TAX FOUNDATION
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FISCAL FACT
Apr. 2014
No. 426

Response to CBPP: Flat Income Taxes Don't Endanger Public Finances or Create Inequality

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A recent blog post by the Center on Budget and Policy Priorities (CBPP) suggests that adopting a constitutional amendment to allow a progressive tax in Illinois would benefit the state due to the state's high and rising inequality and its chronic budget problems.[1] While CBPP is correct that a state's tax structure can have a powerful effect on quality of life and business activity, the economic evidence shows that low, neutral taxes on consumption typically have the least damaging impact on the economy, while high, progressive income and corporate taxes damage economic growth the most.[2]

But CBPP's argument is somewhat different. They assert that higher income taxes *don't* harm growth (even claiming that Minnesota's recent income tax increase is part of a "recipe for future growth"[3]) while simultaneously suggesting that taxes perhaps *do* affect inequality. CBPP points to the faster growth of high incomes in Illinois since the state adopted its current flat income tax in 1969-1970, as well as Illinois' continuing inability to pay its bills, as evidence that not having a progressive income tax has been a fiscal and economic failure.

MYTH: States with progressive income taxes have lower inequality.

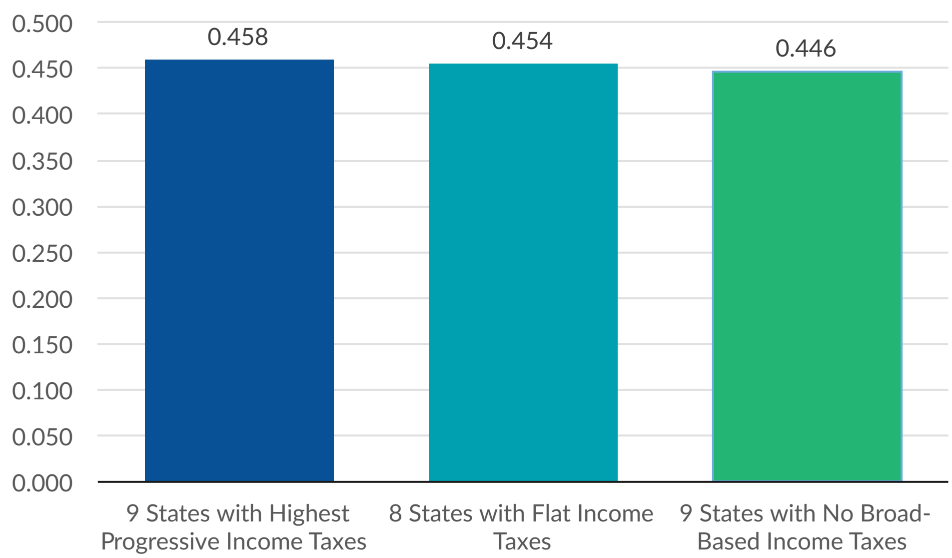
FACT: Inequality varies little between states, and states with highly progressive income taxes are actually associated with higher inequality.

The facts do not substantiate CBPP's implications. If tax structure had a major impact on inequality, it should show up in state inequality data. But if we compare the average Gini coefficient (a common measure of income inequality; a higher value means more inequality) among states with different tax codes, differences in inequality are quite small, certainly smaller than differences in income and employment (see Figure 1). What difference does exist suggests

1 Nicholas Johnson, *In Illinois, a Chance to Fix a Constitutional Flaw*, Center on Budget and Policy Priorities Off the Charts Blog, Apr. 23, 2014, http://www.offthechartsblog.org/in-illinois-a-chance-to-fix-a-constitutional-flaw/.
2 *See, e.g.*, William McBride, *What is the Evidence on Taxes and Growth?*, Tax Foundation Special Report No. 207 (Dec. 18, 2012), http://taxfoundation.org/article/what-evidence-taxes-and-growth.
3 Michael Leachman, *Minnesota's Tax Plan a Recipe for Future Growth*, Center on Budget and Policy Priorities Off the Charts Blog, May 21, 2013, http://www.offthechartsblog.org/minnesotas-tax-plan-a-recipe-for-future-growth/.

Figure 1. Income Inequality by State Income Tax Structure

by Average State Gini Coefficient



Source: U.S. Census Bureau American Community Survey, Tax Foundation calculations

that highly progressive income taxes are associated with *higher* inequality, while states with no income taxes have *lower* inequality.

However, this correlation does not imply causation. It may just be that states with lower inequality simply have less motive to pursue progressive income taxes. But the lack of any meaningful association between income tax structure and inequality suggests that the tax code is not a good instrument for promoting society-wide equality. While reducing inequality may be a worthwhile policy goal, the purpose of the tax code should be to raise revenue with the minimum amount of economic harm.

Before Illinois residents assume that a graduated income tax will meaningfully reduce inequality, they should look at the experience of other states and recognize that, broadly speaking, there is not yet a compelling body of evidence demonstrating that progressive income taxes will actually reduce structural inequalities. Implementing a progressive income tax may just trade a more distortionary and economically damaging tax code for no significant change in inequality in the long run.[4]

4 A distinction must be made between changes in inequality versus direct redistribution. It is true that given a certain distribution of income and level of inequality, progressive taxation or spending can redistribute income and lead to lower inequality. Previous Tax Foundation research as quantified the amount of redistribution in the tax code, finding it to be quite significant. *See* Gerald Prante, *The Distribution of Tax and Spending Policies in the United States*, Tax Foundation Special Report No. 211 (Nov. 8, 2013), http://taxfoundation.org/article/distribution-tax-and-spending-policies-united-states. However, this Fiscal Fact focuses on pre-tax inequality. While a given fiscal policy may reduce or increase inequality in one time period, there is not yet clear evidence on what fiscal policies will lead to reductions or increases in inequality of market income going forward. Put differently, there is evidence demonstrating the degree to which fiscal policy (whether progressive or regressive) can mitigate or exacerbate inequality in a given year; there is no clear evidence on what effect a given fiscal policy has on inequality in subsequent years.

MYTH: Flat taxes limit a state's ability to cover costs.

FACT: Most flat tax states have excellent government finances, suggesting Illinois's problems have more to do with bad financial management.

The CBPP report claims that Illinois' flat tax is a major source of its financial and budgetary woes because "limited revenue options" means "Illinois for many years did not raise enough tax dollars to cover its costs."

The flat tax is not the cause of Illinois's imbalance between spending and revenue. Flat-tax states like Utah, North Carolina, and especially Indiana[5] have all managed to pay their bills and retain AAA credit ratings, while highly-progressive California had fiscal woes similar to Illinois and currently has a barely better credit rating. Even Michigan, which has suffered serious negative economic shocks due to a struggling auto industry, Detroit's ongoing bankruptcy, and significant out-migration has managed to keep a better credit rating than Illinois while maintaining a flat tax. Meanwhile, virtually every state with no income tax has a mid-grade or better credit rating, such that the average credit rating of no-income-tax states is almost a whole notch higher than the average rating for the states with the highest, most progressive income taxes.[6]

Admittedly, this is not evidence that having a flat tax causes a *better* credit rating; instead, it simply shows that CBPP's diagnosis is simplistic and wrong. Ultimately, state financial health depends not only on tax rates but tax structures (volatile taxes like progressive income taxes encourage overspending in good economic times, causing a deficit during economic contractions), spending policy, division of responsibilities with the federal and local governments, and financial management. Illinois' state and local tax collections are actually at or above national averages by most measures. With such revenue levels, the source of Illinois' fiscal woes is likely more to do with overspending and bad financial management than insufficient revenue.

Conclusion

Concerns about inequality are an important part of public policy debates. But condemning simple, flat taxes as contributing to inequality (when they are, by definition, flat) is factually unsupported. Further, there is no evidence that more progressive taxes are inherently better for state finances. In fact, the evidence suggests that high, non-neutral taxes can hurt economic growth, leading to worse outcomes for the whole state regardless of where on the distribution tables a person's income happens to fall.

5 Lyman Stone, *Should Nebraska Follow the Example of Illinois or Indiana?*, Tax Foundation Tax Policy Blog, Jan. 10, 2014, http://taxfoundation.org/blog/should-nebraska-follow-example-illinois-or-indiana.
6 Liz Malm & Richard Borean, *Monday Map: State Credit Ratings*, Tax Foundation Tax Policy Blog, Nov. 11, 2013, http://taxfoundation.org/blog/monday-map-state-credit-ratings-0.

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