Wednesday, June 17, 2009

Taxes for States in Trouble?

by Linda Beale

[Excerpted from an earlier posting on ataxingmatter]

On ataxingmatter, I considered Michigan's tough problems and proposed a solution that could offer a way to deal fairly with the many issues the State faces. Michigan, as everybody knows, is a depressed state these days. High unemployment, high foreclosure rates, and even the Red Wings can't win it all. As two of the Big Three auto companies go into bankruptcy, Michigan is shedding jobs as fast as ice melts on a sidewalk on a hot summer day in Mississippi. Michigan, in other words, has real problems, and real needs that the state government should address.

My suggestion? It's time to change Michigan's income tax. Michigan has its share of very wealthy people--just look at the millionaires' homes in the wealthy suburbs of Detroit, from the Grosse Pointes to those new 'burbs to the Northeast. But the wealthy in Michigan pay the same flat income tax rate that the middle class pays--4.35%. A family of four starts paying that on wages above the personal exemption of $13,200 (after other deductions, if any). But a family of four with a salary of $500,000 pays the same rate.

Obviously, those few dollars mean a lot to the poor family and hardly anything to the wealthy one. That's why the federal income tax has had a progressive rate structure since its inception. It's also why almost all of the states that have a broad-based income tax, have a progressive tax rate structure, generally ranging between 3 and 8 or 9% of adjusted gross income (sometimes as modified under state rules). Only seven have a flat rate structure. See this chart from the Federation of Tax Administrators for a synopsis of state rate structures and exemptions. (Note--apparently, the tables to which I linked yesterday are not accessible at the link at this time. Wikipedia has some of the same information, at this link.)

Michigan should enact a progressive rate structure. How about a zero bracket for the first $25,000 in income, and then a progressive rate structure moving from the current 4.35% on the first $100,000 above that, to 5.35% on the next $200,000, to 6.35% on the next $400,000, to 7.35% on the next $2 million, to 8.35% on anything above $2,725,000. (Look at this study, which has information on city and state tax burdens, including income, property and sales taxes, and you'll see that Detroit has very high tax burdens--because of the flight of its industrial base and the white flight to the suburbs; so most of the wealthy who work in Detroit don't live in the city and don't pay those higher taxes--they live in the surrounding suburbs that can't be annexed to the city.).

Would people move out of Michigan because of the income tax change? Sure, some in the upper brackets would. (They're already doing so, of course, because of the Great Recession, which has hit Michigan particularly hard.) But most other states already have a progressive income tax, often reaching 6% on fairly low incomes--so many of those states' effective tax rates would be much higher than Michigan's current flat rate and maybe higher than the proposed change. So those that move *because of* the tax would have to choose a state that had a lesser tax than Michigan's new one--and states with lower rates may also have a troubled economy. But a reasonable tax of less than 7% on the first $725,000 would make a difference in the ability of Michigan to help create a sustainable economic environment through expenditures for human capital infrastructure (i.e., for K-12 through university funding) and physical public infrastructure. Not to mention that it would also be much fairer, by taxing people on their ability to pay.

Is this a "pie in the sky" proposal or one that has some chance of enactment in the current political climate. A big negative factor that operates at the federal and state level is the anti-tax rhetoric on the right. Tax increases have been an incessant target of the libertarian "think tanks" that oppose most government programs for vulnerable populations and most tax increases, as a matter of faith. Tthese groups have blanketed the internet with PR pieces proselytizing for their faith. See, for example, my various critiques of the the Cato Institute's Dan Mitchell's videos for the "Center for Freedom and Prosperity": CFP's Laffer Curve Video (Feb. 18, 2008) and The Laffer Curve II--proof? (Mar. 10, 2008) and More Class Warfare from the Cato Institute's Dan Mitchell (June 17, 2009).

This anti-tax propaganda has made it politically difficult for any person in Congress to address tax increases in a deliberate, thoughtful way. Especially in the Senate, the anti-tax groups' rhetoric--about corporate taxes, capital gains taxation, and rate structures, in particular--has made it hard to have an open and in-depth discussion of alternatives. As a consequence, the tax agenda in Congress continues to be dominated, to a considerable extent, by objectives that favor those in the top distributional quintile. Take the alternative minimum tax (AMT) as one example. Congress continues to pass annual "patches" to the AMT to prevent the clawback that would otherwise result from the interaction between the lower rates of the regular tax as amended under Bush and the AMT, which was left without corresponding changes. But these "patches" are not limited to much smaller amount needed to keep whole the below-$100,000 crowd. They instead cost many tens of billions annually to keep taxes lower for those most affected in the $200,000 to $500,0000 range. (The AMT generally doesn't result in additional tax liability for the "super-rich", since they are ordinarily in the highest tax brackets so their AMT calculation is still less than their regular tax liability.) Yet the patch is urged by the anti-tax rhetoric and touted as preventing tax increases for the middle class. Those same influences are at play in the several states, making it just as difficult to enact progressive tax changes at the state and local levels.

But state legislatures are, for all that, somewhat more exposed to and perhaps even more aware of their local constituencies. The populist distaste for the amount of government money going to financial institutions (and bankers) in the bailout--and the high bonuses for bankers in banks on the public dole--has made an impression. States often have more stringent requirements about running deficits, which has the potential for forcing more decisive action, for good (setting taxes at the right amount to fund needed programs) or for worse (refusing to increase taxe, to 'starve the beast', and axing government programs of high importance). The problems are growing more visible, as California's hobbling by Proposition 13 and its inability to enact needed tax increases has put it in a state of crisis that is shutting the doors to essential state services. See Krugman, State of Paralysis, NY Times (May 24, 2009).

There is some movement in some states. As a commenter noted on the original ataxingmatter post, Wisconsin's governor proposed an added 1% on joint filers' income in excess of $300,000 ($225,000 for individual filers), bringing Wisconsin's top rate to 7.75%. (The budget also proposed dropping the exemption for capital gains, taxed at the same rate as ordinary income, from 60% to 40%.) See Wisconsin Tax Summary 2009-2011, Wisc. Estate Planning and Tax law Blog (Mar. 13, 2009). Meanwhile, Pennsylvania, which increased its personal income tax rate from 2.8% to 3.07% in 2003 in the first change since 1991, is considering at least a temporary income tax increase to 3.57% to avoid cutting state employees and Medicaid reimbursements to hospitals. See, e.g., Hamill, Proposal to Raise Income tax in Pennsylvania, NY Times (June 16, 2009) (noting proposal for a 16% increase for 3 years); Bumsted, Tax increase needed to erase state's $3.2 billion deficit: Evans, Pittsburgh Tribune-Review, June 5, 2009.

Addendum: California's Democratic leaders announced today that they intend to send a partial budget fix amounting to $23.2 billion to the governor that will include massive cuts to public education and health and human services, along with $2 billion in new taxes--$1.50 per pack on cigarettes ($1 billion annual revenue projected) and 9.9% tax on each barrel of law ($900 million projected). According to BNA Daily Tax RealTime (June 17, 6:54 pm), Senate President Pro Tempore Steinberg said that "Our biggest argument [with the Republicans] is over the $2 billion in taxes."

Posted by Linda Beale at 11:56 AM