Income Tax Bracket Collapse is Costly and Ineffective

Moving Towards a Balanced Approach in 2011

MBPC Montana Budget & Policy Center

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All Montanans want a state we can be proud of--a state where our children can learn, grow, prosper, and stay to raise their own families. That future depends on our ability to invest in the public structures that educate our children, keep our communities safe, protect our land and water, and provide health care and other services when we struggle to make ends meet.

Like all other states, the Great Recession is threatening Montana's ability to adequately invest in these public structures. State revenues are plummeting, and legislative staff is estimating that the next legislature may face over a $400 million deficit.

Montana deserves a balanced approach to this revenue crisis that looks not just at dramatic and harmful cuts to public services, but also targeted efforts to increase revenue. This brief is one in a series of MBPC reports that explores potential policies to raise revenue in the state.

In 2003, the Montana legislature made significant changes to Montana's income tax system through Senate Bill 407 (SB 407). The changes enacted in SB407 have had a significant negative impact on Montana's revenue streams, yet are often ignored in discussions about the state's current revenue challenges. In 2005, SB 407 decreased total income tax revenue by $100 million (13%), with almost half of the benefit going to families earning incomes over $500,000 per year.[1]

In order to protect our future, we need a tax system that maintains the schools, roads, and natural resources that create opportunities for all Montana families. With Montana facing potentially severe and damaging cuts to these public structures, it's time to take a hard look at the usefulness of SB 407's costly tax changes.

This policy brief will analyze the impact of one portion of SB407--changes made to Montana's income tax brackets. MBPC finds that the bracket collapse has been unaffordable, disproportionately targeted to upper income Montanans, and ineffective as a tool for economic growth.

Income Tax Changes Passed in 2003

When the Montana Legislature passed SB407 in 2003, the tax code changed dramatically. In particular, two major changes to the income tax system disproportionately benefited Montana's highest earners and cost the state millions: (1) a capital gains credit equal to 2% of income from capital gains[2], and (2) a collapse of the income tax brackets, which:

- Reduced the income level at which the top tax rate is effective from $80,300 to $13,900;
- Lowered the top bracket rate from 11% to 6.9%; and
- Reduced the number of tax brackets from 10 to 6.

Appendix A shows the changes in state tax brackets from 2004 to 2005.

Restoring Pre-2003 Income Brackets Would Raise Much-Needed Revenue

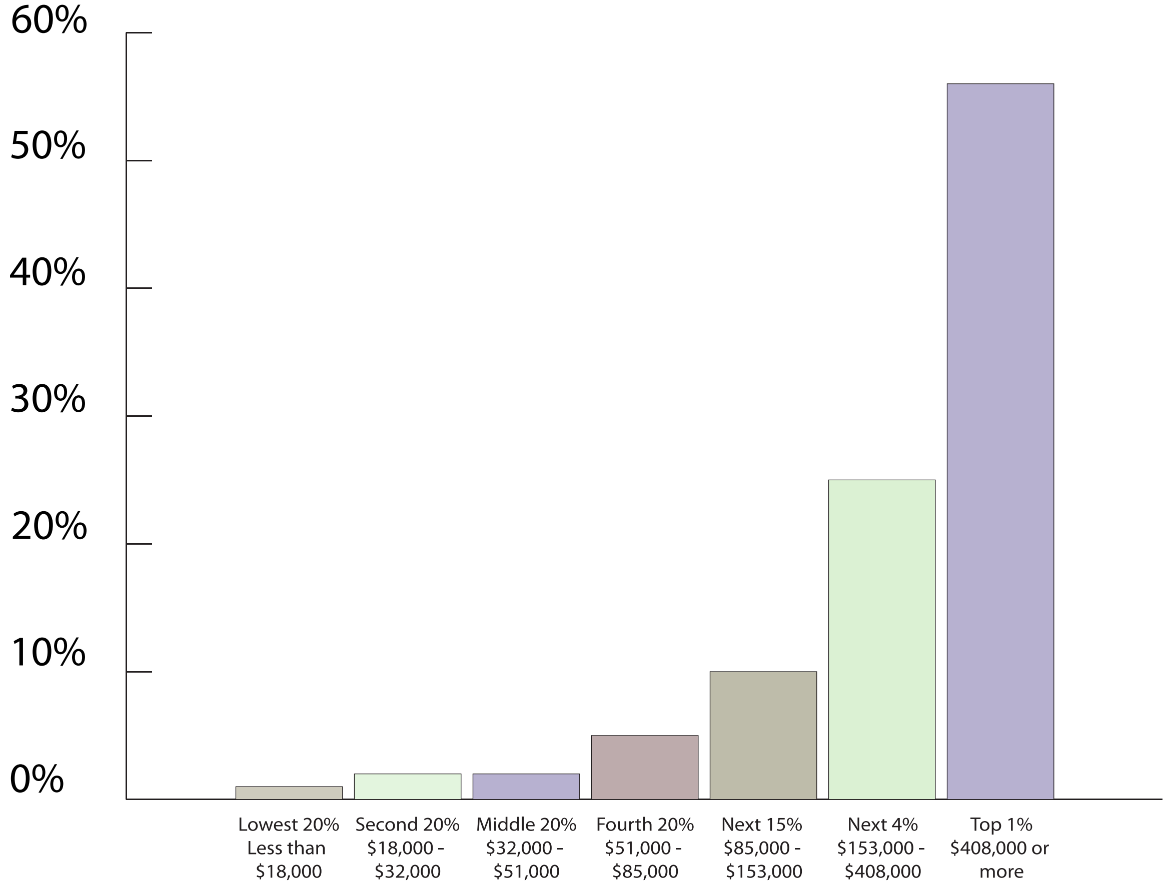
Tax brackets are adjusted for inflation every year. If the original tax brackets were restored and adjusted for inflation, Montana would benefit from an additional $185 million in revenue each year.[3] In other words, the bracket collapse will cost the state $185 million in 2012, during the height of the revenue crisis caused by the Great Recession.

Bracket Changes Disproportionately Benefit Highest Income Households

The top 1% of taxpayers in Montana, who have incomes above $408,000 per year, benefit the most. In 2012, this group will receive an estimated 56% of the benefit from the bracket collapse. Over 90% of the benefit will go to those making more than $85,000 (the top 20% of earners).

The following figure illustrates the estimated tax benefit that will be received by income groups from the bracket changes in 2012.

Table 1: Estimated Share of Benefits from Bracket Collapse



Source: Institute on Taxation and Economic Policy

Bracket Collapse Costs the State More Than It Benefits Taxpayers

The bracket collapse leads taxpayers to contribute less to Montana and more to the federal government. Because state income taxes are deductible on federal tax returns, when someone pays less to the state in taxes, they pay more to the federal government. In the case of the bracket collapse, 16% of the tax benefit goes directly to the federal government. Although the bracket collapse costs the state $185 million, taxpayers' bills are only reduced by $155 million.

Conclusion: Why Montana Needs to Restore Revenue Lost from the Bracket Collapse

The 2003 bracket changes are worsening a state revenue outlook that is already weak due to the recession. Unless the legislature raises more revenue, deep cuts to public programs, services, and infrastructure will be inevitable – measures that would further harm our already fragile economy.

Investments in public structures strengthen our economy, especially when it is weak, so it makes sense to find new revenue to fund them now that times are tough. Hundreds of economists have argued that carefully chosen tax increases, particularly on the highest income earners, are preferable to spending cuts when the economy is suffering.[5] Furthermore, Montana Budget and Policy Center's own study of the effects of SB 407 on economic growth in Montana found that the income tax breaks did not lead to improvements in the economy (see Appendix B for details).

SB407's income tax changes have disproportionately benefited Montana households with the highest incomes, but Montana as a whole will be harmed by the resulting unaffordable revenue losses caused by the changes.

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Appendix A

Tax Break Changes from 2004 to 2005

2004 Tax Brackets and Table

If your taxable income is:

At least	But less than		Then your tax is:		Less:
0	2,300		2%	of taxable income	
2,300	4,600		3%	of taxable income	-23
4,600	9,200		4%	of taxable income	-69
9,200	13,800		5%	of taxable income	-161
13,800	18,400		6%	of taxable income	-299
18,400	22,900		7%	of taxable income	-712
32,100	45,900		9%	of taxable income	-1033
45,900	80,300		10%	of taxable income	-1492
80,300			11%	of taxable income	-2295

2005 Tax Brackets and Table

If your taxable income is:

At least	But less than		Then your tax is:		Less:
0	2,300		1%	of taxable income	
2,300	4,100		2%	of taxable income	-23
4,100	6,200		3%	of taxable income	-64
6,200	8,400		4%	of taxable income	-126
8,400	10,800		5%	of taxable income	-210
10,800	13,900		6%	of taxable income	-318
13,900			6.90%	of taxable income	-443

Source: Montana Department of Revenue

Appendix B

Determining Effects of Policy on Economic Growth

In order to determine if a policy change has affected economic growth, it is not sufficient to see if the economy grew after the policy was implemented. The economy may have grown without the policy implementation. Likewise, a decline in the economy is not sufficient to say a policy has hurt the economy. The economy may have declined even further without the policy change.

The key to determining the effect of a policy change is to estimate how the economy would have grown without the policy change and see if the actual growth is significantly different than what would have been expected.

In the case of SB 407, the income tax provisions were implemented in two stages. The income tax bracket and rate changes were effective for tax year 2005. The capital gains credit was phased in at 1% in 2005 and increased to 2% in 2007 and beyond. Using regression analysis, we estimated the effect of the tax law changes on five measures of economic growth controlling for growth across the country and the faster economic growth occurring in the mountain states. Regression analysis is a statistical tool that allows us to isolate the effects of the implementation of SB407.

We found no evidence that SB407 has helped the state economy, as measured by Montana's unemployment rate, income per capita, jobs, wages or gross state product after either the initial implementation of the credit in 2005 or the full implementation in 2007.

The following table shows the coefficients for each equation.

Coefficients Generated by Regression Analysis

		Growth in GSP Coefficients	Growth in Jobs Coefficients	Growth in Wages Coefficients	Growth in Per Capita Income Coefficients	Growth in Unemployment Rate Coefficients
Percent change for US	Controlling for growth across the US will help isolate growth.	0.9306054	0.9972761	0	0.9522244	0.9782426
Mountain State?, 1- yes, 0=no	This variable was included because the mountain states have recently had faster economic growth than the rest of the nation.	0.0170447	0.0146641	0	0	0
Montana?, 1= yes, 0=no	This variable was included to indentify if Montana was simply growing faster than other states, before and after the change.	0	0	0	0.0183861	-0.1335893
2005 or after?, 1=yes, 0=no	This variable was included to identify if there was a change for all states after 2005.	0	0	0.0059236	-0.0050425	0
2007 or after, 1=yes, 0=no	This variable was included to identify if there was a change for all states after 2007.	0	0	0.0056168	0	0
After initial implementation?, 1=yes, 0=no	This variable was included to indentify if the initial implementation of the capital gains credit had an effect.	0	0	0	0	0
After complete implementation?, 1=yes, 0=no	This variable was included to indentify if the complete implementation of the capital gains credit had an effect.	0	0	0	0	0
Intercept	Initial starting level.	0	0	0.0221804	0.0059126	0

Coefficients are reported as 0 if they are not significantly different than 0 at the 95% confidence level.

Endnotes

1. "The Revenue and Taxpayer Impacts of the Income Tax Provisions of SB 407," Montana Department of Revenue, December 2006.
2. For more information see, "Capital Gains Tax Reform will Strengthen Montana," Montana Budget and Policy Center, June 14, 2010, at www.montanabudget.org.
3. "Impact of Various Tax Reform Options: All Montanans, 2012 Levels," Institute on Taxation and Economic Policy, May 10, 2010.
4. Ibid.
5. See e.g., "Montana Economists Join Hundreds across the Nation in Urging States to Maintain Public Services," Montana Budget and Policy Center, April 21, 2009, http://www.montanabudget.org/sites/default/files/reports/Economist%20letter%20press%20release.pdf