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Idea

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Modernize state income brackets

Each Southern state with an income tax should modernize its income tax structure by adjusting brackets and should consider creating a new top rate to provide *progressive* balance.

Background

Southern states began implementing individual income taxes in the first half of the 20th century. The income tax structures were *progressive* by design. That meant an earlier generation of lawmakers created a system for higher tax rates on higher levels of income. But since that time, many of those income tax structures have not been significantly altered. While the tax structures were *progressive* for 1930s and 1940s incomes, they are now outdated and act much like a flat tax system (Figure 1). Georgia, for example, begins taxing at the top tax rate (6 percent) at just $7,000 of income for single filers and $10,000 for married households filing jointly. So in Georgia, just about everyone who pays income tax has much of their income taxed

in the top bracket. In contrast, Kentucky, which updated its rate structure for 2005, has a top tax rate of 6 percent beginning at $75,000. Prior to those changes, Kentucky's top rate started with $8,000 of income.

Income tax brackets in Southern states are so outdated that they're much like a flat tax system.

Southern states are now in a 21st century economy with 21st century incomes. It is imperative for states to modernize their tax systems for today's economy by expanding tax brackets and by possibly creating new top rates to reflect actual conditions of today's Southern residents. Making these improvements in state individual income tax systems will ensure the *progressivity* of the income tax as it originally was designed.

No tax system is perfect. But a having a *progressive* income tax is a vital part of the overall tax system because it can offset the *regressive* nature of other taxes, such as sales and property taxes, which hurt working families.

Figure 1: Individual income tax structures

Southern state	Tax structure (Singles, 2005)	
	Rate	Brackets
Alabama	2%	Less than $500
	4%	500—3,000
	5%	$3,000 and above
Arkansas	1%	Less than $3,500
	2.50%	3,500—7,000
	3.50%	7,000—10,500
	4.50%	10,500—17,500
	6%	17,500—29,200
	7%	$29,200 and above
Florida	None	

Figure 1: Individual income tax structures

Southern state	Tax structure (Singles, 2005)	
	Rate	Brackets
Georgia	1%	Less than $750
	2%	750—2,250
	3%	2,250—3,750
	4%	3,750—5,250
	5%	5,250—7,000
	6%	$7,000 and above
Kentucky	2%	Less than $3,000
	3%	3,000—4,000
	4%	4,000—5,000
	5%	5,000—8,000
	5.80%	8,000—75,000
	6%	$75,000 and above
Louisiana	2%	Less than $12,500
	4%	12,500—25,000
	6%	$25,000 and above
Mississippi	3%	Less than $5,000
	4%	5,000—10,000
	5%	$10,000 and above
North Carolina	6%	Less than $12,750
	7%	12,750—60,000
	7.75%	60,000—120,000
	8.25%	$120,000 and above
South Carolina	2.50%	Less than $2,530
	3%	2,530—5,060
	4%	5,060—7,590
	5%	7,590—10,120
	6%	10,120—12,650
	7%	$12,650 and above
Tennessee	None (6% on interest and dividend income only)	
Virginia	2%	Less than $3,000
	3%	3,000—5,000
	5%	5,000—17,000
	5.75%	$17,000 and above

Source: Tax Foundation[1]
Note: Arkansas has an additional tax rate and bracket table for low-income taxpayers.

Updating income tax brackets

States can make several reform measures to improve and update the individual income tax system. Deductions, exemptions and earned income credits can be created and expanded to establish tax floors or thresholds, which protect poor taxpayers from paying income taxes on poverty wages, as highlighted in Idea 4 and Idea 6. Updating state income tax brackets is another measure to make state tax systems more *progressive* and more relatable to the 21st century economy for all taxpayers. While creating *tax thresholds* can shield the lowest incomes, broadening brackets creates a fairer tax on all income.

Tax brackets are structured so that increments of income (or marginal amounts of income) are subject to different tax rates. For example, the first $3,500 of income in Arkansas is subject to a 1 percent tax rate. The income between $3,500 and $7,000 is taxed at a rate of 2.5 percent. As income increases, the marginal tax rate continues to increase until all income over $29,200 is taxed at a rate of 7 percent (see Figure 1).

Case study: Georgia

Broadening the brackets means that higher marginal tax rates will occur at higher levels of income. An illustration can be seen in Georgia's income tax system. Broadening the brackets, as demonstrated in Figure 2, would stretch the tax brackets to make lower increments of income subject to a lower tax rate. Under the current system, single filers are taxed at 1 percent for the first $750 of income. At $750, the tax rate increases to 2 percent, so that the income between $750 and $2,250 is taxed at 2 per-

cent. In the expanded brackets example in Figure 2, the first $2,500 of income for single filers would be taxed at 1 percent. The next $1,250 of income (i.e. income between $2,500 and $3,750) would be taxed at 3 percent.[2] Figure 3 shows the change in a single filer's income tax liability under the new brackets. With broader brackets, the single taxpayer with $20,000 of taxable income has a 5.6 percent drop in taxes.

If Georgia were to modernize its tax brackets, a family with $20,000 of taxable income would pay $57 less in state taxes every year.

The Georgia example also removes the marriage penalty that currently exists in the Georgia income tax structure. Removing this bias makes the system more neutral, and could be included among the broadening reforms.

Increasing *progressivity*

While broadening income brackets and making other bracket reforms will make the income tax more *progressive* and *neutral*, it will also cause revenues to decrease. To ensure that revenues remain at an adequate level, those states that broaden income tax brackets should also consider creating a new top tax rate. Enacting a new top tax rate can make this *progressive* tax reform revenue neutral, while again increasing the *progressivity* of the tax structure.

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Figure 2: Georgia income tax brackets, current and expanded

Current tax brackets			Expanded tax brackets		
Tax rate	Single	Married filing jointly/ HH	Tax Rate	Single	Married filing jointly/Head of Household
1.00%	$0	$0	1.00%	$0	$0
2.00%	$750	$1,000	3.00%	$2,500	$5,000
3.00%	$2,250	$3,000	4.00%	$3,750	$7,500
4.00%	$3,750	$5,000	5.85%	$7,000	$14,000
5.00%	$5,250	$7,000	7.10%	$35,000	$70,000
6.00%	$7,000	$10,000			

Source: Institute on Taxation and Economic Policy[3]
Note: The new brackets remove the marriage penalty that exists in the current Georgia tax brackets.

Figure 3: Hypothetical Georgia taxpayer

Income	Tax rate	Tax	Income	Tax rate	Tax
$0 to $750	1.00%	$7.50	$0 to $2,500	1.00%	$25.00
$750 to $2,250	2.00%	$30.00	$2,500 to $3,750	3.00%	$37.50
$2,250 to $3,750	3.00%	$45.00	$3,750 to $7,000	4.00%	$130.00
$3,750 to $5,250	4.00%	$60.00	$7,000 to $20,000	5.85%	$760.50
$5,250 to $7,000	5.00%	$87.50			
$7,000 to $20,000	6.00%	$780.00			
Total Tax:		$1,010.00	Total Tax:		$953.00

Source: Author's calculations

The example provided on the opposite page for Georgia includes a new top rate of 7.1 percent to make the bracket reforms revenue neutral. Approximately 19 percent of Georgia taxpayers would reach the new top tax rate. While this new bracket would raise taxes for a minority of Georgians, those increases might not be as high as one might think. First, the top rate (7.1 percent) occurs at $35,000 of taxable income for singles and $70,000 for married taxpayers filing jointly and head of households. Again, that is a marginal rate.

Thus, if a married taxpayer had $72,000 of taxable income, only $2,000 would be taxed at 7.1 percent (i.e. the income between $70,000 and $72,000). The difference in taxing that $2,000 at the current 6 percent rate and the new 7.1 percent rate would be $22. Another example: a married taxpayer with $100,000 of taxable income would pay about $330 more per year—less than a dollar a day—in state income taxes.

If Georgia were to add a new higher tax bracket, a family with $72,000 of taxable income would pay only $22 more in state taxes every year. A family with $100,000 of taxable income would pay only about $27 more per month in state taxes.

It's also important to note that the $35,000 and $70,000 benchmarks are taxable income—which means deductions and exemptions have been taken out of earned income. Bottom line: Single taxpayers could earn up to $41,750 before hitting the top rate. Likewise, married/head of household taxpayers could earn up to $95,000 before having taxable income of $70,000.[4]

For many higher-income taxpayers, the higher state tax liability would be somewhat offset by a decrease in federal tax liability. In other words, since state income taxes can be taken as a deduction when itemizing on federal tax returns, the increased state income tax would cause a decrease in federal taxes. And like all other taxpayers, they would receive the same benefits of broader tax brackets with income taxed at lower marginal rates until reaching the top bracket.

Creating a more progressive, modern income tax

In 2005, Kentucky reformed much of its tax system, including the individual income tax structure. The Bluegrass State updated its income tax structure by broadening brackets and expanding the low-income tax credits. Kentucky did not increase its top tax rate, but performed income tax reform in combination with reforms throughout the tax code.

> **Southern states should improve upon the steps taken by Kentucky and modernize their rates and brackets to ensure a truly *progressive* income tax structure.**

Southern states should improve upon the steps taken by Kentucky and modernize their rates and brackets to ensure a truly *progressive* income tax structure. As discussed elsewhere in this publication, the combination of state and local taxes throughout the South creates a *regressive* tax system. Sales taxes, in particular, fall more heavily on low- and moderate-income taxpayers than higher earners. Protecting and enhancing the *progressive* structure of the income tax system is vitally important to balancing

the *regressive* sales and property taxes, and thereby, lessening the overall *regressivity* of the state and local tax system. In addition, Tennessee and Florida, which do not have broad-based individual income taxes, should consider the benefits of this progressive element in the overall state tax system.

Talking points

- When lawmakers from the 1930s to 1950s implemented state income taxes, they adopted the tools as ways to generate more state revenue and to make the state's taxing structure more *progressive*. This new tool helped to balance aspects of sales and property taxes that put more of an income burden on working families.

- Through the years, the South's economy has changed, but its governments haven't changed the income tax structure to keep up with the times.

- If states want to recapture the *progressive* structural benefits provided in the early days of the income tax, they need to change the brackets to reflect modern wages. And they should consider adding a new top rate to protect revenues and make the tax system even more *progressive*.

Endnotes

[1] Tax Foundation. "State Individual Income Tax Rates." December 31, 2005. *www.taxfoundation.org/files/7ee86c80446a807117594787f17fbba5.pdf.:*

[2] Davis, Kelly. Analysis for the Georgia Budget and Policy Institute. Institute on Taxation and Economic Policy. April 2006.

[3] *Ibid.*

[4] *Ibid.*