TAX FOUNDATION Since 1937

Fiscal Fact

June 14, 2012
No. 312

Trend #2: Income Tax Reform

Top 10 State Tax Trends in Recession and Recovery, 2008 to 2012

By
Joseph Henchman

Most economists agree that tax systems should have broad bases and low rates: if targeted deductions, credits, and exclusions are avoided, substantial revenue can be raised with low tax rates. Such tax systems reduce political distortions of economic decision-making and promote overall economic growth.

Unfortunately, many state tax systems are precisely the opposite: high tax rates on a relatively narrow tax base. California, for instance, reported in 2008 that its various "tax expenditures"—credits, deductions, and exclusions—reduce individual income tax collections by approximately $36 billion, or 39 percent.[i] Put another way, only 61 percent of income earned in California is subject to the individual income tax. California's high tax rates, it could be argued, are higher than they would need to be if the tax base was broader.

Although "tax reform" can mean different things to different people, the term generally refers to tax changes that broaden the base and lower the rate. Revenue impacts can vary by proposal, but tax reforms can be accomplished with revenue increases, revenue reductions, as well as by staying "revenue-neutral." In 2006, for example, **Utah** under Gov. Jon Huntsman (R) enacted a tax reform replacing its complicated income tax system with a flat 5 percent rate and eliminating many deductions. (Huntsman's efforts to similarly reform the sales tax, however, came to naught.)

The key income tax reform accomplishment during the recent recession occurred in **Rhode Island**, which for many years had a 5-bracket income tax with a top rate of 9.9 percent. Beginning in 2006, an optional flat tax was introduced to parallel the regular income tax, and continued bipartisan pressure to do something about Rhode Island's poor economic performance and tax system complexity led to further reform in 2010, that took effect on January 1, 2011.[ii] Elements of the reform:

- Eliminates the optional flat tax system and the alternative minimum tax.
- Reduces the number of tax credits.
- Increases the standard deduction for most taxpayers.
- Eliminates the option to itemize deductions.
- Reduces the number of brackets from 5 to 3, and reduces the top tax rate from 9.9% to 5.99%.

Overall, the reform was designed to be revenue-neutral and actually increase progressivity, while dramatically reducing compliance costs and barriers to economic growth. While Rhode Island still has problematic property and corporate income taxes, and although the income tax changes are still new, their tax reform will greatly boost the state's competitive position. That an overwhelmingly Democratic legislature and the Republican governor came together to enact it shows that tax reform is a possibility in any state.

Rhode Island's positive changes were unfortunately an outlier. Other states that made income tax changes either did so to adopt "millionaires' taxes" on high-income earners, or adopted rate increases or decreases without base changes. Illinois, for instance, boosted its tax rate by 67 percent (from 3% to 5%) in 2011 and actually expanded the tax preferences in its tax code. (Revenue estimates have since fallen far short of expectations.)

Although Utah and Rhode Island are the only recent success stories, proposals are increasingly popping up across the country. A **Maine** tax reform proposal, which unfortunately incorporated a "millionaires'" tax and new tourism taxes, passed the Legislature but was repealed by the voters in 2010, interestingly on the same day that Rhode Island's was signed into law.[iii] A **Georgia** income tax reform proposal in 2011 fell due to controversial components in its related sales tax reform.[iv] Also in 2011, an **Arizona** proposal died in the state Senate after passing the House.[v] This year, governors in **Kansas** and **South Carolina** have proposed reforms, with the Kansas effort resulting in a reduction in tax rates.[vi]

Table: State Income Tax Rate Changes, 2007-2012

States Increasing Income Tax Rates	States Reducing Income Tax Rates	Other
California Connecticut Delaware Hawaii Illinois Maryland New Jersey New York North Carolina Oregon Wisconsin District of Columbia	Maine New Mexico New York North Dakota Ohio Oklahoma Rhode Island Utah Vermont	**Maine** (tax reform repealed at ballot) **Washington** (failed tax increase initiative)

Source: Tax Foundation.
Note: States may appear in multiple columns. Expiration of temporary tax increases are not counted as tax reductions.

National Press Building
529 14th Street, N.W., Suite 420
Washington, DC 20045
202.464.6200
www.TaxFoundation.org

About the Tax Foundation
The Tax Foundation is a 501(c)(3) non-partisan, non-profit research institution founded in 1937 to educate the public on tax policy.

---

[i] California Department of Finance, *Tax Expenditure Report 2008-09*, http://www.dof.ca.gov/research/documents/Tax_Expenditure_Rpt_08-09-w.pdf.

[ii] *See* Ryan Forster, *Rhode Island Approves Tax Reform Package*, TAX FOUNDATION TAX POLICY BLOG (Jun. 9, 2010), http://www.taxfoundation.org/blog/show/26410.html.

[iii] *See* William Ahern, *Income Tax Reform Repealed by Referendum in Maine*, TAX FOUNDATION TAX POLICY BLOG (Jun. 9, 2010), http://www.taxfoundation.org/blog/show/26408.html.

[iv] *See* Joseph Henchman, *Georgia Legislators Considering Changes to Income and Sales Taxes*, TAX FOUNDATION TAX POLICY BLOG (Mar. 29, 2011), http://www.taxfoundation.org/blog/show/27162.html.

[v] *See* Joseph Henchman, *Arizona Weighs Income Tax Reform*, TAX FOUNDATION TAX POLICY BLOG (Mar. 21, 2011), http://www.taxfoundation.org/publications/show/27136.html.

[vi] *See* Joseph Henchman, *Kansas Governor Proposes Significant Income Tax Reform, Reducing Rate From 6.45% to 4.9%*, TAX FOUNDATION TAX POLICY BLOG (Jan. 19, 2012), http://www.taxfoundation.org/blog/show/27905.html;
Joseph Henchman, *South Carolina Governor Calls for Reducing Individual and Corporate Taxes*, TAX FOUNDATION TAX POLICY BLOG (Jan. 26, 2012), http://www.taxfoundation.org/blog/show/27926.html.