Why did some state tax revenues increase during the pandemic?

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The pandemic has been bad for business, but it hasn't necessarily been bad for U.S. state tax revenues; in fact, 22 states saw tax revenues increase during 2020. These outcomes ran counter to estimates made during the year, but a new analysis from researchers at NC State and the University of Texas at Dallas reveals one possible explanation.

The researchers specifically point to a combination of progressive income tax rates and COVID-19 restrictions as the reasons and explain how these factors could increase tax revenue—at the expense of greater income inequality.

Nathan Goldman, assistant professor of accounting in NC State's Poole College of Management, and Gil Sadka, from UT Dallas's Jindal School of Management, looked at the correlation between income tax rate structures, pandemic restrictions, and state income tax revenues during 2020.

They found that states with progressive income tax rates and more restrictive COVID-19 policies performed better in terms of state income tax collections relative to states with flat income tax rates and less restrictive COVID-19 policies. Their study highlights that the overall effect on tax collections across all states was essentially a "break even," and nearly half of the states' income tax collections increased from 2019 to 2020. However, their study also points out that progressive income tax rates and COVID-19 restrictions lead to more income inequality, a significant unintended consequence.

A progressive income tax structure means that the more you make, the higher percentage of your income you pay in taxes—it's how the federal government calculates income tax. States with progressive income tax rates do better when higher earners make more. For example, under a progressive income tax rate structure, someone getting a $1,000 increase in income on a $1 million salary is going to contribute much more in tax revenue than someone getting a $1,000 increase on a $20,000 salary. This can inadvertently lead to policies that favor higher earners.

"It seems counterintuitive, but progressive income tax rates can prolong the use of policies that increase inequality because the policies less adversely impact state budget deficits," Goldman says. "In the case of

the pandemic, COVID-19 restrictions unintentionally favored people whose jobs weren't dependent on being in a face-to-face environment. Those jobs also tend to pay higher wages. So workers in lower-earning positions lost their jobs due to the state's COVID-19 restrictions, while these same policies tended to benefit higher-earning workers. All else equal, these policies resulted in an increase in state tax collections."

California is a good example of Goldman and Sadka's findings: it has the most progressive income taxes in the U.S. (there is a 9.3% difference in tax on somebody with $25,000 of income versus somebody in the highest tax bracket). California was also ranked fifth in the U.S. in terms of most stringent COVID-related restrictions. In 2020, the state saw a 1.2% increase in tax collections compared to 2019. Another example, Vermont, has the third most progressive state income tax structure and the second most stringent COVID-related restrictions. Vermont saw a 2.2% increase in tax collections from 2019 to 2020.

On the other hand, a state like Florida, which collects no state income tax and had the fifth least stringent COVID-related restrictions, saw an 11.3% decline in income tax collections in 2020. In contrast, Washington also has no state income tax, but had the ninth most stringent COVID-related restrictions. Washington increased tax collections by 2.5% on the previous year.

The effect also occurred in states with flat tax rates but varying COVID-19 restrictions. For example, states like North Carolina and Oklahoma have a flat tax rate across all taxpayers. However, North Carolina increased tax collections in 2020 by 2.1%, and Oklahoma decreased tax collections by 4%. The two states differed in their approach to COVID-19 restrictions. North Carolina had the seventh most stringent set of restrictions, whereas Oklahoma had the third least stringent restrictions.

"The COVID-19 restrictions put the unintended consequences of tax policies in the spotlight, even in a state like North Carolina," Goldman says. "As pandemic restrictions set in, not only were those with lower-income jobs put at a disadvantage, people with higher-income jobs had some opportunities to increase their earnings.

"For example, some of North Carolina's major industries—banks, biotechnology, pharmaceuticals—were busy during the pandemic. Other studies show that productivity increases among some industries were dependent upon retaining remote employees and bringing in additional remote employees to address their demands. Thus, some higher-waged remote employees could benefit from the COVID-related restrictions by finding a higher-paying job or getting paid more in their current role. As these people's wages increased at the expense of lower-wage earners, state income tax collections benefitted."

More information: Nathan C. Goldman et al. Progressive Tax Rates, Income Inequality, and Tax Collections: Implications from COVID-19 Restrictions, *SSRN Electronic Journal* (2021). DOI: 10.2139/ssrn.3808836

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