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In It for the Long Haul: Why Concerns over Personal Income Tax “Volatility” Are Overblown

The precipitous drop in state tax collections during the recent recession has prompted some observers to argue that relying on volatile state taxes is a recipe for budgetary disaster. The most recent version of this argument, made by the *Wall Street Journal*'s Robert Frank, suggests that the personal income tax in particular is highly volatile, growing dramatically during periods of economic growth and plummeting during recessions.¹ Frank suggests that volatile income taxes make the annual task of budgeting more challenging for state lawmakers, and offers California as a poster child for the dangers of income tax volatility.

But Frank's analysis misleads in several important ways. First, short-term revenue volatility affects all the major taxes used by states—and it's not obvious that the income tax is any more volatile than other major taxes. Second, over the long term, progressive income taxes are the most reliable revenue source available to states, displaying more robust growth in the long run than sales, property or excise taxes. Lastly, states faced with revenue volatility have a variety of sensible fiscal management strategies available to mitigate the impact of volatility—and the states that are currently experiencing the greatest budget pain are all too often those that don't follow these sensible management strategies.

Volatility: What It Means, Why It Happens

In early 2006, California newspaper headlines noted that the state had seen a \$4.3 billion increase in April personal income tax collections over the same month in 2005.¹ One estimate was that as much of an eighth of this increase was due solely to Google millionaires cashing in their stock options. Five years later, headlines in the Golden State are now just as grim as the 2006 news was giddy, with income tax collections plummeting compared to previous years.

When policymakers say they want to avoid excessive “volatility” in tax revenues, California's Google experience is usually what they have in mind: a volatile tax is one for which year-over-year revenue growth experiences noticeable peaks and troughs. By contrast, a stable tax is one for which the growth rate varies little from year to year.

When volatile taxes grow or fall, they're usually responding to changes in the business cycle: tax collections increase rapidly when the economy grows, and grow more slowly when the economy slows down. In the recent recession, virtually no tax levied by state governments has

¹ “The Price of Taxing the Rich,” *Wall Street Journal*, March 24, 2011.

² “Google's April Surprise for State,” *San Francisco Chronicle*, May 9, 2006. <http://bit.ly/fZBJ0V>

been immune from this effect. In recent years, states have seen a downturn in everything from the sales tax to gambling revenues to corporate income taxes.

The most obvious reason why volatile taxes are a concern for lawmakers is that tax revenues are how state and local governments pay for the public services they provide each year, and the cost of providing these services tends to grow at least with inflation. If the cost of public investments such as education, transportation and healthcare grows each year, lawmakers will be left scrambling when tax revenues actually *decline*, as has happened in many states during the recent recession.

The Tradeoff: Volatility v. Long-Term Growth

Some lawmakers, eager to reduce the role of the progressive personal income tax in their state's revenue portfolio, have argued that making a state's tax system less volatile is unambiguously a good thing. But it has long been recognized that there is generally a tradeoff between short-term volatility and long-term growth—and that the price of making your tax system less volatile is usually a diminished capacity to fund public investments in the long run.

This tradeoff was explicitly addressed in a 2005 report by California's nonpartisan Legislative Auditor's Office (LAO). Asked to evaluate the volatility of the state's income tax—and the impact of taking steps to reduce its volatility—the LAO found that “any rebalancing which reduces the state's dependence on California's progressive PIT [personal income tax] would likely result in less growth in revenues over the long term.”²

This finding—that taking steps to reduce volatility will have the unforeseen impact of reducing long-term revenue yields—is entirely understandable given the difficulties states have encountered in modernizing their sales tax laws. Most states, including California, apply their sales tax to the goods purchased by consumers, but exempt the huge and growing array of intangible services, from haircuts to car repairs, from sales tax. These exemptions virtually guarantee that sales tax revenues will grow more slowly than consumer spending—and more slowly than the economy—over time. Similarly, the strict property tax caps implemented by California and many other states in the past sharply limit the potential growth of that important revenue source compared to the income tax.

Given this basic tension between the goals of reducing revenue volatility and adequately funding services in the long run, it seems clear that reducing volatility wouldn't make the task of budgeting any easier for lawmakers. A volatile tax system makes it more likely that lawmakers will have to adjust tax rates in the short term to deal with deficits and surpluses—but a slow-growth tax system makes it inevitable that taxes will need to be revised substantially five or ten years down the road. Put another way, reducing volatility is by no means a recipe for a low-maintenance tax system.

³ “Revenue Volatility in California,” California Legislative Analyst's Office, January 2005.

If Volatility is the Problem, Is Cutting Income Taxes the Solution?

Leaving aside the question of whether reducing volatility is a sensible long-term goal, it's not obvious that shifting away from income taxes would reduce revenue volatility to begin with. There is growing economic evidence that income taxes, as states have chosen to structure them, are no more volatile than the sales taxes the same states levy. In a 1996 paper, Russell Sobel and Randall Holcombe examined long-term trends in collections from these taxes and found that "the personal income tax has about the same cyclical variability as the retail sales tax."¹ A study by Bruce, Fox and Tuttle (2006) reports a similar finding: in the short run, "neither the personal income tax nor the sales tax emerges as the universally more volatile tax."² These same studies confirm the LAO's finding that shifting away from income taxes is likely to reduce the long-term sustainability of state revenue streams: Sobel and Holcombe find that the income tax "has a significantly higher long-run growth rate" than the sales tax, while Bruce, Fox and Tuttle find that in the long run, the average growth rate of state income tax bases is "more than double" that of state sales tax bases.

Is Having Rich Residents a Recipe for Fiscal Disaster?

In his recent *Wall Street Journal* piece, Robert Frank asserts that "New York, New Jersey, Connecticut and Illinois—states that are the most heavily reliant on the taxes of the wealthy—are now among those with the biggest budget holes."

Now, it would probably be news to residents of Illinois that their state income tax falls heavily on the rich—and in fact, it doesn't. A November 2009 ITEP study, *Who Pays: A Distributional Analysis of the Tax Systems in All Fifty States*, shows that of all the states levying an income tax, the effective income tax rate paid by the very best-off Illinoisans was the lowest—bar none—in the nation. Illinois has a flat-rate income tax, which means the best-off taxpayers pay at the same rate as a minimum-wage worker.

So if Illinois relies heavily on taxes paid by the wealthy, it's not because the state has a progressive income tax—it's because the state simply has more wealthy residents than other states. If their presence has been responsible for the state's fiscal woes over the past decade, the only obvious policy response for Illinois lawmakers would be to politely ask them to leave.

Dealing with Volatility: Rainy Day Funds

Any parent who has huddled around the kitchen table planning family finances recognizes the need to set aside extra income during good times for use when (usually unforeseen) hard times arrive. And most states have established special "rainy day funds" designed to serve the

⁴ Sobel, Russell S., and Randall G. Holcombe. 1996. "Measuring the Growth and Variability of Tax Bases Over the Business Cycle," *National Tax Journal*, vol.49, no.4, pp.535-52.

⁵ Bruce, Donald, William Fox and M.H. Tuttle. 2006. "Tax Base Elasticities: A Multi-State Analysis of Long-Run and Short-Run Dynamics," *Southern Economic Journal*, vol.73, no.2, pp.315-341.

same purpose. Yet as the Center on Budget and Policy Priorities has noted, relatively few states have adequately reinforced these rainy day funds to deal with budget shortfalls of the magnitude states have recently experienced.³

Robert Frank's recent article grudgingly admits (eventually, and without elaboration) that in dealing with revenue volatility, "economists and state budget chiefs say the best hedge is better planning." Yet Frank fails to acknowledge that California's fiscal crisis has been exacerbated by the lack of a meaningful rainy day fund. Although a reserve fund was created in 2004, it has never been allocated sufficient funds to deal with shortfalls because of the consistently tough times the state has faced. As California Budget Project Director Jean Ross has pointed out, "it hasn't stopped raining long enough to fill up the fund."⁴ Lacking a meaningful reserve, California finds itself handcuffed by volatility in each of the taxes it levies—not just the income tax.

Conclusion

Revenue volatility is not a concern to be idly shrugged off. The short-term fluctuations in income, sales and corporate taxes that states are experiencing at this writing are making the budgetary process more difficult for elected officials across the nation. But short-term volatility is often the price policymakers pay for a sustainable long-term revenue stream—and the claim that progressive personal income taxes are more volatile than alternative revenue sources isn't backed up by available evidence. Academic research casts doubt on the conventional wisdom that income taxes are more volatile than sales taxes to begin with—and the same studies show that over the long term, income taxes simply perform better than sales taxes as a means of sustainably funding public investments.

Making state tax systems less volatile is, at best, a subsidiary goal of state tax systems. The sensible main purpose of state revenue systems is to raise sufficient revenues to fund needed public investments over the long term—and a progressive income tax, coupled with prudent fiscal management of a meaningful rainy day fund, is a sensible tool for achieving this goal.

⁶ <http://www.cbpp.org/cms/index.cfm?fa=view&id=3387>

⁷ http://www.cbp.org/pdfs/2009/0906_CaliforniaJournalofPoliticsandPolicy.pdf