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Special Series | Dealing with Deficits: How States Can Respond

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RAISING STATE INCOME TAXES ON HIGH-INCOME TAXPAYERS

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As states face increasingly difficult choices for closing the gap between available resources and the cost of needed programs and services, one potential revenue source can be found at the high end of the income tax spectrum.

The personal income tax, a major source of revenue for 41 states, can yield a significant amount of money from small rate increases that involve a relatively low number of taxpayers — those that are best able to afford the cost. This is because wealth in the United States has become concentrated among the nation's richest households to an extent not seen since the late 1920s.

An effective way to tap this revenue source is to create an additional tax bracket at the top of the existing income tax rate structure. The first decision a state must make is to determine the income cut-off. One option is what some call a "millionaire's tax" — an additional rate applied to incomes above $1 million. More revenue can be raised if the income cut-off is lower, say $250,000 or $500,000; in such a case the new top rate still affects a relatively tiny percentage of taxpayers.

KEY FINDINGS

- Raising income taxes on a small number of states' highest-earning households can help close budget gaps. Structuring such a change is administratively simple and can be implemented quickly.
- Nationwide, some $8 billion could be raised if every state with a personal income tax enacted a 1 percent rate increase on households making more than $500,000 a year.
- Because many filers can deduct state income taxes from their federal taxable income, high-bracket taxpayers will find that state increases "net out" to less than they appear.
- Raising taxes, especially on the wealthiest households, is less harmful for the economy than cutting many types of services.

The amount that any state could raise at a particular income level would, of course, vary. But the magnitude can be seen from this statistic: If every state with an income tax increased its rates by 1 percentage point on incomes above $500,000, it would raise about $8 billion nationwide — funds that could be used as an alternative to some of the deep cuts in education, health care, and other important services being made in many states and considered in others.[1]

[1] The nine states that do not levy a broad-based income tax are Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming.

Another way a state could choose the cut-off for the new bracket would be to structure it to affect only the top 1 percent of taxpayers rather than those above a particular income level. In the typical state, this approach would mean a rate increase on households with taxable incomes greater than about $330,000. Because the proportion of households at a given income level varies from state to state, the actual income cut-off would differ by state and could range from $225,000 to more than $600,000. An additional 1 percent tax levied on the top 1 percent of households in states with income taxes would raise over $8 billion nationwide.

Revenue plus Economic Benefits

An advantage of high-end income tax rate increases is that they not only produce revenue that can help close budget gaps, but also close those gaps in a way that is not harmful to a state's economy relative to relying solely on cuts in government spending.

In a paper written at the start of the last recession, Nobel prize-winning MIT economist Joseph Stiglitz and Peter Orszag — then a Brookings Institution economist, now director of the federal Office of Management and Budget — concluded that tax increases on higher-income families are preferable for closing state fiscal deficits in the short run.[2] They reasoned that reductions in government spending on goods and services, or in transfer payments to lower-income families, take money out of circulation and, as a result, reduce demand in the overall economy. By contrast, when taxes are increased on the wealthiest households, the impact on the economy is not as great because some of the additional tax payments will be made from savings rather than from funds that would otherwise be spent.

In addition to the revenue-raising potential and the impact on a state's economy, there are a number of reasons why states should consider upper-bracket income tax increases during the current fiscal crisis.

- **Help now and later:** The new rate structure could be used to address both the shortfalls that have developed in current fiscal year budgets and the gaps that loom next year because an increase enacted before the end of the fiscal year can take effect in time to produce some revenue very quickly.

- **Easy to administer:** Because it is based on the existing personal income tax system, little would be required than to change withholding tables and inform employers.

- **Deductibility advantage:** State income taxes are deductible on the federal tax returns of taxpayers who itemize. For those taxpayers, the cost of an income tax increase is partially offset by a corresponding *decrease* in federal tax obligation. For example, someone who is in the top federal income tax bracket, for which the marginal rate is currently 35 percent, receives a 35-cent federal tax cut for every additional $1 in state income tax. So if the taxpayer's state income

[2] Peter Orszag and Joseph Stiglitz, "Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive than the Other During a Recession?" Center on Budget and Policy Priorities, revised November 6, 2008, http://www.cbpp.org/archiveSite/10-30-01sfp.pdf.

tax were increased by $5,000, he or she could receive a *federal* tax cut of $1,750, and so in effect pay a net increase of just $3,250, even as the state government receives the full $5,000 in revenue. Note that this benefit is negated for those taxpayers affected by the federal alternative minimum tax, a group that includes many households with incomes between $200,000 and $500,000 but a minority of those households that would be most affected by a new top rate on incomes of $500,000 to $1 million and above.[3]

- **Respond to income inequality**: Adding new rates for the highest income households results in tax increases only on those that are in the best position to afford it: The high-income families that benefited most from the economic expansion of the past 30 years. The income of households in the top tenth of the income scale more than tripled between 1977 and 2006. At the same time, the incomes of the remaining 90 percent of households barely grew — increasing by only 10 percent over those 30 years.

  High-income households also enjoyed the largest windfalls from cuts in many states' income taxes dating to the 1990s and in federal taxes over the past eight years. In fact, just in the last decade the gaps between the richest and poorest families have grown dramatically. From the late 1990s through the mid-2000s, income among the nation's richest 5 percent of families grew by more than 15 percent, while the poorest 20 percent of families saw their incomes decline by 2.5 percent. During this period, gaps between the wealthiest fifth of families and the poorest fifth of families widened significantly in 19 states. In no state did the bottom fifth grow significantly faster than the top fifth.[4]

  According to data from the Federal Reserve Board, in 2007 the richest 1 percent of households held 26.2 percent of total wealth in the United States. And in 2006, 21.4 percent of total income went to this same small group of families.[5] Not since 1928 has the top 1 percent held such a large share of the nation's income.[6]

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[3] The Tax Policy Center projects that in 2011, under current federal tax law, 26 percent of taxpayers with total incomes between $500,000 and $1 million and 21 percent of taxpayers with incomes above $1 million will pay taxes under the AMT.

[4] Jared Bernstein, Elizabeth McNichol, and Andrew Nicholas, "Pulling Apart: A State-by-State Analysis of Income Trends," Center on Budget and Policy Priorities, Economic Policy Institute, April 2008. Available on-line at www.centeronbudget.org.

[5] Arthur B. Kennickell, "Ponds and Streams: Wealth and Income in the U.S., 1989 to 2007," Federal Reserve Board, January 7, 2009.

[6] This share of income going to the richest families increased through 2006 despite a temporary interruption in growth as the result of the 2001 recession. Very recently, the highest-income families are likely again seeing declines in real income, due both to the broad sweep of the current recession on the job market and to the loss of realized capital gains due to the decline of the stock market. This could reduce the share of income accruing to the highest-income families. However, if the experience of the 2001 recession is repeated, their incomes will again bounce back strongly. In addition, high-income families have more savings to cushion the impact of the economic slowdown than the low- and moderate-income families who benefited least from the recent expansion and are also hard hit by the recession.

Recent Top-Bracket Increases

Usually, increases — or, for that matter, reductions — in income tax rates for the wealthiest taxpayers come in the context of changes in a state's entire income tax system. But in recent years some states have opted for the revenue gains that come from focusing on the highest-income households, a policy approach that takes into account the increasingly skewed concentration of wealth and income among a small fraction of a state's households.

- Connecticut enacted a new top income tax bracket in 2009. This bracket starts at $500,000 for single filers, $800,000 for heads of households, and $1 million for married couples filing jointly. The tax rate on incomes above those thresholds increased to 6.5 percent from 5 percent, and will take effect for tax year 2009.

- New York in 2003 enacted a three-year income tax increase that raised the top rate to 7.7 percent on taxable income greater than $500,000 for both married and single filing status. This was part of a two-tiered change that also added a 7.5 percent rate on income between $150,000 and $500,000 for married joint filers and between $100,000 and $500,000 for singles. The previous top rate had been 6.85 percent, effective on all income greater than $40,000 for married filers and $20,000 for singles.

  In April 2009, New York again created new high-income tax brackets. This time the state enacted two temporary brackets for the 2009, 2010, and 2011 tax years. For filers with taxable income above $500,000, regardless of filing status, the tax rate rises to 8.97 percent from the current 6.85 percent; for those with taxable income below $500,000 but above $200,000 for single individuals, $250,000 for heads of households, and $300,000 for married couples filing joint returns, the rate increases to 7.85 percent from 6.85 percent. In addition, for most filers affected by the new rates, they will cover *all* of their taxable income. The changes are projected to raise more than $4 billion a year.

- In 2004, California raised its top income tax bracket. The top rate became 10.3 percent on taxable income greater than $1 million, regardless of filing status. The increase was approved as a ballot initiative to fund county mental health services. California's previous top rate was 9.3 percent, effective on income greater than $47,055 for single filers and $94,110 for married taxpayers filing jointly.

- New Jersey raised its top rate in 2004 to 8.97 percent on taxable income greater than $500,000 (married or single). The previous top rate had been 6.37 percent on income greater than $150,000 for married filing jointly and $75,000 for singles. In 2009, New Jersey temporarily increased income taxes on households with incomes above $400,000. For one year, the tax rate on joint filers with incomes $400,000 and $500,000 will rise to 8 percent from 6.37; the rate on income between $500,000 and $1 million will increase to 10.25 percent from 8.97 percent; and a new 10.75 percent rate is applied to all income over $1 million. These changes will generate about $1 billion in fiscal 2010.

- As part of extensive changes to the overall state tax structure, Maine replaced its existing income tax system, under which the top rate took effect at a relatively low income level, with a two-bracket system that levies a 6.5 percent rate on income below $250,000 and 6.85 percent

tax rate on income over $250,000. Previously, Maine's income tax had four brackets, ranging from 2 percent on income less than $4,850 to 8.5 percent on income over $38,900 for a married couple. The overhaul also expanded the sales tax base to include a range of previously untaxed goods and services, created new household credits, and made the state Earned Income Tax Credit partially refundable.

- In Maryland, a new top rate of 6.25 percent took effect in 2008 on income greater than $1 million, regardless of filing status. The increase is scheduled to expire after three years. Maryland also added three new rates ranging from 5 to 5.5 percent, with no expiration date, on income from $150,000 to $1 million for single filers and $200,000 to $1 million for joint filers. The state also cut income taxes for lower- and middle-income taxpayers. The Maryland changes made a tax system that was effectively flat — with a top tax rate that had been 4.75 percent on taxable income above just $3,000 — into a more progressive system.

- In 2009, North Carolina placed a temporary surcharge on upper-income taxpayers, effective for tax years 2009 and 2010. This surcharge is added to the filer's tax liability. Married filers with incomes over $250,000 and single filers with incomes over $150,000 calculate their tax under previously existing law and then increase it by three percent. For married filers with incomes between $100,000 and $250,000, and single filers with income between $60,000 and $150,000 the surcharge is two percent. This is the second time this decade that North Carolina has used a tax increase on upper-income households to help the state maintain services in an economic crisis. In the recession of 2001, North Carolina enacted a top rate of 8.25 percent on married couples with incomes above $200,000. The rate was lowered to 8 percent in tax year 2007 and eliminated in 2008. Prior to 2001, the top rate in North Carolina was 7.75 percent on all income over $100,000 for a married couple.

- In Oregon, the legislature approved and the governor signed a measure adding two brackets at the top of the state's income tax structure. Married couples will pay 10.8 percent on income between $250,000 and $500,000; and 11 percent on income over $500,000. These rates will be in effect for tax years 2009 to 2011. After tax year 2011, the top rate will fall to 9.9 percent for joint filers with incomes over $250,000. These changes are projected to generate more than $230 million in each of the next two fiscal years. Oregon's previous top rate was 9 percent on all income over $15,200. However, if enough valid signatures are gathered the measures will not go into effect unless approved by the voters in January 2010.

- Hawaii adopted a measure temporarily creating three new state income tax brackets. Beginning in tax year 2009, for married couples the rates will be 9 percent on income between $300,000 and $350,000; 10 percent between $350,000 and $400,000; and 11 percent rate for income above $400,000. Additionally, the state's standard deduction and the personal exemption were each raised by 10 percent, which will lower tax bills for low- and moderate-income families. All of these changes are set to expire after tax year 2015. Hawaii's current top tax rate is 8.25 percent on all income over $96,000.

- Wisconsin enacted a new 7.75 percent income tax bracket on income over $300,000 for a married couple and $225,000 for individuals and heads of households. This change is expected to generate about $164 million in fiscal 2010.

Building a Bracket

Because they are built on top of existing income tax structures, upper-bracket tax increases are relatively simple to design and administer.

FIGURE 1

State X
Income Tax Rate Schedule

If Income is At Least:	But is Less Than:	Tax Owed Equals			Of the Amount over:
0	$ 5,000	0	plus	2.0%	0
$ 5,000	$15,000	100	plus	3.0%	$ 5,000
$15,000	$30,000	400	plus	4.0%	$15,000
$30,000		1,000	plus	6.0%	$30,000

The following example demonstrates how one could be designed. (It is based on the hypothetical graduated state income tax structure for State X shown in Figure 1.) Under the provisions of the income tax in State X, taxpayers first determine the portion of their income that is taxable by subtracting any applicable exemptions and deductions from their "gross" income. Next, the amount of personal income tax owed is determined using the rate schedule.

For example, a family with $40,000 of taxable income would owe $1,600 under this tax. This is the sum of $100 (2 percent of the first $5,000) plus $300 (3 percent of the next $10,000) plus $600 (4 percent of the next $15,000) plus $600 (6 percent of the amount over $30,000).

The state might then add a new 7 percent rate on income greater than $500,000. Figure 2 shows the impact of this on two hypothetical families — one with taxable income of $40,000 and one with taxable income of $700,000.

FIGURE 2

High-Income Surcharge
(Additional 1% on income over $500,000)

	Taxpayer A	**Taxpayer B**
Taxable Income	$40,000	$700,000
Current Tax	**$1,600**	**$41,200**
Additional Tax:		
Income above $500,000	$0	$200,000
Times .01 = Surcharge	$0	$2,000
Total Tax w/surcharge	**$1,600**	**$43,200**

The family with taxable income of $40,000 would owe no additional tax. The family with income of $700,000 would owe an additional $2,000 (1 percent of the $200,000 that falls within the new bracket). This family's total tax bill would increase to $43,200 from the $41,200 owned under the previous rate schedule.

Revenue Potential

The amount of revenue that states could raise from setting new tax rates on income above $500,000 would depend on what rate is chosen as well as how income is distributed in the state. Table 1 provides rough estimates of the amount of revenue that states could raise if they created new top marginal tax rates on income above $500,000 that are one percentage point higher than existing top rates.[7] The table also lists the percentage of each state's taxpayers that would be

[7] These estimates include only the tax that would be paid by state residents, not the typically small amount of a state's income taxes paid by nonresidents.

affected. As the table shows, a small rate increase on high-income taxpayers would produce a significant amount of revenue from a small number of taxpayers. In total, an additional one percent rate levied on income above $500,000 would raise about $7.8 billion and would affect only 0.6 percent of taxpayers in all states with an income tax.

While in most states with an income tax these changes could be enacted by statute, in five states it would require amending state constitutions that mandate a single-rate income tax structure. Those states are: Colorado, Illinois, Massachusetts, Michigan, and Pennsylvania.

The estimates in Table 1 were obtained from the Institute on Taxation and Economic Policy's (ITEP) Microsimulation Tax Model, which is based on data from the Internal Revenue Service. For states that have not produced their own estimates, the ITEP model provides a very good estimate of the amount of revenue that could potentially be raised from increasing rates on income greater than $500,000. Where they exist, however, a state's own estimate of the revenue-raising potential of a rate increase is more accurate than estimates derived from the ITEP model because state revenue departments generally have more detailed and current information on the taxpayers in their state as well as the details of their tax system.

Rather than using $500,000 or another dollar level as the income cut-off, state lawmakers could define who would pay a higher tax rate by applying that rate only to the wealthiest 1 percent of residents. In all but five states with income taxes, the minimum amount of income needed to be among the richest 1 percent of taxpayers is less than $500,000 (see Table 2). So, a rate increase on incomes above the cut-off for the top 1 percent would bring in more revenue than an increase at $500,000. Table 2 provides rough estimates of the amount of revenue that could be raised if each state enacted a rate increase on the top 1 percent of taxpayers. If all states with an income tax did this, it would generate about $8.5 billion per year nationwide. In 22 states, the tax would add more than $100 million to state coffers. And in six states, more than $300 million would be generated.

Some Administrative Issues

Whichever approach is taken — adding a new rate at a certain income level or for a particular percentage of taxpayers — the goal is to generate revenue needed to sustain important state services during the current fiscal crisis. It is important, then, that states increase revenues relatively quickly. Nevertheless, the need for additional revenues must be balanced with administrative feasibility and impact on taxpayers.

Two major factors will influence when revenue starts to flow from an upper-bracket tax increase — the effective date of the change and the way the state chooses to collect the money.

Although many Americans associate April 15 with income tax collections, state and federal income taxes actually are collected throughout the year. Income taxes on wage earnings are withheld from paychecks by employers and remitted to state treasuries at regular intervals throughout the year. In addition, most taxes on non-wage income also are collected throughout the year by means of quarterly estimated tax payments made by individual taxpayers. An exception is that a significant portion of the taxes on non-wage income are paid the following April when income tax forms are filed.

TABLE 1. TAX INCREASE ON INCOMES OVER $500,000 YIELDS NEARLY $8 BILLION Additional 1% on Taxpayers with AGI over $500,000		
State	**Revenue (millions)**	**Taxpayers Affected (%)**
Alabama	$82.8	0.4
Alaska	X	X
Arizona	152.2	0.5
Arkansas	33.7	0.2
California	1,725.6	0.9
Colorado	169.0	0.7
Connecticut	338.3	1.4
Delaware	27.0	0.6
District of Columbia	45.9	1.4
Florida	X	X
Georgia	204.7	0.5
Hawaii	27.1	0.3
Idaho	25.0	0.3
Illinois	492.8	0.6
Indiana	99.4	0.4
Iowa	40.8	0.4
Kansas	55.3	0.5
Kentucky	57.8	0.3
Louisiana	66.9	0.4
Maine	19.1	0.3
Maryland	207.4	0.6
Massachusetts	390.0	0.9
Michigan	171.5	0.4
Minnesota	154.6	0.6
Mississippi	27.6	0.3
Missouri	113.9	0.4
Montana	13.7	0.3
Nebraska	37.2	0.5
Nevada	X	X
New Hampshire	X	X
New Jersey	421.3	1.0
New Mexico	20.1	0.2
New York	1,276.1	0.8
North Carolina	165.8	0.4
North Dakota	9.2	0.4
Ohio	201.7	0.4
Oklahoma	77.2	0.4
Oregon	69.8	0.4
Pennsylvania	302.7	0.5
Rhode Island	24.1	0.4
South Carolina	53.2	0.3
South Dakota	X	X
Tennessee	X	X
Texas	X	X
Utah	52.8	0.4
Vermont	11.1	0.4
Virginia	231.9	0.6
Washington	X	X
West Virginia	13.4	0.2
Wisconsin	97.1	0.4
Wyoming	X	X
Total	**$7.8 billion**	**0.6**

X = State does not levy a personal income tax.
Source: Institute on Taxation and Economic Policy, March 2009.

TABLE 2. APPLYING INCREASE TO TOP 1 PERCENT OF TAXPAYERS YIELDS OVER $8 BILLION (Additional 1% Tax)			
State	**Revenue (millions)**	**Number of Taxpayers Affected**	**Minimum AGI (AGI Floor)**
Alabama	$113.8	19,299	$305,286
Alaska	X	X	X
Arizona	206.3	24,550	383,732
Arkansas	47.8	11,350	267,469
California	1,666.4	150,001	469,003
Colorado	194.4	21,152	420,012
Connecticut	284.2	16,483	671,706
Delaware	29.3	3,976	354,213
District of Columbia	35.6	2,716	637,407
Florida	X	X	X
Georgia	264.1	39,163	370,333
Hawaii	33.2	6,037	314,316
Idaho	40.8	6,111	330,279
Illinois	521.6	57,300	427,938
Indiana	135.0	28,567	278,841
Iowa	56.6	13,291	273,750
Kansas	72.7	12,263	332,255
Kentucky	76.2	17,598	271,174
Louisiana	113.0	17,643	322,864
Maine	26.4	6,105	284,606
Maryland	210.5	25,940	421,521
Massachusetts	352.9	30,262	501,449
Michigan	214.1	44,097	296,386
Minnesota	161.5	24,225	373,812
Mississippi	49.0	11,535	249,052
Missouri	142.1	25,715	305,597
Montana	20.2	4,432	301,942
Nebraska	49.3	7,972	292,678
Nevada	X	X	X
New Hampshire	X	X	X
New Jersey	380.6	40,429	528,387
New Mexico	37.2	8,359	281,212
New York	1,274.1	85,314	517,780
North Carolina	212.2	38,479	341,627
North Dakota	13.2	3,029	268,564
Ohio	255.9	53,420	286,193
Oklahoma	105.8	14,696	311,677
Oregon	88.7	16,104	340,636
Pennsylvania	375.4	58,259	345,357
Rhode Island	30.8	4,897	345,265
South Carolina	95.8	18,784	310,190
South Dakota	X	X	X
Tennessee	X	X	X
Texas	X	X	X
Utah	70.6	10,315	349,948
Vermont	17.2	3,059	309,069
Virginia	255.4	34,677	402,382
Washington	X	X	X
West Virginia	21.5	7,507	225,697
Wisconsin	151.1	26,272	308,832
Wyoming	X	X	X
Total	**$8.5 billion**	**1,051,383**	

X = State does not levy a personal income tax.
Source: CBPP calculations of Statistics of Income data from the Internal Revenue Service.

If We Tax Them, Won't the Wealthy Flee?

Opponents of raising tax rates on high-income households often argue that sensitivity to marginal tax rates is so extreme that those affected will vote with their feet and depart for states where they would pay lower income taxes or none at all. The result, they contend, is to diminish, or even eliminate, the revenue potential of such tax increases.

This argument is highly exaggerated and not based on real-world evidence. Research in New Jersey and California shows conclusively that tax rate increases for high-income residents in fact raise significant amounts of revenue. And recent analysis also shows that tax increases have, at most, only a small impact on interstate migration patterns.

In fact, attempts to measure the relationship between interstate migration and tax progressivity have yielded mixed results. The most recent studies have found that higher marginal income tax rates have a very small impact on where people decide to live. Other factors such as crime rates and the natural environment play a very significant role.

For example, a September 2008 Princeton University study concluded, "the 'half-millionaire tax,' at least in New Jersey, appears to be an effective and efficient revenue-generation mechanism, having little impact on migration patterns among half-millionaire households." The study estimated that New Jersey lost $37.7 million a year from people leaving the state because of the 2004 tax increase. They called this "a small opportunity cost of a tax policy that generated more than $1 billion for Tax Year 2006." Furthermore, the study found that household income has grown rapidly among wealthy New Jerseyans in recent years despite the tax. From 2002 to 2006, the number of New Jersey households with incomes of $500,000 or more grew to 44,000 from 26,000, an increase of 70 percent.[a]

Similarly, an analysis by the California Budget Project found that the number of high-income households in that state has grown substantially during periods in which higher top income tax rates were in effect. According to CBP's findings, "the number of California's joint personal income tax filers with incomes of $200,000 or more rose by 33.4 percent between 1991 and 1995 — a period in which California temporarily imposed 10 percent and 11 percent tax rates on high income earners." More recently, California enacted a 1 percentage point increase on income over $1 million. The tax generated new revenue totaling about $1.5 billion in fiscal year 2008 alone. Much like the pattern observed following the tax increases of the early 1990s, the CBP analysis showed the number of taxpayers with incomes over $1 million increased — by 37.8 percent from 2004 to 2006.[b]

An analysis by the Institute on Taxation and Economic Policy in May 2009 calls into question the claim that the higher tax rates passed in Maryland in 2007 and 2008 have caused millionaires to leave the state. It suggests, rather, that a drop in the number of tax returns with income greater than $1 million was due to the recession's impact on people's holdings. Using data from the state Comptroller's office, ITEP found that the second highest tax bracket -- for incomes between $500,000 and $999,999 – saw a rise in returns, as did the bracket immediately below it. Since tax rates were raised on all three of these tax brackets in 2007 and 2008, ITEP states: "a far more likely explanation for the alleged disappearance of Maryland's millionaires is that, for 2008 at least, they are no longer millionaires. Instead, their incomes may now fall in lower ranges of the distribution, thus potentially accounting for some portion of the increase in the number of returns in those ranges."[c]

Other research suggests that tax changes alone have little, if any, impact on interstate migration trends. A recent study by the Harvard-trained economist Andrew Leigh, now a professor of economics at the Australian National University, found no significant relationship between income tax changes and migration patterns among U.S. states. According to Leigh, "…tax changes do not impact interstate population flows, nor do they affect the relative wages of movers." As part of a broader examination of wage inequality and the extent to which tax structures are based on the ability to pay, Leigh analyzed migration patterns of workers along all points of the income scale. Published in the March 2008 edition of the *National Tax Journal*, his work concluded that people are not deterred from moving to states with tax systems under which upper-income residents pay more.[d]

Other studies have found that factors ranging from crime to climate play key roles in explaining state-to-state migration. For instance, Richard J. Cebula found that "non-economic factors play a very significant role in determining migration patterns." Cebula examined the effect of both economic and non-economic conditions on interstate migration. According to his study, non-economic or "quality-of-life factors" explain much of the recent trends in cross-state migration. Recent migrants were shown to be attracted to states with large amounts of sunshine, warmer winters, and numerous state parks; the study also found that people were less likely to move to states where there are many hazardous waste sites and higher rates of violent crime.[e]

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[a] Cristobal Young, Charles Varner, and Douglas S. Massey, "Trends in New Jersey Migration: Housing, Employment, and Taxation," Princeton University, Woodrow Wilson School of Public and International Affairs, Policy Research Institute for the Region, September, 2008. Available on-line at www.princeton.edu/prior/.

[b] The California Budget Project, "The Number of High-Income Taxpayers Increased Significantly During a Period With 10 Percent and 11 Percent Tax Rates on High-Income Earners," August 2008. Available on-line at www.cbp.org.

[c] The Institute on Taxation and Economic Policy, "Where Have All of Maryland's Millionaires Gone?," May 2009.

[d] Andrew Leigh, "Do Redistributive Taxes Reduce Inequality?" National Tax Journal, Vol. LXI, 1, March 2008.

[e] Richard J. Cebula, "Internal Migration Determinants: Recent Evidence," International Advances in Economic Research, 11:267–274, 2005.

As a result, on average about 34 percent of state income taxes are collected in the second quarter of the calendar year (April-June) and about 22 percent are received during each of the remaining quarters. Because state fiscal years generally run from July 1 to June 30, this means that states receive about 45 percent of their income tax revenues during the first half of the fiscal year and about 55 percent in the second half.

When income taxes are increased or decreased, states must change the withholding tables that employers use and individual taxpayers must adjust their estimated payments. How quickly these changes occur will determine when a state will receive the additional revenue from a rate change.

Upper-bracket rate increases adopted in a given year would most likely either be retroactive to January 1of that year or take effect on January 1of the following calendar year. The additional revenue from an income tax rate increase enacted, for example, in the spring of 2009 and made retroactive to January 1, 2009 would mainly provide revenue beginning in the 2010 state fiscal year. But it would be possible to collect some of the additional revenue during the 2009 fiscal year by quickly adjusting withholding tables and the June estimated payment instructions.

If, on the other hand, a tax increase took effect January 1, 2010, about 45 percent of the increase would be received during the 2010 fiscal year and the rest would be collected in the 2011 fiscal year, when states are likely to have lingering fiscal problems.

Conclusion

As the fiscal crisis deepens, states need alternatives to relying only on budget cuts that endanger the well-being of struggling families and dampen economic demand. As part of a balanced approach, an upper-bracket income tax rate increase is an appropriate and effective way to raise revenue that is crucial to help address the massive budget gaps.

A key advantage of this approach is that it excludes low- and moderate-income taxpayers while helping to preserve programs and services upon which they are likely to rely. It would have a less negative impact on economic growth than would spending cuts, and, a further attraction is that for at least some taxpayers part of the cost would be borne by the federal government in the form of deductibility from federal income tax.

METHODOLOGICAL APPENDIX

How the Estimates in Tables 1 and 2 Were Computed

The figures in tables 1 and 2 are rough estimates of the revenue individual states could raise from income tax rate increases on two types of high-income taxpayers — those with incomes over $500,000, and those with incomes above the threshold for the richest 1 percent of households. Both sets of estimates were calculated based on national data sources. As a result, they will likely differ somewhat from estimates prepared by states. In general, a state's own estimate of the revenue-raising potential will be preferable to these estimates. However, these provide the best estimate of the amount of revenue that a state could raise by enacting an upper bracket rate increase for states where no state estimate has yet been prepared.

Table 1

The estimates in Table 1 were derived from the Institute on Taxation and Economic Policy's (ITEP) Personal Income Tax Model. The ITEP model is a tool for calculating revenue yield and incidence, by income group, of federal, state and local taxes. It calculates revenue yield for current tax law and proposed amendments to current law. As a "microsimulation model," it works on a very large stratified sample of tax returns and other data, aged to the year being analyzed. This is the same kind of model used by the U.S. Treasury Department, the congressional Joint Committee on Taxation and the Congressional Budget Office. The model relies on Internal Revenue Service data as well as other government and widely respected economic projections.[8]

Table 2

The estimates in Tables 2 were based on federal Statistics of Income published by the Internal Revenue Service for Tax Year 2006, the most recent year available.[9] For each state, the IRS provides the following pieces of information on the richest 1 percent of federal income tax filers: the total number of returns; the total amount of adjusted gross income (AGI); and the minimum amount of income to be among the top 1 percent of taxpayers — also referred to as the "AGI floor." In order to estimate the total amount of income subject to the rate increase in each state, the total number of returns was multiplied by the AGI floor, yielding the total amount of income beneath the AGI floor. This figure was then subtracted from total adjusted gross income to obtain the total income above the AGI floor. Finally, all income above the AGI floor in each state was multiplied by 1 percent (the amount of the tax increase used in this paper), which produced the final revenue estimates.

The federal Statistics of Income data by state differ from state figures in part because SOI data are attributed to a state based on the address shown on the federal income tax return, which might

[8] For detailed information on the ITEP's model and methodology, visit www.itepnet.org/model.htm.

[9] The IRS Statistics of Income data by descending cumulative percentiles is located on-line at http://www.irs.gov/taxstats/index.html. Estimates for this analysis were derived from Table 1 under the section, "Individual Income Tax Returns with Positive Adjusted Gross Income."

differ from the official state of residency for state tax purposes. This will have a particularly large impact in states where many people live in one state and work in a neighboring state. In 2005, for example, 15 percent of New York's total state income tax liability was owed by taxpayers not living there. In addition, the estimates are based on total AGI, which does not take into account such individual features of a state tax system as personal exemptions and standard deductions.

Comparability

As noted above, the estimates in Tables 1 and 2 were derived from two different data sources, covering different taxable years. ITEP's micro-simulation model is based on income earned in 2008, while the IRS Statistics of Income data are based on income earned in tax year 2006. Additionally, ITEP's model accounts for numerous state-specific factors not included in the SOI data, such as different personal exemptions and standard deductions. As a result, the estimates in Tables 1 and 2 are not directly comparable. These estimates are meant to provide a rough idea of the amount of revenue that could be raised from tax increases affecting these two types of high income households.