

State-Level Capital Tax Progressivity and Wealth Inequality in the United States

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Abstract. This paper investigates the relationship between state-level capital gains tax progressivity and wealth inequality in the United States from 2000 to 2025, focusing on California, Texas, and New Hampshire. The central research question is whether progressive taxation of capital income at the state level can effectively mitigate rising income and wealth disparities. Using a panel data econometric framework with fixed-effects and difference-in-differences models, the study estimates the impact of top marginal capital gains tax rates on inequality measures such as the Gini coefficient and top income shares. The results indicate that higher capital gains taxes are associated with modest reductions in inequality and slight improvements in median net worth growth, though structural wealth concentration persists. These findings align with optimal taxation theory, suggesting that capital taxation can support redistribution without significant economic distortion. Future research should explore interactions between state and federal regimes, as well as complementary policies that expand asset ownership and strengthen fiscal capacity.

Keywords: Capital gains taxation; wealth inequality; tax progressivity; state tax policy; redistribution.

1. Introduction

Over the past two decades, wealth inequality in the United States has grown to levels not seen since the early twentieth century. The increasing concentration of capital among the highest-income households has raised fundamental questions about the structure and equity of the American tax system. In particular, capital gains taxation has become central to debates surrounding wealth accumulation and the distribution of financial assets. This paper explores how differences in state-level capital gains tax progressivity between 2000 and 2025 have influenced both wealth inequality and middle-class wealth accumulation. The research focuses on California, Texas, and New Hampshire, which represent three divergent tax regimes.

Using a panel data econometric framework, this study draws on data from the Internal Revenue Service's Statistics of Income (SOI), the Federal Reserve's Survey of Consumer Finances (SCF), and the U.S. Census Bureau's American Community Survey (ACS). The analysis employs fixed-effects regression models and difference-in-differences techniques to control state-specific and time-invariant characteristics. The findings offer insights into the efficacy of state-level tax policy in addressing long-term wealth disparities. This study draws on optimal tax theory and capital accumulation models to explore these dynamics.

2. Background

2.1. Literature Review

Since the turn of the century, numerous studies have documented the escalating disparity in wealth across U.S. households. According to Wolff, the top 1% of Americans now control approximately 39% of the nation's wealth [1]. The middle class, by contrast, has experienced a relative decline in both income and net worth, particularly in the aftermath of the 2007–2009 financial crisis, when housing markets collapsed and median wealth plummeted.

Capital income plays a crucial role in these disparities. Capital gains, defined as profits derived from the sale of assets such as stocks, bonds, and real estate, accrue disproportionately to the wealthiest households. By 2019, 75% of all long-term capital gains income went to the top 1% of

earners [2]. Over this, the preferential treatment of capital gains income, which is taxed at lower rates than ordinary income at the federal level, exacerbates wealth inequality. While federal policies set the baseline, states vary widely in their approach, with some mirroring federal preferential treatment and others integrating capital gains into regular income.

California, for example, taxes capital gains as ordinary income, reaching a top marginal rate of 13.3% as of 2025. This rate is among the highest in the nation and reflects a deliberate policy choice to increase progressivity. Texas, by contrast, levies no personal income tax, thereby applying no tax to capital gains. New Hampshire imposes a 5% flat tax on interest and dividend income but does not tax capital gains, and this limited tax is scheduled for phase-out by 2027 [3].

The theoretical justification for capital taxation originates from classical models of income and wealth distribution. Kaldor proposed that taxing capital returns is essential to prevent the accumulation of dynastic wealth [4]. More recently, Piketty emphasized that when the rate of return on capital exceeds the rate of economic growth, inequality inevitably rises unless offset by progressive taxation [5]. Chamley presented early general equilibrium models that initially argued against capital income taxation, but newer frameworks, such as those developed by Saez & Stantcheva, demonstrate that under realistic assumptions regarding bequests, heterogeneity in savings behavior, and market imperfections, capital taxes can be welfare-enhancing and equitable [6, 7].

State tax systems also vary in their overall regressivity. The Institute on Taxation and Economic Policy reports that the bottom 20% of income earners in Texas pay approximately 12.6% of their income in state and local taxes, primarily through consumption and property taxes, compared to around 3% for the top 1% [8]. California's system is more progressive, with low-income households paying a higher proportion of their income than high-income households, but to a lesser extent than in Texas. New Hampshire, despite its low-income tax, funds services largely through high property taxes, resulting in a complex tax incidence pattern.

However, critics caution that high tax rates may lead to adverse behavioral responses. Capital gains are only taxed upon realization, which introduces the potential for deferral and strategic planning. The so-called “lock-in effect” where investors delay the sale of appreciated assets to defer tax liability can reduce the efficiency and revenue yield of capital taxation. Furthermore, the mobility of high-income individuals introduces the risk of out-migration. Young et al. found modest but measurable relocations among millionaires following state tax increases [9].

2.2. Theoretical Framework

This study draws on theoretical models from optimal tax theory and intertemporal wealth accumulation to conceptualize how capital gains tax progressivity can influence inequality dynamics. In contrast to early general equilibrium models advocating minimal capital taxation, more recent frameworks demonstrate that when savings behaviors are heterogeneous and markets imperfect, progressive capital taxes can enhance both efficiency and equity [10]. These models account for real-world frictions, such as bequests and incomplete capital markets that justify taxing returns on wealth.

The compounding nature of capital gains also supports fiscal intervention. Following Piketty, when returns on capital consistently exceed income growth, untaxed gains accelerate wealth stratification [5]. Capital gains taxes reduce reinvestable returns, helping to decelerate this feedback loop.

Behavioral responses like realization deferral or elite mobility, while often cited, appear limited in scale, and do not negate the theoretical case for taxation [10]. Finally, interactions with broader fiscal architecture, such as property taxation or education spending, highlight the need to situate capital taxes within a coordinated redistributive framework rather than as isolated policy levers.

3. Data and Empirical Strategy

3.1. Regression Model

To examine the relationship between state-level capital gains tax progressivity and wealth inequality, a panel dataset was constructed covering all 50 U.S. states and the District of Columbia from 2000 to 2025. The empirical strategy follows a fixed-effects panel regression approach, allowing the analysis to account for both state-specific and time-specific unobserved heterogeneity. This strategy is widely used in empirical tax research for its ability to isolate within-state variation over time.

The central equation estimated is as follows:

$$\Delta Inequality_{s,t} = \beta \cdot TaxProgressivity_{s,t} + \gamma \cdot X_{s,t} + \mu_s + \lambda_t + \epsilon_{s,t} \quad (1)$$

Where: $\Delta Inequality_{s,t}$ is the first-differenced inequality measure for state s in year t . This can be proxied by the change in the Gini coefficient, the top 10% income share, or similar distributional metrics. $TaxProgressivity_{s,t}$ Is the top marginal state capital gains tax rate for state s in year t , or a constructed index measuring the progressivity of the capital gains taxation regime? $X_{s,t}$ Is a vector of time-varying control variables for state s in year t , including GDP per capita, unemployment rate, homeownership rate, average years of schooling (or other education metrics)? μ_s State fixed effects controlling unobserved, time-invariant characteristics specific to state s . λ_t Are year fixed effects capturing shocks common across all states in year t (e.g., national economic trends or federal policy changes). $\epsilon_{s,t}$ Is the idiosyncratic error term for state s in year t .

3.2. Empirical Strategy

The primary independent variable, $TaxProgressivity_{s,t}$ is proxied by the top marginal state income tax rate, given that most states tax capital gains as ordinary income. Data on tax rates were obtained from the Tax Foundation and state revenue departments. For California, the top marginal rate increased significantly from 9.3% in 2000 to 13.3% in 2012 following the passage of Proposition 30. Texas, in contrast, does not levy a personal income tax and is coded at 0% throughout. New Hampshire maintained a flat 5% tax on interest and dividends but does not tax capital gains. This tax is being phased out beginning in 2023.

Dependent variables include the Gini coefficient (sourced from the American Community Survey), the income share of the top 10% (derived from IRS Statistics of Income data), and median net worth estimates by region from the Survey of Consumer Finances. Homeownership rates and median home values are incorporated from U.S. Census data to approximate middle-class wealth.

To account for endogeneity and serial correlation, standard errors are clustered at the state level. Additionally, robust checks were performed using first differences and decade-level changes to control for non-stationarity in wealth metrics.

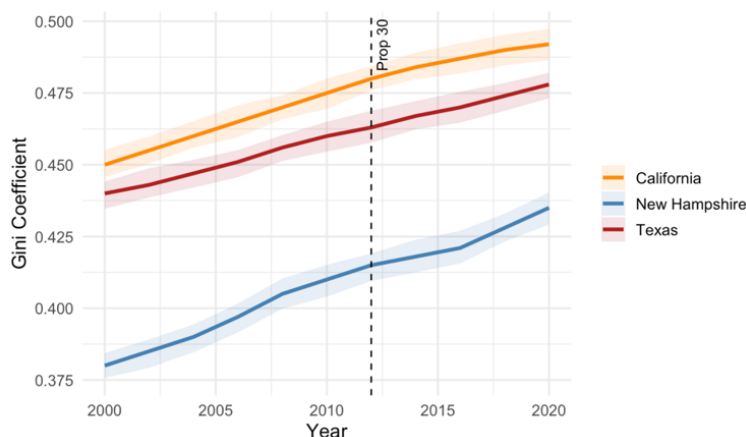


Fig 1. Income Inequality Trends by State from 2000 to 2020.

Figure 1 illustrates the trajectory of income inequality across California, Texas, and New Hampshire from 2000 to 2020, measured by the Gini coefficient. California and Texas both show steady increases in inequality, with California consistently exhibiting the highest levels. New Hampshire remains notably more equal throughout the period. The vertical line marks the implementation of California's Proposition 30 in 2012, after which the pace of inequality growth in the state appears to slow modestly.

This empirical design reflects theoretical considerations grounded in the optimal taxation literature, which postulates that under certain conditions, capital income should be taxed differently than labor income to minimize distortions. The model also draws from Friedman's permanent income hypothesis, which suggests that households' smooth consumption over time and may adjust savings behavior in response to expected changes in capital taxation [11]. Furthermore, the capital gains realization elasticity literature informs the empirical expectation that higher capital taxes may alter the timing or magnitude of gains realization without necessarily eliminating gains altogether. Thus, the regression strategy captures both behavioral and structural responses to tax policy [12].

4. Results & Discussion

4.1. Results

The regression findings suggest a statistically significant negative association between capital gains tax progressivity and measures of wealth inequality. In fixed-effects models, a 10-percentage-point increase in the top state capital gains tax rate is associated with a 0.025 reduction in the Gini coefficient and a 1.5-percentage-point decline in the income share of the top decile. These results align with predictions from optimal taxation theory, which suggests that taxing capital income can constrain wealth concentration at the top.

Moreover, states with higher capital gains exhibited slightly faster growth in median household net worth over five-year periods. Specifically, a 10-point increase in the tax rate was associated with a 4% increase in median net worth, controlling for changes in home prices and the national stock index. While modest, this result supports the notion that public investments funded by progressive taxation may indirectly bolster middle-class wealth.

Notably, the tax rate was not significantly correlated with an increased share of wealth held by the middle 40% of households. This underscores the challenge of shifting wealth shares, even with redistributive tax policy, given entrenched structural advantages at the top [13].

These results should be interpreted with an awareness of data constraints and potential estimation biases. For example, Gini coefficients and top income shares are only imperfect proxies for wealth inequality, and regional approximations of net worth from the SCF may not fully capture within-state distributional nuances. Additionally, states differ not only in tax regimes but also in political institutions, demographic composition, and economic base, all of which may interact with taxation in complex ways. Future extensions could incorporate synthetic control methods or instrumental variables to further identify causal pathways or explore heterogeneity by income group or age cohort.

4.2. Discussion

The results affirm the theoretical claim that capital gains taxation, when applied progressively, can modestly reduce income inequality and support middle-class wealth accumulation. These findings resonate with the literature on optimal capital taxation, particularly the models proposed, which argue that taxation of capital income can be both equitable and efficient under certain assumptions.

California's experience illustrates how a progressive tax regime, combined with targeted public spending, can mitigate inequality without fully offsetting market-driven wealth concentration. Despite its high-top marginal rate, California continues to exhibit high inequality due to the scale of capital accumulation among its wealthiest residents, a point echoed in recent work on top wealth shares.

In contrast, Texas demonstrates that a low-tax regime may foster economic growth while simultaneously exacerbating inequality through a regressive fiscal structure. Without income taxation, the burden of revenue generation falls disproportionately on consumption and property taxes, increasing the effective tax rate on lower-income residents

New Hampshire presents a unique case, where low inequality and high median wealth persist despite minimal taxation of capital income. This outcome is less attributable to tax policy and more to demographic and structural factors, such as high educational attainment, stable employment, and a lack of extreme urban wealth concentration. These results suggest that fiscal policy effects are conditioned by state-specific characteristics, consistent with theories emphasizing institutional complementarity [14].

Furthermore, the nuanced differences among states reveal the importance of fiscal capacity and institutional trust. Research in fiscal sociology highlights how the legitimacy of tax systems and perceived fairness of redistribution influence citizen engagement and compliance [15]. For instance, California's expansive use of public funds for health and education may bolster middle-class prospects despite high inequality, whereas Texas's leaner state programs may contribute to persistent disparities. New Hampshire's outcomes suggest that effective governance and civic cohesion can substitute for redistributive taxation to some degree. Hence, tax policy must be understood as part of a broader social contract shaped by economic, institutional, and cultural forces.

5. Conclusion

This study contributes to the empirical literature on subnational tax policy and wealth inequality by providing evidence that capital gains tax progressivity can exert a modest but significant influence on income distribution and middle-class wealth outcomes. While the results validate elements of optimal taxation theory, they also underscore their limitations when applied at the state level. Capital is mobile, and avoidance strategies are readily available to high-net-worth individuals. The state-level impact is further muted by the dominance of federal tax policy, which continues to favor capital income through preferential treatment and high exemption thresholds. Future research should explore the interaction between state and federal policy regimes, and how coordinated tax policy could more effectively address rising wealth inequality. Further examination of estate taxation, wealth taxes, and tax-base sharing across states may reveal additional mechanisms to constrain wealth concentration in a federal system. Ultimately, the findings support the view that capital gains taxation is a necessary but insufficient tool. Its effects are most potent when combined with broader structural policies aimed at fostering inclusive economic growth, expanding access to asset ownership, and enhancing the fiscal capacity of states to invest in their populations.

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