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New Income Tax Rates for High Earners: A Progressive Approach to Addressing DC's Budget Shortfall

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As the District has struggled to balance its budget, a number of options to raise revenue have been proposed. One is to create new income tax rates for high-income households, as a number of states have done in recent years.

This proposal should be seriously considered. Creating new top income brackets is sound tax policy for several reasons:

- **A high-income tax raises revenue without hurting the local economy.** Raising revenue during an economic downturn helps avoid severe spending cuts which take money and services out of the local economy at a critical time. Prominent economists note that a new tax for high-income residents is healthier for the local economy than budget cuts because such tax increases are unlikely to affect local consumer spending.

- **Many states recently have raised income taxes on top earners.** Ten states, including Maryland, have raised top income tax brackets or added surcharges. For example, Montgomery County taxpayers with more than $1 million in taxable income pay a 9.45 percent rate, a 6.25 percent state tax and 3.2 percent county tax. The states of New York, New Jersey, California, North Carolina, Hawaii, Vermont and Oregon currently have higher top rates than DC. Studies have shown that most high-income taxpayers maintain their residence after these tax increases, refuting the argument such increases cause "rich flight."

- **The District cut income tax rates over the last decade.** DC's top tax rate has fallen from 9.5 percent to 8.5 percent, and income tax collections as a share of household income have fallen as well. Even with a new rate for high-income households, most DC families would face lower taxes than they did a decade ago. And high-income residents can claim DC income tax payments as a deduction on their federal income taxes, which would reduce the impact of an increase in their DC taxes. Finally, because DC's top rate now starts at $40,000 of taxable income, creating a new high-income bracket would provide a way to separate taxes paid by very high-income residents from the taxes paid by middle-income households.

- **A high-income tax would be more progressive than recent tax increases in DC.** The creation of a new top tax rate would move DC toward a more progressive taxation system. In recent budget balancing, DC leaders have relied heavily on regressive taxes--such as increasing the sales tax--that take a bigger chunk of money out of those who earn less.

Last year, legislation was introduced in the DC Council to create an 8.9 percent top rate for DC residents with taxable income above $500,000. Other options, including multiple high-income rates, should be considered as well. For example, Maryland has four rates for residents starting at taxable income above $150,000, with a top rate for those with taxable incomes of $1 million or more.

These issues are discussed in more detail below.

How a High-Income Tax Bracket Works

When a higher tax bracket is created, the new rate applies only to income that exceeds the minimum for that bracket. For example, under the bill introduced in DC last year, the new 8.9 percent rate would apply to taxable income (gross income minus allowed deductions) above $500,000. The top rate would <u>not</u> apply to the household's first $500,000 of income.

Because the top tax rate only applies to income above the new threshold, the impact for many families can be relatively modest.

Consider a household with taxable income of $600,000. The proposed new rate would apply to the $100,000 of income above $500,000. Because the proposed rate of 8.9 percent is 0.4 percentage points above the current top rate of 8.5 percent, the household's tax bill would increase by $400, or just 1/15 of one percent of income.

In addition, state income taxes are deductible on the federal tax returns of taxpayers who itemize. So an increase in state taxes is partially offset by a reduction in federal tax obligations. Consider a household whose DC taxes increase by $1,000. The family would be allowed to claim an additional $1,000 deduction from its federal taxable income. If that family is in the 35 percent federal income tax bracket, a $1,000 deduction from income would mean a $350 income tax reduction.[i]

High-Income Taxes Help Close Budget Gaps Without Hurting the Local Economy

Prominent economists have found that raising income taxes on higher-income households is a sensible approach to addressing budget shortfalls. Why? A top earners' tax has the positive impact of raising revenue, and studies have found that affluent households don't react by cutting spending or moving.

Peter Orszag, head of the U.S. Office of Management and Budget, and 2001 Nobel Prize-winner Joseph Stiglitz have noted that "tax increases on higher-income families are the least damaging mechanism for closing state fiscal deficits in the short run."[ii] They explain that severe cuts in government programs can be damaging because they take money out of the local economy. Tax increases on higher-income families are better because these families spend and invest much of their income outside of the local area, and modest tax increases are unlikely to affect their consumption.

Similarly, more than 100 economists sent a letter to New York Governor David A. Paterson in 2008 urging him to raise the top income tax rate rather than make severe spending cuts: "Economic theory and historical experience gives a clear and unambiguous answer: It is economically preferable to raise taxes on those with high incomes than to cut state expenditures."[iii]

A Top Earners' Tax Is an Approach Taken By Many States

Adopting a new top income tax rate would be following the lead of states that have recently done the same: Maryland, California, Connecticut, Delaware, Hawaii, New York, New Jersey, Oregon, and Wisconsin. As a result, at least nine states now have income tax rates higher than DC's top rate of 8.5 percent. Some states have chosen to sunset their high-income tax provisions, which means the top rate will lower after a certain date. Others have made the increases permanent.

States with Higher Top Income Tax Rates than DC	
Oregon	Married joint filers > $500,000 = 11% (till 2011) Married filers between $250,000 and $500,000 = 10.8% (till 2011) After FY 2011, married filers > $250,000 = 9.9%
Hawaii	Married filers between $300,000 and $350,000 = 9% (till 2015) Married filers between $350,000 and $400,000 = 10% (till 2015) Married filers > $400,000 = 11%(till 2015)
California	Households > $1 million = 10.3% Married joint filers > $94,112 = 9.3%
New Jersey	Households > $500,000 = 8.97% Households between $500,000 and $1 million = 10.25% (till 2010) Households > $1 million = 10.75%
New York New York City	Households > $500,000 = 8.97% (till 2011) Households > $500,000 = 12.62%
Montgomery and Prince George's Counties, Md.	Households > $1 million = 9.45% (till 2010) Households between $500,000 and $1 million = 8.7%
Vermont	Married filers between $200,301 and $372,950 = 9% Married filers > $372,951 = 9.5%
North Carolina	Households > $250,000 = 10.75% (till 2010)

- **Maryland:** As a result of state income tax increases adopted in 2008, residents of Montgomery and Prince George's counties pay a combined state and local income tax rate of 9.45 percent if they have taxable income above $1 million. The top state rate is 6.25 percent, and 3.2 percent comes from county income taxes.

New York: The top tax rate in New York State is 8.97 percent. New York City households with taxable income above $500,000 pay a local income tax of 3.65 percent, making the combined rate 12.62 percent.

North Carolina: For tax years 2009 and 2010, North Carolina placed a 3 percent surcharge on single filers above $150,000 and married joint filers above $250,000. The surcharge increases North Carolina's top rate from 7.75 to 10.75 percent.

There is no evidence that a substantial number of taxpayers change their state of residence because of these increases. Douglas S. Massey, a demographer at Princeton University and President of the American Academy of Political and Social Science, published a report last year analyzing the impact of a 2.6 percentage point tax hike in New Jersey on those making more than $500,000 a year. Massey estimated the tax increase resulted in New Jersey losing less than 1 percent of the "half-millionaire" households in the state, and that it resulted in a substantial increase in tax revenue.[iv]

Other studies find similar results. In California, for example, the number of high-income households grew substantially after high-income tax rates were raised in both the 1990s and 2000s.[v]

Finally, a 1999 study by the Institute for Taxation and Economic Policy found that high income tax states experienced more rapid economic growth than states with low income taxes during the 1980s and 1990s.[vi]

Those who oppose raising DC's top rate of 8.5 percent may point out that this rate is higher than Virginia's top income tax rate of 5.75 percent. While this is true, the total taxes paid by DC residents tend to be less than the total paid by those living in Northern Virginia. That's because the Virginia suburbs have far higher property taxes than the District, and they levy an annual car tax that DC does not. A September 2006 study by the DC Fiscal Policy Institute found that when both income and property taxes are added up, DC residents at many income levels pay the lowest overall taxes in the region.[vii]

For example, income and property taxes for a married couple with two children and income of $100,000 were $1,300 lower in DC than in Fairfax County, and $1,100 lower than in Arlington County.[viii] A study by the DC Chief Financial Officer came to similar conclusions.[ix]

Even with a New Top Rate, Most Residents Would Pay Less Income Tax than a Decade Ago

Income tax rates were lowered over the past decade for DC residents at all income levels. As a result, most families would continue to pay lower taxes than in the 1990s, even if a new top rate is created.

DC's tax rates have been reduced as follows since the late 1990s:

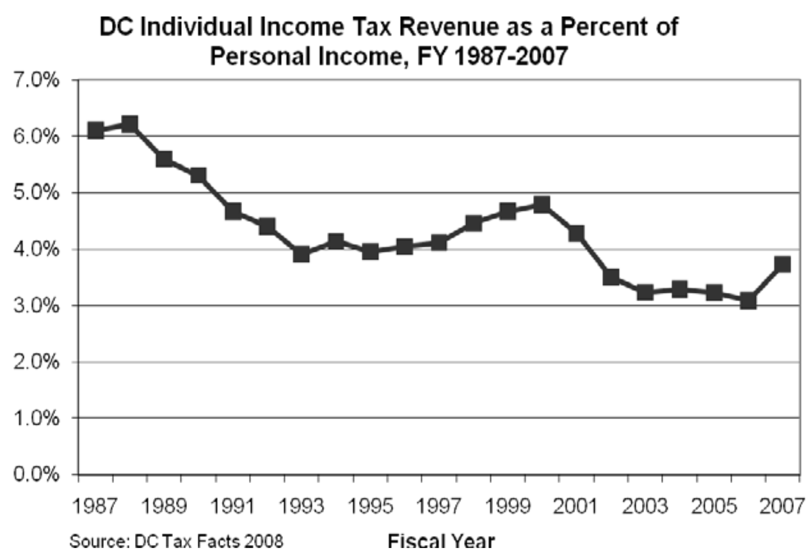
- The lowest tax bracket was reduced from 6 percent to 4 percent

- The middle tax bracket was reduced from 8 percent to 6 percent
- The top tax rate was reduced from 9.5 percent to 8.5 percent.

As a result, income taxes make up a smaller percentage of income today than a decade ago. At the peak of DC's recent economic growth, in 2007, income taxes equaled less than four percent of income citywide. In a comparable period in the late 1990s, income tax collections equaled nearly 5 percent of personal income. This equates to a tax cut of roughly $300 million per year.

These findings suggest that a new top income tax rate would still leave many families with taxes lower than they were a decade ago. For example, under the legislation introduced in the DC Council this year — setting an 8.9 percent rate for income above $500,000 — a household with $1 million in taxable inome would pay nearly $10,000 less in income taxes than under the rates in effect in 1998. Moreover, by limiting a tax increase to high-income households, the tax cuts for middle and lower-income families would all remain in place.

Finally, a new high-income rate would have the advantage of creating a distinction between the tax rates that middle-income DC residents pay, and the taxes paid by higher-income families. As the District adjusted its tax brackets and rates, it has never had a tax bracket to distinguish between middle income and high income residents. The top tax rate now starts at $40,000 of taxable income, which means that middle-income families are subject to the same tax rate as very high-income families.



A Top Earners' Tax Is a More Progressive Way to Raise Revenues

A progressive tax system is structured according to income, with higher-income families paying a greater share of income in taxes than lower-income families. However, DC's current system is regressive, as is the tax system in most states. Those who earn less pay a higher percentage of their income in DC taxes than those who earn more. While the District has a progressive income tax, this is offset by other regressive taxes, especially the sales tax.

A new study by the Institute on Taxation and Economic Policy found that the top 1 percent of DC households—those earning more than $1.5 million—pay 6.4 percent of their income in taxes after the federal offset. Yet those who earn between $33,000 and $57,000 pay 10.5 percent of their income in taxes using the same calculation. In other words, those with higher incomes pay a lower combined tax rate than working and middle-class families in the city.[x]

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	Top 1%
Income Range	Less than $20,000	$20,000-$33,000	$33,000-$57,000	$57,000-$97,000	$97,000-$262,000	$262,000-$1,543,000	$1,543,000 or more
Average Group Income	$12,400	$26,300	$45,400	$75,500	$143,200	$443,700	$2,708,300
Income Paid in Taxes After Federal Offset	6.2%	9.7%	10.5%	8.8%	8%	7%	6.4%

*Source: Institute on Taxation and Economic Policy

The high-income tax bracket proposal stands in contrast with several revenue provisions recently adopted by the Mayor and DC Council to balance the FY2010 budget, which made DC's tax system even more regressive.

Facing a $340 million shortfall for FY 2009 and 2010, the Mayor and DC Council adopted an amended budget for fiscal year 2010 that increases the sales, cigarette and gas taxes. Councilmembers argued that much of the sales tax would be paid by out-of-town visitors and commuters, but the increased sales tax rate will fall on residents as well.

Another regressive measure was the elimination of cost-of-living adjustment for the standard deduction and the personal exemption in the DC income tax and the homestead deduction in the property tax. All of these tax deductions provide the greatest benefit to lower-income families.

This means that the tax changes adopted this year will raise taxes more (as a share of income) on DC poorest families than on its highest-income families. A high-income tax rate, by contrast, would not affect low and moderate-income families at all, and would focus only on higher income families.

Conclusion

Legislation has been introduced this DC Council session to create an 8.9 percent rate for DC residents with taxable income above $500,000. This is one possible way to create a high-income tax rate, but there are other options. A number of states, including Maryland, have created multiple high-income rates, and the District should consider this as well. For example, Maryland has four rates for residents with taxable income above $150,000. The highest bracket affects those with taxable income above $1 million.

Creating a high-earner tax bracket is sound public policy that many states have implemented already. It structures taxes so that those who earn less do not pay a greater percentage of taxes out of their income than those who make more. It is sensible, equitable, and practical public policy that DC leaders should seriously consider.

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[i] 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. See *Raising State Income Taxes on High-Income Taxpayers,* Center on Budget and Policy Priorities, September 2009

[ii] 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, 2001.

[iii] Letter to Governor David A. Paterson, http://www.fiscalpolicy.org/Letter_EconomistsOnFiscalPolicy_December2008.pdf

[iv] Douglas S. Massey, "Trends in New Jersey Migration: Housing, Employment and Taxation," September 2008

[v] See Center on Budget and Policy Priorities, *Raising State Income Taxes on High-Income Taxpayers*, September 2009

[vi] Institute for Taxation and Economic Policy, "High Income Tax States Have Strong Economies," December, 1999.

[vii] DC Fiscal Policy Institute, Taxes on DC Families Are Now The Lowest in Washington Region, September 20th, 2006

[viii] See, for example, DC Fiscal Policy Institute, *Bridging the Gaps in DC: Strategies to Help Low-Income Working Families*, November 2008, page 5.

[ix] See DC Government, *Tax Rates and Tax Burdens: Washington Metropolitan Area*, 2008. For a family with $100,000 income, for example, the study found taxes to be lower for DC residents than in any of the suburban jurisdictions studied: the city of Alexandria and Prince George's, Montgomery, Fairfax, and Arlington counties.

[x] Institute for Taxation and Economic Policy, Who Pays: A Distributional Analysis of Tax Systems in All 50 States, 3rd Edition, November 2009.