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INSTITUTE ON TAXATION AND ECONOMIC POLICY

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Most of Indiana Tax Rate Cut Would Flow to Upper-Income Taxpayers

Alternative Could Provide Larger Tax Cuts for Most Hoosiers

Indiana gubernatorial candidate, and current U.S. Representative, Mike Pence recently unveiled his plan to cut the state's flat personal income tax rate from 3.4 percent to 3.06 percent, should he be elected governor.[1] Pence described the plan as an "across the board" tax cut for "every Hoosier." But a new analysis performed using the ITEP Microsimulation Tax Model shows that some Hoosiers would see no benefit from the plan, and that the majority of the plan's benefits would flow to the highest-income Indiana taxpayers. Moreover, ITEP's analysis shows that if lawmakers insist on prioritizing an income tax cut over other budgetary options, there is a better alternative: raising the state's long-stagnant personal exemption would provide larger tax cuts to most Indiana residents, at the same cost to the state as Rep. Pence's proposed rate cut.

Tax Cut Depends on Level of Income

Had Rep. Pence's rate cut been in effect last year (for taxes due in April 2012), a typical middle-income Indiana resident would have seen their taxes fall by about $102, while the state's richest 1 percent of taxpayers would have received an average tax cut of $2,264. **In total, more than half (56 percent) of the benefits of the rate cut would flow to the best-off 20 percent of Indiana residents.**

The state's poorest taxpayers, meanwhile, would see little or nothing in the way of tax cuts. **For the poorest 20 percent of Indiana residents, the average tax cut would amount to just $18 per household, with about one-third of this group receiving no tax cut at all.**

Overall, about 12 percent of Hoosiers would see no benefit from cutting Indiana's income tax rate. Most of this group is comprised of low-income taxpayers who are too poor to owe state income taxes, but who pay significant amounts in sales taxes, excise taxes, property taxes, and other state and local taxes and fees. **In November 2009, ITEP found that the poorest 20 percent of Indiana households devote more of their household budgets to paying state and local taxes than any other income group.[2]**

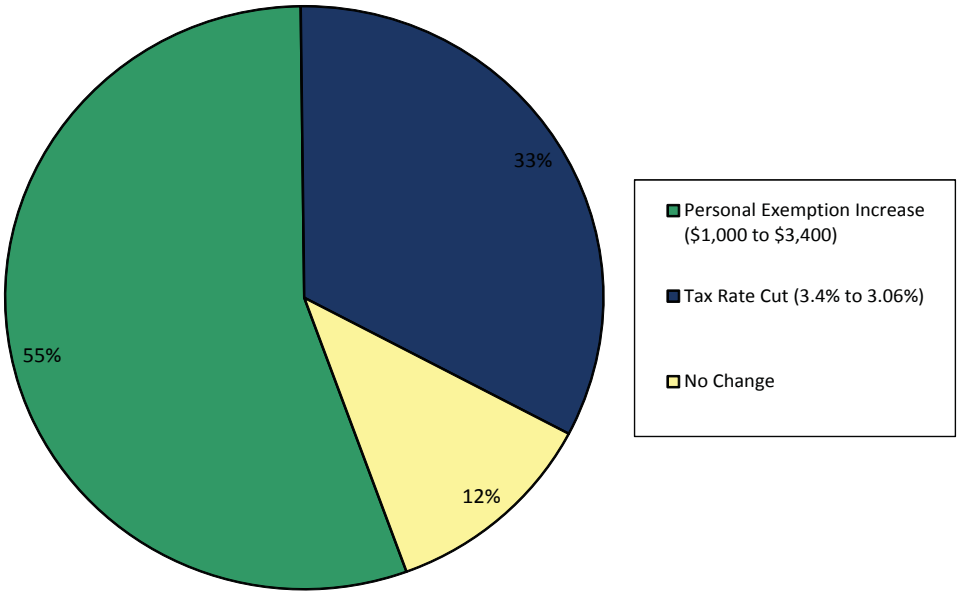
Rate Cut Would Send $50 Million Out-of-State

A significant portion of any state personal income tax rate cut would end up not in the hands of Indiana taxpayers, but in the federal Treasury. More than one out of every four Indiana taxpayers claims itemized deductions on their federal tax returns, and is thus able to write-off any state and local income tax payments they make. By lowering Hoosiers' state tax bills, Rep. Pence's plan would shrink these taxpayers' federal itemized deductions, and thus raise their federal tax bills. In effect, 10 percent—or roughly $50 million—of the tax rate cut would flow to the federal government in this way.

[1] http://www.mikepence.com/issues-taxpayers/
[2] http://www.itep.org/state_reports/whopaysfactsheets.php

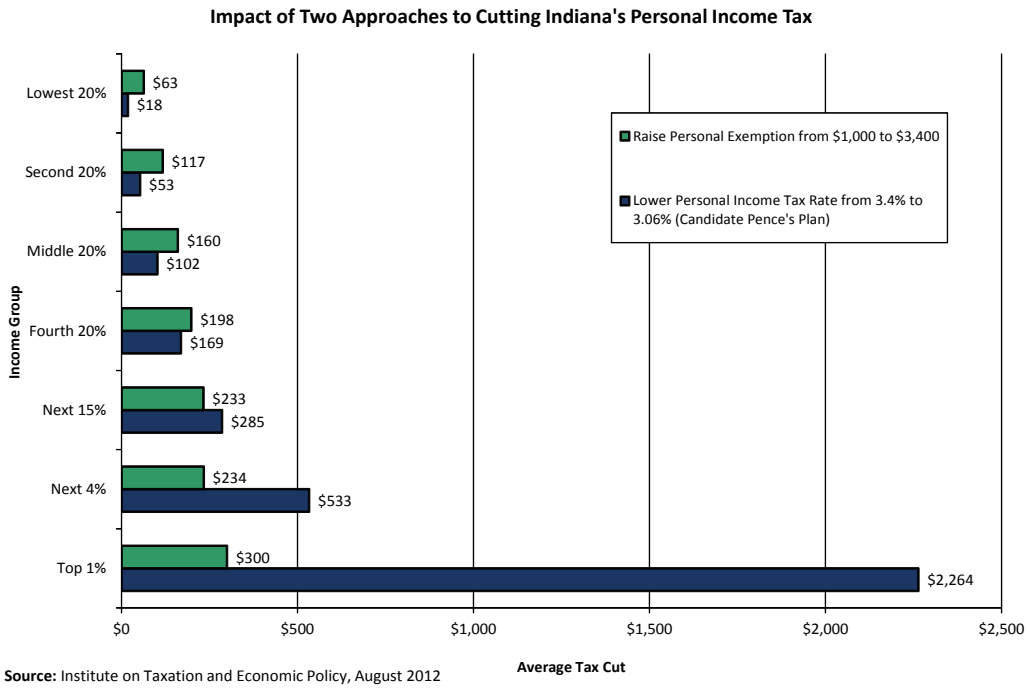
Raising Personal Exemption Is a Better Alternative

If enacting a large cut in the personal income tax is a priority of Indiana lawmakers, a far more equitable approach would be to update the state's personal exemption, which exempts a flat amount of income per family member for every Indiana household subject to the income tax. Unlike in some states and at the federal level, Indiana's personal exemption is not tied to inflation. As a result, its real value to Hoosier families has been steadily eroding since it was enacted at its current level of $1,000, along with the Indiana income tax itself, in 1963. Had the exemption been allowed to rise with inflation, its value today would be roughly $7,500. Put another way, Indiana's personal exemption is worth less than one-seventh of what it once was—a major factor in making Indiana one of a minority of states that taxes many of its working poor residents deeper into poverty.[3]



Source: Institute on Taxation and Economic Policy, August 2012

Raising the personal exemption to $7,500 per family member would likely be prohibitively expensive, absent an increase in the state's tax rate. But for the same cost to the state as the rate cut proposed by Rep. Pence, the personal exemption could be more than tripled—to $3,400 per family member. **This approach to cutting Indiana's income tax would benefit the same number of Hoosier households as cutting the tax rate, and would provide larger tax cuts to most Hoosiers than the rate cut proposed by Rep. Pence.**



Source: Institute on Taxation and Economic Policy, August 2012

Under the personal exemption increase just described, the poorest 20 percent of Indiana families would see an average tax cut of $63, versus a cut of just $18 from cutting the tax rate. Middle-income families would fare similarly, receiving a $160 average tax cut under the personal exemption change, but just $102 under the rate cut.

[3] http://www.cbpp.org/files/4-4-12sfp.pdf

The tax cuts created by increasing the personal exemption—as opposed to cutting the rate—would also be distributed far more evenly among Indiana families of different income levels. As the analysis at the end of this report shows, the top 5 percent of households would see roughly 8 percent of the benefits associated with raising the personal exemption, as opposed to reaping a whopping 28 percent of the benefits under Rep. Pence's preferred tax rate cut. Focusing just on the richest 1 percent of Indiana taxpayers, their average tax cut under the personal exemption change would amount to $300 per household—much more in line with an average taxpayer's benefit than the $2,264 cut they could expect from Rep. Pence's plan.

Opting for an increase in the personal exemption would also reduce the amount of the tax cut that would flow outside of the state and into the federal Treasury. This is because proportionately more of the benefits from raising the personal exemption would go to lower- and middle-income families that do not claim itemized deductions on their federal returns, and thus do not face a federal tax hike when their state tax bills decline. Only 6 percent of the state tax cut created by raising the personal exemption would flow into federal coffers—versus 10 percent under the rate cut plan. In effect, this difference between the two plans amounts to an additional $20 million in tax cuts for Indiana residents, at no additional cost to the state.

A full distributional analysis of cutting the personal income tax rate, as well as an analysis of increasing the personal exemption, is included below.[4]

Impact of Two Approaches to Cutting Indiana's Personal Income Tax, if fully implemented in Tax Year 2011

All Indiana Residents, 2011 income levels

2011 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%				
Income Range	Less Than $19,000	$19,000 – $33,000	$33,000 – $53,000	$53,000 – $80,000	$80,000 – $145,000	$145,000 – $325,000	$325,000 – Or More	**State Tax Change ($1000)**	**Federal Tax Change ($1000)**	**Federal Offset %**	**Net Tax Change ($1000)**
Average Income in Group	$ 11,000	$ 26,000	$ 43,000	$ 65,000	$ 103,000	$ 195,000	$ 828,000				
Candidate Pence's Proposed Income Tax Rate Cut, from 3.4% to 3.06%											
Tax Cut as % of Income	–0.2%	–0.2%	–0.2%	–0.3%	–0.3%	–0.3%	–0.3%	–453,000	+46,000	10%	–406,000
Average Tax Cut	–18	–53	–102	–169	–285	–533	–2,264				
% with Tax Cut	68%	83%	95%	99%	100%	100%	100%				
Share of Total Tax Cut	2%	7%	13%	22%	28%	14%	15%				
Raising Personal Exemption from $1,000 to $3,400											
Tax Cut as % of Income	–0.6%	–0.5%	–0.4%	–0.3%	–0.2%	–0.1%	–0.0%	–452,000	+27,000	6%	–426,000
Average Tax Cut	–63	–117	–160	–198	–233	–234	–300				
% with Tax Cut	68%	83%	95%	99%	100%	100%	100%				
Share of Total Tax Cut	8%	15%	21%	26%	23%	6%	2%				
Comparison of Two Plans											
% of Taxpayers Better off Under Rate Cut	0%	15%	33%	44%	67%	94%	100%				
% of Taxpayers Better off Under Exemption Increase	68%	68%	62%	55%	31%	6%	0%				

Detail	
% of Total Tax Cut Going to Top 5%	28%
% of Total Tax Cut Going to Top 20%	56%

Detail	
% of Total Tax Cut Going to Top 5%	8%
% of Total Tax Cut Going to Top 20%	30%

Detail	
Total % of Taxpayers Better off Under Rate Cut	33%
Total % of Taxpayers Better off Under Exemption Increase	55%
Total % of Taxpayers With No Change in Tax Bill	12%

SOURCE: Institute on Taxation and Economic Policy, August 2012

[4] A description of the ITEP Model methodology is available at: http://www.itep.org/about/itep_tax_model_simple.php