

The Progressive Income Tax: An Essential Element of Fair and Sustainable State Tax Systems

In recent months, a few vocal critics have pointed to state personal income taxes as the source of a variety of fiscal and economic problems, arguing that it has enabled wasteful spending or fueled the volatility of revenue collections. Accordingly, some of these critics have called for the outright repeal of the income tax, while others have suggested making it significantly less progressive. Such proposals, if acted upon, would make it all but impossible for state tax systems to produce revenue in a fair and sustainable fashion.

This policy brief examines the contributions a progressive income tax makes towards two fundamental goals in state tax policy and describes several reforms states could adopt to address some of the problems wrongly attributed to progressive income taxes.

Achieving a Fair State Tax System

The fairness of state's tax system is largely determined by two factors: the mix of different taxes it levies and the design of each of those taxes. Most of the taxes states and localities typically impose are *regressive* – they require low- and moderate-income taxpayers to devote a larger share of their incomes to paying taxes than upper-income taxpayers do. Sales and excise taxes certainly fit this description, since consumption constitutes a much larger share of income for poor and middle class taxpayers. Property taxes do as well, since homes and vehicles are both usually the only type of property taxed and the only type of property typically owned by individuals and families in the lower half of the income distribution. Yet, sales, excise, and property taxes made up 65 percent of all state and local tax collections in 2006; in fact, seven states counted on these taxes for more than 75 out of every 100 tax dollars collected.

To mitigate the regressivity of sales, excise, and property taxes, states must levy a personal income tax. The personal income tax, because it is directly linked to one's ability to pay, is the most *progressive* major tax levied by states and localities. Of course, given the degree to which states and localities depend on regressive forms of taxation, a personal income tax, by itself, is not a sufficient means for achieving a tax system that is progressive overall. It must also be designed to produce an especially progressive outcome, combining features that mitigate the impact of the tax on low- and moderate-income taxpayers – such as sizable personal exemptions or refundable credits – with a graduated rate structure, so that the tax rate one effectively pays rises with income.

Fostering a Sustainable Tax System

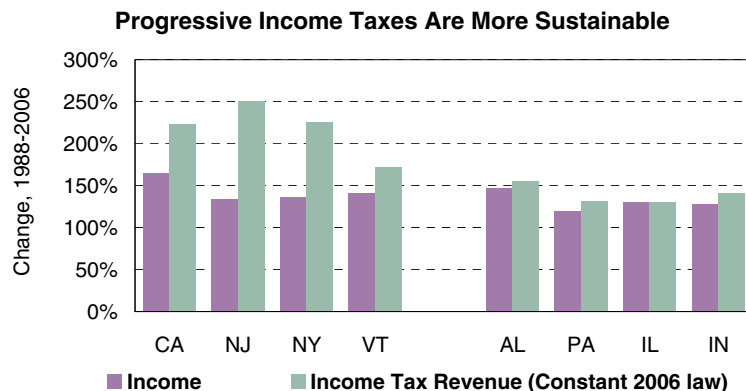
For a tax system to be considered sustainable, it must yield a stream of revenue that grows at the same pace as the services it is intended to fund; over the long-run, both should grow along with the economy. To achieve that particular rate of growth, the taxes that make up a given tax system must, in turn, reflect the broad economic developments that affect the base on which they are levied.

For the income tax, no economic trend is more important than the tremendously unequal growth in incomes that has characterized the last three decades. By one estimate, the average income for the top 1 percent of US households shot up by more than 200 percent between 1976 and 2006, while the average income for the bottom 90 percent

of households rose just 10 percent; the majority of states have seen similarly disparate growth since the mid-1980s.

In this context, a progressive income tax is indispensable. As the figure below suggests, those states with particularly progressive income taxes – California, New Jersey, and New York among them – would have experienced revenue growth substantially in excess of income growth over the last twenty years, if the income tax parameters they have in place today had been in place for that entire period. Under the same set of circumstances, revenue growth would have only barely kept pace with income growth in those states – such as Alabama, Pennsylvania, and Illinois – that fail either to employ progressive exemptions and credits or to use a highly graduated rate structure. This is

not to suggest that states should maintain income taxes that consistently rise faster than income in the aggregate, but rather to demonstrate that progressive income taxes are far more responsive to changes in income overall.



Promoting a Stable Revenue System

In the wake of the current financial crisis, many states expect a sharp drop in income tax revenue, particularly the portion of such revenue attributable to upper-income taxpayers and to capital gains realizations. In response, some policymakers have expressed concerns about the lack of predictability associated with income taxes. Concerns of this kind are akin to complaining that acing a few exams has added to the volatility of your grades. Just as it would be foolish to stop trying to perform well in the classroom, it would be equally shortsighted to reduce the progressivity of a state’s income tax in an effort to produce a more predictable tax system.

In fact, many of the keys to a more stable tax and revenue system lie outside the personal income tax. They include:

- **Improving fiscal management** – States can smooth out revenue fluctuations through the use of well-designed reserve or “rainy day” funds, depositing surplus revenue during prosperous times to be drawn upon in times of need.
- **Expanding the base of other taxes** – Most states could expand the base of at least one of the taxes they levy, whether by broadening the sales tax to include services, repealing property tax assessment limitations, or employing combined reporting as part of the corporate income tax. Each of these reforms would leave states less vulnerable to economic downturns and the revenue fluctuations they induce.

Conclusion

For any state to have a sound tax system that will yield an adequate stream of revenue into the future, it must levy a progressive income tax. For any state to have a fair tax system that will ensure those with the greatest ability to pay will bear more responsibility for funding government services, it must levy a progressive income tax. For any state to have a stable tax system, it must ensure that all of the fiscal policies it has in place are functioning properly.

From the perspective of individual taxpayers, the federal offset makes state income tax hikes a good deal—and state income tax cuts a lousy deal.

The federal offset gives lawmakers a chance to decide whether tax cuts ought to go to state residents or to the federal government.

To find out more about this issue, contact ITEP at (202) 299-1066