





# Tax Fairness: An Answer to State Budget Problems

*Taxing top incomes at the same rate as the middle class creates up to \$128 billion in additional revenue for critical state priorities*

## Executive Summary

Economic inequality is the greatest problem facing American families today, and many recent studies have found it is growing worse. This report examines the impact that inequality has on state budgets and the ability to fund vital public services.

**We ask: what would happen if the top one percent of highest-income Americans paid state and local taxes at the same rate as the middle class?** The answer: states would gain sufficient revenue to solve budget problems and invest in long-term economic stability.

If the top one percent paid taxes at the same rate as the middle-fifth of income earners in all states in which the top now pays lower rates than the middle, states and localities could solve many budget problems—**raising \$68 billion per year for education, infrastructure, health care, pensions and job creation.**

**If the top 20 percent paid taxes at the same rate as the middle-income fifth, states and localities would have \$128 billion more each year** to invest in the future, secure the social safety net, and cover the operating costs of state government.

Two recent national studies document America's increasingly unequal economy. The Economic Policy Institute revealed a stunning and worsening level of income inequality in all 50 states.<sup>1</sup> One percent of people at the top now claim at least one *sixth* of all personal income in

38 states, while incomes for the middle class have remained flat.

The Institute on Taxation and Economic Policy (ITEP) found that the rich pay much smaller shares of their income in taxes in most states than the middle class.<sup>2</sup> In 20 states, the top one percent pay less than *half* the tax rate of the middle class. On average across the 50 states, the top one percent pay only 60 percent as much in taxes as the middle fifth.

In other words, money that used to grow the middle class increasingly flows up to the one percent, where it gets taxed far less. This is a key driver of the structural deficits plaguing many state governments.

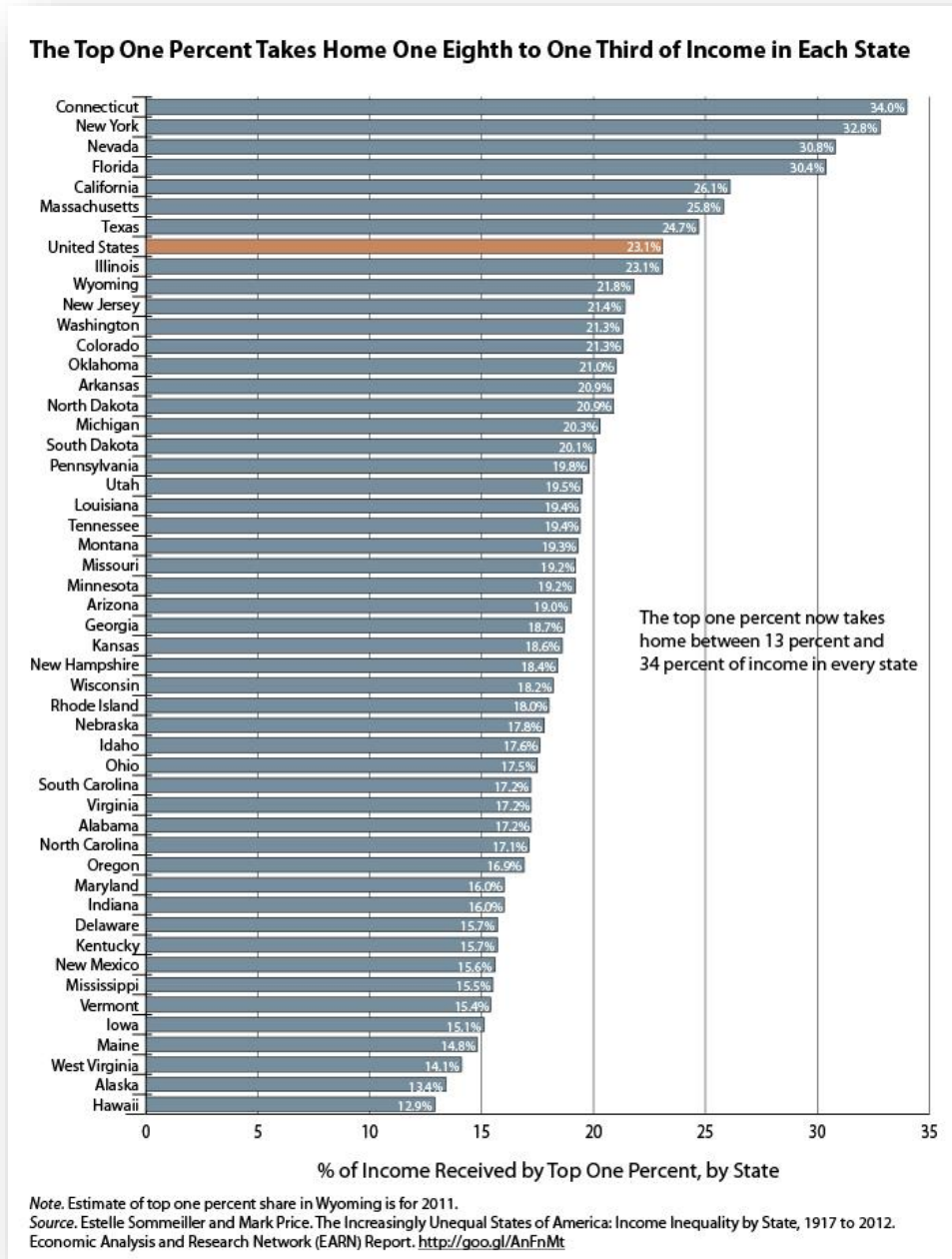
Despite the growth of structural deficits because of the one-two punch of rising income inequality and low tax rates at the top, lawmakers in many states have been choosing exactly the wrong response on tax policy. They have cut corporate tax rates, expanded business tax breaks and loopholes and, in some cases, repealed temporary top-income surtaxes that helped states weather the Great Recession.

After 30 years of a middle-class squeeze, it's time to restore balance through fairer taxation. Solving infrastructure deficits, restoring investments in education, community colleges and universities, and funding essential public services depend on it.

## The Rich Are Getting More Income than Ever

Income inequality has been rising for three decades. Between 1979 and 2007, the bottom 99 percent of U.S. taxpayers saw real income growth of just 18.9 percent, while the top one percent's income grew more than 10 times as much—by 200.5 percent. The recovery from the Great

Recession has exacerbated the inequality. Since the recovery began in 2009, the top one percent captured *all* income growth in 17 states.<sup>3</sup> In another 22 states, the top one percent captured more than half of all income growth.

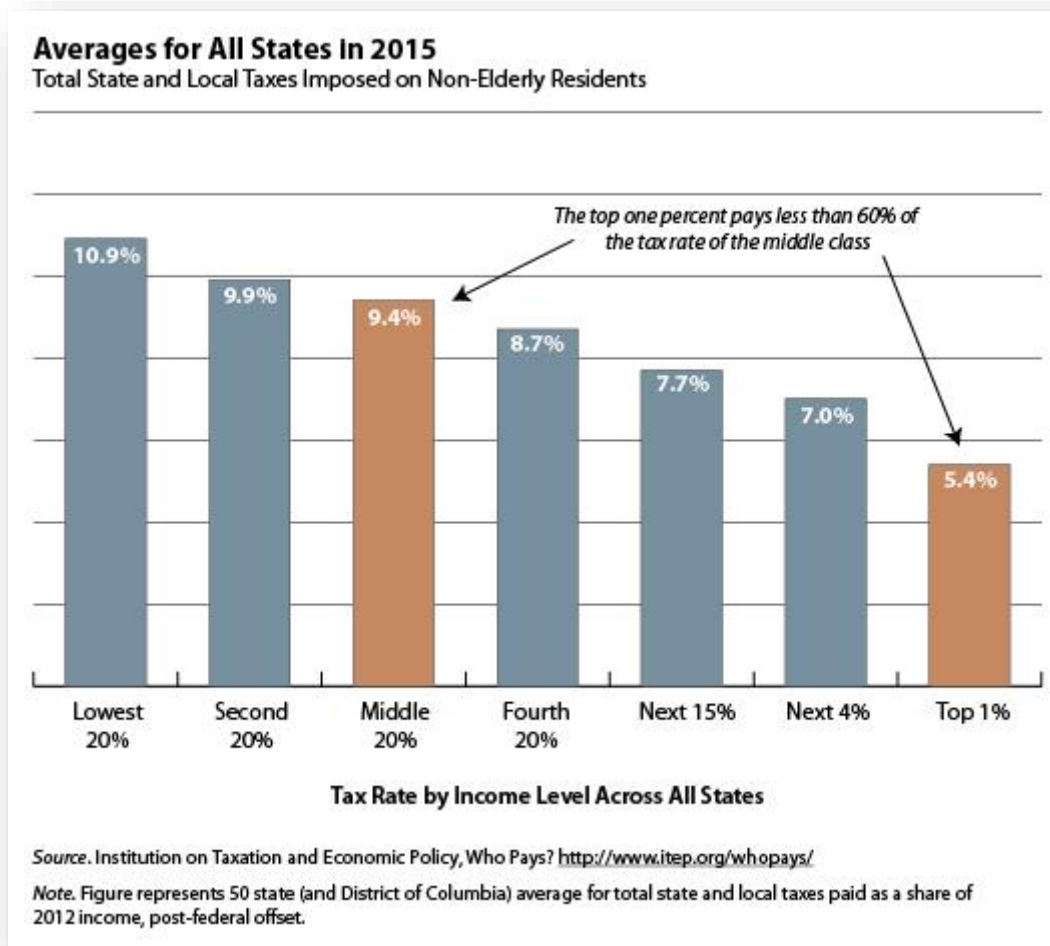


By 2012, the one percent took home more than a sixth of state income in 38 states.

The total annual income of the top one percent in all 50 states now exceeds \$2 trillion annually.<sup>4</sup> If the top one percent share of income remained

today at the 1979 level in each state, the top one percent in all 50 states would have less than \$1 trillion instead of more than \$2 trillion. **The roughly \$1 trillion increase in top one percent income as a result of rising inequality is an enormous *shift*, equal to about 1.5 times the total of all 50 state budgets combined.**<sup>5</sup>

## High-Income People Pay Far Less of Their Income in Taxes than the Rest of Us



Upper income groups have not only enjoyed a more rapid increase in income in recent decades. The Institute on Taxation and Economic Policy (ITEP) finds that they also pay smaller shares of their income in state and local taxes.<sup>6</sup>

- Virtually every state's tax system places a heavier burden on low- and middle-income families than on high-income families. The figure above shows that the top one percent pays only 5.4 percent of its income in taxes: the middle fifth pays well over one-and-half

times as much (9.4 percent). Low-income families pay twice as much as the top 1 percent (10.9 percent).

- In the 10 states with the most regressive tax structures, the bottom 20 percent pay up to seven times as much of their income in taxes as their wealthy counterparts. Washington State is the most regressive, followed by Florida, Texas, South Dakota, Illinois, Pennsylvania, Tennessee, Arizona, Kansas, and Indiana.

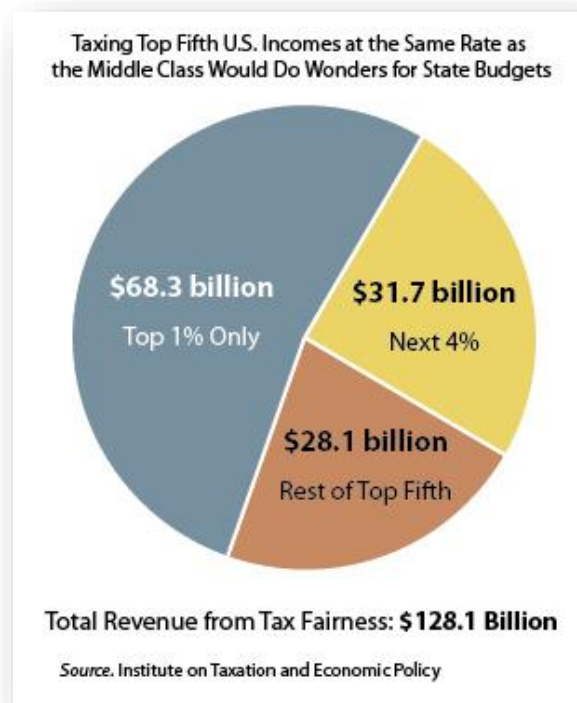
The absence of a graduated personal income tax is a key reason that middle- and low-income families pay many times what the top one percent pay. Nine states have no personal income tax and another eight states have flat

income taxes. In states with flat income tax rates, middle-class families pay the same income tax rate as CEOs and hedge fund managers.

States with regressive tax systems also rely largely on sales taxes, the broad-based tax that disproportionately impacts lower-income families.

In addition, states with unfair tax systems tend to incorporate significant corporate loopholes into their tax structure. These loopholes allow profitable corporations to game state tax systems, lowering their tax liabilities. The additional after-tax income accrues mostly to high-income shareholders in the form of dividends and capital gains.

## Taxing the Rich at Middle-Class Rates Would Do Wonders for State Budgets



Taxing upper income groups at the same overall tax rate as the middle-class would relieve enormous pressure on state budgets. Taxing just the highest one percent at the rate that the

middle fifth pays would raise \$68.3 billion in new revenue.<sup>7</sup> That amounts to a more than 10 percent increase in total 50-state general fund revenues. (See the Methodology Appendix for

details on how ITEP generated these estimates of revenue generation from tax fairness. As noted there, the methodology used conservative and alternative definitions of tax fairness could generate substantially more revenue.)

Extending tax fairness to the top 20 percent would generate an estimated \$128.1 billion in additional revenue each year.<sup>8</sup>

These revenues from tax fairness are enough to substantially restore and increase investments in vital public services—education and infrastructure—expand Medicaid coverage, and pay down pension debt.

President Obama's proposal for free community colleges would cost only \$6 billion total—one 11<sup>th</sup> of the revenues from tax fairness on the top one percent. The state share of this proposal is estimated at only \$1.5 billion.<sup>9</sup>

Reversing all state cuts to higher education funding—including for four-year schools—imposed between 2007-08 and 2012-13 would cost \$7.1 billion, about a tenth of the revenue from tax fairness on the top one percent.<sup>10</sup>

Universal pre-kindergarten would cost the states and federal government an estimated \$19-\$24 billion per year, only about a third of the revenue from tax fairness on the top one percent.<sup>11</sup>

## What Would Fair Taxation Do for *Your State's* Budget?

The figures on the next two pages show revenue generated from tax fairness on the top one percent and the top 20 percent in selected individual states. (Table A1 reports the revenue generated by state for all states in which tax fairness would generate revenue.<sup>14</sup>)

Texas and Florida would gain the most revenue from tax fairness. Each state could raise roughly \$10 billion from tax fairness on just the one percent and \$20 billion from tax fairness on the top 20 percent.

The annual cost of paying off pension debt in the 50 states is \$30.5 billion, about 45 percent of the revenue generated from tax fairness on the top one percent and less than a quarter of the revenue from tax fairness on the top fifth.<sup>12</sup>

Most (four fifths) of the cost of reversing the decline of America's decaying infrastructure—water purification, roads and bridges, mass transit, electric grids, airports, seaports and waterways—could be paid for by tax fairness on the top 20 percent at the state and local level, leaving the federal government to cover only the last fifth of the cost. The American Society of Civil Engineer's estimates the catch-up annual cost of this at \$157 billion per year—investment that would generate a \$3.1 trillion increase in Gross National Product by 2020.<sup>13</sup>

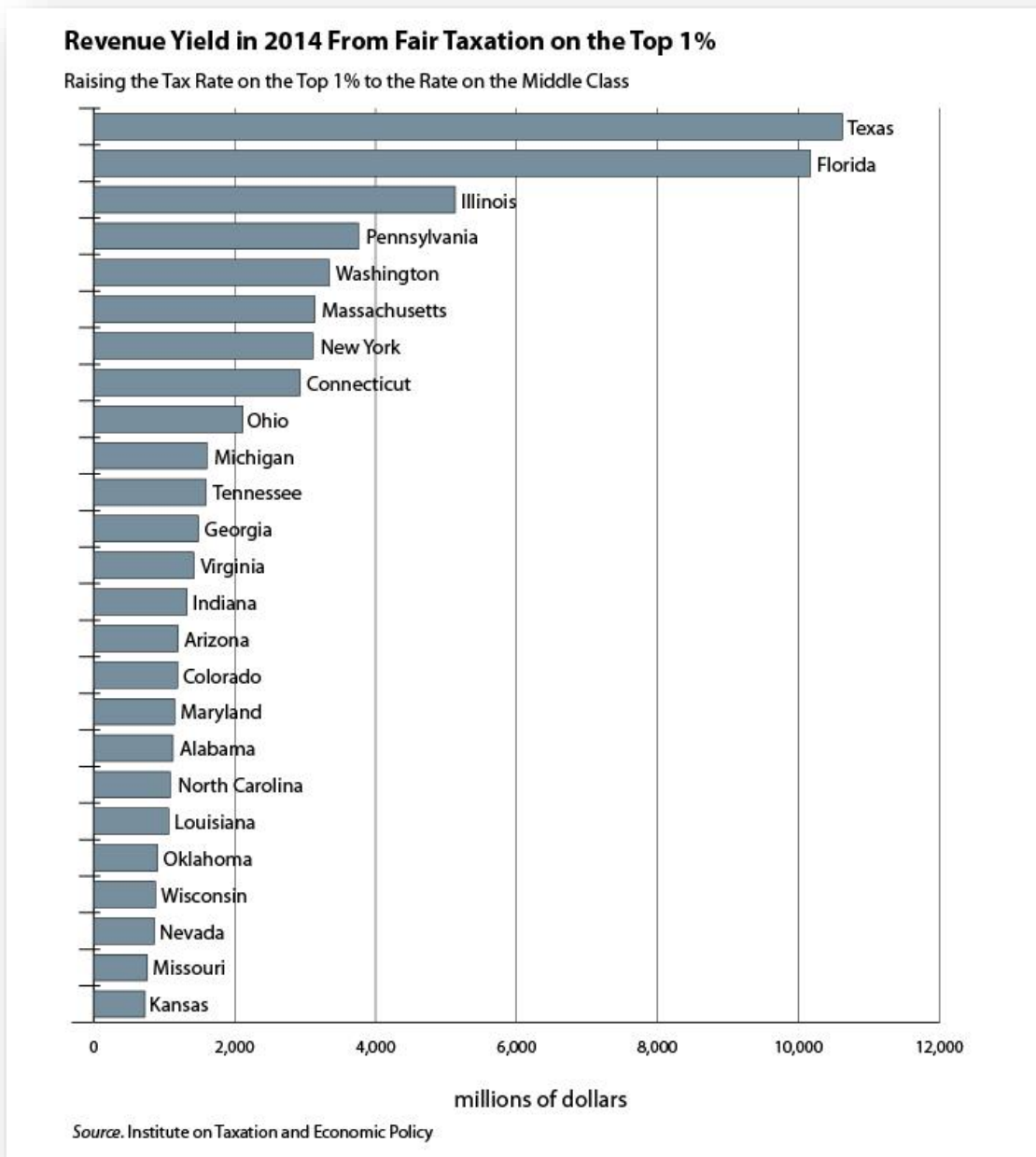
Investing in all of these programs now would create additional revenue for states in the future. Children attending pre-kindergarten are likely to have higher incomes and be less dependent on social welfare programs. Healthier and better-educated adults will be more productive and earn more. Commuters with better roads and more transit choices will waste less time in traffic—increasing productivity and adding economic output.

In Illinois, Pennsylvania, Washington State, Massachusetts, New York, and Connecticut, tax fairness on the top one percent would generate \$5.1 to \$2.9 billion. In these states except for New York, and also in Ohio and Tennessee, tax fairness on the top 20 percent would raise \$4 to \$8.6 billion.

In 20 states, tax fairness on the top one percent would generate at least \$1 billion and tax fairness on the top 20 percent would generate at least \$1.97 billion.

Many states in which tax fairness would raise the largest amounts are also states with substantial pension liabilities. This is not surprising. As Good Jobs First reported last year, many states with large pension debts also have large corporate tax loopholes and generous economic development tax breaks.<sup>15</sup> These giveaways cost revenue that could have been used to cushion the recession's

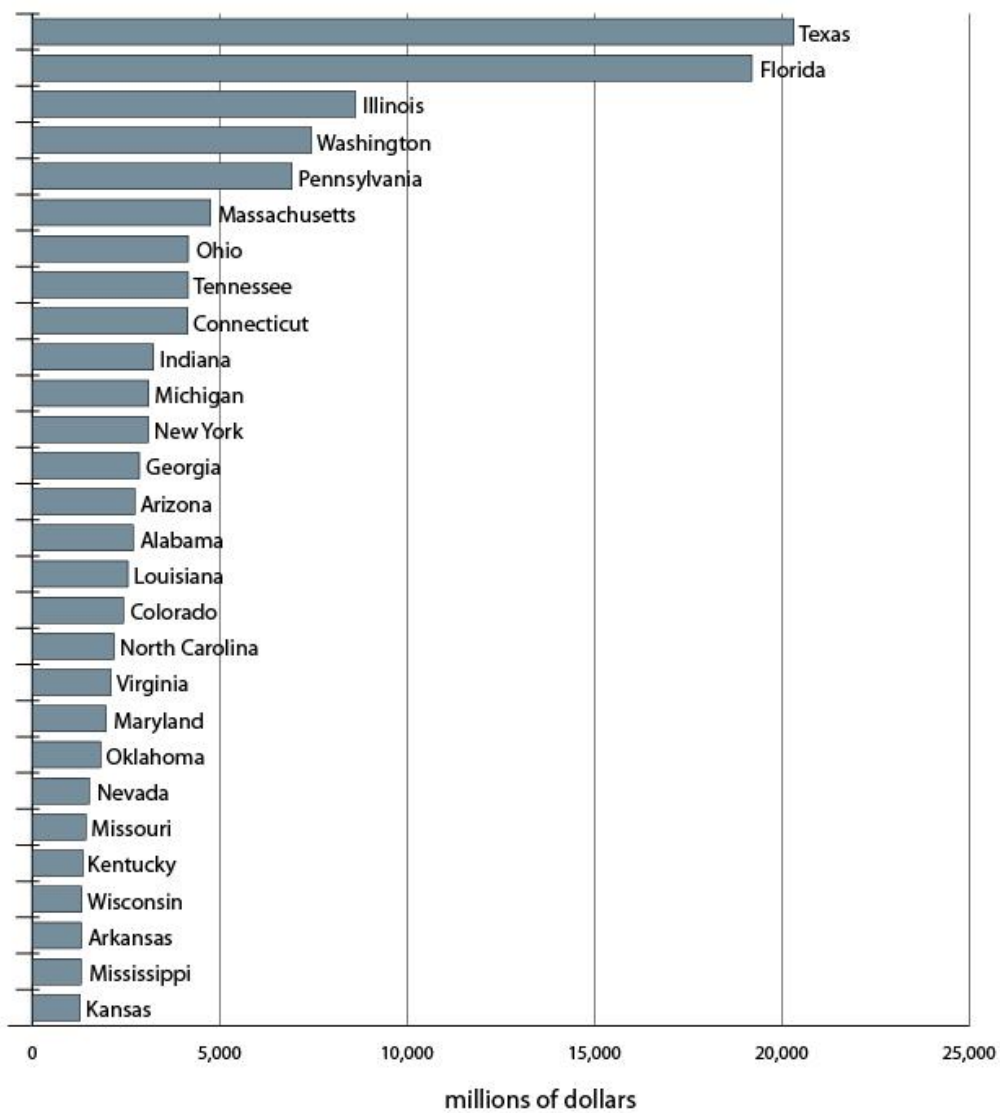
severity and better keep up with obligations such as aging infrastructure and pension liabilities. Thus, for example, the six states that would gain the most revenue from tax fairness on the top one percent include five of the 10 states with the largest pension debts: Illinois, Pennsylvania, Texas, Florida, and Massachusetts.





## Revenue Yield in 2014 From Fair Taxation on the Top Fifth

Raising the Tax Rate on the Top Fifth to the Rate on the Middle Class

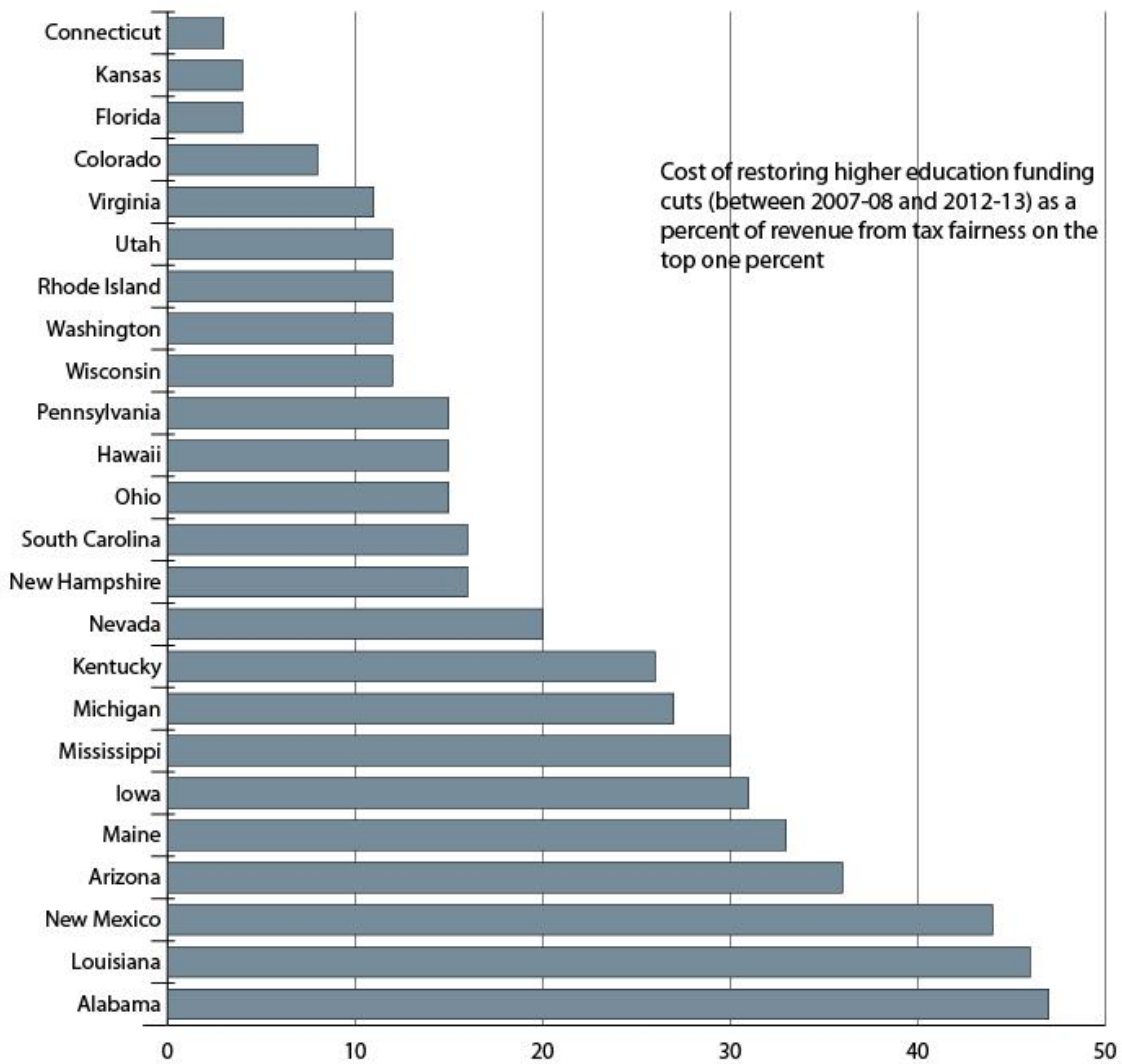


Source: Institute on Taxation and Economic Policy

For some budget categories, data for all 50 states make it possible to compare for individual states spending on those categories with revenue from tax fairness. In 24 states, for example, restoring cuts to higher education funding between 2007-

08 and 2012-13 would cost less than half of the revenue from tax fairness on the top one percent.<sup>16</sup> (In 18 states there was no cut in higher education funding in this period.)

**In 24 States, Restoring Higher Education Funding Would Cost Only a Fraction of the Revenue from Tax Fairness on the Top One Percent**

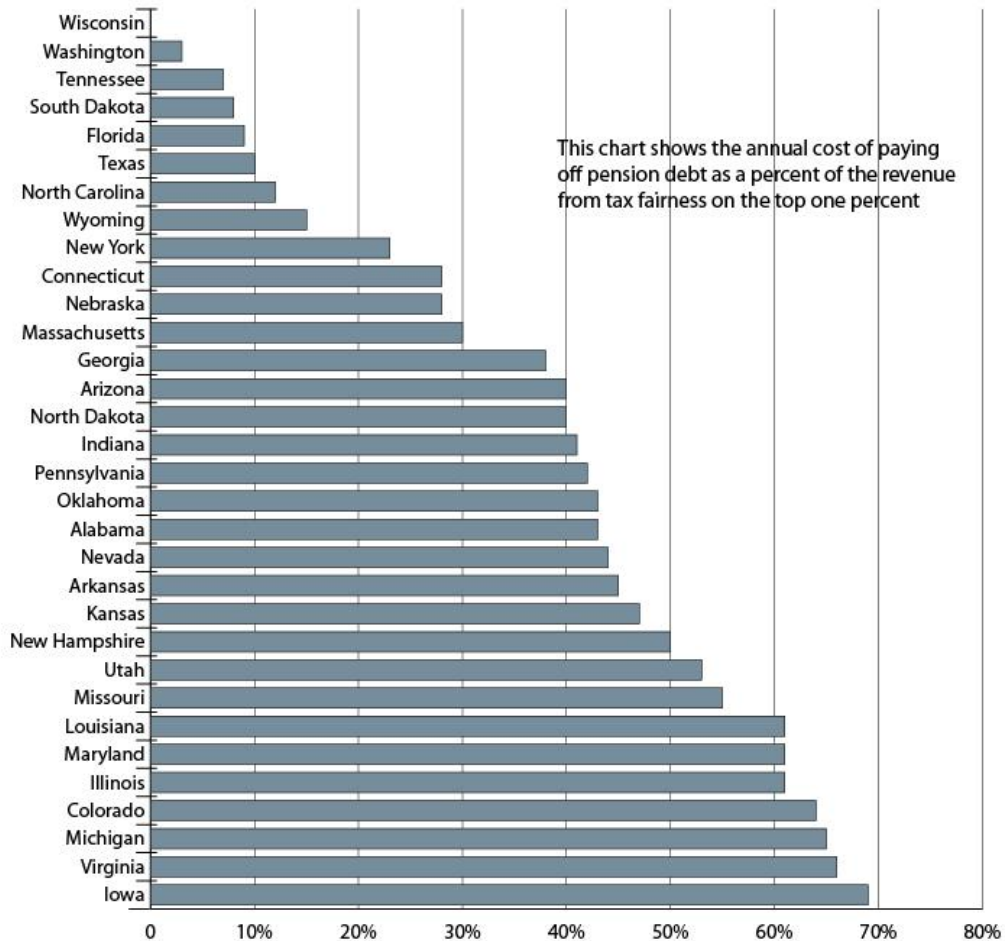


Source: KRC based on ITEP and University of Illinois Grapevine data

Twenty-three states could meet the annual cost of paying off pension debt using half or less of the revenue generated from tax fairness on the top one percent—usually much less than half. Many of these states have had intense debates over pensions in recent years, including Pennsylvania, Arizona, Oklahoma, Kansas, New Hampshire, and

Florida. In Texas, Florida, and four other states, the annual cost of paying off pension debt is less than 10 percent of revenue from tax fairness on the top one percent. Even in Illinois, paying down pension debt would cost only 61 percent of tax fairness on the top one percent.

### In Many States, the Annual Cost of Pension Debt is a Fraction of Annual Revenue from Tax Fairness on Just the Top One Percent



Source: .KRC based on ITEP and Pew Trust data

### Tax Fairness is Not Rocket Science

Tax fairness cannot solve all budgetary problems. There are a small minority of states that already have tax fairness. In states where tax systems are only slightly regressive, tax fairness would only make a small contribution to meeting state revenue needs. But in many states, tax fairness can be part of the solution to solving structural deficits and the challenges of inequitable growth—sometimes a major part.

There are many ways that states could embrace tax fairness. In most states, income taxes could be made more progressive. In more than half the states (27), lawmakers could close corporate tax loopholes by enacting so-called combined reporting, preventing companies from using corporate shells to avoid paying income taxes in the states where they earn profits.

In light of sharp increases in wealth inequality since the 1980s, states could also impose taxes

on wealth. The wealthiest one percent now own 42 percent of total U.S. wealth.<sup>17</sup> Capturing small portions of wealth to reinvest in education, infrastructure, and innovation would benefit all Americans—including the wealthy—by accelerating the long-run rate of economic growth. Some states, including Florida and Pennsylvania, have imposed small taxes on financial wealth (such as stocks and bonds) in the past.

After 30 years of a middle-class squeeze, it's time to restore balance. One percent of Americans get twice the share of income they got 30 years ago. Taxing them at 60 percent of the middle-class rate (and under 50 percent in many states) is the wrong direction. Solving budget deficits and restoring investments in the future through tax fairness will help revitalize state economies and strengthen families and communities.

<b>Table A1. Revenue Yield in 2014 From Fair Taxation on the Top 1%, Top 5%, and Top 20% (increase in state and local tax revenues from increasing the tax rate on these top-income groups to the current tax rate on the middle fifth, in millions of dollars)</b>			
<b>State</b>	<b>Top 20% (i.e., top fifth)</b>	<b>Top 5%</b>	<b>Top 1%</b>
Texas	20,320	15,464	10,622
Florida	19,202	14,619	10,172
Illinois	8,624	7,175	5,128
Pennsylvania	6,930	5,501	3,753
Washington	7,452	5,289	3,341
Massachusetts	4,758	4,107	3,141
New York	3,096	3,750	3,106
Connecticut	4,150	3,874	2,925
Ohio	4,160	3,318	2,118
Michigan	3,109	2,308	1,605
Tennessee	4,155	2,722	1,589
Georgia	2,858	2,212	1,482
Virginia	2,104	1,846	1,420
Indiana	3,238	2,230	1,325
Arizona	2,735	1,903	1,194
Colorado	2,429	1,822	1,185
Maryland	1,967	1,527	1,144
Alabama	2,688	1,836	1,120
North Carolina	2,183	1,683	1,082
Louisiana	2,553	1,776	1,060
Oklahoma	1,824	1,412	905
Wisconsin	1,317	1,267	873
Nevada	1,518	1,183	857
Missouri	1,426	1,113	757
Kansas	1,278	1,071	724
Kentucky	1,353	981	602
Arkansas	1,304	908	558
Utah	748	599	413
South Carolina	550	586	413
Mississippi	1,298	792	393
Minnesota	704	592	375
New Hampshire	603	465	306
Iowa	617	495	300
New Mexico	704	511	294
Nebraska	617	421	286
South Dakota	555	418	281
Wyoming	435	340	254
Hawaii	707	403	186
North Dakota	424	286	167
Rhode Island	325	223	161
Alaska	272	191	127
West Virginia	204	181	92
New Jersey	NA	NA	64
Vermont	144	90	52
Montana	45	47	32
Idaho	NA	28	27
Maine	7	45	27
<b>Total</b>	<b>128,111</b>	<b>99,972</b>	<b>68,260</b>
*Total includes only states in which tax fairness would generate positive income; NA means "Not Applicable" because tax fairness on group shown in that state would not generate positive income.			
Source. Institute on Taxation and Economic Policy			

<b>Table A2. Raising Tax Rates on Top Incomes to Tax Rates on the Bottom Fifth Raises Even More Revenue (Revenue Yield in 2014 From raising state and local tax rates on the top 1%, top 5%, and top 20% to the tax rate on the bottom fifth)</b>			
<b>State</b>	<b>Top 20% (i.e., top fifth)</b>	<b>Top 5%</b>	<b>Top 1%</b>
Texas	40,578	27,358	17,580
Florida	38,348	26,482	17,398
Illinois	14,068	10,338	6,943
Washington	17,191	10,626	6,255
Pennsylvania	10,504	7,451	4,803
Massachusetts	6,206	5,040	3,735
Ohio	6,357	4,510	2,759
Tennessee	6,483	3,982	2,255
Arizona	6,234	3,841	2,247
Connecticut	2,553	2,729	2,207
Georgia	4,153	2,921	1,853
Indiana	4,341	2,807	1,624
Virginia	2,349	1,983	1,495
Michigan	2,674	2,082	1,487
Alabama	2,975	1,991	1,204
Nevada	2,338	1,663	1,151
Louisiana	2,847	1,938	1,148
Colorado	2,283	1,739	1,138
Oklahoma	2,441	1,755	1,097
North Carolina	1,800	1,481	981
Kansas	2,017	1,472	938
New Jersey	2,260	1,466	915
Missouri	1,759	1,296	857
Arkansas	1,495	1,008	611
Maryland	NA	393	496
South Dakota	1,105	731	461
New Hampshire	946	647	401
Utah	673	559	391
Wyoming	751	535	386
Wisconsin	NA	369	383
Mississippi	1,182	736	366
Iowa	874	620	362
New Mexico	977	647	358
South Carolina	280	444	341
Nebraska	734	484	320
Alaska	729	452	294
Hawaii	1,141	619	287
Kentucky	78	329	275
Rhode Island	651	397	251
North Dakota	662	412	233
Idaho	157	132	81
West Virginia	103	131	68
Maine	NA	23	17
Montana	NA	7	12
California	5,147	NA	NA
Total*	200,446	136,627	88,466
*Total includes only states in which tax fairness would generate positive income; NA means "Not Applicable" because tax fairness on group shown in that state would not generate positive income.			
Source. Institute on Taxation and Economic Policy			

## METHODOLOGY APPENDIX

Estimates of top one percent incomes by state come from the Economic Policy Institute report *The Increasingly Unequal States of America: Income Inequality by State, 1917 to 2012*.<sup>18</sup> The authors estimate cash market income before individual income taxes by state based on data published by the Internal Revenue Service. Cash market income is the sum of all income from wages, salaries, pensions, profits, dividends, interest, rents, and realized capital gains. Cash market income excludes all government transfers (social security benefits, unemployment compensation, etc.) and excludes non-taxable fringe benefits like employer provide health insurance. The aggregate of income as defined here (i.e., of “cash market income before individual taxes”) is only about two thirds of personal income because the latter does include income from government transfers and the value of non-taxable fringe benefits.

Estimates of tax rates on each income group in each state come from the Institute on Taxation and Economic Policy’s *Who Pays?*<sup>19</sup> ITEP also provided the estimates in the present report of revenue generated by tax fairness. These ITEP estimates are based on equalizing tax rates *before* taking account the “federal offset” – i.e., the reduction in federal taxes that high-income earners receive because they more often itemize state and local taxes on their federal income tax returns. As a result, the increases in top-end taxes, and the revenue increases from tax fairness, are lower than if tax rates were

equalized *after* accounting for the federal offset. Equalizing top one percent and top one fifth tax rates with the middle fifth tax rate *after* accounting for the federal offset generates \$89 billion and \$174 billion respectively.

As shown in Table A2, an alternative definition of tax fairness—raising tax rates on the top one percent and top fifth to tax rates on the bottom fifth—would also raise more revenue. Equalization of top income tax rates and bottom fifth rates before taking into account the federal offset would generate \$88 billion from the top one percent and \$200 billion from the top 20 percent. Equalization after taking into account the federal offset would generate \$119 billion from the top one percent and \$270 billion from the top 20 percent.

The estimates in this report of the revenue generated by tax fairness are also conservative because they assume that all the addition in revenue comes from in-state residents – which is true only when the personal income tax is used to raise the additional revenue. If other taxes are used to raise a portion of money (e.g., a corporate income tax), the increase in taxes paid by in-state upper-income residents will be accompanied by a substantial amount of revenue collected from out-of-state residents. That tax revenue from out-of-state residents is not included in our revenue from tax fairness estimates.

## END NOTES

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<sup>1</sup> Estelle Sommeiller and Mark Price, *The Increasingly Unequal States of America, 1917 to 2012*, Economic Policy Institute and Economic Analysis Research Network (EARN), January 26, 2015, online at <http://www.epi.org/publication/income-inequality-by-state-1917-to-2012/>

<sup>2</sup> Institute on Taxation and Economic Policy (ITEP), *Who Pays? A Distributional Analysis of the Tax Systems in All Fifty States*, January 2015; online at <http://www.itep.org/whopays/>

<sup>3</sup> Data in this paragraph are from Sommeiller and Price, *The Increasingly Unequal States of America, 1917 to 2012*.

<sup>4</sup> Some readers who know that U.S. GDP is closing in on \$17 trillion and U.S. personal income is about \$15 trillion may be perplexed that the top one percent share of 23.1 percent in 2012 only amounts to just over \$2 trillion. There are three main reasons for this: income as reported by the Internal Revenue Service, which we rely on in this report, does not include income from transfers; second, IRS income does not include the cash value of non-taxable benefits; and third, our taxable income data is for the year 2012, since which incomes has increased. See the Methodology Appendix for more discussion of the first two reasons.

<sup>5</sup> General Fund revenues for 2012 from National Association of State Business Officials, *State Expenditure Report: Examining Fiscal 2011-13*, Table 1 p. 7; online at <http://www.nasbo.org/sites/default/files/State%20Expenditure%20Report%20%28Fiscal%202011-2013%20Data%29.pdf>. We use 2012 General Fund revenue data for consistency with our data for top one percent income.

<sup>6</sup> These bullets are based on ITEP, *Who Pays? A Distributional Analysis of the Tax Systems in All Fifty States*.

<sup>7</sup> This total adds up the revenue gain from fair taxation on the top one percent in the 47 states in which the top one percent now pays less than the middle fifth. This total excludes California, Oregon and Delaware.

<sup>8</sup> If we define tax fairness as top income brackets paying the same tax rate as the lowest income fifth, then tax fairness on the top one percent and top one fifth would generate more revenue—\$88 billion and \$200 billion.

<sup>9</sup> The cost of the Obama program is estimated at \$60 billion over 10 years. See Kyla Calvert, “Obama to Outline Plan for Free Community College,” January 9, online at <http://www.pbs.org/newshour/rundown/obama-outline-plan-free-community-college/>. States are expected to pay one quarter of the costs and the federal government three quarters. See Kyla Calvert, “Obama: Community college should be ‘as free and universal in America as high school’” January 20, 2015, online at <http://www.pbs.org/newshour/rundown/community-college-tuition-top-theme-state-union-speech/>

<sup>10</sup> See data on public higher education funding maintained by the University of Illinois Grapevine data base. [Data for 2007-08 can be downloaded from http://education.illinoisstate.edu/grapevine/historical/](http://education.illinoisstate.edu/grapevine/historical/) and data for 2012-13 can be downloaded from <http://education.illinoisstate.edu/grapevine/tables/>

<sup>11</sup> New America Foundation estimates that the additional cost to states and the federal government, combined, for universal pre-K would be \$10-15 billion per year. This is on top of an estimated \$9 billion on pre-K for four-year-olds that is already spent. See Alex Holt, “Doing the Math: The Cost of Publicly Funded ‘Universal’ Pre-K,” March 14, 2013; online at <http://earlyed.newamerica.net/blogposts/2013/doing-the-math-the-cost-of-publicly-funded-universal-pre-k-80821>

<sup>12</sup> This assumes that the \$915 billion in unfunded pension liabilities across the 50 states is paid off in equal installments over 30 years. Unfunded pension liabilities by state and in aggregate across the 50 states from Pew Charitable Trusts, *The Fiscal Health of State Pension Plans*, March 2014, online at <http://www.pewtrusts.org/~media/Assets/2014/03/31/PewStatesWideningGapFactsheet2.pdf>.

<sup>13</sup> Doug Scott, “ASCE Releases Final Failure to Act Report,” January 16, 2013, online at <http://blogs.asce.org/asce-releases-final-failure-to-act-report/>. See also American Society of Civil Engineers, *Failure to Act: The Impact of Current Infrastructure Investment on America’s Future*, online at [http://www.asce.org/uploadedFiles/Issues\\_and\\_Advocacy/Our\\_Initiatives/Infrastructure/Content\\_Pieces/failure-to-act-economic-impact-summary-report.pdf](http://www.asce.org/uploadedFiles/Issues_and_Advocacy/Our_Initiatives/Infrastructure/Content_Pieces/failure-to-act-economic-impact-summary-report.pdf)

<sup>14</sup> In the minority of states in which tax rates on the top one percent or top fifth already exceed tax rates on the middle, setting top tax rates at the same rate as on the middle fifth does not generate revenue.

<sup>15</sup> Good Jobs First, *Putting State Pension Costs in Context: How They Compare to the Cost of Corporate Subsidies, Tax Breaks and Loopholes*, January 2014, online at <http://www.goodjobsfirst.org/statepensions>



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<sup>16</sup> We examine cuts over this period because it is the period with the deepest cuts. In most states 2007-08 was the pre-Great Recession higher education funding peak. In all but eight states, higher education funding increased again between 2012-13 and 2013-14.

<sup>17</sup> The top 0.1 percent (i.e., one out of 1,000 people) now own 22% of U.S. wealth. For recent estimates of U.S. wealth inequality, see Emmanuel Saez and Gabriel Zucman, "Wealth Inequality in the United States Since 1913: Evidence from Capitalized Income Tax Data," Working Paper 20625, National Bureau of Economic Research, October 2014.

<sup>18</sup> EPI, *The Increasingly Unequal States of America: Income Inequality by State, 1917 to 2012*, January 2015

<sup>19</sup> ITEP, *Who Pays?* January 2015.