For my honor thesis, I’m looking at how income inequality in a certain region affects local tax revenue cyclicality. A desiring characteristic of government tax revenue is its pro-cyclicality, i.e. when the economy is good, the tax revenue is higher; when the economy is in the midst of a crisis, the tax revenue is lower. This auto adjustment helps, to some extent, keeping the economy at equilibrium. However, the cyclical fluctuations are also creating problems for policymakers, as they will be the ones to figure out what to expect out of the tax revenue at time, and how to plan ahead. But tax revenue responds to business cycle with different “responsiveness”—in some places, a small business cycle movement can lead to a huge change in tax revenue. Some literature credited this phenomenon as the direct consequence of the growing dependence of tax revenue on people at the very top of the income distribution. Wealthy people tend to invest more or hold more stock, and these financial instruments tend to be volatile. Thus, it might be reasonable to deduct at places with higher income inequality, local tax revenue is more cyclical (or at least more volatile).

In my paper, I will examine how income inequality contributes to the cyclicality of tax revenue using ZIP Code level income tax data from 2004-2012, and county-level data from 1970 to now. I will perform a diff-in-diff analysis looking at how tax revenue cyclicality varies by income inequality.