

RAISING REVENUE FROM HIGH-INCOME HOUSEHOLDS

Should States Continue to Place the Lowest Tax Rates on Those with the Highest Incomes?

Jeffrey Thompson
Political Economy Research Institute
University of Massachusetts, Amherst

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State and local tax systems are regressive: they tax low-income households at higher rates than high-income households. This issue has come to light as some states, looking for ways to respond to the collapse in tax revenue following the “Great Recession,” have turned to tax increases targeted at high-income households. Alongside the budget cuts that were adopted by every state, this new tax revenue can help sustain public spending on vital services, including education, public safety, and infrastructure.

New taxes on affluent households have given rise to considerable debate. Shifting taxes towards higher-income households has been defended on grounds of ‘fairness’: high-income households reaped the lion’s share of economic growth in recent decades and have also benefitted disproportionately from large federal tax reductions. A case has also been made that taxing wealthy households is the least economically damaging way for states to address their budget shortfalls, because it results in smaller reductions in spending than the feasible alternatives.

In the public debate over these policies, however, a number of potential concerns have been raised. Some policymakers worry that higher taxes might cause affluent households to work fewer hours, to decide against investing or starting a new business, to shield their income from taxes through shelters, or even to move to another state. But the research reviewed in this study suggests that modest tax increases on affluent households are unlikely to make substantial changes in their work

effort or entrepreneurship, and they are very unlikely to leave the state.

The evidence does suggest that high-income households do take tax increases into account in decisions about the timing of income and the form in which they receive income. For example, research on capital gains demonstrates that people may plan when they sell an asset if a pending law change will affect their taxes on income from the sale. Similarly, changes in the difference in tax rates between household and corporate income have been shown to produce shifts in the type of compensation taken by corporate executives and business owners.

A number of studies explore whether *pre-tax* income changes in response to tax policy. Pre-tax income would change if households alter their real economic behavior (i.e., their actual behavior, such as working hours, rather than changes made only on paper) or if they pursue tax-avoidance strategies, such as sheltering income offshore. The literature on this issue suggests that households do pursue some tax avoidance strategies in light of changes in their tax rates, rather than alter their real economic behavior. But this tax avoidance is limited to the very top of the income distribution: the top 0.1 percent. Most of the affected households do not alter their behavior in response to tax changes.

These anticipated reactions are not nearly as dramatic as those predicted by some parties in the debate over tax increases. The revenue to be gained by states by extending taxes on wealthy households is substantial—for example, tax measures being considered in California today would yield between \$5 and \$11 billion. Tax avoidance strategies would have only a small impact on tax revenues generated, and reductions in work hours, entrepreneurial efforts, or migration out of a state are unlikely to occur at all. The benefits of sustaining appropriate levels of funding on K-12 and public higher education, public safety, and transportation, should be weighed against the reality of these consequences, rather than unsubstantiated fears.

For references and notes, please see the full study at www.peri.umass.edu.

TAXES AND STATE BUDGET CRISES

The distribution of state and local taxes

State and local governments finance public services primarily through taxes. The two biggest taxes are the property and sales tax, which generate more than two-thirds of all state and local tax revenue.

Because states rely most on sales and property taxes, and because these taxes place higher effective rates on low and middle-income households (who spend a greater share of their incomes on housing and purchasing necessities than the wealthy), state and local tax systems are regressive. On average, the poorest twenty percent of households pay 10.9 percent of their income in state and local taxes, the middle twenty percent pay 9.4 percent, and the richest one percent pays 5.2 percent—a pattern that holds true in all states.

The recent budget crisis

State government tax revenues declined dramatically following the Great Recession: between the middle of 2008 and 2009, real tax collections fell 18 percent. Declining revenues and increasing demands on public services combined to create extremely large budget gaps. With a very slow economic recovery, state budget gaps have persisted. The projected gap for all states is \$106 billion for 2012 and \$47 billion for 2013.

Along with federal aid to the states from the 2009 Recovery Act, states' primary means of responding to budget gaps has been to reduce spending. A number of states, however, have also pursued efforts to sustain public services by raising taxes on affluent households. New Jersey's "half-millionaire tax" was adopted in 2004, preceding the economic downturn. Several states followed that lead when the recession set in:

- California enacted an across-the-board increase in personal income taxes.
- Maryland adopted a temporary income tax bracket for households with net incomes above \$1 million.
- Connecticut, Delaware, and Wisconsin implemented permanent income tax increases that

were weighted more heavily toward higher income households.

- Hawaii, New York, North Carolina, and Oregon enacted similar, but temporary measures.
- New York added a temporary new top bracket of 8.97 percent for incomes above \$500,000.
- New York later extended its top bracket for a limited group of high-income households, a rate of 8.82 percent on income over \$1 million for single filers and \$2 million for joint filers.
- Connecticut's top rate rose from 5 to 6.5 percent for single filers with incomes over \$500,000 and for joint filers with incomes over \$1 million.
- Oregon households with incomes over \$125,000 (single) or \$250,000 (joint) will pay an additional 1.8 percent.
- Vermont, Rhode Island, and Wisconsin increased taxes on capital gains income.
- Illinois raised personal and corporate tax rates, which will generate \$6.5 billion in its first year, wiping out nearly half of the state's anticipated budget shortfall.

OTHER REASONS TO RAISE RATES ON HIGH-INCOME BRACKETS

In addition to the simple need for revenue, other arguments have been made for why states should raise revenue in this way.

Fairness

The share of income going to the richest 1 percent of households more than doubled between 1979 and 2007, from 10 to 23.5 percent. The concentration is even greater when wealth and assets are included. In 2007, the top 5 percent of households controlled 37 percent of all income, but 60 percent of all net worth. Even after accounting for taxes and transfers, the incomes of the top 1 percent (adjusted for inflation) grew 275 percent between 1979 and 2007, while those of the middle class grew less than 40 percent. Partly a result of the very large tax cuts to the highest-income families implemented under the Bush Administration, between 1992 and 2008, the average effective federal income tax rate for the richest 400 Americans fell from 26 to 18 percent.

The wealthy now have more disposable income than at any time in history. Proponents of raising taxes on the rich to fund services suggest that these households should pay higher taxes now because they have benefitted so much from tax cuts in recent years.

Saving jobs

Taxing high incomes to pay for state services may also be one of the best approaches available to states to limit economic harm in a high unemployment, slow-growth environment. The primary fiscal actions taken by states in the last couple of years – cutting budgets and laying off workers – have been identified as among the most serious drags on economic growth.

The Congressional Budget Office consistently concludes that infrastructure and other state spending provide considerable boosts to the economy, while income tax changes for high-income households have minimal impact on short-term economic activity. Tax cuts for affluent households result in small increases in spending, and tax hikes result in only small decreases. Low- and middle-income households, on the other hand, have little savings, and reductions in their after-tax income result in equivalent reductions in spending. By minimizing spending cuts and drags on private spending, states can minimize the harm to their economies and to employment created by their actions.

BEHAVIORAL RESPONSES TO CHANGES IN TAX RATES

Labor supply

One way affluent households might respond to a tax increase is by working less, as they see a smaller return on each hour of work. Alternatively, since after-tax income would decline, households might work *more* to maintain their pre-law-change levels of consumption.

The research on this question indicates that labor supply, particularly among men, is unresponsive to tax rates. While most studies do not focus specifically on affluent households, the few that do arrive at a similar conclusion. The one group of

workers in affluent households whose labor supply has been found to be responsive to changes in taxes on earnings is women in wealthy married-couple families, who increased their labor force participation when federal tax rates fell significantly in 1986. But no state has considered changes anywhere near those of 1986, when the top marginal tax rate fell from 50 to 28 percent, making these findings not necessarily applicable to the question at hand.

Migration

The concern has arisen that affluent households might simply move to another state if faced with a tax increase. This story ignores the fact that moving – selling a home, hiring movers, buying a new home – is very costly, even for the rich. And leaving a place filled with family, friends, business associates, and other connections, in addition to changing schools, imposes substantial burdens.

The story also neglects the reality that affluent households value the services that are sustained through taxes. The rich drive better cars, but they drive them on public streets. Even if affluent families send children to private schools, the businesses they own hire workers who graduate from local schools. And, rich families – even in gated communities – value the services of fire and police as much any other families.

All of these factors are part of the reason that relatively few people actually move across state lines. Between 2008 and 2009, only 1.6 percent of households moved to a different state. Those who do are predominantly young and moving to or from college, or to launch a career. Once age and education are controlled for, income has only a very weak impact on the chance of moving to a different state, with the likelihood actually dropping for the highest income households.

Studies have found a few exceptions: changes to estate, inheritance and gift taxes have a small effect on the number of tax returns filed in that state, although some of that decline may be due to households filing from a state where they have a second home.

A study of New Jersey's half-millionaire's tax suggested that households with incomes over

\$500,000 were no more likely to leave New Jersey after the higher rate was adopted. The only groups with an identifiable response were rich households with heads age 65 and older and ‘super-rich’ households (in the top 0.1 percent), who earned *all* of their income from investments. These subgroups did appear to increase their migration from New Jersey following the adoption of the tax, but not in numbers that had any significant impact on the revenue collected: nearly \$1 billion annually.

Even in Connecticut, with a relatively large number of very high-income households, migration would be quite small. Tax return data for Connecticut suggest that a new bracket raising the marginal income tax rate by 2.6 percentage points on incomes above \$500,000 would generate nearly \$690 million annually. The results from the New Jersey study imply that this would cause between three and six very rich Connecticut households to file from a different state – a total revenue loss of \$3.4 million, or less than half of one percent.

Entrepreneurship

Another concern over raising taxes on high-income households is that it might influence decisions to start businesses. If increased taxes reduce returns to investing in small business ventures, high-income individuals might be less likely to take risks, and entrepreneurial activity might decline. Some studies conclude that higher taxes reduce entrepreneurship, but a greater number conclude the opposite.

Dozens of studies examine variables that might influence this behavior: the impact of taxes on start-up rates, taxes and levels of entrepreneurship according to a range of definitions, combined federal and state rates and numbers of sole proprietors, levels of investment in education and university research, and the effects of estate, inheritance, and gift taxes on entrepreneurship. Ultimately this body of research gives little reason to think that state tax policy has much impact on decisions to pursue entrepreneurial ventures.

Capital gains taxes and investment

Raising capital gains taxes will lower the return on some types of assets, and could decrease

investment. If investors decrease stock holdings, and businesses rely on financing from in-state investors, then a state’s economy could grow more slowly. But a debate on capital gains taxes in the 1980s and 1990s inspired extensive research, which ultimately found that these taxes have little impact on long-term investment.

Key studies demonstrated that while investors changed the *timing* of their actions in response to taxes, they did not significantly reduce their level of investment over the long term. Since investors’ willingness to hold assets is unaffected by capital gains taxes, there is little reason to think those taxes impact the broader economy. Numerous studies have found little or no long-term correlation between capital gains taxes and GDP. Changes to state-level capital gains taxes would have an even smaller impact on economic activity, since they would affect only investment within the state.

TIMING AND TYPES OF INCOME

According to public finance economist Joel Slemrod, households will use the least costly and least disruptive means of responding to taxes, if in fact they respond at all. If households can simply alter the timing of an activity and largely avoid the impact of a tax change, they can be expected to do so. If they can alter the way their income is categorized for tax purposes and avoid the tax, they can be expected to do that.

Households have been shown to dramatically shift *when* they sell an asset in advance of a pending capital gains tax increase, such as the surge in the exercising of stock options in 1992 in advance of increases in the top marginal tax rates.

Similarly, executives, business owners, or investors shift toward tax-favored forms of income and assets. For example, if the tax difference between earnings and capital gains rises, corporate executives can shift their pay between salary and stock options. Similarly, owners of small businesses can choose to incorporate if personal income tax rates rise relative to corporate tax rates.

Studies indicate that this also applies to how households allocate their savings, although the

magnitude of that response is not clear. Following the 1992 law change, high-income households modified their portfolios to some extent, reflecting changes in the tax treatment of different types of assets and debts.

RESPONSES IN CONTEXT

The literature suggests that the fears voiced in policy debates over raising revenue from high-income households are unlikely to materialize. The rich will not go on strike. They will not cease working, stop investing, or move, but they will find ways to shift the timing and composition of their income to avoid some taxes.

The result is that revenue collections will be slightly below levels projected by models that do not take tax avoidance into account. But revenue will certainly rise nonetheless. And, to the extent that timing shifts are used to *avoid* taxes, actual collections will re-converge with projections over time if the tax changes are permanent; taxes cannot be postponed indefinitely.

Higher taxes on rich households will generate some inefficiency and deadweight loss. Paying accountants and attorneys to find ways to avoid taxes helps affluent households, but is wasteful from society's perspective. This behavior, however, already exists, driven by federal taxes, which are much higher than state income taxes for affluent households. A temporary increase of even a few percentage points in a new millionaires' tax bracket will impose little lifetime cost on affluent households and will result in little additional avoidance. Temporary changes, though, may result in greater use of timing shifts, driving revenues from a tax increase to be somewhat lower than anticipated.

These anticipated reactions are not nearly as dramatic as predicted by some parties in the debate. The revenue to be gained by states by extending taxes on wealthy households is substantial. For example, measures being considered in California would yield between \$5 and \$11 billion annually. Avoidance strategies would have minimal impact on that bottom line, and reduced work hours, decreased investment, and interstate moves would have no impact on it at all. The benefits of sustaining appropriate levels of funding for education,

public safety, and infrastructure should be weighed against these realities, rather than unsubstantiated fears.

About the authors

Jeffrey Thompson is Assistant Research Professor at the Political Economy Research Institute, where he focuses primarily on domestic economic policy, with particular emphasis on the New England region and public finance at the state and local government levels. He completed his Ph.D. in economics at Syracuse University, and his research has been published in the *National Tax Journal*, *Research in Labor Economics*, and the *Industrial and Labor Relations Review*.

Dr. Thompson's recent publications can be found [on the PERI website](#).

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Political Economy Research Institute
University of Massachusetts, Amherst
418 N. Pleasant St.
Amherst, MA 01002
413.577.3147

www.peri.umass.edu