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USING INCOME TAXES TO ADDRESS STATE BUDGET SHORTFALLS

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Introduction

States are on the brink of their worst fiscal problems since the 2001 recession. At least half the states are anticipating budget shortfalls for next year (fiscal year 2009). For those states that have estimated the size of the gap, estimated deficits range from $34 billion to $38 billion in total. Among affected states, these deficits represent between 8 percent and 9 percent of total state expenditures.

These shortfalls result in large part from the downturn of the economy. The bursting of the housing bubble has reduced state sales tax revenue collections. Property tax revenues have also been affected and local governments will be looking to the states to address the squeeze on local and education budgets.

Furthermore, many economists expect that a recession will follow the recent housing crash. This would result in larger shortfalls, more affected states and a state fiscal crisis that lasts well beyond the next fiscal year. Virtually all states have balanced budget requirements, so they will have to take actions to close these deficits.

While many states may be able to draw down rainy day funds in the short-term, most do not have reserves large enough to weather a protracted recession. Thus, states will soon be forced to use some combination of cuts in programs and revenue increases to close most of these gaps.

KEY FINDINGS

- States facing deficits due to the current economic downturn should avoid spending cuts that can further weaken their economies.
- Raising taxes, especially on wealthy households, is less economically damaging than cutting many types of services.
- To fill budget gaps, states should consider enacting temporary income tax surcharges.
- Nationwide, over $13 billion could be raised if every state with a personal income tax enacted a 1 percent rate increase for high-income taxpayers. An across-the-board surcharge equal to 5 percent of taxes owed could raise a similar amount.
- If enacted quickly, revenues from a surcharge could help states close gaps in their current year budgets.

If — as is increasingly likely — the state fiscal crisis deepens, state actions are highly likely to cut basic services such as health care and education. Indeed, many such cuts have already been proposed in states facing the largest shortfalls. The depth of the cuts necessary, however, can be reduced if states include revenue increases as a part of their budget balancing packages.

The personal income tax, which is a major revenue source for all except nine states, is a particularly promising source of new revenues because it can yield a significant amount of new revenues to help plug the large budget gaps.[1] One way to tap this revenue source is to adopt an income tax surcharge.

An income tax surcharge refers to an increase in an existing income tax that is calculated as an add-on to the amount of taxes that would be owed under existing tax law. The amount of this additional tax is generally determined in one of two ways:

- ***A high-income surcharge*** - an additional rate (or rates) are added to the top of the existing rate structure;

- ***An across-the-board surcharge*** - an additional amount of tax is levied on all taxpayers that is equal to a percentage of the taxes that would be owed under existing law.

States have often used income tax surcharges and the creation of additional tax brackets to fill budget gaps in past recessions. There are a number of reasons why states should consider enacting surcharges during the current fiscal crisis.

- States can raise a substantial amount of revenue from an income tax surcharge with a relatively small increase in current tax rates. For example, if every state with an income tax added a tax bracket for taxpayers with incomes exceeding $200,000 and applied a tax rate that is one percent higher than its current top rate to those high-income taxpayers, the total additional revenue raised in all states would be $13 billion. Alternatively, a surcharge equal to 5 percent of taxes owed for all state income taxpayers — regardless of income — would raise over $13.5 billion.

- An income tax surcharge could be used to address both the shortfalls that have developed in fiscal year 2008 budgets and the looming gaps in fiscal year 2009 budgets. A surcharge effective for the current tax year (2008) would bring in revenue during fiscal year 2008 if it were enacted prior to the end of the current fiscal year (July 1 for most states) and withholding tables were adjusted.

- Because it is based on the existing personal income tax system, an income tax surcharge would be relatively easy for states to administer.

- In addition, an income tax surcharge is one of the least painful options available to states to raise significant amounts of revenue. This is because it can be targeted by income, because part of its cost would be borne by the federal government and because it would have less effect on economic growth than other budget balancing options.

[1] The nine states that do not levy a broad-based income tax are Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming.

An Income Tax Surcharge is One of the Least Painful Budget Balancing Alternatives Available

There are few easy choices for governors and state legislators as they seek to close large and growing budget gaps. However, an income tax surcharge can be one of the least painful options available.

An income tax surcharge — especially one targeted to high-income taxpayers — will likely have less negative impact on economic growth than cuts in state programs or a tax increase on low and middle-income taxpayers. In a paper written at the start of the last recession, Nobel prize-winning MIT economist Joseph Stiglitz and Brookings Institution economist Peter Orszag concluded that tax increases on higher-income families are the least damaging mechanism for closing state fiscal deficits in the short run.[2] Reductions in government spending on goods and services, or reductions in transfer payments to lower-income families, are likely to be more damaging to the economy in the short run than tax increases focused on higher-income families. This is because money a state no longer spends causes a dollar for dollar reduction in demand. By contrast, when taxes are increased, some of the additional tax payments will be made from savings rather than from funds that would otherwise be spent.

In addition, state taxpayers will not bear the full cost of the surcharge. Because state income taxes are deductible on the federal tax returns of taxpayers that itemize, the cost to state residents of a state income tax increase will be reduced by an offsetting decrease in federal income taxes. Up to one-third of a state income tax increase will be offset by reduced federal income taxes for those taxpayers who itemize their deductions on their federal income tax returns. The federal offset would be larger for a high-income surcharge than for an across-the-board surcharge because most of the taxpayers affected do itemize on their federal tax returns. For example, 93 percent of taxpayers with incomes above $200,000 itemized their deductions in 2005. By contrast, less than 18 percent of taxpayers with incomes below $50,000 itemized their deductions during the same year.

Because it is a tax based on income, an income tax surcharge can be targeted to exempt low- and moderate-income families. These arguably are the families who are being hardest hit by the current economic downturn.

A surcharge could also be designed to focus on high-income taxpayers who are best able to afford tax increases, leaving the vast majority of taxpayers with no tax increase. Levying a surcharge on high-income taxpayers only would result in a tax increase on those taxpayers that are in the best position to afford a temporary tax increase.

High-income taxpayers have benefited most from the federal income tax cuts enacted in 2001 and 2003. Taxpayers with income above $200,000 received a federal tax cut that averages $17,000 for 2007 as a result of those measures. Even with a state income tax surcharge of the size likely to be considered by states, high-income taxpayers will receive a substantial net income tax cut.

[2] Peter Orszag and Joseph Stiglitz, "Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive than the Other During a Recession?" Center on Budget and Policy Priorities, revised November 6, 2001.

FIGURE 1

State X
Income Tax Rate Schedule

If Income is At Least:	But is Less Than:	Tax owed Equals			Of the Amount Over:
0	$ 5,000	0	plus	2.0%	0
$ 5,000	$15,000	100	plus	3.0%	$ 5,000
$15,000	$30,000	400	plus	4.0%	$15,000
$30,000		1,000	plus	6.0%	$30,000

For example, in 2003 New York State temporarily increased top marginal tax rates on married couples filing jointly with taxable income above $150,000. These higher rates expired in 2005. Yet, even while these surcharges were active, high-income taxpayers in New York enjoyed a large net tax reduction due to the 2001 and 2003 federal income tax cuts. A New York State family of four with $300,000 adjusted gross income owed an additional $1,737 in state income taxes for 2003 as a result of the surcharge. However, this was far outweighed by the $10,114 reduction in federal taxes that a family with this income received as a result of the federal changes and the fact that the increased state taxes resulted in higher itemized deductions.

In addition, high-income families benefited most from the economic expansion of the last 29 years and, thus, are most able to afford tax increases. The after-tax income of families in the top fifth of the income scale increased by 80 percent between 1979 and 2005 and the incomes of the top one percent grew 228 percent. At the same time, the incomes of the bottom fifth and second fifth grew only 6 percent and 16 percent, respectively.

Surcharge Design

An income tax surcharge is relatively easy to design and administer because it is an add-on to an existing tax. The amount of this additional tax is generally determined in one of two ways: either as a high-income surcharge — an additional rate (or rates) added to the top of the existing rate structure — or as an across-the-board surcharge — an additional amount of tax levied on all taxpayers that is equal to a percentage of the taxes that would be owed under existing law.

The following examples demonstrate how the two basic types of surcharges could be designed. (These examples are based on the hypothetical graduated state income tax structure for State X shown in Figure 1.) Under the provisions of the income tax in State X, taxpayers first determine the portion of their income that is taxable by subtracting any applicable exemptions and deductions from their "gross" income. Next, the amount of personal income tax owed is determined using the rate schedule.

FIGURE 2

High-Income Surcharge
(Additional 1% on income over $200,000)

	Taxpayer A	**Taxpayer B**
Taxable Income	$ 40,000	$300,000
Current Tax	**1,600**	**17,200**
Additional tax:		
Income above $200,000	0	100,000
Times .01 = **surcharge**	**0**	**1,000**
Total Tax w/surcharge	**1,600**	**18,200**

For example, a family with $40,000 of taxable income would owe $1,600 under this tax. This is the sum of $100 (2% of the first $5,000) plus $300 (3% of the next $10,000) plus $600 (4% of the next $15,000) plus $600 (6% of the amount over $30,000). A family with taxable income of $300,000 would owe $17,200 under this tax.

High-Income Surcharge

One way to raise additional revenue through this income tax would be to add an additional bracket for high-income taxpayers. For example, the state could levy an additional tax equal to one percent of income exceeding $200,000. For State X's income tax system this would mean adding a rate of 7 percent for income above $200,000. This change would not affect any taxpayers with income below $200,000.

Figure 2 shows the impact of this surcharge on two hypothetical families — one with taxable income of $40,000 and one with taxable income of $300,000.

The family with taxable income of $40,000 would owe no additional tax under this surcharge because its income is less than $200,000. By contrast, the family with income of $300,000 would owe an additional $1,000 (1% of the $300,000 minus $200,000). This family's total tax bill would increase from $17,200 under the existing rate schedule to $18,200 with the surcharge included.

This strategy has been used by a number of states during past recessions. In the early 1990s, California, Maine, Maryland, Rhode Island and Vermont enacted new temporary top brackets.[3] In addition, Minnesota, New Jersey, North Carolina, Ohio and Oklahoma enacted new top brackets,

[3] Maine also adopted a temporary surcharge that was larger for higher income taxpayers. Maine's surcharge equaled five percent of total income tax liability for taxpayers with incomes below $75,000 and ten percent for incomes above $75,000.

some of which were rolled back in the mid-1990s. Another state, Kansas, adopted a permanent income tax rate increase that affected taxpayers with income above $30,000.

During the fiscal crisis of the early 2000s, states also turned to income tax increases in order to avoid cutting vital services. From 2001 to 2003, four states — Nebraska, New York, North Carolina, and Oklahoma — enacted temporary increases in their top rates. During this period, several other states delayed scheduled tax cuts. In 2004, New Jersey increased the top marginal rate on incomes above $500,000.

Last year, Maryland became one of the first states to address the current fiscal crisis. As part of a package designed to close the state's projected fiscal year 2009 budget gap of $1.7 billion, Maryland lawmakers enacted three new tax brackets for high-income filers. Starting this year, the new rates will increase revenues and improve the progressivity of Maryland's income tax, raising the top rate from 4.75 percent to 5.5 percent.

The amount of revenue that states could raise from enacting a high-income surcharge by adding a new top rate will depend on the income cut-off (or cut-offs) chosen and the additional rate imposed. In addition, the distribution of taxpayers by income in the state will affect the amount of revenue that can be raised. Table 1 provides rough estimates of the amount of revenue that states could raise with the addition of new top rates at income levels of $100,000 and $200,000. The table also shows the percentage of taxpayers that would be affected. As the table shows, a small rate increase targeted to high-income taxpayers can raise a significant amount of revenue from a small number of taxpayers. For example, an additional one percent rate levied on income above $100,000 would raise nearly $20 billion in all states with an income tax in total but would increase taxes for only 10.8 percent of taxpayers.

The estimates in Table 1 are based on federal Statistics of Income data rather than on data provided by state agencies. As a result, they will likely differ from estimates prepared by states.[4] In general, a state's own estimate of the revenue-raising potential of a surcharge will be better than these estimates. However, these provide the best estimate of the amount of revenue that a state could raise by enacting a high-income surcharge for states where no state estimate has yet been prepared.

Across-the-Board Surcharge

An alternative way to design a surcharge is to levy an additional tax that is a percentage of the taxes that would be owed under the existing system. Figure 3 shows how this would work for the two hypothetical taxpayers in State X if the surcharge were 5 percent of tax liability. The family with $40,000 in taxable income would owe an additional $80 (.05 times its current law tax bill of $1,600). The family's total tax bill would increase from $1,600 to $1,680. The family with taxable income of $300,000 would owe an additional $860 (.05 times $17,200). This family's total tax bill would increase from $17,200 to $18,060.

[4] The federal Statistics of Income data on adjusted gross income by state differ from state figures in part because SOI data is attributed to a state based on the address shown on the income tax return which may differ from the official state of residency for state tax purposes. This will have a particularly large impact in states where many people live in one state and work in a neighboring state. For example, some 14 (need to update) percent of New York state taxpayers do not live in New York. In addition, the estimates are based on total AGI which does not take into account the individual features of a state tax system such as personal exemptions and standard deductions.

TABLE 1: POTENTIAL REVENUE FROM A TEMPORARY RATE INCREASE				
	Additional 1% on Taxpayers with AGI over $100,000		Additional 1% on Taxpayers with AGI over $200,000	
State	Revenue (millions)	Taxpayers Affected (%)	Revenue (millions)	Taxpayers Affected (%)
Alabama	259	7.8%	164	1.8%
Arizona	502	10.5%	331	2.6%
Arkansas	110	6.5%	67	1.5%
California	4,134	13.2%	2,806	3.5%
Colorado	472	12.4%	300	2.9%
Connecticut	719	16.7%	527	4.9%
Delaware	87	9.2%	49	2.5%
Georgia	640	10.0%	400	2.5%
Hawaii	83	9.7%	50	2.2%
Idaho	76	7.6%	49	1.8%
Illinois	1215	11.7%	800	2.9%
Indiana	275	8.2%	162	1.6%
Iowa	116	7.7%	65	1.5%
Kansas	176	9.1%	106	2.0%
Kentucky	153	7.2%	90	1.6%
Louisiana	167	7.6%	105	1.8%
Maine	54	7.3%	31	1.7%
Maryland	607	15.4%	358	3.5%
Massachusetts	845	15.0%	563	3.9%
Michigan	488	10.2%	277	1.9%
Minnesota	409	11.4%	254	2.6%
Mississippi	105	5.9%	64	1.3%
Missouri	323	8.3%	200	1.8%
Montana	39	6.4%	24	1.6%
Nebraska	89	7.8%	56	1.7%
New Jersey	1236	16.6%	771	4.4%
New Mexico	70	7.6%	40	1.6%
New York	2710	12.0%	2,003	3.3%
North Carolina	539	9.0%	321	2.1%
North Dakota	21	6.4%	12	1.4%
Ohio	505	7.7%	301	1.7%
Oklahoma	125	7.1%	83	1.7%
Oregon	226	9.5%	131	2.2%
Pennsylvania	884	9.7%	551	2.3%
Rhode Island	62	11.1%	36	2.5%
South Carolina	230	7.8%	139	1.8%
Utah	166	8.6%	108	2.0%
Vermont	35	8.6%	20	2.0%
Virginia	658	14.2%	382	3.4%
West Virginia	55	5.8%	31	1.1%
Wisconsin	318	9.0%	194	1.9%
Total	19,984	10.8%	13,021	2.7%

FIGURE 3

Across-the-Board Surcharge
(Additional 5% of Taxes Owed)

	Taxpayer A	Taxpayer B
Taxable Income	$ 40,000	$300,000
Current Tax	**1,600**	**17,200**
Additional tax (surcharge):		
= .05 times current tax	80	860
Total Tax w/surcharge	**1,680**	**18,060**

During the early 1990s recession, a number of states adopted surcharges that affected all taxpayers at all income levels or enacted the similar policy of raising rates for all income levels. For example, Montana, Illinois and Pennsylvania adopted surcharges or increases in their rates.

During the fiscal crisis of the early 2000s, only Arkansas adopted a temporary across-the-board income tax surcharge. More recently, Michigan — a state that has faced lingering economic and fiscal problems — adopted an increase in its single-rate income tax last year. This increase will begin to phase out in 2011.

Other states raised their income tax rates in ways similar to an across-the-board surtax during the recession of the early 2000s. Pennsylvania — which has a single rate income tax — raised that rate in 2004. In addition, the increase in Connecticut's top rate — described in the earlier section — is similar to an across-the-board increase as the state has only two brackets. Similarly, Nebraska's 2002 rate increase exhibited across-the-board characteristics in that all tax brackets experienced some increase.

Table 2 provides state-by-state estimates of the amount of revenue that could be raised through the adoption of an across-the-board income tax surcharge. Estimates are provided for surcharges equaling 5 percent or 10 percent of taxes owed. These estimates are based on fiscal year 2008 personal income tax collections as reported by the state to the National Association of State Budget Officers in their most recent annual survey of state finance officers.

Some Administrative Issues

The primary reason states should consider adopting an income tax surcharge is to generate revenue to sustain important state services during the current fiscal crisis. Thus, it is important that states increase revenues relatively quickly. Nevertheless, the need for additional revenues must be balanced with administrative feasibility and impact on taxpayers.

TABLE 2: POTENTIAL REVENUE FROM ACROSS-THE-BOARD SURCHARGE								
	Revenue (millions)			Revenue (millions)			Revenue (millions)	
State	**5% surtax**	**10% surtax**	**State**	**5% surtax**	**10% surtax**	**State**	**5% surtax**	**10% surtax**
Alabama	156	311	Kentucky	162	324	North Carolina	545	1,090
Arizona	199	397	Louisiana	128	257	North Dakota	12	24
Arkansas	115	230	Maine	69	138	Ohio	457	915
California	2,612	5,224	Maryland	352	704	Oklahoma	108	216
Colorado	245	490	Massachusetts	580	1,161	Oregon	301	602
Connecticut	360	719	Michigan	315	631	Pennsylvania	538	1,075
Delaware	53	106	Minnesota	378	755	Rhode Island	54	108
Georgia	450	899	Mississippi	75	150	South Carolina	146	293
Hawaii	82	163	Missouri	257	515	Utah	129	257
Idaho	63	126	Montana	40	80	Vermont	29	58
Illinois	493	986	Nebraska	82	163	Virginia	526	1,052
Indiana	234	468	New Jersey	619	1,238	West Virginia	75	150
Iowa	158	315	New Mexico	56	113	Wisconsin	338	676
Kansas	139	278	New York	1,841	3,682	Total	13,568	27,136

Please see methodology notes in Appendix.

Three major factors will influence the timing of the revenue collections from an income tax surcharge — the effective date of the change, the way the state chooses to collect the surcharge and the type of surcharge (that is, whether it is a high-income surcharge or an across-the-board surcharge.)

Although many associate April 15 with income tax collections, state income taxes — like federal income taxes — are actually collected throughout the calendar year. Income taxes are collected on wages and on non-wage income such as interest, dividends, and capital gains. Income taxes on wage earnings are withheld from paychecks by employers and remitted to state treasuries at regular intervals throughout the year. Thus, payments of taxes that are withheld from wages are spread evenly over the tax year. In addition, most taxes on non-wage income are also collected throughout the year through quarterly estimated tax payments made by individual taxpayers. However, a significant portion of the taxes on non-wage income (about 15 percent) are paid the following April when income tax forms are filed.

As a result, on average about 30 percent of state income taxes are collected in the second quarter of the calendar year (April-June) and 22 to 23 percent of state income tax revenues are received during each of the remaining quarters. Because state fiscal years generally run from July 1 to June 30, this means that states receive about 45 percent of state income tax revenues during the first half of the fiscal year and about 55 percent in the last half.

When income taxes are increased or decreased, states must change the withholding tables that employers use and individual taxpayers must adjust their estimated payments. How quickly these changes occur will determine when a state will receive the additional revenue from a surcharge.

Most states will be considering surcharges during the spring (between now and July 2008). An income tax surcharge enacted during that time period would most likely be effective on one of two dates. Either the change would be retroactive to January 1, 2008 or it would be effective January 1, 2009.

The additional revenue from an income tax surcharge enacted in the spring of 2008 and made retroactive to January 1, 2008 would produce revenues in both the 2008 and 2009 state fiscal years. The earlier the increase was enacted, the larger the amount of revenue that could be collected during the 2008 fiscal year. By changing withholding tables, the state could collect a portion of an increase in 2008 tax year taxes before the end of the 2008 fiscal year in June. In addition, estimated payments for the 2008 calendar year are made in April, June, September and the following January. Two of these payments (April and June) are in the 2008 fiscal year. As a result, if a surcharge was adopted before April 2008, states could receive from 20 to 40 percent of the additional revenue during the 2008 fiscal year with the remainder collected in fiscal year 2009.

If, on the other hand, a surcharge was enacted effective January 1, 2009, about 45 percent of the increase would be received during the 2009 fiscal year and the remainder would be collected in the 2010 fiscal year, a year in which states are likely to have lingering fiscal problems.

Conclusion

A temporary income tax surcharge is an appropriate way to raise the amount of revenue that is necessary to help address the massive budget gaps many states are currently facing. A surcharge is relatively easy to put into place and to administer and can generate revenue quickly.

In addition, a surcharge can be designed to exclude low and moderate income taxpayers if desired. Part of the cost of a surcharge would be borne by the federal government and a surcharge — especially a high-income surcharge — would have less effect on economic growth than other budget-balancing options.

Finally, because income tax forms and withholding schedules typically are re-issued each year, it is administratively easy for a state to remove the surcharge once the fiscal crisis has passed.

METHODOLOGICAL APPENDIX

How the Estimates in Tables 1 and 2 Were Computed

The figures in tables 1 and 2 are rough estimates of the revenue individual states could raise from an income tax surcharge. They were calculated based on national data sources. As a result, they will likely differ from estimates prepared by states. In general, a state's own estimate of the revenue-raising potential of a surcharge will be better than these estimates. However, these provide the best estimate of the amount of revenue that a state could raise by enacting a surcharge for states where no state estimate has yet been prepared.

Table 1

The estimates in Table 1 are based on federal Statistics of Income published by the Internal Revenue Service for Tax Year 2005, the most recent year available. The federal Statistics of Income data on adjusted gross income by state differ from state figures in part because SOI data is attributed to a state based on the address shown on the federal income tax return which may differ from the official state of residency for state tax purposes. This will have a particularly large impact in states where many people live in one state and work in a neighboring state. In 2004, for example, 15 percent of New York's total state income tax liability was owed by taxpayers not living in New York State. In addition, the estimates are based on total AGI which does not take into account the individual features of a state tax system such as personal exemptions and standard deductions.

To arrive at the revenue estimates in Table 1, each state's surcharge calculation was increased by the percentage of growth in its state income tax revenues between fiscal years 2005 and 2008. This adjusts for the increase in revenues since 2005.

Table 2

The estimates of revenue that could be raised by an across-the-board surcharge were calculated by applying a percentage (5% or 10%) to 2008 personal income tax collections reported in the November 2008 Fiscal Survey of the States published by the National Association of State Budget Officers.