INDIANA FISCAL POLICY INSTITUTE
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Income Taxation in Indiana

Concepts and Issues

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Overview

Indiana is one of seven states that levy flat-rate income taxes. Of the 41 states that levy broad-based income taxes, 34 use graduated rates. In addition, the federal income tax, which provides approximately 80 percent of the total individual income tax revenue, is levied on rates ranging from 10 percent to 35 percent.

Graduated state income taxes vary widely in their degree of progressivity. A few states have adjusted their brackets in order to account for rising incomes, but many have not done so or have not done so recently, substantially reducing the progressivity of the taxes. The recent economic crisis has led several states to add brackets at the top of the income range in order to place higher rates on those with higher incomes.

Individual income taxation in Indiana consists of the state adjusted gross income tax, levied at a rate of 3.4 percent and an array of county income taxes levied at varying rates in 91 of Indiana's 92 counties. Revenue from the state tax has shown very slow growth over the last decade and is forecast to decline by 12.5 percent in the current fiscal year.

Although a sizeable majority of states use graduated income taxes, such taxes raise several issues concerning fairness of the tax system, effect on investment, problems in maintaining a rate structure, and volatility of the tax, especially as levied on capital gains.

Individual Income Taxation: General

By far the largest source of governmental revenue in the United States is the individual income tax. It is levied at every level of government—state, local and, most notably, federal. In 2007, the most recent year for which comparable data are available, total revenues for all levels of government from the taxation of individual income amounted to $1.45 trillion, not including taxes for Social Security and Medicare.

Income Tax Base

The great bulk of individual income taxation in the United States is derived from the base of the federal income tax, federal adjusted gross income (AGI), which consists of wages, interest, dividends, capital gains/losses, etc., less various adjustments (IRA contributions, alimony, etc.) The AGI is calculated before various deductions (standard or itemized), exemptions, and credits are applied.

Of the 41 states that levy broad-based personal income taxes, 35 levy those taxes on federal AGI.

Income Taxes: Progressive, Proportional, and Regressive

The rates of personal income taxes may be progressive, proportional, or regressive. In *progressive* taxation, the rate of taxation increases, or progresses, as taxable income increases. In *proportional* taxation, the rate remains the same ("flat rate"), and in *regressive* taxation the proportion of income taxed declines as income rises. A progressive tax can be achieved in two ways: 1) graduation of rates, or 2) the use of exemptions, deductions, and credits.

Graduated Rates. In a tax with graduated rates, taxpayer income is divided into brackets, which segment taxable income by amount, and gradually increasing rates are applied to the brackets as the taxable income increases. An important distinction exists between *marginal* rates and the *average* rate of a tax. If a taxpayer's income moves from a lower bracket to a higher one, only the additional income is subject to the higher, or marginal, rate, so it does not "cost" a taxpayer to move upward in income. The average rate applied to the taxpayer's entire taxable income will rise, but will not be as high as the marginal rate.

Exemptions, Deductions, and Credits. In a flat rate tax, progressivity can be achieved through the use of exemptions, deductions, and credits. Personal exemptions and earned income tax credits are commonly used to insulate a portion of a taxpayer's income from taxation. As income rises and more and more income is subject to taxation, the average rate will rise, even though the tax rate is flat. Credits may be *refundable*, which means that, if the taxpayer's tax liability is less than the value of the credit, the taxpayer will receive a refund in the amount of the difference between the credit and the tax liability.

Exemption, deductions, and credits can also be, and are, used in concert with graduated rates to further amplify the progressivity of a tax.

Prevalence of Graduated Income Taxation

Because the federal income tax is graduated, about 96 percent of income tax collections in the United States are based on graduated rates. (The federal income tax in 2007 made up $1.16 trillion of the $1.45 trillion in total income tax collections.) In addition, most states that levy broad-based income taxes use graduated rates, with about 78 percent of total state-local income tax collections based on graduated rates.

Federal Income Tax. Because federal income tax collections are so large and because state income tax bases are heavily related to federal AGI, no discussion of state and local taxation is complete without reference to the federal tax. Federal individual income tax rates are changed frequently and are scheduled to change in the future. For tax year 2009, the rates for selected taxpayers are as follows:

TAXABLE INCOME **TAX RATE**

Single	Married, Filing Jointly	Tax Rate
0 – 8,350	0 – 16,700	10%
8,350 – 33,950	16,700 – 67,900	15%
33,950 – 82,250	67,900 – 137,050	25%
82,250 – 171,550	137,050 – 208,850	28%
171,550 – 372,950	208,850 – 372,950	33%
372,950 and above	372,950 and above	35%

Thus, 80 percent of individual income tax liability in the United States is determined by schedules more or less like those above. While the federal income tax has not pre-empted the states from levying income taxes, it has definitely limited the latitude of states to do so and provided an incentive to accommodate state income taxes to the federal tax.

State Income Taxes. The personal income tax is employed by 43 states, although New Hampshire and Tennessee tax only dividends and interest. Of the 41 states that have broad-based income taxes, 34 employ graduated rates.

To say that a state income tax is graduated, however, may mean markedly different things from state to state. Three states (North Dakota, Rhode Island, and Vermont) peg their brackets to the federal income tax and have the same degree of progressivity as the federal tax, albeit with substantially lower rates. Ohio recently amended its income tax laws to provide for a reasonably smooth graduation of rates based on nine brackets ranging from 0-$5,000 to $200,000 and above. Similarly, Arizona has a fairly smooth graduation of rates.

The situation in other states often reflects an unwillingness to change brackets over time to take account of inflation. Georgia, for example, has brackets ranging from 0-$750 (1%) to $7,000 and above (6%) (single taxpayer rates). Although this, at one time, may have represented a fair degree of progressivity, rising incomes have transformed the Georgia individual income tax into what is essentially a flat rate tax. The bracket structures in many other states exhibit the same attribute to one degree or another.

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STATE INDIVIDUAL INCOME TAX RATES AS OF JULY 1, 2009

State	No. of brackets	Rates (single)	Top bracket start	Federal Deductibility
Alabama	3	2-5	$3,000	Yes
Alaska		No tax		
Arizona	5	2.59-4.54	$150,000	No
Arkansas	6	1-7	$31,700	No
California	7	1.25-10.55	$1,000,000	No
Colorado	1	4.63% of fed. taxable income		No
Connecticut	3	3-6.5	$500,000	No
Delaware	6	2.2-6.95	$60,000	No
Florida		No tax		
Georgia	6	1-6	$7,000	No
Hawaii	12	1.4-11	$200,000	No
Idaho	8	1.6-7.8	$25,441	No
Illinois	1	3		No
Indiana	1	3.4		No
Iowa	9	0.36-8.98	$63,315	Yes
Kansas	3	3.5-6.45	$30,000	No
Kentucky	6	2-6	$75,000	No
Louisiana	3	2-6	$50,000	Yes
Maine	4	2-8.5	$20,150	No
Maryland	8	2-6.25	$1,000,000	No
Massachusetts	1	5.3		No
Michigan	1	4.35		No
Minnesota	3	5.35-7.85	$74,650	No
Mississippi	3	3-5	$10,000	No
Missouri	10	1.5-6	$9,000	Yes
Montana	7	1-6.9	$15,600	Yes
Nebraska	4	2.56-6.84	$27,000	No
Nevada		No tax		
New Hampshire		Tax only on dividends and interest		
New Jersey	7	1.4-10.25	$500,000	No
New Mexico	4	1.7-4.9	$16,000	No
New York	7	4-8.97	$500,000	No
North Carolina	3	6-7.75	$60,000	No
North Dakota	5	1.84-4.86	$372,950	No
Ohio	9	0.587-5.925	$200,000	No
Oklahoma	7	0.5-5.5	$8,700	No
Oregon	5	5-11	$250,000	Yes
Pennsylvania	1	3.07		No
Rhode Island	5	$372,950	3.75-9.9	No
South Carolina	6	3-7	$13,350	No
South Dakota		No tax		
Tennessee		Tax only on dividends and interest		
Texas		No tax		
Utah	1	5		No
Vermont	5	3.55-9.4	$372,950	No
Virginia	4	2-5.75	$17,000	No
Washington		No tax		
West Virginia	5	3-6.5	$60,000	No
Wisconsin	5	4.6-7.75	$225,000	No
Wyoming		No tax		
D. C.	3	4-8.5	$40,000	No

Unless otherwise noted, base is Federal AGI - Local taxes not included - Source: Tax Foundation, Inc.

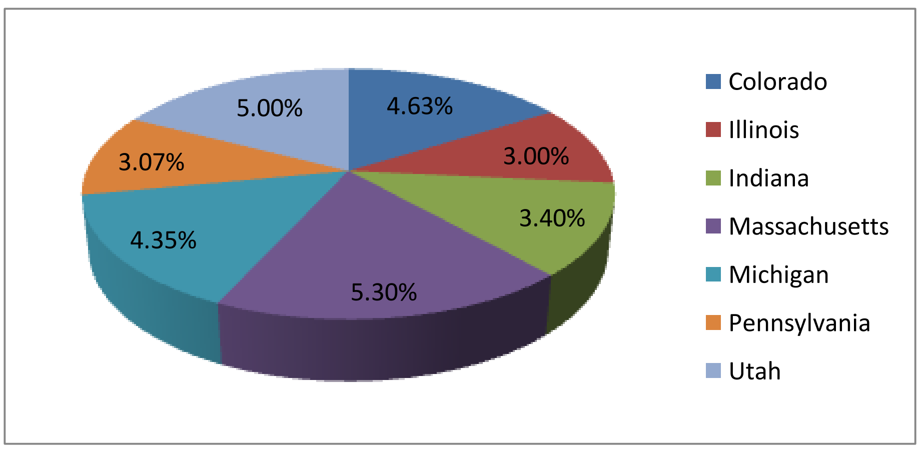
The recent economic stress and its impact on state revenues has led a number of states to amend their income taxes not by adjusting existing brackets and rates, but by tacking on additional brackets to impose higher rates on those with very high incomes. For example, New York increased its brackets from five to seven, as follows (single taxpayer rates):

0-$8,000	4%
$8,000-$11,000	4.5%
$11,000-$13,000	5.25%
$13,000-$20,000	5.9%
$20,000-$200,000	6.85%
$200,000-$500,000	7.85%
$500,000 and above	8.97%

(The last two brackets were added in 2009 retroactive to Jan. 1, 2009, and are scheduled to be in effect for three years.)

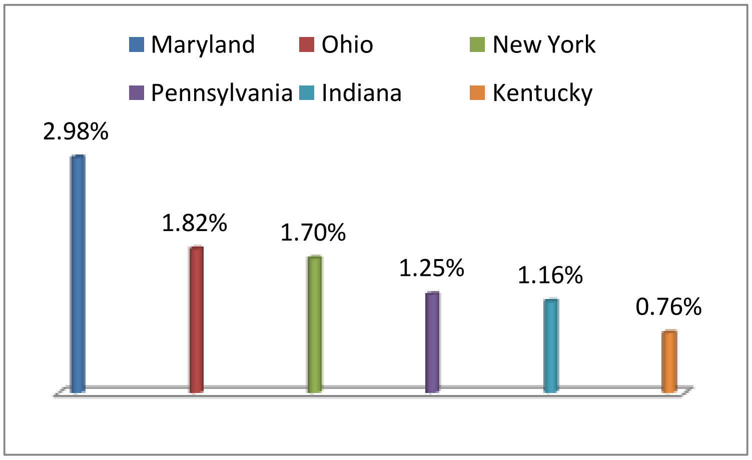
Several other states (for example, California, Delaware, Hawaii, Maryland, New Jersey, Oregon, and Wisconsin) have made similar additions to their rate structures in the last year.

Seven states use flat rate income taxes:



<u>Local Income Taxes</u>. Relatively few states permit significant local income taxation. Five states (Indiana, Maryland, Michigan, Ohio, and Pennsylvania) allow local income taxes in most of the state or all of it, while another five (Alabama, Delaware, Missouri, New York, and Oregon) limit local income taxation to specific large local jurisdictions.

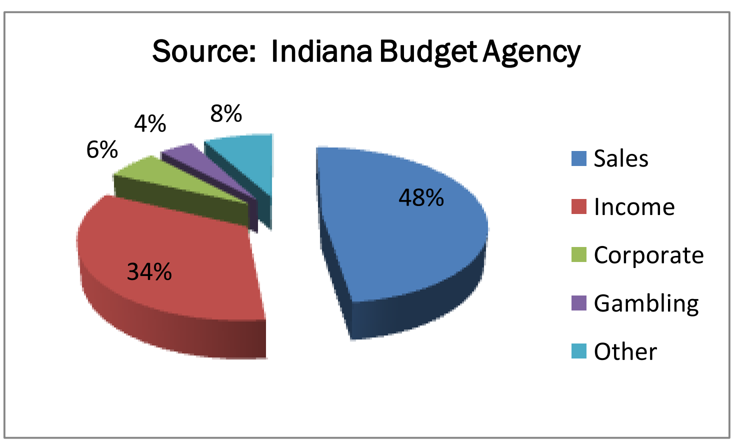
Local income taxes are typically flat rate and levied on the state income tax base. No state that does not levy a state income tax permits its local units to levy an income tax. Although local income taxes do not normally loom large in the finances of the states that permit them, in some states, including Indiana, they increase overall income taxation by significant amounts. According to the Tax Foundation, the "average rate for all counties and cities, weighted by total personal income within each jurisdiction," is as follows (for the highest states):



Personal Income Taxation in Indiana

Indiana Adjusted Gross Income Tax

The individual adjusted gross income tax is the second largest source of state revenue in Indiana. In Fiscal Year 2009, revenues from this source totaled $4,313.8 million or 31 percent of total state tax revenues.



Base. The base of the Indiana individual income tax is, except for trusts and estates, federal adjusted gross income with several modifications. It is not the purpose of this paper to describe the base of the tax, except to note certain deductions, exemptions, and credits that contribute to progressivity. Deductions include Social Security benefits, rent on principal residence, and Unemployment Compensation. Personal exemptions are allowed ($1,000 per Federal exemption, $1,500 per dependent child, $1,000 elderly or blind, and $500 low income and elderly), although they are not large compared to those in other states or to the exemptions in the federal income tax. Indiana also has an earned income tax credit, which is equal to 9 percent of the federal EITC. The federal EITC can range between $3,043 and $5,657, depending on the number of children.

Rate. The rate of the Indiana individual income tax is 3.4 percent.

Revenue. Revenue from the Indiana individual income tax, which is all deposited in the General Fund, has been growing slowly over the last decade. It has also shown significant volatility, for example, FY03-05 and FY08-11:

Fiscal Year	Revenue (millions)	Pct. Increase (decrease)
1999-2000	$3,753.30	
2000-01	3,779.80	0.7
2001-02	3,540.80	(6.3)
2002-03	3,644.20	2.9
2003-04	3,807.90	4.5
2004-05	4,213.20	10.6
2005-06	4,381.50	4.0
2006-07	4,615.60	5.3
2007-08	4,837.50	4.8
2008-09	4,313.80	(10.8)
	Average Percent Increase	*1.7%*
Source: Indiana Legislative Services Agency, Office of Fiscal and Management Analysis		

Forecast revenues for the current biennium are dismal:

Fiscal Year	Revenue (millions)	Pct. Increase (decrease)
2009-2010	$3,775.70	(12.5)
2010-2011	4,120.50	0.7
Source: Indiana State Budget Agency		

If these forecasts turn out to be accurate, the average annual increase since FY00 would fall to an even lower 1.1 percent.

Local Income Taxes in Indiana

Indiana has a mosaic of local option income taxes and, while local income taxation as practiced in Indiana raises a large number of issues related to administration and revenue disposition, it is sufficient for this analysis to outline the tax options and their rates.

All Indiana counties, except Lake, levy one or more of three basic local option income taxes and three subsidiary taxes, the revenues of which are collected by the state and distributed to the counties. The "certified distribution" of local option income taxes for FY10 totals $1,595 million, or about 42 percent of the depressed revenues of the state income tax for FY10. The taxes are levied on the state income tax base.

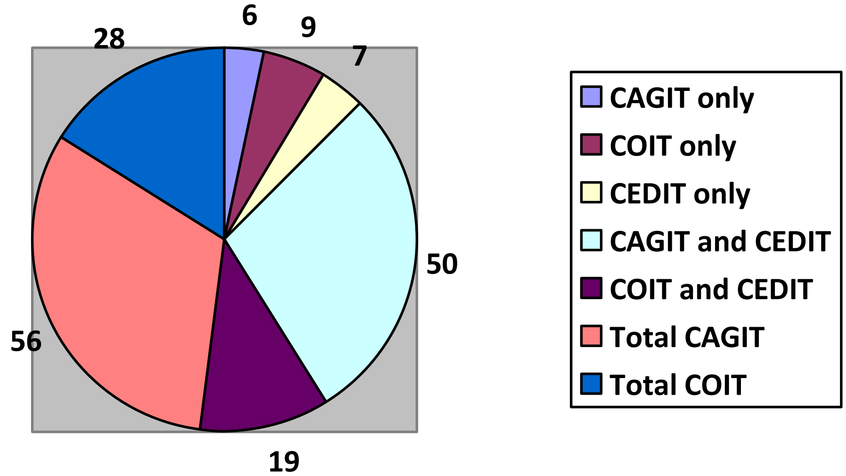
The three basic taxes are 1) County Adjusted Gross Adjusted Income Tax ("CAGIT"); 2) County Option Income Tax ("COIT"); and 3) County Economic Development Income Tax ("CEDIT"), distinguished primarily by the local units and purposes to which their revenues may be directed. CAGIT and COIT have additional tax provisions for property tax control and public safety. CEDIT has an additional provision for homestead tax credit.

CAGIT. The County Adjusted Gross Income Tax, distributed to all local units, may be levied at rates of 0.5, 0.75, or 1.0 percent. In addition, rates of 1) up to 1 percent may be levied to freeze non-school operating property taxes; 2) up to 1 percent to reduce existing property taxes; and 3) up to 0.25 percent for public safety.

COIT. The County Option Income Tax, distributed to all non-school units, may be levied at rates ranging from an initial rate of 0.2 percent to 1.0 percent. In addition, rates of 1) up to 1 percent may be levied to freeze non-school operating property taxes; 2) up to 1 percent to reduce existing property taxes; and 3) up to 0.25 percent for public safety.

CEDIT. The County Economic Development Income Tax, distributed to counties, cities, and towns, may be levied at the following rates: 0.1, 0.2, 0.25, 0.3, 0.35, 0.4, 0.45, or 0.5 percent. In addition, up to 0.25 percent may be levied to mitigate the effects on homeowners of the elimination of the property tax on inventories by funding a local homestead credit.

Combined Rates. Counties may adopt either CAGIT or COIT, but not both. CEDIT may be adopted in addition to either CAGIT or COIT. For 2010, county option income taxes are levied as follows (number of counties):



For CAGIT counties, 17 have adopted one or more of the added rates, while in COIT counties 7 have done so.

The rates available can be significant. The maximum total rate in CAGIT counties is 3.75 percent; in COIT counties, 3.5 percent; and in CEDIT-only counties, 0.75 percent. It is therefore possible for the county rate to exceed the state rate, and while this is not the case in any county, a few have come close. Rates above 2.5 percent occur in Pulaski (3.13), Jasper (3.05), Wabash (2.82), Morgan (2.72), and Miami (2.54) counties.

In combination with the state rate, the rate of income taxation in CAGIT counties could be as high as 7.15 percent and as high as 6.9 percent in COIT counties.

COUNTY	RATE	COUNTY	RATE
Adams	1.12%	***Lawrence***	1.75%
Allen	1.00%	***Madison***	1.75%
Bartholomew	1.25%	***Marion***	1.62%
Benton	2.29%	***Marshall***	1.25%
Blackford	1.36%	***Martin***	1.00%
Boone	1.00%	***Miami***	2.54%
Brown	2.20%	***Monroe***	1.05%
Carroll	1.55%	***Montgomery***	2.10%
Cass	1.50%	***Morgan***	2.72%
Clark	2.00%	***Newton***	1.00%
Clay	2.25%	***Noble***	1.50%
Clinton	2.00%	***Ohio***	1.00%
Crawford	1.00%	***Orange***	1.25%
Daviess	1.75%	***Owen***	1.30%
Dearborn	0.60%	***Parke***	2.30%
Decatur	1.33%	***Perry***	1.06%
DeKalb	1.50%	***Pike***	0.40%
Delaware	1.05%	***Porter***	0.50%
Dubois	1.00%	***Posey***	1.00%
Elkhart	1.50%	***Pulaski***	3.13%
Fayette	2.37%	***Putnam***	1.50%
Floyd	1.15%	***Randolph***	1.50%
Fountain	1.10%	***Ripley***	1.38%
Franklin	1.25%	***Rush***	1.50%
Fulton	1.93%	***Scott***	1.41%
Gibson	0.50%	***Shelby***	1.25%
Grant	2.25%	***Spencer***	0.80%
Greene	1.00%	***St. Joseph***	1.75%
Hamilton	1.00%	***Starke***	1.06%
Hancock	1.20%	***Steuben***	1.79%
Harrison	1.00%	***Sullivan***	0.30%
Hendricks	1.40%	***Switzerland***	1.00%
Henry	1.25%	***Tippecanoe***	1.10%
Howard	1.60%	***Tipton***	1.33%
Huntington	1.60%	***Union***	1.50%
Jackson	1.60%	***Vanderburgh***	1.00%
Jasper	3.05%	***Vermillion***	0.10%
Jay	2.45%	***Vigo***	1.25%
Jefferson	0.35%	***Wabash***	2.90%
Jennings	1.25%	***Warren***	2.12%
Johnson	1.00%	***Warrick***	0.50%
Knox	1.10%	***Washington***	1.50%
Kosciusko	1.00%	***Wayne***	1.50%
LaGrange	1.40%	***Wells***	2.10%
Lake	0.00%	***White***	1.32%
LaPorte	0.95%	***Whitley***	1.23%

Revenues. For FY10, the certified distribution for the various local option income taxes in Indiana totals $1,594.8 million, or 29.7 percent of the total state and local income taxes in Indiana. The distributions of the basic taxes are as follows (in millions):

COIT	$ 591.6
CAGIT	435.5
CEDIT	294.6
Total basic	$1,321.7

Additional taxes are as follows:

Freeze Property Tax	$ 63.2
Property Tax Relief	109.4
Public Safety	94.5
Total additional	$ 267.1

Source: Indiana Legislative Services Agency, Office of Fiscal and Management Analysis

Issues Related to Graduated Income Taxation in Indiana

Although progressive rates dominate the taxation of individual income in the United States, certain issues should be considered.

Basic Considerations

Supporters of graduated income tax rates make the case that, as income rises less of it is devoted to the necessities of life and more to luxuries, and that it is unfair to ask those whose income is heavily devoted to necessities to pay the same rate as those who receive enough to afford an array of goods and services not vital to daily living. Moreover, it is argued that income, as is the case with goods and services, has declining marginal utility and that higher rates on higher incomes will not have as great an effect on utility. It is also argued that those with higher incomes have a declining marginal propensity to consume, thereby contributing to a dampening of economic activity. Finally, supporters point to statistics that show that the only quintile (20 percent) of household income that has shown growth over the last four decades is the highest quintile and that in order to maintain stability in governmental revenues, that quintile should be taxed at higher rates.

Those that oppose progressive taxation argue that society has a long-term interest in the investment made possible by those with high incomes and that the tax system should not be employed to reduce that investment. It is also argued that rising marginal rates can contribute to diminished efforts to increase income and that rising rates create increasing incentives to protect income from taxation, either legally or illegally. Finally, opponents argue that no specific structure of graduated rates can be defended on grounds other than political expediency.

Revenue Productivity

Graduated rates have become a focus of attention because they can contribute to an increase in the growth rate of the income tax by taking advantage of changes in income distribution. As incomes rise and become subject to increasing rates, revenue growth will exceed the growth of a flat rate tax. The extent to which this occurs, however, depends on a rate schedule extensive enough to permit such growth.

The Role of Inflation/Indexing. One of the problems with graduated rates is that the same brackets that may have provided for a reasonable degree of progressivity when originally adopted will, over time as income levels rise, provide less and less progressivity until the tax is, practically speaking, proportional. Political reluctance to open up income tax statutes may contribute to such stagnation. One solution to this problem is to index the brackets to some acceptable measure, such as the Consumer Price Index or a measure of household income distribution. In this way, those in the lower range of income distribution will not be subject to rates originally intended for the wealthy. Of course, this means that as brackets are adjusted revenue productivity will be affected because large portions of the tax base will not move into higher brackets.

Volatility. A desirable attribute of a tax is stability. The provision of governmental services benefits when the jurisdiction has a reasonably steady flow of tax revenue. The recent economic downturn has destabilized even the most recession-resistant taxes, such as the property tax, and has exacerbated the fluctuations of the more volatile taxes, such as the income tax.

A part of the income tax base is capital gains, which rise sometimes dramatically during economic booms, such as during the 1990s, and can become capital losses when the stock market crashes, as it did in 2008 and 2009. These fluctuations are far greater than the fluctuations in salary and wage income. Capital gains, then, become a larger part of the income tax base during booms and much smaller during busts. This can have a significant effect on the revenues of any income tax, but the effect both up and down is magnified with a graduated tax because much of the income from capital gains is concentrated in the upper brackets with the highest rates. In addition, taxpayers in the upper brackets have been receiving a higher proportion of their incomes from non-wage sources. A state with a graduated income tax may be well-advised to pay close attention to the size of a budget stabilization fund to help compensate for the volatility in the revenue from capital gains.

Tax System Progressivity/Regressivity

It is beyond the scope of this paper to assess the overall progressivity or regressivity of the Indiana tax system. Nevertheless, the progressivity of a graduated rate tax should be considered in the context of the progressivity or regressivity of other sources of revenue that make up the state and local tax system. Federal taxation may also enter into the consideration.

Conclusion

A graduated income tax is an option that has been advanced from time to time as a way of helping the Indiana tax system to be more responsive to changes in the underlying economy. Graduated rates, however, raise significant issues that would have to be addressed in any consideration of moving in that direction.

Indiana Fiscal Policy Institute
The Indiana Fiscal Policy Institute was formed in 1987 as a private, non-profit governmental research organization. The IFPI is Indiana's only independent statewide source of continuing research into the impact of state taxing and spending policies, and it is privately supported by a variety of organizations, corporations, associations and individuals in Indiana and surrounding states. The IFPI's Mission is to enhance the effectiveness and accountability of state and local government through the education of public sector, business, and labor leaders on significant fiscal policy issues and the consequences of state and local decisions.

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