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Idea

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Deal with hidden income tax increases

Each Southern state with an income tax should modify its tax policies to account for inflation to preserve long-term *fairness* and reduce back-door inflationary tax hikes.

Background

The federal government indexes income taxes for inflation. In other words, every year the income tax changes slightly to account for inflationary increases in the cost of living. Adjusting the income tax structure for inflation protects taxpayers from having a tax increase without having a true increase in income. Unlike the federal government, not all states account for the effects of inflation in their income tax codes. The result: a hidden tax increase. Taxpayers can get higher tax bills even though incomes have not really risen and tax rates have remained unchanged.

Consider an example of a taxpayer living in Mississippi who receives a 3 percent salary increase the same year inflation is 3 percent. The taxpayer's raise offsets this higher cost-of-living, or inflation of 3 percent. But this increase in salary really doesn't represent a real increase in income or well-being because everything costs 3 percent more. In the meantime, Mississippi does not account for inflation in its income tax structure. The taxpayer is treated as if he had a salary increase of 3 percent without regard to increased cost-of-living. In turn, the taxpayer could pay a higher income tax bill—even though neither the state's tax rates nor the livelihood of the taxpayer changed. Thus, the state could raise taxes on the taxpayer in a complex but hidden manner.

> **If states don't index their income tax for inflation, you end up with a hidden tax increase—a slightly higher tax bill even if your income doesn't change and the income tax rates don't change.**

To avoid this problem, Southern states should consider adopting a variety of strategies that will account for inflation in state tax codes. These strategies would improve the *fairness* and *transparency* of state personal income taxes. While these strategies improve the tax system in certain respects, they will cost the state money since income tax collections will not rise with inflation. Thus, these strategies should not be enacted in isolation, but rather should be part of comprehensive tax reform that balances the revenue losses.

Inflation and personal income taxes

State income tax structures create *tax thresholds*, which set a point at which residents start paying taxes. For example, Louisiana's *tax threshold* was $16,400 in 2005 for a family of four. So in Louisiana in 2005, families of four with income below $16,400 did not owe state income taxes.[1]

Standard deductions, personal exemptions and tax credits within state income tax systems create these *tax thresholds* by making a certain amount of income nontaxable. These provisions not only protect the lowest incomes from taxation and help make the income tax a progressive tool, but they also go to other taxpayers as well to exempt a certain amount of income from taxation.

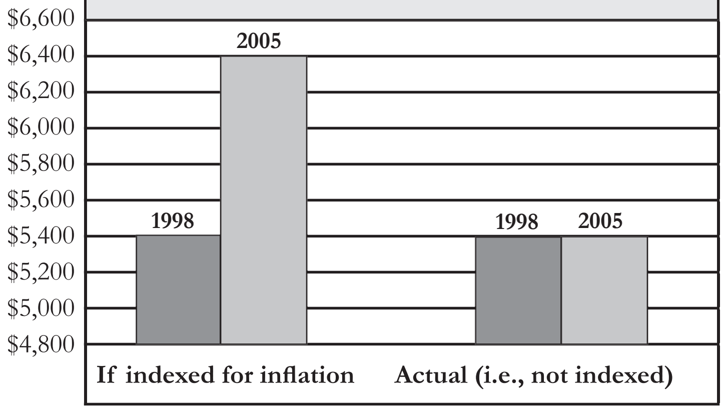
The failure to control for inflation can push people into higher tax brackets and erode the value of standard deductions, personal exemptions and tax credits over time.

Most Southern states peg deductions, exemptions, credits and tax brackets to fixed dollar amounts. The failure to control for inflation can push people into higher tax brackets and erode the value of standard deductions, personal exemptions and tax credits over time. An example of the erosion of exemptions can be found in Georgia. Since 1998, Georgia's personal exemption has been $5,400 for married joint filers. Accounting for inflation, the $5,400 exemption in 1998 should have risen to around $6,470 in 2005.[2] Since Georgia does not index for inflation, however, the exemption remained at $5,400 and taxpayers in 2005 were not receiving the same benefit from the personal exemption as they did earlier (Figure 1).

Who pays for inflationary tax increases?

Inflationary tax increases most directly impact low- and middle-income taxpayers. Unlike affluent taxpayers who

Figure 1: Georgia's personal exemption, 1998 and 2005



already pay the highest tax rate, low- and middle-income taxpayers can be forced into higher tax brackets or past the *tax threshold* as a result of inflation.[3] For example, an analysis of inflationary tax increases in Georgia found income taxes would have been $170 million lower in 2004 if Georgia had indexed features of its income tax to inflation since 1998. The bottom 40 percent of taxpayers in income bore the bulk of that tax increase, when measured as a share of income.[4]

If states don't adjust the income tax for inflation, they can force low- or middle-income earners into higher brackets, which makes them pay even more in income tax.

Allowing unintentional but hidden tax increases is even more troublesome in the South since Southern states already have some of the nation's lowest *tax thresholds* (Figure 2). In 2005, for example, eight of the nine Southern states with income taxes taxed four-person families with incomes below the federal poverty level. South Carolina was the only state not to do so. Tax liabilities ranged from $11 in Mississippi to $538 in Alabama. (It should be noted that Alabama recently raised its *tax threshold* significantly from $4,600 to $12,600.) Furthermore, the growth in the tax liability of poor Southern families over the past decade has outpaced inflation in five Southern states: Alabama, Arkansas, Louisiana, Mississippi and Virginia.[5] Because these *tax thresholds* are pegged at fixed dollar amounts, inflation steadily has left more poor families owing more and more in state income taxes.

Figure 2: Tax thresholds and tax liability for poor 4-person families, 1994-2005, Southern states

	1994		2004		2005	
State	Threshold	Tax bill at poverty ($15,141)	Threshold	Tax bill at poverty ($19,311)	Threshold	Tax bill at poverty ($19,961)
AL	$4,600	$348	$4,600	$513	$4,600	$538
AR	$10,700	$214	$15,500	$403	$15,900	$406
FL	--	--	--	--	--	--
GA	$11,100	$116	$15,900	$89	$15,900	$112
KY	$5,000	$499	$5,600	$652	$19,400	$78
LA	$11,000	$83	$15,900	$168	$16,400	$178
MS	$15,900	$0	$19,600	$0	$19,600	$11
NC	$13,000	$128	$19,400	$0	$19,400	$39
SC	$16,800	$0	$25,200	$0	$27,000	$0
TN	--	--	--	--	--	--
VA	$8,200	$217	$18,900	$425	$19,400	$389

Threshold is the level at which a family starts owing state income taxes. The tax bill shows what a family of four at the poverty level owed in state income taxes. Florida and Tennessee do not levy personal income taxes. Source: Center on Budget and Policy Priorities

Eight of nine Southern states with income taxes made families of four pay income taxes when they had incomes below the poverty line.

Consider the experience in North Carolina. During the 1990s, policymakers decided four-person families with incomes below the poverty level should not owe state income taxes. The state set a higher *tax threshold*—a higher point at which families started owing taxes—to shield these poor families from income taxes. But Tarheel State lawmakers did not adjust that threshold for inflation. As a result, inflation gradually pushed four-person families with incomes below the poverty level above the adjusted threshold, and in 2005, these families again owed state taxes.[6]

States have several policy options

States have several policy options available to address the issue of inflationary tax increases, including indexing the following income tax components (Figure 3):

Figure 3: Southern states indexing for inflation

	Tax brackets	Personal exemption	Standard deduction	Tax credits
AL				
AR	Yes			Yes
FL	No income tax			
GA				
KY				
LA				
MS				
NC				
SC	Yes	Yes	Yes	
TN	No broad-based income tax			
VA				Yes

Source: Federation of Tax Administrators

- **Tax brackets.** States can index their tax brackets for inflation so brackets are set at a slightly higher dollar amount every year (Figure 4). South Carolina, for example, links the state brackets to the federal tax code, which bases its inflation adjustment on the Bureau of Labor Statistics' Consumer Price Index. South Carolina adjusts its brackets using the federal standards, but limits the inflation adjustment to one-half of the federal adjustment and less than 4 percent annually.[7] While indexing brackets to inflation allows brackets to keep pace with the economy, it does not reverse the years of neglect when such indexing did not occur. For example, Arkansas began indexing its brackets in 1999. So from 1999 until today, the brackets have kept pace with the economy. But from 1971 (when the brackets were last reformed) to 1999, the brackets were not indexed and lost a great deal of their *progressivity*. As discussed in Idea 5, broadening brackets is the first step towards a better income tax, one which is *progressive* for today's economy rather than that of the 20th century. After broadening brackets, indexing them for inflation will keep the brackets current and modern for the years ahead.

Figure 4: Arkansas indexed income tax brackets

Tax Rate	2004 Tax Brackets	2005 Tax Brackets
1%	$0 to $3,399	$0 to $3,499
2.5%	$3,400 to $6,799	$3,500 to $6,999
3.5%	$6,800 to $10,299	$7,000 to $10,499
4.5%	$10,300 to $17,099	$10,500 to $17,499
6.0%	$17,100 to $28,499	$17,500 to $29,199
7.0%	$28,500 and over	$29,200 and over

Source: Arkansas Department of Finance & Administration

- **Personal exemptions and standard deductions.** Personal exemptions and standard deductions are the components of a tax system that create a *tax threshold*, as discussed above. Personal exemptions are provided to taxpayers and their dependents in recognition of the increased costs of having a larger family. For example, a single mother with two children may take three exemptions, one for herself and one for each of her dependents. The standard deduction is available to taxpayers who do not itemize deductions on their federal income taxes and provides a varying amount for single filers, married filing jointly, and head of household. The federal government began indexing both personal exemptions and standard deductions for inflation in the Tax Reform Act of 1986.[8] Numerous states across the nation have also indexed these features to ensure the *tax threshold* increases annually with the cost-of-living. South Carolina, for example, offers an indexed deduction for taxpayers with children under age 6 equal to the federal personal exemption, if the state has enough revenues to allow this revenue loss. Since the South Carolina deduction links to the federal exemption (which indexes for inflation), the deduction is automatically indexed for inflation.

- **Tax credits.** Tax credits can assist taxpayers with certain activities, such as child care, or can work with personal exemptions and standard deductions to create a higher *tax threshold*. Tax credits are a final component of state income tax systems that can be indexed to inflation. Arkansas, for example, has a small personal tax credit for elderly or disabled taxpayers that is indexed annually, but only if the budget allows. The tax credit increased from $20 in 2004 to $21 in 2005.[9] Another example is the state Earned Income Tax Credit, which is outlined in detail in Idea 4. Nineteen states and the District of Columbia offer a state-level Earned Income Tax Credit (EITC) based on the refundable federal tax credit for working-poor families. Since the federal

EITC is indexed to inflation, states that piggyback on the federal EITC will also adjust for inflation. Thus, the credit will increase every year to shield low-income working families from tax increases. In tax year 2006, Virginia will become the first Southern state to offer a state-level EITC.

By automatically increasing the value of these tax features, policymakers can avoid situations like North Carolina's where inflationary increases reversed an intentional policy decision to end the tax liability of poor families. Such a strategy not only would make states tax systems fairer, but it also would make the system more *transparent* since hidden tax increases would be removed.

Indexing the income tax to inflation can make state tax systems fairer and more transparent because it would remove hidden tax increases.

While all of these strategies could improve the *fairness* and *transparency* of state tax systems, they come at a cost to states. Indexing for inflation will restrict the current hidden, inflationary tax increases that currently provide states with increased income tax collections. In addition, linking to the federal tax code puts state revenues at risk since changes at the federal level will ripple through the state tax system and affect revenues.

But the policy intention of shielding taxpayers from inflationary tax increases is valuable. It is, however, critical for state leaders to protect the *adequacy* of funds by offsetting the revenue declines caused by these approaches. As discussed in Idea 5, adding a new top income tax rate is one way to offset the revenues lost due to inflationary reforms. There are other reform options available, such as expanding the sales tax base to include services (Idea 2) that also would offset the lost income tax revenues through increases in other revenue streams. Adjusting for inflation within the tax code should be part of comprehensive tax reform, which will protect and enhance the *adequacy* of funds while maintaining the gains in *fairness* achieved through these inflationary improvements.

Case study: Alabama makes strides, but misses out on inflation solution

Alabama's legislature and governor passed significant income tax reform in 2006 by moving the *tax threshold* from $4,600 to $12,600 for a family of four.[10] These gains, which will begin in 2007, provide the largest tax breaks to those with the lowest incomes and make Alabama's income tax more *progressive*. While the improvements in Alabama are considerable, the final legislation did not include indexing deductions and exemptions for inflation. The original legislation (HB 292) linked state personal exemptions and standard deductions to the federal amounts. This provision would have annually increased those exemptions and deductions, and thus the threshold, but was removed prior to final passage. Without the link to the federal code, and thus to inflation-adjustment, Alabama will face the same problems encountered in North Carolina and will have to continually update its *tax threshold* in future years if it wishes to shield poor residents from income taxes.

Deal with inflationary increases by indexing income taxes

By failing to account for inflation in income tax codes, many Southern states have allowed hidden, inflationary tax increases to occur. Individuals whose incomes have not grown apart from cost-of-living adjustments often find themselves paying higher tax bills—even though their incomes really have not changed and tax rates have remained steady. There are, however, compelling and pragmatic measures for states to address this problem and improve the *fairness* and *transparency* of state income tax systems. Indexing components such as brackets, personal exemptions, standard deductions and tax credits for inflation will allow states to maintain their *tax thresholds* and automatically shield those with the lowest-incomes from unintended tax hikes. It's important for lawmakers to recognize that these improvements should be part of comprehensive tax modernization and reform to ensure the *adequacy* of revenues.

Talking points

- When the cost of living rises due to inflation, the federal government automatically adjusts the income tax to take rising prices into account so people don't face annual hidden tax increases.
- South Carolina, Arkansas and Virginia are the only Southern states to adjust parts of their income tax for inflation. In other states, taxpayers who get cost-of-living salary increases that allow them to keep up

with higher prices are penalized because their home states do not index for inflation. This is a hidden tax increase.

- States across the South can take proactive steps to halt hidden income tax increases every year by indexing their state income tax for inflation.

- Indexing the income tax for inflation is just plain common sense because it keeps the level of income taxation about the same, instead of the slow, silent rise that otherwise occurs.

- States shouldn't have tax structures that take advantage of cycles of inflation just to generate more revenue. State leaders need to be forthright with people about tax structures so taxpayers will have more confidence in the system.

Endnotes

[1] Jason Levitis and Nicholas Johnson, "The Impact of State Income Taxes on Low-Income Families in 2005." Washington, DC: Center on Budget and Policy Priorities, February 2006.
[2] Calculation using the Bureau of Labor Statistics' Inflation Calculator.
[3] Institute for Taxation and Economic Policy, "Indexing Income Taxes for Inflation: Why It Matters," Policy Brief, 2005.
[4] *Ibid.*
[5] Levitis and Johnson (2005)
[6] *Ibid.*
[7] South Carolina Legislature. "South Carolina Code of Laws: Section 12-6-520." Current through the end of the 2005 Regular Session.
[8] Cordes, Joseph J. "Personal exemption, federal." *The Encyclopedia of Taxation and Tax Policy.* Second Edition. Ed. Joseph J. Cordes et. al. Washington D.C.: The Urban Institute Press. 2005. p. 297.

[9] Arkansas Department of Finance and Administration. "Instructions for AR1000 and AR1000NR—Long Form." 2005. *www.ark.org/dfa/income_tax/documents/AR1000_Instr_2005.pdf*.
[10] Carnes, Jim. "House Passes Tax Fairness Bill." *Alabama Arise* Vol. 19 No. 1. March 16, 2006.