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Revised June 13, 2003

USING INCOME TAXES TO ADDRESS STATE BUDGET SHORTFALLS

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Introduction

States are currently facing their worst fiscal crisis in decades. States have closed or are in the process of closing deficits for fiscal year 2003 that totaled nearly $80 billion, along with deficits for fiscal year 2004 that exceed $70 billion. These deficits have been closed by a combination of depleting reserves, raising taxes, and cutting programs. Most observers expect state fiscal problems to continue in fiscal year 2005, and further rounds of tax increases and program cuts will be made as states struggle to meet their balanced budget requirements.

States have already cut basic services such as health care and education and many additional cuts have been proposed. 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.

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[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.

- 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 $6 billion. Alternatively, a surcharge equal to 5 percent of taxes owed for all state income taxpayers — regardless of income — would raise over $9 billion.

- An income tax surcharge could be used to address the gaps in fiscal year 2004 budgets and to address ongoing shortfalls in fiscal year 2005 budgets. A surcharge effective for the current tax year (2003) would bring in revenue during fiscal year 2004. If the surcharge remained in effect for tax year 2004, it would also continue to bring in revenues for fiscal year 2005.

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

- 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 — as much as a third — would be borne by the federal government and because it would have less effect on economic growth than other budget balancing options.

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

There are few easy choices left for governors and state legislators as they seek to close record-setting 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, and less negative impact than a tax increase on low and middle-income taxpayers. In a recent paper, 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. 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 2000. By contrast, payments of sales taxes — the other major state revenue source — are not deductible on federal income taxes. As a result, state sales tax payers do not receive an offsetting federal tax reduction when the sales tax is increased.

Because it is a tax based on income, a surcharge can be designed to exclude low-income taxpayers. An income tax surcharge can be targeted to exempt the low- and moderate-income 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 would result in a tax increase only on those taxpayers that are in the best position to afford a temporary tax increase.

High-income taxpayers will benefit most from the federal income tax cuts enacted this year and in 2001. Taxpayers with income above $200,000 will receive a federal tax cut that averages $16,365 for 2003 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. For example, New York State recently instituted higher top rates for taxpayers with income above $150,000.[2] Despite this surcharge, high-income taxpayers in New York will still receive a large net tax reduction when both federal and state income taxes are considered. A New York State family of four with $300,000 adjusted gross income will owe an additional $1,737 in state income taxes for 2003 as a result of this surcharge. This is far outweighed by the reduction in federal taxes of $10,114 that a family with this income would receive as a result of the federal changes and the fact that the increased state taxes would result in higher itemized deductions.

High-income families benefited most from the economic expansion of the last two decades and, thus, are most able to afford tax increases. The pre-tax income of families in the top fifth of the income scale increased by 53 percent between 1979 and 1997 and the incomes of the top one percent grew 142 percent. At the same time, the incomes of the bottom fifth declined and the next fifth grew only 5.5 percent.

[2] The rate on income between $150,000 and $500,000 was raised .65 percent; the rate on income above $500,000 was raised an additional .2 percent.

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

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.

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.

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**

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.

In the last recession, a number of states enacted new top brackets in order to raise revenue to get them through the fiscal crisis. For example, 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, 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.

Some states have already turned to income tax increases to address the current fiscal crisis. North Carolina enacted a temporary increase in top rates in 2001. Nebraska and Oklahoma increased their top income tax rates last year.[4] Massachusetts postponed — for at least six years — a scheduled reduction in its top rate. New York recently adopted additional top rates for married taxpayers filing jointly with taxable income above $150,000.[5] Connecticut has increased its top income tax rate (which applies to married taxpayers with taxable incomes over $20,000) from 4.5 percent to 5 percent.

[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.

[4] Oklahoma's increase was the result of a provision that was automatically triggered due to declining revenues.

[5] In New York, for tax year 2003, the income tax rate for income above $150,000 for married taxpayers filing jointly was increased from 6.85 percent to 7.5 percent. (This rate declines to 7.375 and 7.25 for tax years 2004 and 2005 respectively. The rate for income above $500,000 was raised to 7.7 percent for tax years 2003 through 2005.

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**

Other states are considering this option. The Connecticut legislature included a tax on income above $500,000 in its budget package for the upcoming budget year. California's governor has proposed instituting an additional bracket for married-filing joint taxpayers with income above $300,000. Missouri's governor has proposed an additional rate on income over $200,000.

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, $200,000, $500,000 or $1,000,000. 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 $9.6 billion in all states with an income tax in total but would increase taxes for only 8.6 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.[6] 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 in states where no state estimate has yet been prepared.

[6] 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, in New York State, some 14 percent of income taxes are paid by non-residents. 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.

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. 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.

In the last recession, a number of states raised their income tax rates or adopted surcharges that affected all taxpayers at all income levels. For example, Montana, Illinois and Pennsylvania adopted surcharges or increases in their rates.

Thus far, during the current fiscal crisis, only one state has adopted an across-the-board surcharge. Arkansas has adopted a surcharge equal to 3 percent of income tax liability. 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. Pennsylvania's governor has proposed an income tax rate 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 2002 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 are considering the adoption of 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.

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

Table 1
Potential Revenue from Temporary Rate Increase

	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		Additional 1% on Taxpayers with AGI over $500,000		Additional 1% on Taxpayers with AGI over $1,000,000	
State	Revenue (millions)	Percent of Taxpayers Affected	Revenue (millions)	Percent of Taxpayers Affected	Revenue (millions)	Percent of Taxpayers Affected	Revenue (millions)	Percent of Taxpayers Affected
Alabama	93	5.6%	53	1.2%	27	0.2%	16	0.1%
Arizona	157	7.7%	90	1.7%	50	0.3%	33	0.1%
Arkansas	48	4.4%	28	1.0%	15	0.2%	11	0.1%
California	1,898	10.7%	1,207	2.6%	761	0.6%	547	0.2%
Colorado	220	10.1%	132	2.3%	79	0.5%	55	0.2%
Connecticut	365	13.7%	262	3.9%	179	1.0%	133	0.4%
Delaware	31	9.1%	18	1.8%	10	0.4%	7	0.1%
Georgia	298	8.3%	172	1.9%	93	0.4%	59	0.1%
Hawaii	30	6.7%	16	1.3%	8	0.2%	6	0.1%
Idaho	26	5.3%	15	1.1%	8	0.2%	5	0.1%
Illinois	593	9.5%	366	2.3%	215	0.5%	143	0.2%
Indiana	146	6.3%	81	1.2%	42	0.2%	26	0.1%
Iowa	56	5.3%	29	1.1%	13	0.2%	8	0.1%
Kansas	71	6.9%	39	1.5%	19	0.3%	11	0.1%
Kentucky	81	5.4%	44	1.2%	21	0.2%	12	0.1%
Louisiana	95	5.3%	56	1.2%	29	0.3%	17	0.1%
Maine	29	5.2%	16	1.2%	8	0.2%	5	0.1%
Maryland	266	11.8%	145	2.4%	80	0.4%	53	0.1%
Massachusetts	472	12.5%	305	3.2%	192	0.7%	138	0.2%
Michigan	300	8.5%	157	1.6%	81	0.3%	50	0.1%
Minnesota	200	8.9%	116	1.9%	64	0.4%	41	0.1%
Mississippi	44	4.0%	26	0.9%	14	0.2%	9	0.1%
Missouri	157	6.4%	93	1.4%	52	0.3%	34	0.1%
Montana	17	4.2%	9	1.0%	5	0.2%	3	0.0%
Nebraska	46	5.6%	28	1.2%	17	0.3%	12	0.1%
New Jersey	632	13.8%	388	3.5%	228	0.7%	153	0.3%
New Mexico	52	6.3%	31	1.4%	18	0.3%	12	0.1%
New York	1406	9.8%	1,031	2.7%	730	0.7%	558	0.3%
North Carolina	224	7.0%	122	1.6%	59	0.3%	34	0.1%
North Dakota	10	4.3%	5	1.0%	2	0.1%	1	0.0%
Ohio	287	5.8%	160	1.3%	80	0.2%	48	0.1%
Oklahoma	74	5.2%	44	1.1%	24	0.2%	16	0.1%
Oregon	96	7.1%	52	1.5%	26	0.3%	17	0.1%
Pennsylvania	415	7.4%	242	1.7%	134	0.3%	89	0.1%
Rhode Island	38	8.2%	22	1.7%	13	0.3%	9	0.1%
South Carolina	86	5.6%	47	1.2%	22	0.2%	13	0.1%
Utah	54	6.3%	30	1.3%	17	0.2%	11	0.1%
Vermont	16	6.4%	9	1.4%	4	0.2%	3	0.1%
Virginia	308	10.8%	161	2.2%	86	0.4%	56	0.1%
West Virginia	24	4.0%	12	0.8%	6	0.1%	3	0.0%
Wisconsin	155	6.7%	90	1.4%	49	0.3%	32	0.1%
Total	9,617	8.6%	5,951	2.0%	3,581	0.4%	2,488	0.1%

Please see methodology notes in Appendix.

Table 2
Potential Revenue from Across-the-Board Surcharge

State	Revenue (millions) 5% surtax	10% surtax	State	Revenue (millions) 5% surtax	10% surtax	State	Revenue (millions) 5% surtax	10% surtax
Alabama	103	206	Kentucky	135	270	North Carolina	357	714
Arizona	106	211	Louisiana	88	177	North Dakota	10	20
Arkansas	76	151	Maine	59	118	Ohio	365	730
California	1,693	3,386	Maryland	239	477	Oklahoma	109	218
Colorado	167	335	Massachusetts	396	791	Oregon	184	368
Connecticut	213	427	Michigan	313	627	Pennsylvania	357	714
Delaware	36	71	Minnesota	287	573	Rhode Island	40	81
Georgia	353	705	Mississippi	50	99	South Carolina	96	192
Hawaii	54	107	Missouri	188	375	Utah	80	161
Idaho	42	84	Montana	26	52	Vermont	20	40
Illinois	374	747	Nebraska	58	116	Virginia	336	671
Indiana	177	354	New Jersey	339	677	West Virginia	52	104
Iowa	119	237	New Mexico	51	102	Wisconsin	249	498
Kansas	92	183	New York	1,293	2,585	Total	9,377	18,755

Please see methodology notes in Appendix.

taxpayers. However, a significant portion of the taxes on non-wage income (about 15 percent) are made 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.

An income tax surcharge enacted this year would most likely be effective on one of two dates. Either the change would be retroactive to January 1, 2003 or it would be effective January 1, 2004.

At this point, all the additional revenue from an income tax surcharge enacted now and made retroactive to January 1, 2003 would be received in the 2004 state fiscal year. By June, it is too late to change withholding tables in time to collect any portion of an increase in 2003 tax year taxes before the end of the 2003 fiscal year in June. In addition, estimated payments for the 2003 calendar year are made in April, June, September and the following January. While two of these payments (April and June) are in the 2003 fiscal year they have already been made by mid-

June. As a result, if a surcharge was adopted before July 2003, states would receive the additional revenue collected in fiscal year 2004.

If, on the other hand, a surcharge was enacted effective January 1, 2004, about 45 percent of the increase would be received during the 2004 fiscal year and the remainder would be collected in the 2005 fiscal year, a year in which states are likely to have lingering fiscal problems.[7]

Conclusion

A temporary income tax surcharge is an excellent way to raise the amount of revenue that is necessary to help address the massive budget gaps most 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 are re-issued each year, it is administratively easy for a state to remove the surcharge once the fiscal crisis has passed.

[7] This discussion is based on the assumption that a state is operating on a July 1 to June 30 fiscal year as all but four states do. The timing of the collection of an income tax surcharge would be somewhat different in those states — Alabama, Michigan, New York and Texas — and in the District of Columbia.

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 in 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 2001, 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. For example, in New York state, some 14 percent of income taxes are paid by non-residents. 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, an additional rate of one percent is applied to all adjusted gross income above the indicated bracket (for example, $100,000 or $200,000). The result of this calculation was reduced by 13.7% to adjust for the revenue decline since 2001.

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 2002 personal income tax collections reported in the November 2002 Fiscal Survey of the States published by the National Association of State Budget Officers.