

CHAPTER FIVE

PERSONAL INCOME TAXES

The personal income tax can be—and usually is—the fairest of the main revenue sources relied on by state and local governments. When properly structured, it ensures that wealthier taxpayers pay their fair share, provides lower tax rates on middle-income families, completely exempts the poor and allows “refundable” low-income tax credits that can be used to offset the sales, excise and property taxes that fall most heavily on low-income families. In this way, the income tax can provide an important counterbalance to these other regressive taxes.

But in many states, the income tax fails to live up to its potential. Some states have flat-rate taxes, which apply the same tax rate to the wealthiest CEO as it does to middle-class workers. Other states tax the income of families living in poverty. Many states allow expensive tax breaks that favor wealthier taxpayers. And, of course, some states don’t currently levy an income tax at all. This chapter explains the basic workings of the income tax and discusses important issues that should be addressed in order to ensure the continued fairness and sustainability of this tax.

How Personal Income Taxes Work

In most states, the income tax base—that is, the types of income that are subject to the tax—looks a lot like the federal income tax base. There’s a straightforward reason for this: because the income tax is the one major tax levied both by the states and by the federal government, it provides a unique opportunity for states to reduce the cost of tax compliance, both for taxpayers and tax administrators, by “piggybacking” on the income definitions used in federal law.

In practice, this means that income taxpayers can calculate their federal taxes first, and then simply copy their total income from the federal tax forms to their state form. Most states link to federal **adjusted gross income** (AGI), which is income before exemptions and deductions, and then allow their own special exemptions and deductions. A few states link instead to federal **taxable income**, which means that these states adopt the generous federal exemptions and deductions, and then apply

their own tax rates. A few states do not link to the federal tax base at all.

Which Income is Taxed—and Which Is Exempt?

The federal income tax and most state income taxes apply to most, but not all, types of money income.¹ But different types of income are, in some systems, taxed differently:

- The **wages and salaries** that form the bulk of income for most middle-income families are almost always fully taxed. However, all states follow the federal practice of excluding the “fringe benefits” that are a growing share of workers’ pay packages. For example, the value of employer-paid health insurance is usually tax-exempt. This is problematic because two workers with the same total pay can have different income tax bills depending on whether their pay all takes the form of salary (in which case it will all be taxed) or it includes substantial fringe benefits (in which case much of it will not be taxed).
- **Interest** from bank accounts and bonds is generally taxed. A few states, however, exempt some interest from tax, usually for senior citizens only. Interest from government bonds usually gets preferential treatment: interest from federal treasury bonds is exempt from state taxation, and interest from state and municipal bonds is exempt from the federal tax. States usually exempt interest on their own bonds, while taxing other states’ bonds.

- Some **business income** is reported on individual tax forms. In particular, businesses that are unincorporated include their taxable profit (or loss) in personal income. (Incorporated businesses are taxed under the corporate income tax.) For example, if a self-employed craftsman, known as a “sole proprietor,” makes and sells furniture, she reports her gross proceeds from selling the furniture minus any deductible expenses such as the cost of wood, tools and advertising. (Farm profits are reported in the same way.) If a craftsman worked jointly with another craftsman in a multi-member unincorporated business called a “partnership,” each member would report her share of taxable partnership profit. In each case, when these businesses report losses rather than profits, most or all of the loss is allowed to offset other positive income sources on income tax forms.
- **Rental income** from real estate is also part of the personal income tax base. As with other business income, gross rents are allowed to be reduced by various expenses. One “expense” that is commonly used to reduce taxable rental income is “depreciation.” For tax purposes, rental real estate is assumed to gradually lose its value, or depreciate, over time. (Of course, this is usually a fiction—rental real estate typically becomes more valuable over time.) For some real estate professionals (broadly defined), depreciation expenses can be used to reduce not just rental income, but other income as well. But for most people, depreciation can only reduce taxable rental income.
- **Capital gains** are profits from the sale of assets such as stocks, bonds and real estate. Income tax on a capital gain is paid only when the asset is sold. Thus, a stockholder who owns a stock over many years doesn’t pay any tax as it increases in value each year. He or she pays tax only when the stock is sold. At that time, the capital gain is calculated by taking the difference between the original buying price and the selling price. Special rules apply to homes that were a family’s primary residence for at least two of the last five years, for which the first \$250,000 of home value gains are exempt from tax (\$500,000 for a married couple). In addition, a valuable capital gains tax break called “stepped-up basis” means that people who inherit property don’t have to pay any tax on capital gains that accrued during the original owner’s life.² The federal government now taxes capital gains at a far lower rate than wages. A few states also provide capital-gains tax breaks. State capital-gains tax breaks are discussed on page 41.
- Dividends are the part of a corporation’s earnings that are distributed to its shareholders. Most dividend income **flows to upper-income** families: in 2009, the poorest 60 percent of Americans enjoyed about 10 percent of all dividend income, and the best-off 1 percent received more than a third of all dividend income. Notwithstanding this, about half a dozen states misguidedly allow taxpayers (usually senior citizens) to exclude some of their dividend income from tax.
- Transfer payments from governments to individuals are subject to a variety of different rules. Payments from the Temporary Assistance to Needy Families (TANF) program are fully exempt; unemployment compensation is generally fully taxed, and the federal income tax taxes a fraction of Social Security benefits above certain income levels. States always follow the federal lead on TANF benefits, but most states have chosen to not follow the federal rule on Social Security benefits and instead completely exempt these benefits.
- Pension income is generally taxable at the federal level, with an offset for already-taxed employee contributions to pension plans. But many states depart from the federal rule by excluding all or some pension income from taxation. All too often, these tax breaks are given even to the best-off taxpayers, but some states provide targeted pension tax relief that is available only to lower-income taxpayers.

“Adjustments” and Adjusted Gross Income

Once all of a taxpayer’s potentially-taxable income is added up, **adjustments to income** are applied. Many adjustments originate on federal tax forms—and most states following federal rules will include these adjustments, too. For example, health insurance payments by self-employed people and alimony are subtracted from total income as an adjustment on federal forms, and most states have chosen to conform to federal rules by allowing the same tax breaks. On federal forms, adjusted gross income is the income that is subject to tax after subtracting adjustments.

Of course, states always have the option of “decoupling” from these federal adjustments, and sometimes do so. For example, when Congress enacted a temporary subtraction for the first \$2,400 in unemployment benefits in 2009, lawmakers in Oklahoma and several other states decided not to conform to this tax break—so Oklahoma tax forms for 2009 require anyone who benefitted from this federal tax break to add it back to Oklahoma income.

In addition to these federal adjustments, most states diverge from the federal starting point to allow special tax breaks of their own invention. These tax breaks are the difference between the federal starting point (usually federal AGI) and a state’s own adjusted gross income. These include:

- Exemptions for capital gains or dividends;
- Tax breaks for pensions or Social Security;
- Deductions for federal income taxes paid.

Computing Taxable Income

Taxable income is the amount of income that is subject to tax after subtracting all deductions and exemptions from AGI. This is the amount of your income to which the tax rates are actually applied.

In computing their taxable income, federal taxpayers have a choice of subtracting either a basic standard deduction or special “itemized” deductions—whichever is larger. Many (but not all) states give their taxpayers the same options.

Standard Deduction

Most low-income families, and many middle-income taxpayers, claim the **standard deduction**. This is a basic “no-tax floor”, designed to ensure that all families should have a certain amount of income that should not be subject to tax.

On federal tax returns, the standard deduction is set at \$11,400 for couples, \$8,400 for unmarried parents and \$5,700 for single filers in 2010. (These amounts are increased every year to allow for inflation.) Twelve states allow the same standard deductions as the federal amounts; three allow larger amounts; and the rest either have smaller standard deductions or don’t allow one at all.

Itemized Deductions

Itemized deductions are the collective name for a motley group of about a dozen separate tax deductions available as an alternative to the basic standard deduction. Generally, better-off families are more likely than lower-income families to have enough deductions to make itemizing worthwhile. Deductions related to homeownership are often what makes a family’s itemized deductions exceed its standard deduction.

In general, the rationale for each itemized deduction is to take account of large or unusual personal expenditures that affect a taxpayer’s ability to pay. Itemized deductions are also offered as a way of encouraging certain types of behavior. For example, on the federal income tax return:

- Charitable contributions are deductible to encourage charitable giving, and because people who give income to charities have less money left over with which to pay income taxes.
- Mortgage interest paid by homeowners is deductible to encourage home ownership, and because interest paid on mortgages is one of the main costs associated with owning a home.
- State and local income and property taxes are federally deductible because families that pay a lot in those taxes

How the Personal Income Tax Works



have less ability to pay federal income taxes than those who pay little. Sales and excise taxes are generally not deductible, however, because Congress found that (a) they don't affect ability to pay very much for those who itemize, (b) they are difficult for taxpayers to compute and hard for tax agencies to audit, and (c) since they are regressive, states shouldn't be encouraged to rely too heavily on them.³

- Very large medical expenses are deductible to reflect taxpayers' reduced ability to pay taxes under adverse medical circumstances. At the federal level and in most states, medical expenses that exceed 7.5 percent of a taxpayer's adjusted gross income are deductible.

Each of these tax breaks are frequently defended as an important means of offsetting large household expenses that reduce a family's ability to pay taxes. But because they are structured as deductions, they typically provide much larger tax breaks to the best-off families than to middle-income taxpayers. This is because the tax cut you get from an itemized deduction depends on your income tax rate: imagine two Kansas families, each of which has \$10,000 in mortgage interest payments that they include in their itemized deductions. If the first family is a middle-income family paying at the 15 percent federal tax rate, the most they can expect is a \$1,500 federal tax cut from this deduction (\$10,000 times 15 percent). But if the second family is much wealthier and pays at the 35 percent top rate, they could expect a tax cut of up to \$3,500.

Because state income taxes are less graduated than the federal income tax, the inequity of itemized deductions is generally less extreme at the state level. But these deductions remain an upside-down tax subsidy that is entirely unavailable to low-income families. No lawmaker would ever seriously propose a direct spending program designed to make home-ownership more affordable that started by excluding low-income families entirely, while reserving the most assistance to the richest families. Yet that is precisely how the itemized deduction for mortgage interest works.

Personal Exemptions

The final step in arriving at taxable income—the tax base to which income tax rates are applied—is to subtract **personal exemptions**.

At the federal level, the personal exemption is currently \$3,650 for each taxpayer and dependent (indexed each year for inflation). Thus, in 2010 a family of four gets a total of \$14,600

in federal exemptions. State personal exemptions vary greatly, but are usually less generous than the federal amounts. Some states provide additional exemptions for the elderly, disabled or veterans.

A Graduated Rate Schedule	
Taxable Income Bracket	Marginal Rate
0-\$25,000	2%
\$25,001-\$40,000	4%
\$40,001-\$100,000	6%
Over \$100,000	8%

The theory behind exemptions is that at any income level, a taxpayer's ability to pay declines as family size increases: the more mouths to feed, the less money is left over to pay taxes. So if two families each make \$40,000 and family A has no children while family B has two, then family A has greater ability to pay. To adjust for this, family B gets two more exemptions than family A.

Some states tie their exemptions to the federal amount. Because federal exemptions grow each year with inflation, this is an administratively easy way to ensure that exemptions will not lose their value over time. The many states that fail to adjust their exemptions for inflation end up imposing a hidden tax hike on their citizens over time. For instance, when the Illinois income tax was adopted in 1969, the state's personal exemption was set at \$1,000—and was subsequently left unchanged for thirty years. 1998 legislation doubled the exemption to \$2,000—but if the exemption had been kept up with inflation since 1969, it would have been worth \$5,800 in 2009. In other words, the Illinois personal exemption is worth \$3,800 less than it originally was. As a result, Illinois taxpayers paid almost \$1.5 billion more in income taxes in 2009 than they would have if the exemptions had been adjusted to preserve their 1969 value.

Tax Rates

The single most important policy choice in determining the fairness of a state's income tax is the way its tax rates work. Most states use graduated tax rate schedules where higher tax rates are applied at higher income levels. The table at right shows an example of a graduated rate system in which the first \$25,000 of a family's taxable income is taxed at 2 percent, income from \$25,000 to \$40,000 is taxed at 4 percent, income from \$40,000 to \$100,000 is taxed at 6 percent and income over \$100,000 is taxed at 8 percent.

But not all graduated income taxes are created equal. The overall progressivity of a state’s rate structure depends on two factors: the difference between the top and bottom tax rates, and the width of the tax brackets.

Truly progressive income taxes, like California’s, use broad income tax brackets to ensure that relatively few taxpayers are subject to the top rate and also have a fairly wide range between the lowest and top income tax rates. Some states fall short of this approach by having relatively low top rates. For example, Arizona’s top income tax bracket only applies to married couples with taxable income over \$300,000, but the top rate is just 4.54 percent. Other states use higher tax rates, but apply them to a much broader swath of the population. For example, Oregon’s 9 percent marginal rate applies to married couples with taxable incomes over \$15,200.

Still other states don’t use graduated rates at all, usually because the state’s constitution forbids it. Seven states (Colorado, Illinois, Indiana, Massachusetts, Michigan, Pennsylvania and Utah) have flat rate systems that tax all taxable income at the same rate, with rates ranging from 3.07 percent in Pennsylvania to 5.3 percent in Massachusetts.

Graduated rates are an important step toward tax fairness because they allow states to apply higher tax rates very precisely to whichever group they view as “upper-income” taxpayers.

Understanding Marginal Tax Rates

Tax policy debates sometimes confuse the distinction between effective tax rates, which tell us what fraction of a taxpayer’s income goes to income tax overall, and marginal tax rates, which tell us the tax rate that applied to the last dollar of income. Anti-income-tax advocates are only too happy to foster this confusion—which is why it’s important for clear-eyed observers to understand this important distinction. What confuses some people is that they look at a tax table like the one on the preceding page, know that they earn \$45,000 per year, for example, and conclude that they must have to pay 6 percent of their income in tax. But that isn’t the way it works at all.

First, the tax rate table is based on taxable income, not total income. Thus, someone making \$45,000 per year probably has taxable income under \$40,000 after deductions and exemptions are subtracted—and taxable income is what determines your tax rate. So this person is

probably only paying tax at the 4 percent rate.

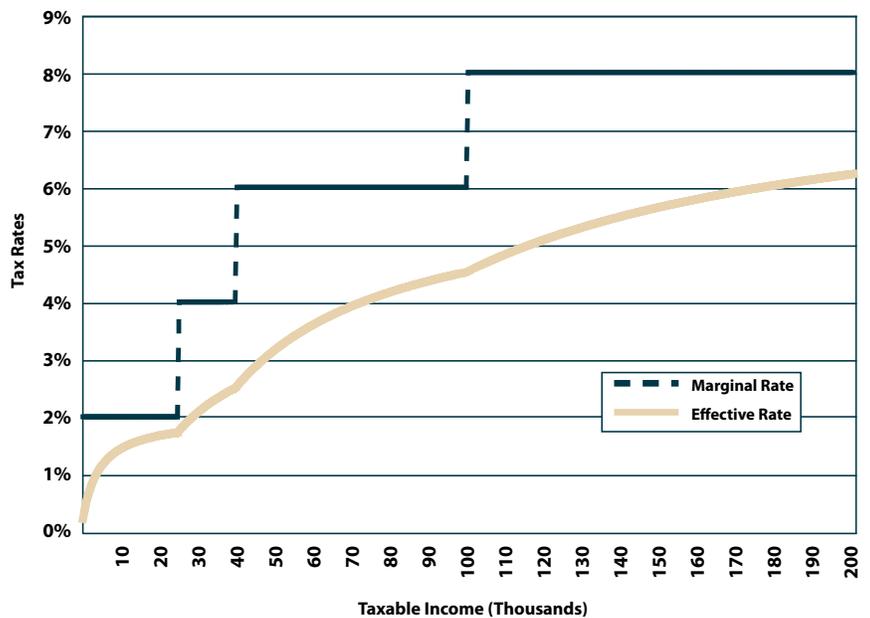
Second, because these tax rates are marginal tax rates, even if a family does have taxable income of \$45,000, only the last \$5,000 of that will be taxed at 6 percent. Marginal rates apply only to taxable income over the amount where the tax bracket starts. This means that the effective tax rate paid at any income level (that is, the percentage of your total income you pay in tax) will always be lower than the top marginal rate. The chart on this page shows how the effective tax rate on a married couple with no children compares to the marginal tax rate at each income level, assuming the state allows a \$2,000 personal exemption and no other deductions. The first \$25,000 of taxable income is taxed at 2 percent, so the effective tax rate starts at zero and gradually approaches 2 percent as taxable income approaches \$25,000.⁴ As the marginal rate increases, the effective rate increases too—but it always remains well below the top marginal rate.

Credits

After computing the amount of income tax based on the applicable tax rates, **credits** (if any) are subtracted. Credits are taken directly off the tax amount that would otherwise be owed, as opposed to deductions, which are subtracted from the amount of income that is subject to tax.

Low-income credits are commonly used at both the federal and state levels to reduce income taxes on those least able to pay. Other credits are designed to provide relief from other taxes. For example, low-income sales tax rebates and property

Marginal Versus Effective Rates: An Example



tax circuit breakers are often administered as credits against the personal income tax.

However, not all low-income tax credits are created equal. The hallmark of a truly effective low-income credit is that it is **refundable**. This means that if the amount of the credit exceeds the amount of personal income tax you would otherwise owe, you actually get money back. The best-known refundable credit is the federal earned-income tax credit (EITC), which allows low-income working families with children to get a direct payment from the government if the amount of the credit exceeds the income taxes they otherwise would owe. In 2011, 25 states (including the District of Columbia) allowed earned income tax credits modeled after the federal credit.

Refundability is a vital feature in low-income credits simply because for most fixed-income families, sales and property taxes take a much bigger bite out of their wallets than does the personal income tax. Refundable credits on income tax forms are the most cost-effective mechanism for partially offsetting the effects of these other regressive taxes on low-income families.

Local Income Taxes

In most states, local taxes are much less diverse than state taxes: local governments tend to rely mostly on property taxes to fund needed services. But more than a dozen states, seeking a fairer and more diversified revenue structure, now allow local-option income taxes. States allowing these taxes usually do it in one of two ways: by granting authority to every taxing district of a particular kind in a state, or by granting authority to specific

metropolitan areas. One example of the broader approach is Maryland, where each county government levies a “piggyback” tax that applies to the same tax base as the state income tax.

In states that already levy state income taxes, these local taxes can be administered and collected by state tax administrators on state tax forms, requiring no new paperwork.

Revenue and Stability

Advocates for a “flat tax” sometimes make the case that progressive personal income taxes are excessively volatile, growing too rapidly during good times and collapsing during economic downturns in a way that makes budgeting more difficult for state policymakers. It’s certainly true that progressive income taxes are much more responsive to economic growth than the other taxes levied by state and local governments, as California found out during the last economic boom years in the Golden State (see text box on this page).

Academic economists have shown that while income taxes are sometimes more volatile over the short run than sales taxes, that’s not always the case. And in the long run, virtually any income tax, whether flat or graduated, will outperform sales taxes in keeping pace with the cost of funding public investments. In fact, the more progressive the income tax, the more it grows. Why? Because virtually all income growth over the past decade has been concentrated in the top of the income scale. Thus, a state that has high rates on the wealthy captures this growth better than a state with low rates on the well-to-do. Progressive income taxes will usually grow faster than personal income over time. This is important because the cost of providing public services often grows faster than income as well.

Of course, in a severe recession, personal income tax collections will decline as taxpayers’ income declines. But in the long run, the personal income tax is the most reliable source of revenue to fund public services.

Federal Deductibility

A final step in the calculation of state income taxes doesn’t even appear on your state tax form: part of what people pay in state and local income taxes is offset by the deduction itemizers get in computing their federal taxable income. On average, every dollar that a state collects in income tax ends up costing its residents only about 80 cents, because about 20 percent of the cost of these state taxes is offset by federal tax cuts for itemizers. And, from the point of view of many high-income taxpayers, every dollar paid in state income tax costs only 65 cents. For a more detailed discussion of this “federal offset” effect, see page 9.

The Best of Times...

In early 2006, California newspaper headlines trumpeted “Google’s April surprise,” referring to the fact that the state’s income tax revenue had grown from \$7 billion to \$11.3 billion in just one year, in part due to Google millionaires cashing in their stock options.

The flip side of this explosive growth is that it can’t happen all the time. When investors hit hard times and choose not to cash in capital gains income, progressive income tax collections will decline. But over the business cycle, progressive income taxes simply do a better job of keeping pace with overall income growth than any other major tax levied by state governments.

Simplicity and the Personal Income Tax

Every special state tax break has to be subtracted from income—which means it takes at least one line on your state’s tax form. The main reason why state income tax forms—and instructions—are so complicated is because taxpayers must wade through these special tax breaks.

When these tax breaks discriminate between taxpayers who have a similar ability to pay, such unfair distinctions can make the tax system seem more arbitrary—and can undermine public confidence in the system. These tax breaks also make it harder to understand the overall effect of a tax system on people at different income levels.

Personal Income Tax Reform: Issues and Options

A personal income tax can be designed to be as fair as lawmakers want it to be. Almost every income tax is at least slightly progressive. A progressive personal income tax is the key to a fair overall tax system: without it, a tax system is doomed to being highly regressive. With a sufficiently progressive personal income tax, the whole tax system can be made to be at least slightly progressive even if the system includes regressive sales, excise and property taxes.

But in practice, virtually no states have achieved this. Only a handful of states require their wealthiest taxpayers to pay as much of their income in overall state and local taxes as the poorest state residents. By this measure, very few tax systems can even be described as “flat.” This section looks at the policy choices that can either enhance or limit income tax fairness.

Graduated Rate Structures

The easiest way to make an income tax adequately progressive is through graduated rates. The higher the rates are on wealthier taxpayers, the lower the rates can be on everyone else to raise the same amount of revenue. But many states fall short of this goal, for a variety of reasons:

- Seven states don’t apply graduated rate structures at all, but use a flat tax rate that applies to all taxable income. These states are Colorado, Illinois, Indiana, Massachusetts, Michigan, Pennsylvania and Utah.
- Some states use nominally graduated rate structures that don’t mean much in practice. For example, Alabama’s top income tax rate begins at just \$6,000 of taxable income. As a result, about 75 percent of Alabama families pay at the top rate. In states (like Alabama) that do not index their

income tax brackets for inflation, this problem grows worse every year.

- Other states use much wider income brackets, but apply relatively low rates. For example, Arizona’s top tax rate takes effect for married couples earning over \$300,000—but these taxpayers pay a marginal rate of just 4.54 percent. The relatively small difference between the bottom tax rate and the top tax rate makes the Arizona income tax less progressive.

Tax Breaks for Middle- and Low-Income Families

Policymakers can also make income taxes fairer without adjusting the tax rates. Large standard deductions and exemptions provide relief to all income groups, but are more significant to middle- and low-income families than to the well off. For instance, \$10,000 worth of exemptions amounts to 25 percent of income for a family earning \$40,000. But the same exemption offsets only 2 percent of income for a family making \$500,000. For this reason, providing a generous no-tax floor will generally be a more progressive move than simply reducing income tax rates “across the board.”

Targeted tax credits like the Earned Income Tax Credit are an even more effective (and less costly) way of making income taxes progressive. Because the benefits of these credits can be designed to phase out above a specified income level, these credits can be targeted to the low-income families who need them most, and the cost of the credit can be kept to a minimum. As previously noted, making these credits refundable is probably the single most effective step policymakers can take towards achieving a fairer tax system.

Capital Gains Tax Breaks

The progressive reforms outlined above can be undermined when a state allows major tax shelters for a state’s wealthiest residents. The federal income tax provides a special tax break from dividends and capital gains income, and a number of states have followed in this misguided path. Since most dividend and capital gains income goes to a small group of the very wealthiest Americans, these tax breaks mainly benefit the wealthy while offering only a pittance to middle- and low-income families.

Capital gains tax breaks have not been shown to encourage additional investment on the federal level—and this linkage is even more tenuous at the state level.⁵ A general state capital gains tax break is highly unlikely to benefit a state’s

The Impact of Indexing Income Taxes for Inflation

Many features of the personal income tax are defined by fixed dollar amounts. For instance, income taxes usually have various rates starting at different income levels. If these fixed income levels aren't adjusted periodically, taxes can go up substantially simply because of inflation. This hidden tax hike is known as “bracket creep.”

Take, for example, a state that taxes the first \$20,000 of income at 2 percent and all income above \$20,000 at 4 percent. A person who makes \$19,500 will only pay tax at the 2 percent tax rate. But over time, if this person's salary grows at the rate of inflation, she will find herself paying at a higher rate—even though she's not any richer in real terms. Suppose the rate of inflation is five percent a year and the person gets salary raises that are exactly enough to keep up with inflation. After four years, that means a raise to \$23,702. Now part of this person's income will be in the higher 4 percent bracket—even though, in terms of the cost of living, her income hasn't gone up at all.

The way the federal personal income tax and some states deal with this problem is by “indexing” tax brackets for inflation. In the example above, indexing would mean that the \$20,000 cutoff for the 4 percent bracket would be automatically increased every year by the amount of inflation. If inflation is five percent, the cutoff would increase to \$21,000 after one

year. After four years (of five percent inflation), the 4 percent bracket would start at \$24,310. So, when the person in our example makes \$23,702 after four years, he or she would still be in the 2 percent tax bracket.

Inflation has just the same impact on other features of income taxes, including standard deductions, exemptions, and targeted low-income tax credits. Unless these progressive tax breaks are indexed, they will gradually become less valuable over time—imposing a hidden tax hike on the low- and middle-income taxpayers for whom they are most valuable.

Of course, the flip side of indexing income taxes is that it reduces the growth of income tax revenues. Lawmakers discussing indexation should be aware that the fairness gains from indexing income taxes do come at a cost.

“Hidden Tax Hikes”: An Example

	Year 1	Year 5
Actual Income	\$19,500	\$23,702
Taxed at 2%	\$19,500	\$20,000
Taxed at 4%	\$0	\$3,702
Inflation-Adjusted Income	\$19,500	\$19,500

economy, since any investment encouraged by the capital gains break could take place anywhere in the United States or the world.

In addition, a substantial part of any state capital gains tax break will never find its way to the pockets of state residents. Because state income taxes can be written off on federal tax forms by those taxpayers who itemize their federal income taxes, as much as 35 percent of any reduction in state capital gains taxes will be directly offset by an increase in federal income tax liability.

And capital gains tax cut promoters ignore the significant advantages capital gains already receive. First of all, the federal income tax applies a special lower top tax rate on capital gains than it applies to other income (15 percent versus 35 percent—so the top rate on capital gains is less than half the top rate on wages). Second, income tax is only paid on capital gains when the asset is sold. This is the equivalent of only paying tax on interest earned in a bank account when it is withdrawn. And,

of course, not a dime of income tax is ever paid on capital gains that are inherited. Thus, a significant amount of capital gains (the amount held at the time of death) are never taxed at all.

Tax Breaks for Senior Citizens

Virtually every state's income tax allows some form of special tax break for senior citizens. The most sensible approach to doing so, followed by more than thirty states, is allowing a larger personal exemption or standard deduction to seniors. For example, some states follow the federal government's example and add \$1,250 to a married couple's standard deduction if one or both spouse is over 65.

But many states have taken a less sensible, and less inclusive, approach to exempting senior citizens' income, allowing tax breaks only for specific types of senior income. For example, New York's income tax now exempts the first \$20,000 of private pension benefits from tax. This type of exemption creates two glaring tax fairness problems: first, it provides a tax

of the wealthiest executive receive the same treatment as the benefits of the lowest-paid worker. Second, it provides special treatment for non-working taxpayers, with no comparable break for the earned income of otherwise identical seniors. Over-65 workers whose earnings are based on salaries rather than pensions are completely excluded from this generous tax break. Since elderly taxpayers who work tend to be poor, this tax preference for non-wage income is hard to justify.

Limiting senior tax breaks to low- and middle-income retirees—or replacing the pension tax break with a more general elderly exemption that applies to both earned income and unearned income—are two approaches to tax reform that would improve the perceived fairness of state income taxes.

Itemized Deductions

Thirty one states and the District of Columbia allow itemized deductions patterned after federal rules which are costly, “upside-down” subsidies for the best-off taxpayers, offering little or no benefit for many low- and middle-income families. Most states have taken steps to make their itemized deductions somewhat less unfair by limiting the ability of upper-income taxpayers to claim them. This has typically been done by piggybacking on a federal law that phased out up to 80 percent of the benefit of certain itemized deductions for individuals with incomes above \$166,000 (in 2009). But as of 2010, the Bush tax cuts repealed this phaseout—so itemized deductions are now more of an “upside-down” tax subsidy that at any time in the past decade. Unless this federal law is reintroduced for 2011, most states’ laws will have no mechanism for making itemized deductions less unfair.

A few states have reduced the unfairness of itemized deductions in their own ways, either by capping the allowable deduction, phasing out deductions for the best-off taxpayers or by changing them to a tax credit. For example, Vermont caps the itemized deduction for real property taxes at \$10,000 and New York has an additional phaseout above and beyond

the federal rules which begins for taxpayers with AGI greater than \$475,000. Wisconsin allows taxpayers to claim a credit for 5 percent of their federal itemized deductions. This is a straightforward way of ensuring that the value of the credit is the same for middle-income families as for upper-income taxpayers—and can go a long way towards reducing the cost of these tax breaks.

The most comprehensive reform approach available to states is simply to repeal all itemized deductions and ensure that most middle- and low-income families are held harmless by simultaneously increasing the basic standard deduction available to all families, a step taken by Rhode Island in 2010.⁶

Deduction of Federal Income Taxes from State Taxable Income

Another pitfall for state income taxes is the deduction for federal income taxes paid.⁷ Since the federal personal income tax is progressive, this deduction significantly reduces the state income taxes paid by the wealthy in the seven states that allow it. In fact, for people in the top federal bracket, the state deduction for federal income taxes effectively lowers a state’s top marginal tax rate by about a third. For low- and middle-income taxpayers, on the other hand, this tax break offers little or no relief.

Conclusion

State governments rely on three main sources of revenue— income, sales and property taxes. Of these, only the income tax is progressive. For this reason, an effective income tax, with graduated rates and a minimum of regressive tax loopholes, is the cornerstone of any fair state tax system. But many states have undermined the effectiveness of their income taxes in a variety of ways described in this chapter. The result, as noted in Chapter One, is that even the most progressive income taxes are usually insufficient to offset the unfairness of sales and property taxes. But a progressive income tax makes the difference between extreme and mild tax unfairness at the state level. 

¹ New Hampshire and Tennessee tax only interest and dividend income, and local governments in half a dozen states have income taxes that apply only to wages.

² Here’s how it works: if Sally Jones buys stock in 2000 worth \$1,000, then dies in 2011 with it having a value of \$10,000, no income tax is ever paid on the \$9,000 of gain from 2000 to 2010. If her heirs sell the stock in 2014 for \$12,000, the heirs pay tax on only the \$2,000 gain from 2011 (the date of inheritance) to 2014.

³ Federal legislation enacted in 2004 allows an optional, temporary deduction for sales taxes paid, but taxpayers claiming the deduction cannot write off their state and local income taxes—which means that this temporary deduction will generally only be useful—very modestly—for residents of non-income tax states.

⁴ Even when taxable income is exactly \$25,000, however, the effective tax rate remains less than 2 percent in this example. This is because the \$2,000-per-person exemption means that this family’s total income is \$29,000, not \$25,000. Not all of the family’s income is subject to the 2 percent tax.

⁵ For more information see “A Capital Idea.” Institute on Taxation and Economic Policy, August 2010. <http://www.itepnet.org/pdf/capitalidea0111.pdf>

⁶ To find out more about options for making state itemized deductions less unfair, see “Writing Off Tax Giveaways: How States Can Help Balance Their Budgets by Reforming or Repealing Itemized Deductions.” Institute on Taxation and Economic Policy, August 2010. <http://www.itepnet.org/pdf/itemize0810.pdf>

⁷ For more information see “Topsy-Turvy: State Income Tax Deductions for Federal Income Taxes Turn Tax Fairness on its Head.” Institute on Taxation and Economic Policy, March 2011. http://www.itepnet.org/pdf/topsyturvy_0311.pdf