THE CONNECTICUT POLICY INSTITUTE

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February 7, 2011

Don't Kill the Golden Goose! Raising the Income Tax May Be Good Politics, But It Is Bad Policy

SUMMARY

Nearly every state in the country has budget problems. Solving these problems will require reducing spending or increasing taxes or both. The arguments for each are emotionally charged, highly partisan, and rarely supported by persuasive policy analysis. Connecticut is no exception to the usual dogma accompanying taxing versus cutting arguments, but we are an exception when it comes to the availability of persuasive policy analysis regarding taxes.

Connecticut's economy and geographic location make it a special tax case. The state depends on a disproportionately small group of mobile, high income earners for its revenues. In 2008, the last year for which statistics are available, 9,506 Connecticut taxpayers earned over $1 million annually. These taxpayers, who make-up 0.66% of all taxpayers, paid more than a quarter of the state's income taxes ($1.28 billion of $4.79 billion) and over 10% of the state's total non-federal revenues[1]. They are Connecticut's golden goose.

This is well and good and relieves the burden on those who aren't among the 9,506, but only as long as those high income taxpayers remain here. The problem is, unlike in most other states, a high percentage of these taxpayers don't have to be in Connecticut to earn their incomes. Many of them moved here with already high incomes and at least partly because Connecticut's income taxes are lower than other states in the New York metropolitan area.

These high income taxpayers are not a static population. They are coming to and leaving Connecticut every year in large numbers[2]. To understand this part of Connecticut's tax base, it's easiest to think of a revolving door. As long as the same number is coming in the door as going out, we will have a large enough number here to help pay the bills. But if taxpayers stop coming or accelerate their departures, the total number here will decline and an essential component of our revenue base will be gone.

A typical high earner coming to the state is someone who has been living in New York City and who is thinking about moving out of the city, but wants to remain in the New York City area. His or her choices are New York State, New Jersey, or Connecticut. There are many good reasons to choose

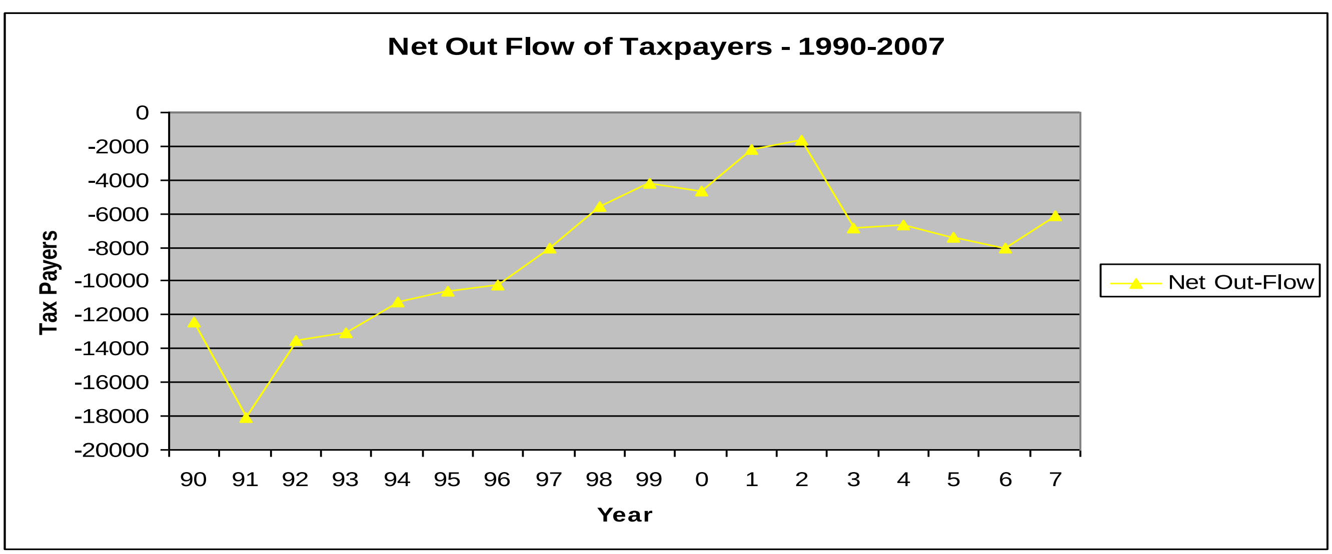
Connecticut, but an important factor for many with high incomes is Connecticut's lower marginal income tax rate. Connecticut's top marginal income tax rate currently stands at 6.5% versus 12.6% in New York City, 8.95% in the rest of New York State, and 10.75% in New Jersey. These differences add-up to significant savings for people with high incomes.

To learn more about these taxpayers and understand their movements, we looked at those who have the largest economic incentive to choose Connecticut over its neighbors – those with federal adjusted gross income (AGI) over $1 million – and we will refer to them here as high earners.

In a typical year about 40,000 taxpayers annually move to Connecticut. About 10,000 of them come from New York and New Jersey. We estimate 300 of those in-migrants each year are high earners. These high earners average about $3.2 million in AGI when they come to Connecticut and add to the approximately 10,000 high earners already here[3].

This is a very good thing because there are many high earners among the 45,000 taxpayers who leave the state every year. Many of the people leaving the state move to Florida or other warm weather states for their retirement, but some also move to New York City where they may have lived before.

Hundreds, if not thousands, of high income people every year are making decisions about whether to move to or from Connecticut. Connecticut's past tax policies account for a large portion of those 10,000 high earners being here. Prior to 1991, Connecticut had no income tax on earned income. Since then, Connecticut has successively reduced the economic benefit for high earners choosing to move here by instituting a 4% tax on earned income and increasing it in several steps to the current 6.5%. In Connecticut's case, history shows that increasing the marginal tax rate will reliably increase the migration of taxpayers out of the state. Net migration from Connecticut was the highest in 1991, the year the tax on earned income was introduced. From 1991 through 2002, Connecticut lost 102,985 taxpayers, but the annual out-migration had slowed by 2002 to 1,677 taxpayers a year from more than 18,000 in 1991. In 2003, Connecticut raised its marginal tax rate to 5% and the out-migration of taxpayers increased again reaching more than 6,000 in each of the years from 2003-2007[4]. So as rates go up, we know the size of the golden goose goes down.



Continuing to shrink the golden goose would not be a small matter for the Nutmeg state. The New York Times recently published an article placing Connecticut number one in debt per capita ($9,366) and third in debt as a percent of GDP (16.2%)[5]. Connecticut needs its high earners to support its ailing economy and pay its debts. Each of the state's high earners had an average 2008 AGI of $3.85 million and on average contributes an estimated $400,000 each year directly or indirectly to state and local government coffers. Each adds an estimated $1 million annually to the state GDP which supports at least five Connecticut jobs[6].

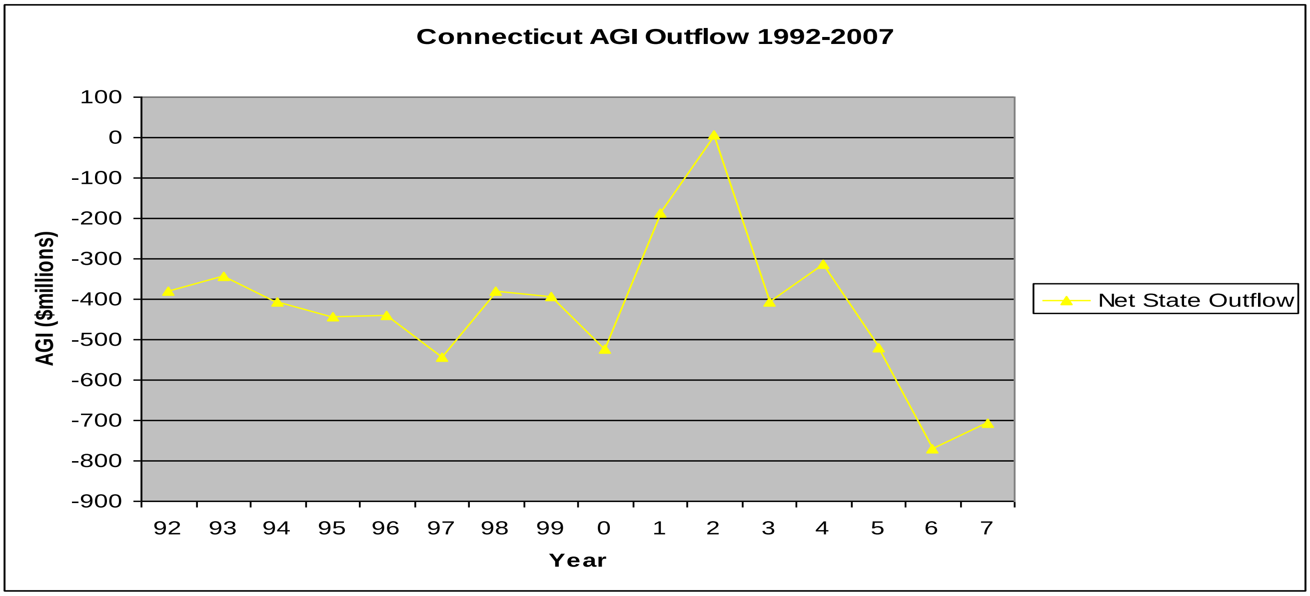
This is a gravy train that no serious policy-maker would want to stop. Intelligent and responsible tax policy must ensure that these high earners keep coming to Connecticut and that we don't drive away those already here. Our analysis indicates that raising the marginal income tax rate even 1%, from 6.5% to 7.5%, would reduce the number of high earners in the state by 10% over ten years, reduce state GDP by $2 billion a year, and cost the state over 15,000 jobs. At the end of those ten years, the tax increase would produce $13 million less revenues that year than if the rate had been left unchanged. Raising marginal income taxes would be bad long term policy for the state and would further complicate the state's budget and employment challenges.

ANALYSIS

Not all states are the same. Illinois recently raised its income tax rate from 3% to 5%, a 67% increase, but still 23% below Connecticut's rate. In Illinois' case, the increase may make economic sense. High earners in Illinois don't have the same choices Connecticut high earners do.

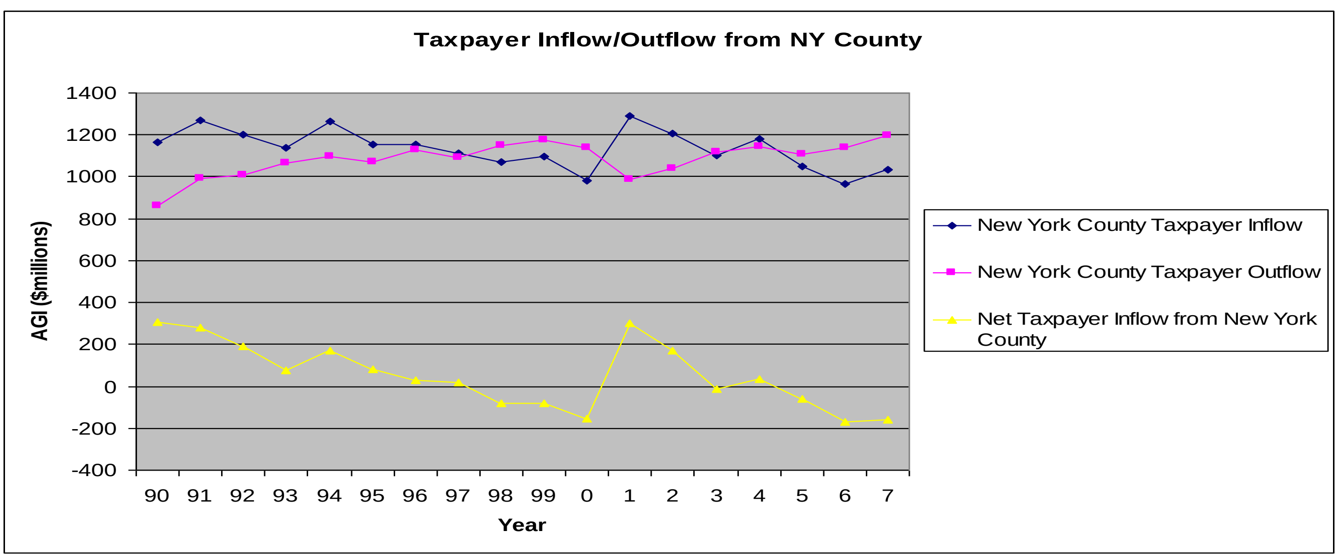
High earners who must be near Chicago, for example, to earn their living or who want to be there for other reasons, don't have any convenient lower tax alternatives. Wisconsin's top marginal rate is 7.75%, Iowa 8.98%, and Missouri 6%. Indiana at 3.4% is now slightly lower, but would require a long, inconvenient commute to Chicago. With no good alternatives to staying in Illinois, imposing the tax may hasten the retirement of some residents to Florida or other states with no income tax, but will not have a significant impact on the number of high income residents in the state.

Not so in Connecticut. Connecticut taxpayers have choices and our advantage over other tax venues has slipped as we have raised our marginal tax rates. We are now losing the competition with other states for taxpayer income. About $450 million a year more AGI moved out of state than moved in during the ten years following the 1991 introduction of the tax on earned income. By 2002, the outflow of AGI had slowed and in that year about the same amount of AGI moved into Connecticut as left. But since the income tax was raised again in 2003, the outflow of AGI from Connecticut has been alarming. Losses to other states increased to over $700 million annually by 2006 and 2007 amounting to a departure of nearly half a percent of state personal income each year[7].



We estimate this departure of income from the state just since 2002 has cost Connecticut $3.8 billion of cumulative state gross domestic product (GDP), $200 million of tax revenues, and over 4,000 jobs[8].

A close look at in-migration and out-migration between New York City and Fairfield County paints an even bleaker picture. An important part of Connecticut's golden goose since 1990 has been high income New York City residents moving to Fairfield County. In the early 1990's, Connecticut could count on about 300 more people moving to Fairfield County each year from New York City than those going the other way. A dramatic drop occurred in the years following the introduction of the tax on earned income in 1991. Except for the two years following 9/11 when migrants may have been motivated by security concerns, Fairfield County now has net losses of about 200 taxpayers a year to New York City[9].



Since 1991, Connecticut tax policy has made it less and less attractive for taxpayers with high earned income to move to Connecticut versus New York or New Jersey. We can't say by how much, but we believe state tax policy is largely responsible for the net out flow of high earning taxpayers and GDP.

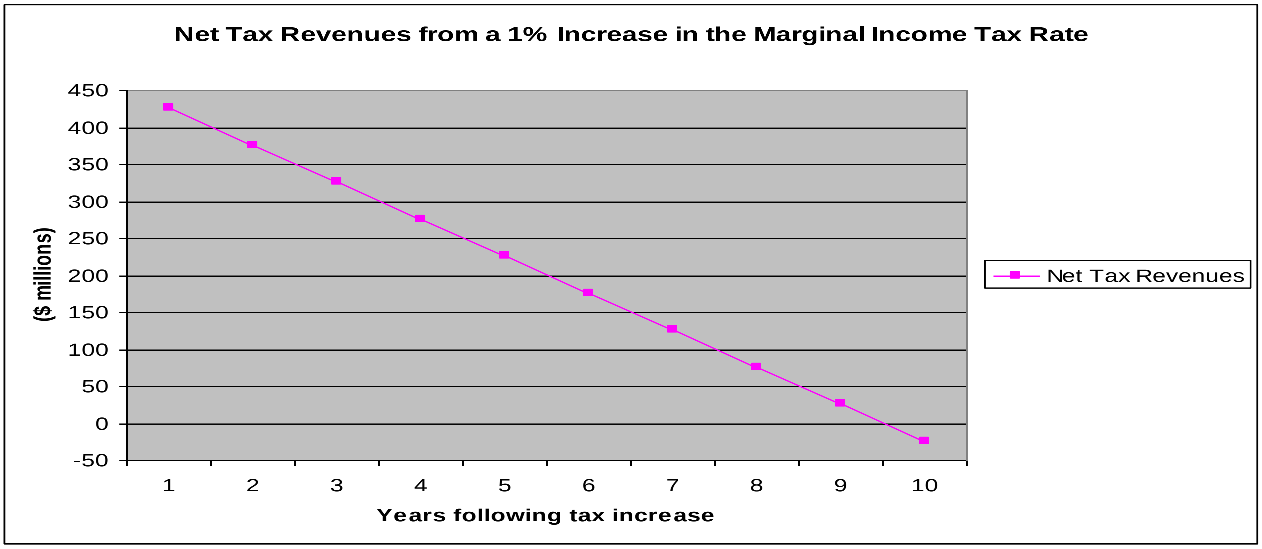
So what impact would a further increase in Connecticut's income tax have on our revolving door and, as a result, tax revenues, GDP, and jobs? We looked at what a 1% higher tax rate (increasing the current marginal tax rate from 6.5% to 7.5%) would do to the economic benefit of living in Connecticut versus neighboring states. A 1% increase in Connecticut's marginal rate is a 16.4% reduction in the economic benefit of living in Connecticut versus New York City, a 40% reduction in the benefit of living here versus Westchester County, and a 23.5% reduction in the benefit of living here versus New Jersey.

We estimated the impact of such a tax increase on the average earner of the 9,506 high earners in Connecticut as of 2008, the last year for which data is available. Their state taxes would have been $146,250 (net of the federal deduction) at the old rate and $171,250 at the new rate, a $25,000 annual increase. At current rates, they would save the entire $146,250 if they moved to Florida or Texas or Wyoming where there are no state income taxes. They would save $25,000 a year more after a 1% increase in the rate. At the old rate, they would pay $150,000 more living in New York City than Connecticut and $105,000 more living in New Jersey. Each of these would be reduced by $25,000 a year at the new rate[10]. These are not small amounts of money even for these high earners, and while taxes alone may not prompt someone to move, these savings or additional costs are surely a factor in these taxpayers deciding whether and when to move to or out of Connecticut.

We looked at the years from 2005 to 2008 to estimate the recent flow of Connecticut high earners in and out of the state. In 2005, Connecticut had 8,793 taxpayers with incomes over $1 million. In 2008 there were 9,506. However, if 2008 taxpayers' income is adjusted for inflation, 1,887 high earners would drop below $1 million level when stated in 2005 dollars, leaving 8,190 high earners in 2008 on an adjusted basis, or 597 fewer than in 2005, a loss of nearly 200 per year[11].

Many of the high earners migrating in and out of Connecticut are included in the migration data between New York and Fairfield Counties. We can assume there is a high correlation of the data trends between the two groups. From 2005-2008 about the same number of high earners left the state as all taxpayers who left Fairfield County for New York County. In the early 1990s, before the tax on earned income was in effect, there was an in-flow of about 300 taxpayers a year from New York to Fairfield County. We believe this data suggests there would also have been an in-flow of about 300 high earners per year into Connecticut in the early 1990's, indicating a net negative swing of 500 high earners per year since then. If the number of taxpayers leaving the state for tax reasons is related proportionally to the magnitude of the marginal rate, a 1% increase in the rate (20% of the 5% increase in marginal rates) would correlate with a net increase in outflow of 20% of 500, or 100 high earners each year[12].

If these estimates are correct, a 1% increase in the marginal income tax rate, which in a static analysis would generate $476 million in annual revenues, would generate $426 million in its first year. Ten years after introduction of the higher rate, it would cost the state $13 million a year more revenues than it contributed[13]. Not only would the tax increase not have increased revenues after year ten, but we estimate that by year ten it would have reduced state GDP by $2 billion a year and reduced employment by over 15,000 jobs[14].



CONCLUSION

Priority number one for state tax policy should be making sure we don't accelerate the departure, or arrest the in flow, of high earners to Connecticut. This undoubtedly has happened already from marginal rates being raised from 4.5% to 6.5% in recent years, but data showing the impact of that increase is not yet available.

Debates over whether to solve budget deficits by raising taxes or reducing spending too often devolve into emotional arguments and partisan dogma. We must avoid that in Connecticut because the cost of a policy mistake would be very high and long lasting. Connecticut is lucky that its location in the New York City area and past low income tax policies have built a large base of high earners who contribute strongly to the economy and pay a large share of Connecticut's tax revenues. But we can't take them for granted. We cannot forget that these taxpayers are mobile and that many of them came here because of our lower tax rates. Let's not drive them away or discourage others from coming to Connecticut by adopting ill-conceived tax policy. If we fail at this important policy choice, our state and our citizens will be poorer for it.

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[1] Connecticut's Department of Revenue Services (CDRS) Website – Individual Income Tax Data Reports and Connecticut Office of Policy and Management 2008-2009 Budget Report.

[2] Internal Revenue Service (IRS) Tax Statistics – Statistics of Income – U.S. Population Migration Data (http://www.irs.gov/taxstats/article/0,,d=212683,00.html). The IRS data runs from July 1 to June 30. On graphs and in the text the year 1991, for example, would apply to the period from July 1, 1991 through June 30, 1992.

[3] Interpolated from IRS and CDRS data referenced in footnotes 1 and 2.

[4] IRS data referenced in footnote 2.

[5] New York Times, Thursday, January 27, 2011, page B1.

[6] Data is from the Connecticut Department of Revenue Services Website. Tax estimate is based on state income tax rates applied to a $3.85 million AGI, estimated sales taxes of $25,000, estimated state revenues of $75,000 on GDP multiplier from taxpayer in-state expenditures, and local taxes of $50,000. GDP contribution based on an estimated 25% of gross income spent on goods and services produced in state.

[7] IRS data referenced in footnote 2.

[8] Assumes 90% of departed AGI is a deduction from state GDP, tax revenues are in the same proportion as non-federal revenues are to GDP (5.3%), and jobs are in the same proportion as total state employment is to annual state GDP.

[9] IRS data referenced in footnote 2 sorted by county.

[10] Tax amounts assume normal application of state tax rates to federal AGI for a full year resident whose income is earned in the state where they reside. All amounts are net of federal deductions at a 35% marginal rate.

[11] Connecticut Department of Revenue Services data was interpolated to estimate how many taxpayers are in each $50,000 increment of AGI from $750,000 through $1,150,000. From these estimates, it was determined how many would drop below the $1,000,000 threshold when 2008 dollars were discounted by the change in the CPI from 195.3 in 2005 to 215.3 in 2008.

[12] There is a lot of cross over among high earners moving in and out of Connecticut and those moving between New York County and Fairfield County. The tax bias toward less migration to Connecticut among this population would be higher among higher income taxpayers than those with lower incomes.

[13] Calculation is in constant 2008 dollars. Assumes that gross state and local revenues of $40 million annually leave the state with the 100 high earners and another 25% of that amount departs from those who are in income categories below high earners.

[14] $1 billion of direct GDP from the loss of in-state goods and services purchased by the departed high earners plus a 1:1 multiplier. Job losses estimated at one job lost for each $113,500 of GDP lost.