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

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, fueled the volatility of revenue collections, or even stifled job-creation. 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 of progressive income taxes toward better state tax policy, explains why claims about their negative impact on economic growth are unfounded, 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 a 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. Sales and excise taxes certainly fit this description, since consumption takes up a much larger share of income for poor and middle class taxpayers. Property taxes do as well, since homes and vehicles are usually the only types of property subject to tax, and the only types of property typically owned by individuals and families in the lower half of the income distribution. Yet, sales, excise, and property taxes made up 67 percent of all state and local tax collections in 2009; in fact, nine states counted on these taxes for more than 75 out of every 100 tax dollars collected.

A personal income tax is simply the only major revenue source available to states that can meaningfully mitigate the unfairness of sales, excise, and property taxes. 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. For example, Illinois and Pennsylvania have two of the most unfair state tax structures in the nation, despite having income taxes. A graduated rate structure that applies lower tax rates to lower-income families, and the use of refundable tax credits to offset the impact of other regressive taxes, are vital strategies for achieving a modicum of fairness. Even states like California and Vermont with highly progressive income taxes achieve a basically flat tax system overall when other taxes levied by the state are taken into consideration.

### 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 be designed in a way that prepares them for any broad economic developments that affect the tax base.

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 281 percent between 1979 and 2007, while the average income for the bottom 20 percent of households rose just 16 percent.In this context, a progressive income tax is indispensible. By targeting the tax toward wealthier individuals that are experiencing rapid income growth, states can generate a more sustainable stream of revenue that keeps up with the cost of providing public services.

Moreover, this role for the income tax is especially important given the acutely unsustainable nature of so many other state taxes. Sales taxes are lagging as untaxed personal services and online shopping continue to grow in importance. Many property taxes are similarly hamstrung due to various property tax caps. And even excise taxes on gasoline are flat-lining, as vehicle fuel-efficiency rises and flat-rate gas tax rates stagnate.

### *Laying the Groundwork for Economic Growth*

No attack against progressive state income taxes has received more attention as of late than the claim that income taxes stifle economic growth and job-creation. Often times, these critics site bogus numbers about economic growth in non-income tax states. Yet, there is nothing to be gained from looking at the performance of non-income tax states like Alaska and Wyoming, because their economies are enormously dependent on natural resources that most states just don't have. Most states that don't levy an income tax choose not to precisely because they have some unique economic advantage that allows them to generate revenue through other means. Moreover, analyses that claim to find a higher economic growth rate in non-income tax states are typically based on cherry-picked or misleading data. For more on this see ITEP's report: "High Rate" Income Tax States Are Outperforming No-Tax States."

Attacks on the income tax are short sighted and too easily dismiss this important revenue stream. Here are ways that income taxes support economic growth:

- Income tax revenues aren't collected in a vacuum. The sustainable revenue stream made possible by an income tax pays for state services that are vital to economic growth, like education, public safety, the courts, and transportation infrastructure.

- A progressive income tax makes it possible for low-and middle-income taxpayers to pay less in taxes – a good thing since those taxpayers with limited disposable income are more likely to spend that money.

- State income tax bills also are partially paid by the federal government because of the ability of itemizers to write off their state income taxes on their federal tax return. For every dollar in income taxes paid, taxpayers who itemize get a federal tax cut of as much as 35 cents (depending on what federal tax bracket they are in). For more on this see ITEP's Policy Brief, "How State Tax Changes Affect your Federal Taxes: A Primer on the Federal Offset."

### *Promoting a Stable Revenue System*

In the wake of the recent financial crisis, many states experienced a sharp drop in income tax revenue, particularly as income earned by wealthier taxpayers, as well as capital gains realizations, dropped briefly from historic highs. 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, taxing internet sales, or offering fewer special tax breaks through the individual income tax. Each of these reforms would leave states less vulnerable to economic downturns and the revenue fluctuations they induce.

### Conclusion

Progressive income taxes allow states to collect revenue in a way that is both fair and sustainable. Not only do such taxes not harm economic growth, but the vital public investments that they make possible actually pave the way for better state economies. Concerns about tax volatility can be addressed with better fiscal management and reforms to other taxes with bases that are overly narrow.