States Should Consider Partial Wealth Tax Reforms

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States Should Consider Partial Wealth Tax Reforms

by David Gamage and Darien Shanske

This article is a contribution to Project SAFE (State Action in Fiscal Emergencies). In other essays in this project, we explain steps the federal government should take to help state and local governments cope with their looming budget crises. The federal government is much better positioned to manage these crises than states and localities and, ideally, it would act sufficiently to prevent the need for state and local governments to cut spending or raise taxes. However, we fear that the federal government may fail to act sufficiently, leaving states and localities with the need to make painful spending cuts, raise taxes, or both. Here, we make some suggestions for how states should respond if the federal government fails to act sufficiently.

Specifically, we argue that the states should consider adopting partial wealth tax reforms, at least temporarily, to raise needed revenue to weather the budget crises. There are at least two promising options that could be designed and implemented sufficiently quickly (at least in some states) to make good policy responses to the crises.

But first, some more background information. States are subject to balanced-budget constraints that prevent them from engaging in deficit spending during economic downturns, whereas the federal government is not so constrained. During economic downturns, state tax revenues tend to fall sharply, and as such, states can maintain balanced budgets only by increasing taxes (and perhaps licensing fees), cutting spending, or both. Conversely, during the economic upturns that lead to tax revenue surpluses, states typically reduce taxes and increase spending. In particular, social insurance programs such as Medicaid are subject to

1 See Gladriel Shobe et al., “Introducing Project SAFE (State Action in Fiscal Emergencies),” Tax Notes State, Apr. 27, 2020, p. 471.
3 Shobe et al., supra note 1.
4 Gamage, supra note 2.
spending cuts during economic downturns — when they are needed most. The COVID-19 crisis especially highlights the perils of spending cuts as Medicaid, unemployment insurance, and other social insurance programs that are vital to millions now out of work. So the question remains: How can states and localities better contend with fiscal volatility, especially in the face of a looming budgetary crisis?

Ultimately, raising taxes is preferable to harmful spending cuts to cope with budget crises during an economic downturn. Ideally, tax increases should be targeted at economic actors who are better positioned to weather the economic downturn, and with the increases made in a way that minimizes the potential for tax gaming responses or other taxpayer maneuvers for escaping tax.

Absent administrative constraints, the best solution would be a one-time wealth tax on state residents — which is backward-looking in that it taxes wealth accumulated previously. Hence, it is less subject to tax-gaming and other detrimental taxpayer responses. Such a wealth tax should be designed with a large exemption, so that the tax would only apply to the wealthiest, who are generally better positioned to weather the downturn as compared with others — especially the beneficiaries of major state spending programs.

Of course, administrative constraints complicate this story. States do not currently have a general wealth tax, nor is it likely to be feasible for them to design and implement a major new tax quickly enough to offset upcoming budget shortfalls. Moreover, some states face legal prohibitions against general taxes on wealth; for instance, article XVI, section 3, of the New York State Constitution states that:

Intangible personal property shall not be taxed ad valorem nor shall any excise tax be levied solely because of the ownership or possession thereof, except that the income therefrom may be taken into consideration in computing any excise tax measured by income generally.

Thus, because such a large share of wealth consists of intangible personal property (chiefly in the form of financial assets such as stocks and bonds), any meaningful New York wealth tax would likely require a constitutional amendment. Nevertheless, these barriers leave open at least two promising reform options. The first would be a new statewide real property tax with a large exemption level (or circuit-breaker) so that only the wealthiest residents or businesses would be subject to it. Such a new tax (or surtax) could piggyback on the existing administrative valuations for real property taxes, and thus could be designed and implemented quickly. Needless to say, this would only be a quick option in states without constitutional limits on property tax rates or with other legal and administrative barriers. In any case, this proposal could be designed and implemented as a temporary measure, meant for raising the revenue needed to weather the economic downturn.

The second option would be a new tax or deemed realization measure on the stock of unrealized capital gains. This could be done in several possible ways. For instance, the new tax could consist of a deemed realization of a percentage (for example, 50 percent) of unrealized gains that would then immediately be taxed at the state’s income tax rates, with an exemption so that this new levy would only apply to the wealthiest taxpayers. This option would be more difficult to design and implement and would likely need to rely substantially on self-reported appraisals — backed by auditing and penalties — for valuation purposes. But the revenue potential should still be reasonably large, and because so much wealth is constituted by publicly traded securities, neither self-assessment nor auditing ought to be prohibitively onerous.

By taxing these unrealized gains now, states would in effect be accelerating what would otherwise have been future tax payments (at least in theory, as in practice much of unrealized gains

5 For elaboration as to why, see Gamage, supra note 2.


7 Mark Gergen estimates that 73 percent of the total value of income-producing assets are publicly traded securities. Gergen, “How to Tax Capital,” 70 Tax L. Rev. 1, 22 (2016).
are never realized or recognized because of provisions like stepped-up basis upon death). This is appropriate, because the effect of taxing unrealized gains now — during the downturn — would be to at least partially counteract the fiscal volatility roller coaster by moving revenues to when they are needed most. In a sense, then, one might think of the current nontaxation of unrealized capital gains as a sort of emergency rainy day fund that the states should now tap.

It could be argued that either of these partial wealth tax reform proposals (that we explained above) could cause liquidity problems, even for the wealthy. Therefore, as a matter of design, the tax could permit a payment schedule, much like the deemed repatriation in the Tax Cuts and Jobs Act.\(^8\) Note that such a schedule should contain a reasonable interest rate because states should consider then borrowing against this stream of income to pay for immediate needs.

Another possible objection to a tax of either type is that the wealthy might simply leave the state. There is significant economics literature on these issues.\(^9\) We read this literature as implying that migrations from so-called high tax states have so far not represented a phenomenon that should overly trouble states considering more progressive taxation. But however one reads the literature as to ongoing income taxes, our proposed tax measures would be a one-time tax on previously accumulated wealth or gains. Thus, there should be a minimal behavioral response.

And the argument for those taxes runs deeper than that they would be broadly progressive and efficient. Consider that income and wealth inequality have become increasingly pressing issues at both the federal and state levels. Accordingly, recent Pew Research Center polling reveals that six in 10 U.S. adults believe there is too much inequality in the country today, and 84 percent of those who see inequality as a problem believe that the government should increase taxes on the wealthy. Yet states and the federal government do a very poor job of taxing the true economic income of the very wealthy.\(^11\) For the top 0.1 percent of taxpayers and above, whose incomes derive primarily from the returns to owning wealth (rather than from salary or wages), structural features of state and federal income taxes make these taxes “so porous as to be largely symbolic.”\(^12\)

In that light, either option — a new statewide property surtax on the very wealthy or a new statewide tax on the unrealized capital gains of the wealthy — would help ameliorate the lack of effective taxation of the very rich in the years and decades leading up to the current and looming economic downturn. This would have been a good reason to impose these taxes even before the pandemic. During a pandemic and recession, these tax reform proposals are thus even more clearly a good idea. Remember, assuming the federal government fails to act, there is a zero-sum game here. Either states and localities must cut vital services and thereby prolong the recession — or else avert these cuts by raising tax revenues.

Given the scale of the emergency and the importance of the states not eating their seed corn by engaging in overly destructive cuts, it may ultimately become necessary for them to consider revenue instruments that are far less from ideal (for example, gross receipts taxes). But before contemplating such measures, states should start with more targeted and better designed policy options. In that light, we view our proposals for real property surtaxes on the wealthiest or partial deemed realization of the unrealized capital gains of the very wealthy as especially promising.

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\(^8\) IRC 965(h).


\(^10\) For example, we are not considering what would happen if states imposed much higher tax rates than they currently do.


\(^12\) Id. (citing Edward J. McCaffery, “The Death of the Income Tax (Or, The Rise of America’s Universal Wage Tax),” Center for Law and Social Science Research, Papers Series No. 18-25, at 2 (Aug. 31, 2018)).