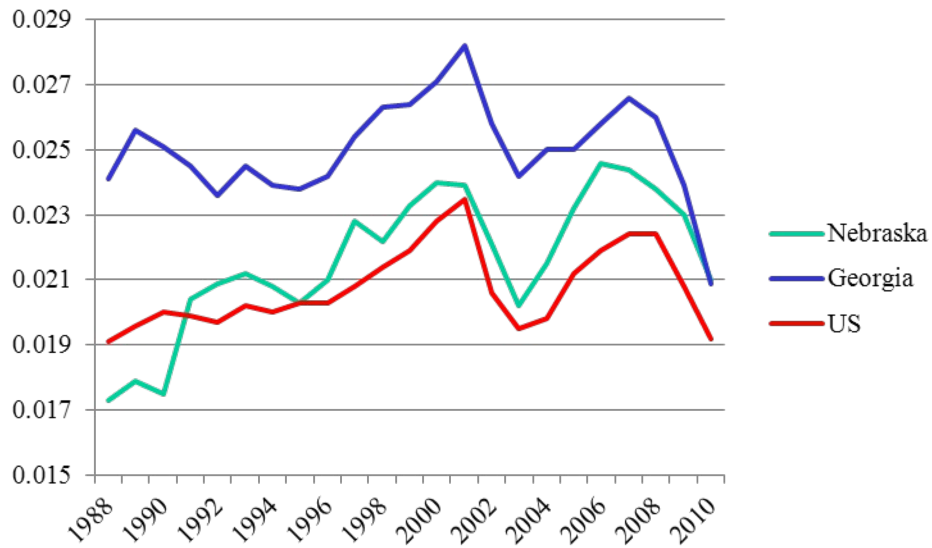

Income tax/Personal income

Source: Brookings-Urban Tax Policy Center data query system: http://slfdqs.taxpolicycenter.org/pages.cfm

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?

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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?

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- 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?

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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

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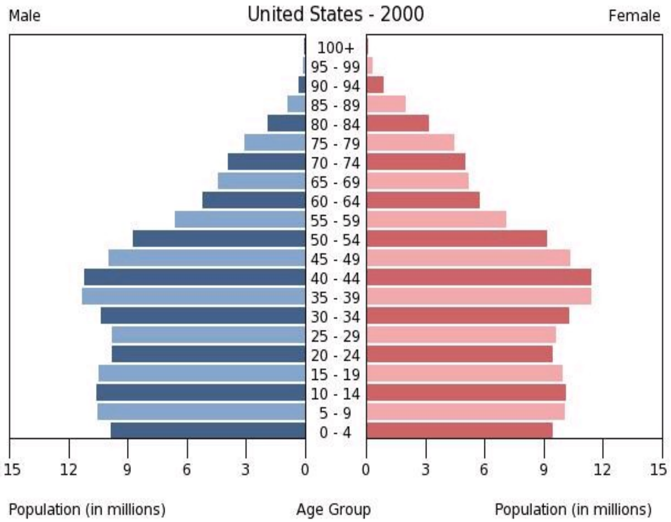
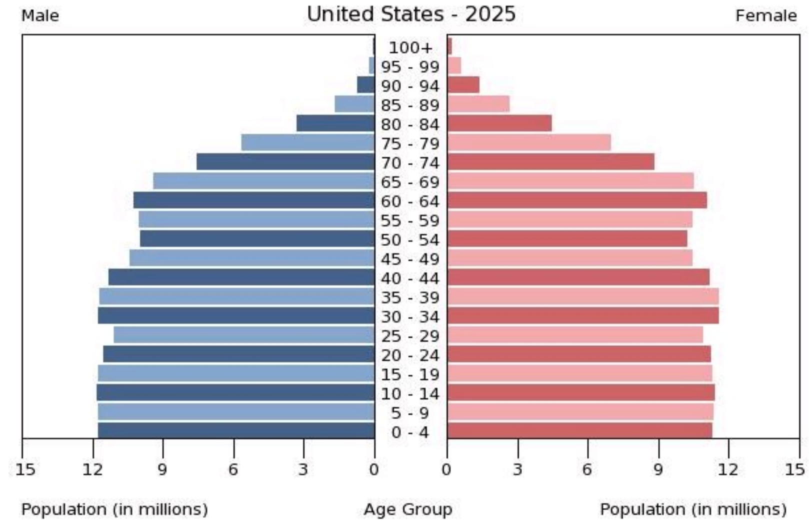
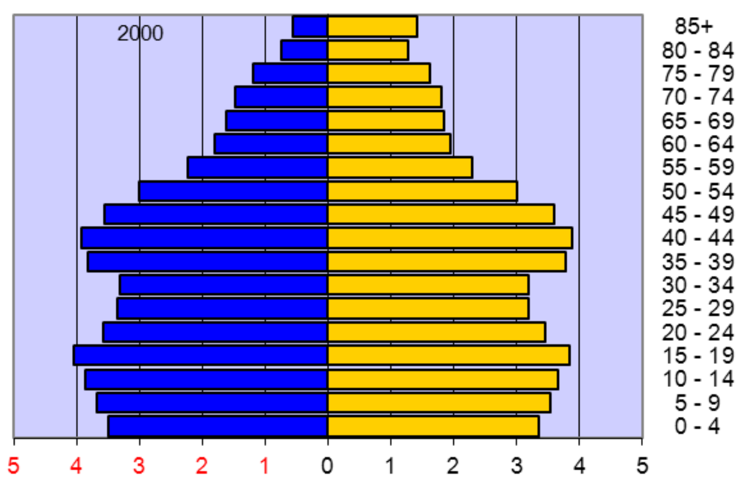
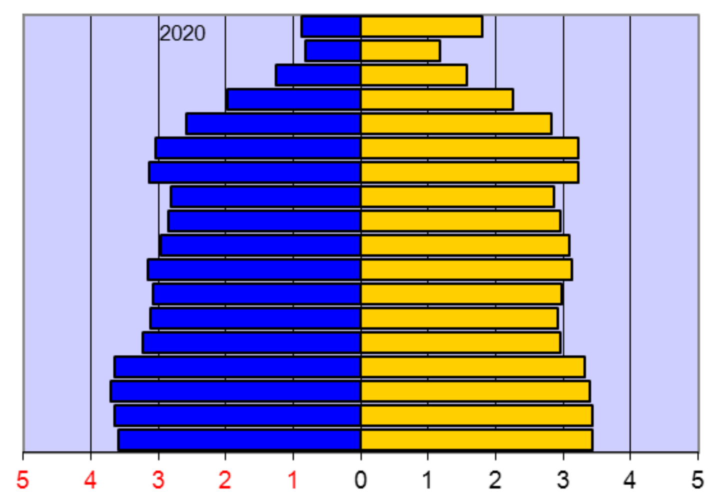
- Demographics:
  - Elderly population growth
  - Affect income, sales and property tax bases
  - Less wage income, more retirement income (capital, social security, pensions)
  - States have felt pressure to reduce taxation of these forms of income









Source: U.S. Census

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

Source: Individual Income Tax Provisions in the States, Olin 2012

- 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)

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- 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 (?)

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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

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