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As Presidential Candidates Target Investment Income for Higher Taxes, Which States Stand to Lose the Most?

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The recent Warren Buffett-Hillary Clinton forum featured the billionaire's oft-repeated theme that the U.S. income tax code treats investment income too generously compared to wage income. This *Fiscal Fact* describes the different types of investment income, how they're taxed and which states they're most commonly earned in.

Two Types of Investment Income in the Spotlight: Capital Gains and Dividends

When people save money—whether by investing in stock directly, through a 401(k) or by simply putting it in the bank—the earnings generated by those savings are called investment income and taxed separately from wages.

When a person sells stock, the income is called a capital gain (or loss). If a person invests in several companies' stock, some will probably pay a regular dividend, and those dividend checks are also investment income.

Capital Gains: Why Has the Rate Historically Been Lower Than the Wage Tax?

If you profit from the sale of your coin collection or your house or some stock you invested in, that's a capital gain. The federal government has almost always taxed those gains at a lower tax rate than it has applied to wages. Why?

- The increased value of any asset is partly due to inflation, but the tax law doesn't adjust for inflation. The lower tax rate makes up for that but in a very rough, approximate way.
- Because people can choose when to sell their assets, capital gains are much more sensitive to tax rates than wages. Facing higher wage taxes, people must continue working, but in the face of higher capital gains taxes, people can cling to their assets. This damages the economy and disappoints hopes for higher tax revenue.
- Because people invest in the stock of specific companies, and because the stock's gain is reduced by the corporate income tax, tax experts usually add the corporate

income tax rate to the capital gains or dividend rate to compute the real tax rate on capital, which adds up to a much higher rate than the tax on wages.

Dividends: Tax-Exempt for 40 Years, then Taxed Like Wages for 50 Years, Now Taxed Like Capital Gains

While capital gains have always been taxed at a lower rate than wages, dividend tax policy, on the other hand, has gone a different route. Until 1954, dividend income was nearly always tax exempt. Between1954 and 2003, it was essentially taxed as ordinary income, and since 2003 it has been given the same preferential rate as capital gains.

Before 2003, the high tax rate on dividends made them much less popular than capital gains as a way for companies to funnel profits to their shareholders. Equalizing the tax rates on these two major sources of capital income has restored the value of dividends, causing many new ones to be issued. Some experts believe this will result in superior corporate governance, as companies decide between the two methods for non-tax reasons. Also, like capital gains, companies can choose when to declare a dividend, which makes them more sensitive to tax rates than wages.

The New Clamor for Taxing Investment Income Like Wages

Many politicians, especially on the Democratic side, have called for capital gains and dividend income to be taxed at the same rate as wage income. That is, investment income would be subject to the progressive rate structure with marginal tax rates from 10 percent to 35 percent, or higher if the tax rate on wages is also raised.

In political terms, this Democratic support for higher taxes on investment is surprising because Democrats represent more states with high investment income and therefore benefit most from the Bush tax cuts on investment income. When the 50 states are ranked by the amount of investment income earned per tax return (see Table 1), all of the bottom 10 ten states voted for Bush in 2004 while 13 of the top 20 voted for Kerry.

The 10 states that earn the most investment income per tax return are Wyoming, Nevada, Connecticut, Florida, Massachusetts, New York, California, Arizona, Colorado and Washington. The ten that earn the least are West Virginia, Mississippi, North Dakota, Iowa, Indiana, Kentucky, Ohio, Alaska, Louisiana and Oklahoma.

Table 1
IRS Data Show Capital Gains and Dividend Income Vary Significantly By State, 2005

State	Average Capital Gains Plus Ordinary Dividend Income Per Tax Return	Rank
United States	**$5,841**	
Alabama	$3,573	39
Alaska	$3,088	44
Arizona	$7,047	9
Arkansas	$3,671	38
California	$7,855	8
Colorado	$7,003	10
Connecticut	$10,433	3
Delaware	$6,073	13
Dist. of Columbia	$10,160	5
Florida	$10,376	4
Georgia	$4,742	24
Hawaii	$5,693	17
Idaho	$5,285	20
Illinois	$5,946	14
Indiana	$3,026	47
Iowa	$2,885	48
Kansas	$3,869	34
Kentucky	$3,039	46
Louisiana	$3,226	43
Maine	$4,166	30
Maryland	$5,530	19
Massachusetts	$8,649	6
Michigan	$3,428	41
Minnesota	$4,702	25
Mississippi	$2,356	50
Missouri	$3,738	37
Montana	$4,776	23
Nebraska	$3,868	35
Nevada	$11,310	2
New Hampshire	$6,222	12
New Jersey	$5,918	15
New Mexico	$3,434	40
New York	$8,397	7

North Carolina	$3,967	31
North Dakota	$2,618	49
Ohio	$3,049	45
Oklahoma	$3,400	42
Oregon	$4,837	22
Pennsylvania	$4,526	28
Rhode Island	$4,539	27
South Carolina	$3,858	36
South Dakota	$4,306	29
Tennessee	$3,931	32
Texas	$5,078	21
Utah	$4,696	26
Vermont	$5,859	16
Virginia	$5,664	18
Washington	$6,971	11
West Virginia	$2,293	51
Wisconsin	$3,876	33
Wyoming	$11,455	1
Source: IRS Statistics of Income, Table 2; Tax Foundation calculations		

It should come as no surprise that one of the states with the most investment-source income is Florida, where there is a large retiree population that largely lives off investment income. For the same reason, Arizona is in the top10.

Aside from each state's percentage of retirees, the other main driver in the rankings is income. As a state's total income rises, its investment income tends to rise even faster. Wyoming earns the most investment income due to the extraordinarily high number of high-income individuals who live in the famous Jackson Hole ski resort in Teton County. Similarly, pockets of high-income individuals make Nevada a state with unusually high investment income, and Connecticut has had the highest average income in the country for many years.

In the next table, we translate the dollar figures from Table 1 into shares of total income, and we include for comparison shares from other income sources.

Table 2
Investment Income Versus Income from Other Sources, 2005

State	Share of AGI* in Wages/Salaries	Investment Income		
		Share of AGI in Capital Gains/Dividends	Share of AGI in Business Income	Share of AGI in Taxable Interest and Retirement Income
United States	70.09%	10.73%	3.66%	9.41%
Alabama	71.69%	7.89%	3.00%	10.37%
Alaska	72.03%	6.40%	4.62%	9.72%
Arizona	66.46%	12.87%	3.37%	10.35%
Arkansas	72.03%	8.85%	3.33%	10.28%
California	67.80%	12.61%	4.96%	8.17%
Colorado	68.77%	12.01%	3.55%	9.49%
Connecticut	68.44%	13.26%	4.16%	8.24%
Delaware	69.87%	10.55%	2.46%	10.29%
Dist. of Columbia	65.90%	14.56%	3.84%	8.96%
Florida	58.61%	18.11%	3.32%	11.08%
Georgia	73.31%	9.33%	2.78%	8.55%
Hawaii	67.95%	11.30%	4.60%	11.01%
Idaho	67.48%	11.50%	3.82%	10.12%
Illinois	70.82%	10.35%	2.93%	9.38%
Indiana	74.80%	6.50%	2.84%	9.33%
Iowa	72.73%	6.30%	3.10%	9.64%
Kansas	72.20%	7.94%	3.37%	9.43%
Kentucky	73.51%	6.97%	3.36%	10.49%
Louisiana	71.92%	7.35%	3.78%	9.12%
Maine	70.09%	9.32%	4.68%	10.10%
Maryland	72.55%	8.69%	3.03%	9.18%
Massachusetts	68.94%	12.88%	4.16%	8.06%
Michigan	73.56%	6.91%	2.71%	11.23%
Minnesota	72.39%	8.38%	2.97%	8.65%
Mississippi	74.07%	6.08%	3.88%	9.74%
Missouri	72.58%	7.95%	3.19%	10.40%
Montana	64.76%	11.68%	4.38%	11.62%
Nebraska	72.71%	8.34%	2.72%	9.07%
Nevada	60.80%	18.01%	3.10%	9.77%
New Hampshire	72.08%	10.78%	5.07%	8.47%
New Jersey	73.41%	8.71%	3.60%	8.11%
New Mexico	70.22%	8.09%	3.42%	11.94%
New York	67.97%	13.25%	3.58%	9.33%
North Carolina	72.28%	8.27%	3.28%	10.16%
North Dakota	70.71%	6.20%	3.55%	8.50%
Ohio	74.23%	6.59%	2.99%	10.65%

Oklahoma	69.19%	7.61%	3.82%	10.40%
Oregon	67.88%	9.82%	4.03%	11.34%
Pennsylvania	71.80%	8.87%	3.70%	10.02%
Rhode Island	71.83%	8.60%	4.01%	9.21%
South Carolina	70.96%	8.63%	2.69%	10.84%
South Dakota	65.35%	9.78%	3.52%	9.85%
Tennessee	73.54%	8.48%	5.05%	9.11%
Texas	72.01%	9.74%	4.24%	8.58%
Utah	71.18%	9.48%	3.05%	8.80%
Vermont	68.22%	12.35%	4.92%	8.96%
Virginia	72.01%	9.34%	3.23%	9.58%
Washington	68.55%	12.12%	3.78%	9.89%
West Virginia	73.77%	5.70%	3.80%	11.25%
Wisconsin	73.08%	7.79%	2.76%	9.64%
Wyoming	58.45%	19.88%	3.53%	9.43%
* AGI is adjusted gross income. Source: IRS Statistics of Income, Table 2; Tax Foundation calculations				

Table 2 shows how little some states depend on investment income, especially the states with fewer retirees. In general, that makes them more dependent on wage income. Mississippi, Indiana, Ohio, and West Virginia far exceed the national average by this measure, with wages making up almost three quarters of total income.

Conclusion

Investment income is a major source of American income, and its preferential rate of taxation has a long history. The idea put forth recently by some politicians—taxing all investment income as wages—would be a radical change, not just from current tax policy but in the context of our nation's tax history.

The impact would vary significantly by state. Overall, the data here indicate that states with higher incomes and larger retiree populations benefit most from lower tax rates on capital gains and dividends. Lawmakers calling for the equalization of wage taxes and investment income taxes will have to take into account the effect that higher taxes on investment income would have on these populations.

Caveat

Careful readers of Tax Foundation analysis will notice that in this paper we are talking only about the legal incidence of the tax on investment income. That is, we are assuming that a tax on investment income affects only the people who file tax returns with investment income. However, the economy is far more complex than that. When the federal government started taxing dividends much more generously in 2003, it was not only the recipients of dividend checks who benefited. The companies that pay dividends also benefited, and they were able to pay their employees more, and their stock prices rose, benefiting all their stockholders.

Therefore, West Virginia and other states that depend mostly on labor income may actually be hurt more by an investment tax than the foregoing state-by-state breakdown suggests. There is a large literature on who bears the burden of capital taxation, and viewpoints differ significantly, with variations largely depending upon assumptions of capital mobility.

At the Congressional Research Service, Chief Economist Jane Gravelle has argued that owners of capital bear almost all of the tax due to imperfect international capital market flows. Others, such as William Randolph at the Congressional Budget Office, have argued that capital mobility is high across the world and investors will seek the lowest taxed jurisdiction regardless of location. That mobility lowers amounts of capital investment domestically and it would lower the productivity (and wages) of domestic labor, thereby making labor bear much of the tax.

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