

A Capital Idea

Repealing State Tax Breaks for Capital Gains Would Ease Budget Woes and Improve Tax Fairness

January 2011



INSTITUTE ON TAXATION AND ECONOMIC POLICY

1616 P Street NW • Washington, DC 20036 • (202) 299-1066 • www.itepnet.org

About ITEP

Founded in 1980, the Institute on Taxation and Economic Policy (ITEP) is a non-profit, non-partisan research organization, based in Washington, DC, that focuses on federal and state tax policy. ITEP's mission is to inform policymakers and the public of the effects of current and proposed tax policies on tax fairness, government budgets, and sound economic policy. Among its many publications on state and local tax policy are *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States* and *The ITEP Guide to Fair State and Local Taxes*. ITEP's full body of research is available at www.itepnet.org.

EXECUTIVE SUMMARY

- Eight states – Arkansas, Hawaii, Montana, New Mexico, North Dakota, South Carolina, Vermont, and Wisconsin – currently offer substantial tax breaks for income derived from capital gains. Capital gains are the profits one realizes from selling assets such as stocks, bonds, investment real estate, art, or antiques.
- Very few low- and moderate-income taxpayers report any income from capital gains. In 2008, taxpayers with federal adjusted gross income (AGI) of less than \$50,000 comprised 66 percent of all federal tax returns filed, but constituted just 10 percent of all returns with income from capital gains. Taxpayers in this income group held 22 percent of AGI nationwide in 2008, but received just 4 percent of reported capital gains income.
- As a result, the benefits of state capital gains tax breaks go almost exclusively to the very best-off taxpayers. In fact, in the eight states highlighted in this report, between 95 and 100 percent of the state tax cuts from these tax breaks goes to the richest 20 percent of taxpayers.
- These tax breaks are also quite costly. In tax year 2010, these eight states will lose about \$490 million due to these capital gains tax breaks, with losses ranging from \$14 million to \$151 million per state. These revenue losses represent a substantial share of currently-forecast budget deficits in several of these states.
- The tide is turning against state capital gains tax breaks. In several states, lawmakers have recently helped to balance their state budgets by paring back existing capital gains tax breaks. Rhode Island eliminated their preferential rates for capital gains income. Vermont and Wisconsin have both acted to reduce their exclusions for capital gains income (although Vermont subsequently partially backtracked on this decision). Regrettably, however, some elected officials now seem bent on bucking this tide by creating new capital gains tax breaks in their states.
- Claims that state capital gains tax breaks help to promote economic growth – and that repealing these tax breaks would impede an economic recovery – are without merit. Extensive economic research demonstrates that there is little connection between lower taxes on capital gains and higher levels of economic growth, in either the short-run or the long-run—and this connection is most tenuous at the state level.
- Concerns about the volatility of capital gains income – and, by extension, the revenue derived from such income – are understandable, but they are no reason to preserve inefficient and inequitable capital gains tax breaks. Rather, concerns about the predictability of state revenue streams can best be addressed outside the income tax – either by reforming state budget processes or by expanding the bases of the other taxes that states typically levy.

Introduction

The budget outlook for the states is improving, but uncertain. In this context, states must find ways to generate additional revenue that create neither additional responsibilities for individuals and families struggling to make ends meet nor additional distortions in the economy as a whole. For eight states – Arkansas, Hawaii, Montana, New Mexico, North Dakota, South Carolina, Vermont, and Wisconsin – one straightforward approach would be to repeal the substantial tax breaks that they now provide for income from capital gains.¹ In tax year 2010 alone, these eight states are expected to lose a total of \$490 million in income tax revenue due to such misguided policies, with individual losses ranging from \$14 million to \$151 million per state. In some of these states, these losses reduce income tax revenues by as much as 7 percent—suggesting that other states seeking to introduce new capital gains tax break in their upcoming legislative sessions could see a similar drop in income tax revenues. Sensibly, two states have at least partially repudiated capital gains tax breaks in the last two years, based on concerns about their fairness and effectiveness.

This report explains what capital gains are, how they are treated for tax purposes, and who typically receives them. It also details the consequences of providing preferential tax treatment for capital gains income for states' budgets, taxpayers, and economies in the eight states currently offering such treatment. Lastly, it responds to claims about both the relationship between capital gains preferences and economic growth and the role capital gains taxation plays in state revenue volatility. (Appendices to the report provide detailed state-by-state estimates of the impact of repealing capital gains tax preferences and describe the computer model used to derive those estimates.)

What are capital gains?

Capital gains are profits from the sale of an asset, such as stocks, bonds, investment or vacation real estate, art, or antiques. Capital gains are not taxed at all unless and until they are “realized” – that is, unless and until the asset is sold. Thus, an investor who owns a stock over many years does not owe any taxes on the value of that stock as it appreciates from one year to the next; he or she owes taxes only when the stock is sold. When that stock – or any asset – is sold, the realized capital gain is, in general, calculated by taking the difference between the original purchase price and the sale price.

Economic theory – and general common sense – suggests that, when it comes to taxation, income from capital gains should be treated in the same manner as income from any other source, whether from wages and salaries, from interest earnings, or from the proceeds of a farm or small business. Taxing one dollar in earnings differently than another dollar not only has the potential to distort how decisions are made – possibly favoring capital investments over investments in labor even if the latter may be more productive – but also creates incentives for people to “game the system” and to reduce the taxes they owe by reclassifying the type of income they receive.

¹ Several other states, including Iowa and Oklahoma, provide tax preferences for capital gains from certain “in-state” assets. The eight states that are the focus of this report do not limit their preferences in this manner.

A Capital Idea

How do states treat capital gains for tax purposes?

Both the federal government and a handful of state governments do, in fact, tax income from capital gains differently than income from other sources. At present – and for much of the last two decades – the federal government taxes capital gains at significantly lower rates than earned income like salaries and wages. Eight states – discussed in greater detail below – offer substantial tax breaks of their own for income derived from capital gains, tax breaks that supplement the already sizable tax reduction granted by the federal government. In providing these preferences, the federal government and most states distinguish between short-term capital gains (that is, gains realized on assets owned for less than one year) and long-term capital gains, singling out the latter type of gains for favorable treatment.

Among the forty-one states that levy a broad-based income tax, most adhere to sound economic principles and generally tax income from capital gains in the same way that they tax income from any other source. However, as Figure 1 shows, eight states offer substantial tax breaks for capital gains income. In six of these states, the capital gains tax break takes the form of a deduction or an exclusion that reduces the total amount of income subject to taxation. Of the remaining states, one follows the federal government’s unfortunate lead and taxes capital gains income at lower rates (at least for some taxpayers), and one provides a tax credit for capital gains income.

Figure 1.

Major State Capital Gains Preferences		
STATE	CAPITAL GAINS PREFERENCE	YEAR ENACTED / IMPLEMENTED
Arkansas	Income tax exclusion equal to 30 percent of net long-term capital gains income	1999
Hawaii	Preferential income tax rates for income from capital gains for upper-income taxpayers	1987
Montana	Non-refundable income tax credit equal to 2 percent of capital gains income	2003 / 2007
New Mexico	Income tax exclusion equal to the greater of \$1,000 or 50 percent of net capital gains income	2003 / 2007
North Dakota	Income tax exclusion equal to 30 percent of net long-term capital gains income for most taxpayers	2001
South Carolina	Income tax deduction equal to 44 percent of net long-term capital gains income	1991
Vermont	Income tax exclusion either equal to 40 percent of net long-term gains from the sale of business assets held for three or more years or equal to the first \$5,000 of net long-term gains on all other transactions <i>EFF. TY 2011</i>	2002/2011
Wisconsin	Income tax exclusion equal to 30 percent of net long-term capital gains income - <i>EFF. TY 2010</i>	1987/2010

But not all assets are eligible for these preferential tax breaks. In fact, the two most common assets held by working Americans – their investments for retirement and their homes – generally are not treated as taxable capital gains when they are sold.² Assets held in 401(k)s or Individual Retirement Accounts (IRAs) – the means by which most households own stocks and bonds – are considered “ordinary” income when they are sold and are therefore ineligible for capital gains tax breaks. At the same time, up to the first \$500,000 of profit from the sale of one’s primary residence – which, theoretically, is a kind of capital gain – is generally exempt from taxation, at both the federal and the state level.³

² In 2004, principal residences, adjusted for outstanding mortgage debt, and retirement accounts, such as IRAs and 401(k)s, constituted 74 percent of the net worth of the bottom half of families in the United States; for families in the fiftieth through ninetieth percentile of the wealth distribution, the comparable figure was 61 percent. See Kennickell, Arthur, *Currents and Undercurrents: Changes in the Distribution of Wealth, 1989–2004*, U.S. Federal Reserve Board, Washington, DC, January 30, 2006.

³ The \$500,000 exclusion is for married couples filing jointly; for single filers, the exclusion is generally \$250,000.

Who receives capital gains?

Simply put, only the very wealthiest Americans have taxable capital gains income to any large degree, due both to the extreme concentration of wealth in the United States and, as described above, the tax treatment of the main assets that working individuals and families own.⁴ The richest 3 percent of U.S. taxpayers – those with federal adjusted gross incomes (AGI) in excess of \$200,000 – not only make up a disproportionate share of filers with capital gains income, but also record a disproportionate share of capital gains income overall.⁵

Indeed, as Figure 2 shows, while taxpayers with federal AGI below \$50,000 represent a large majority of federal taxpayers, both for the country as a whole and in the states highlighted in this report, they are in the distinct minority among taxpayers with capital gains income.

- Nationally, these low- and moderate-income taxpayers comprise two-thirds of federal taxpayers; among the eight states with major capital gains preferences, they range from 64 percent of federal taxpayers living in Wisconsin to 72 percent of federal taxpayers in Arkansas and South Carolina.
- Nonetheless, taxpayers in this broad income group represent less than 15 percent of all filers reporting capital gains income. For instance, in Arkansas, federal taxpayers with AGI of less than \$50,000 represent only about 8 percent of all federal taxpayers with taxable capital gains income.

Not surprisingly, the share of capital gains income reported by taxpayers with incomes below \$50,000 is significantly smaller than their shares of income as a whole. In the states that offer major capital gains tax preferences, taxpayers in this income group receive 24 to 31 percent of all federal AGI reported by those states' residents, but just 2 to 8 percent of total capital gains income reported. As a result, capital gains income represents less than 2 percent of total AGI for taxpayers with incomes below \$50,000 in these states.

In sharp contrast, the 3 percent taxpayers with incomes over \$200,000 nationwide enjoyed 87 percent of all capital gains income. In every state surveyed in this report, this small group enjoys at least 70 percent of statewide capital gains income.

For this small group, capital gains income represents a much larger share of total Adjusted Gross Income than is true for middle-income families, ranging from 14 percent in Wisconsin to 24 percent in Montana.

⁴ Survey of Consumer Finances data from 2007 further reveal that over 70 percent of U.S. net worth is held by just the wealthiest 10 percent of families across the country; the wealthiest 1 percent of families control nearly 34 percent of the nation's net worth. Source: Kennickell, Arthur B., Ponds and Streams: Wealth and Income in the U.S., 1989 to 2007, January 7, 2009 <http://www.federalreserve.gov/pubs/feds/2009/200913/200913pap.pdf>

⁵ Internal Revenue Service, *SOI Tax Stats: Tax Year 2008: Historical Table 2 (SOI Bulletin)* available : <http://www.irs.gov/taxstats/article/0,,id=171535,00.html>

Figure 2.

**Capital Gains Income Among Federal Taxpayers
in States with Major Capital Gains Preferences, 2008**

	Income Group (Federal AGI)	AR	HI	MT	NM	ND	SC	VT	WI	US
Share of all returns filed	Under \$50,000	72%	66%	70%	71%	65%	72%	67%	64%	66%
	\$200,000 plus	2%	2%	2%	2%	2%	2%	2%	2%	3%
Share of all returns with capital gains income	Under \$50,000	8%	10%	15%	8%	13%	7%	13%	13%	10%
	\$200,000 plus	67%	68%	75%	67%	72%	69%	74%	72%	70%
Share of total Adjusted Gross Income	Under \$50,000	31%	26%	28%	29%	24%	30%	26%	24%	22%
	\$200,000 plus	20%	19%	20%	19%	23%	19%	20%	20%	29%
Share of total capital gains income	Under \$50,000	8%	2%	7%	5%	6%	4%	4%	6%	4%
	\$200,000 plus	75%	83%	71%	79%	71%	79%	77%	76%	87%
Capital gains income as a share of Adjusted Gross Income	Under \$50,000	1%	0%	2%	1%	2%	1%	1%	1%	1%
	\$200,000 plus	16%	17%	24%	17%	18%	15%	21%	14%	15%

Source: IRS, 2008 Statistics of Income (SOI) Tax Stats: Historical Table 2

What are the consequences of preferential treatment for capital gains?

In the eight states that currently allow them, state capital gains tax breaks reduce overall income tax revenues between 3 and 7 percent each year, while targeting their benefits overwhelmingly to the best-off taxpayers. Moreover, this inequitable tax cut has a frequently-overlooked effect of shipping state tax dollars from the states to the federal government.

In tax year 2010, the eight states offering major capital gains tax preferences will, taken together, lose approximately \$490 million due to such misguided policies, with individual losses ranging from \$14 million to \$151 million per state. Such losses may constitute a meaningful share of total income tax revenue; as a result, repealing the capital gains tax preferences that yield them could be an important response to projected state budget deficits. For instance, South Carolina's 44 percent capital gains deduction will cost the state roughly \$115 million in tax year 2010. While that sum equals about 4 percent of total income tax revenue, it amounts to 9 percent of South Carolina's expected FY12 budget deficit of \$1.3 billion.⁶

⁶ Due to timing issues, the full impact of any effort to repeal capital gains tax preferences may not be felt until FY 2013. Still, as states are expected to experience significant financial difficulties for some time, measuring the impact of repeal in this fashion helps to illustrate the magnitude of such a change. Further, the estimates presented in this paper reflect the impact of repealing state capital gains preferences on state residents only; the revenue these eight states would ultimately generate from repeal would likely be higher once the effect on out-of-state residents filing in-state returns is taken into account. Changes to the federal tax code and the treatment of capital gains income take effect in 2010 and will likely result in revenue estimates that are higher than in future years.

Figure 3.

Impact of Capital Gains Preferences on State Budgets, Taxpayers, and Economies - 2010

	<u>AR</u>	<u>HI</u>	<u>MT</u>	<u>NM</u>	<u>ND</u>	<u>SC</u>	<u>VT*</u>	<u>WI</u>
Income Tax Revenue Lost to Capital Gains Preferences (\$M)	53	39	35	48	14	115	34	151
Income Tax Revenue Lost to Capital Gains Preferences (%)	3%	3%	5%	5%	4%	4%	7%	3%
Income Tax Revenue Lost to Capital Gains Preferences as a Share of Projected FY 2012 Budget Deficit	n/a	n/a	23%	12%	n/a	9%	30%	8%
Share of Revenue Loss by Income Group								
Bottom 80%	2%	0%	5%	5%	4%	3%	4%	5%
Top 20%	98%	100%	95%	95%	96%	97%	96%	95%
Top 5%	91%	99%	83%	88%	90%	89%	88%	85%
Top 1%	76%	93%	65%	67%	75%	71%	69%	69%
Average Tax Reduction by Income Group								
Bottom 80%	1	0	5	3	2	2	6	4
Top 20%	201	315	356	265	222	272	551	273
Top 5%	759	1,247	1,243	981	845	994	2,539	976
Top 1%	3,174	5,809	4,817	3,734	3,471	3,961	7,933	3,951
Percent of State Revenue Loss Offset by Higher Federal Taxes	10%	9%	6%	14%	14%	11%	3%	10%

* Vermont results assume the new capital gains exclusion rules are fully phased in.

Data on projected budget deficits from *States Continue to Feel Recession's Impact* from the Center on Budget and Policy Priorities December 16, 2010
 Revenue estimates and distributional information from ITEP's Microsimulation Tax Model

Not surprisingly – given the concentration of capital gains income among the very wealthiest taxpayers – the benefits of capital gains tax preferences are similarly focused on the well-to-do. To cite one example, virtually all – 98 percent – of the tax reductions arising from Arkansas’ 30 percent capital gains exclusion are realized by the richest 20 percent of taxpayers in the state; the remaining 80 percent of taxpayers collectively receive just 2 percent of the overall capital gains tax break. Stated slightly differently, the average tax cut for the bottom 80 percent of the income distribution is just \$1 on average, but the average tax cut for the richest 20 percent is \$201. Worse still, the average tax cut for the top 1 percent of taxpayers – those taxpayers with incomes in excess of \$352,000 in 2010 – is \$3,174.⁷ By extension then, the impact of repealing capital gains tax preferences in order to address state budget deficits would largely be limited to the most affluent taxpayers in a given state.

Finally, as states struggle to cope with the national recession and cast about for policies to stimulate local economies, it is worth noting that, due to their interaction with the federal tax code, state capital gains tax preferences can act as an economic depressant. Reducing the state income taxes that local residents pay on capital gains income leads to larger federal income bills for those same residents, meaning that valuable funds are flowing out of the state and into federal coffers. This

⁷ For more detailed estimates on the impact of repealing capital gains tax preferences, please refer to Appendix I.

occurs because, instead of using the standard deduction as most taxpayers do, wealthier taxpayers can elect to itemize their deductions on their federal income tax returns; one of the largest of those deductions is the deduction for state and local income taxes. Since federal tax liability rises as itemized deductions fall (lower deductions mean more income gets subjected to taxation), a state tax cut – such as that provided by capital gains tax preferences – will lead to an increase in federal taxes owed.

This interaction – often called the federal offset – can be substantial. As Appendix 1 suggests, Wisconsin’s \$151 million capital gains tax cut produces a \$15 million federal tax increase – \$15 million that flows out of Wisconsin’s economy. Conversely, if Wisconsin were to repeal that \$151 million tax expenditure, the higher state taxes that wealthy Wisconsinites would pay would yield a \$15 million federal tax cut – \$15 million that would stay within the Wisconsin economy.

In short, repealing capital gains tax preferences could help the states highlighted here to reduce projected budget gaps and to enhance the equity of their tax systems, while keeping vital funds circulating in local economies.

Do capital gains tax preferences promote economic growth?

Given the consequences of capital gains tax breaks for both state budgets and tax fairness – and given that they depart so markedly from widely accepted economic principles – it is only natural to wonder why states might include such preferences in their tax codes. The argument that proponents of preferential treatment for capital gains make most frequently is that it is necessary to foster investment and to spur economic growth. The remarks of New Mexico Governor Bill Richardson are typical of this line of thinking. In his 2003 State of the State address, the Governor proposed a substantial capital gains tax cut, claiming that it would “make New Mexico more competitive with [its] neighbors in attracting and keeping the managerial and entrepreneurial talent that will grow and diversify [its] economy.”⁸ When he later signed that tax cut into law, he maintained that it “declares [New Mexico’s] eagerness to create jobs and improve and grow our economy.”⁹

The theory that reducing taxes on capital gains will lead to a more robust economy is nothing more than that – a theory. An array of experts – from impartial economists within the federal government to non-partisan analysts outside it – agrees on one central fact: there is little connection between lower capital gains taxes and higher economic growth, in either the short run or the long run.

In 2002, the Congressional Budget Office (CBO) evaluated the stimulative effect that several different approaches to cutting taxes might have. It found that “capital gains tax cuts would provide little fiscal stimulus,” since most of the benefits of such cuts would accrue to high-income households, households that are more likely to save than spend, when the very aim of such stimulus is to boost consumption.¹⁰ Indeed, the CBO determined that, of the range of approaches it examined, capital gains tax cuts were among the least effective.

⁸ *Governor Bill Richardson’s State of the State Address*, January 21, 2003.

⁹ “Gov. Signs Tax Cut Package,” *Albuquerque Journal*, February 14, 2003.

¹⁰ Congressional Budget Office, *Economic Stimulus: Evaluating Proposed Changes in Tax Policy*, Washington, DC, January 2002.

Similarly, but more recently, Mark Zandi, the Chief Economist of Moody's economy.com, examined a set of proposals Congress could adopt to stimulate the economy in the wake of the credit crisis and the developing recession. He found that each dollar spent by the federal government in making President Bush's dividend and capital gains tax cuts permanent would boost Gross Domestic Product (GDP) by just 38 cents.¹² To put that in perspective, Zandi determined that each dollar dedicated to bolstering the food stamp program, extending Unemployment Insurance, or improving public infrastructure would yield over \$1.50 in additional GDP.

Capital Gains Tax Breaks on the Table in 2011

Despite the lack of evidence that lower taxes on capital gains spurs higher levels of economic growth, several newly elected governors and some state legislators have recently expressed support for cutting taxes on capital gains income in the name of job creation and economic recovery. Wisconsin's new governor, Scott Walker, has signaled his intention to repeal the recent reduction in his state's capital gains exclusion. Meanwhile, Oregon's governor-elect, John Kitzhaber, is promoting a new break tied to job creation, and some Arkansas lawmakers want to expand their existing exclusion.

Kitzhaber vetoed legislation that would have cut Oregon's capital gains tax when he was previously governor in 2001. His veto letter is still relevant today: "This tax cut would primarily benefit Oregon's higher income households without a demonstrated benefit to Oregon's economy. At the same time it would further constrain a future legislature's ability to address the demand for public services."¹¹

Looking back over time, rather than projecting forward, yields the same conclusion. Research by Len Burman, of Syracuse University and the former Director of the Brookings Institution-Urban Institute Tax Policy Center, indicates that, over the last 50 years, real GDP growth has not varied in response to changes in capital gains tax rates; even when one accounts for the possible lag between a capital gains rate cut and subsequent economic activity, the relationship between rates and growth is not statistically significant.¹³ Likewise, a report released by the Center for American Progress and the Economic Policy Institute reviews the impact that "supply-side" tax cuts, chief among which are lower rates for capital gains, have had on the US economy since 1981. It finds that such an approach to tax policy, when evaluated across a range of economic measures – such as the growth in Gross Domestic Product, median household incomes, average hourly earnings, or employment – simply does not work at the federal level.¹⁴

Attempting to use capital gains tax cuts to promote economic growth on a state-by-state basis is even more shortsighted, for at least two critical reasons. First, an unlimited capital gains tax cut is unlikely to benefit the local economy, since any new investment encouraged by that tax cut could occur anywhere in the United States – or abroad. Stated slightly differently, simply because Arkansas offers a capital gains exclusion does not make it more likely that investors living in Arkansas will steer

capital towards companies based in the Natural State and thus spur in-state economic activity. After

¹¹Governor John Kitzhaber to Secretary of State Bill Bradbury. August 17, 2001. Salem, OR. http://www.sos.state.or.us/archives/governors/Kitzhaber/web_pages/governor/veto01/SB0067.htm

¹² Zandi, Mark, *Testimony before the US House of Representatives Committee on the Budget*, January 27, 2009.

¹³ Burman, Leonard and Kravitz, Troy, "Capital Gains Tax Rates, Stock Markets, and Growth", *Tax Notes*, November 7, 2005.

¹⁴ Ettliger, Michael and Irons, John, *Take a Walk on the Supply Side*, Center for American Progress and Economic Policy Institute, Washington, DC, September 2008.

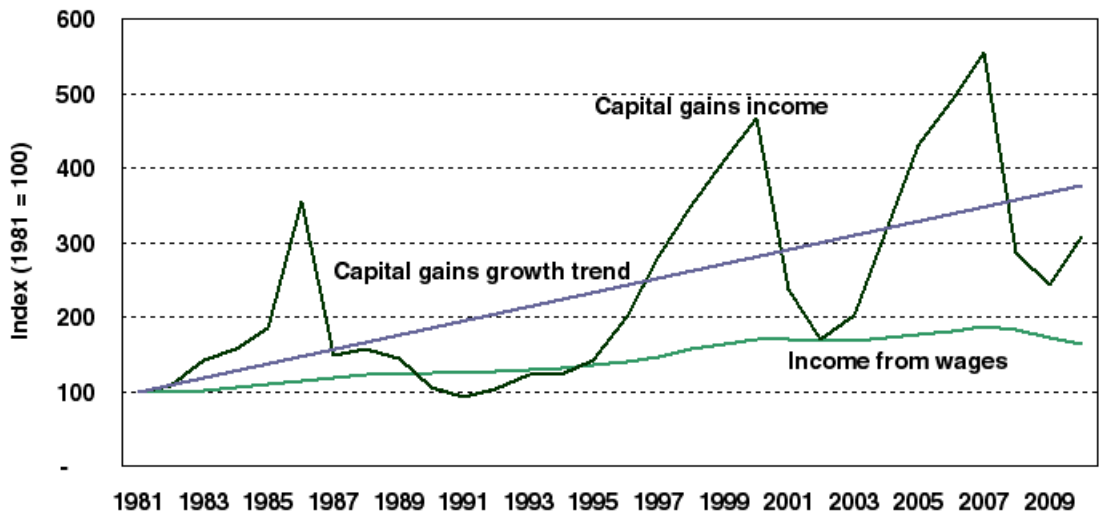
all, they will receive the same tax cut whether they invest in companies based in Arkansas. Consequently, they will seek out the highest return on their investment, without regard to location, just as they would in the absence of a preferential rate for capital gains. Second, as noted earlier, a portion of any capital gains tax break will never find its way into the pockets of state residents nor, by extension, into the cash registers of local merchants or onto the balance sheets of local employers. This is due to the interaction between state and federal income taxes, with any reduction in state capital gains taxes partially offset by an increase in federal income tax liability. To sum up, preferential treatment for capital gains is simply not an effective means of promoting economic growth.

Does the taxation of capital gains add to the volatility of income taxes?

To be sure, revenue from capital gains taxation can fluctuate from year to year, rising significantly in one year only to fall sharply a few years later – and then repeating that same cycle again several years on. One need only look at the performance of the stock and real estate markets over the past decade to see how this might occur. Yet, as understandable as concerns about the volatility of revenue derived from capital gains income may be, they should not lead policymakers to preserve such inequitable and inefficient tax breaks, for at least two reasons.

Figure 4.

Trends in Inflation-Adjusted Wage and Capital Gains Income, 1981-2010



Source: ITEP analysis of Congressional Budget Office data

First and foremost, while income from capital gains can be highly cyclical, it has grown more rapidly than most other forms of income over time. Figure 4 above, based on the most recent data available from the Congressional Budget Office, illustrates how capital gains income rose and fell over the

thirty year period from 1981 to 2010.¹⁵ The peaks that this type of income reached in 1986, 2000, and 2007 contrast quite clearly with the troughs that followed in 1991, 2002, and 2009; the variability of capital gains income also stands in sharp contrast with the trend exhibited by wages, which mostly grew slowly and steadily over that same period.

Second, expressing concern over the effect of capital gains taxation on the predictability of state revenue streams is a little like a student worrying that acing a few exams will add to the volatility of his grades. Just as the solution to one's fluctuating grades isn't to stop doing well on a few exams, the solution to income tax variance isn't to stop taxing capital gains or to tax them at lower rates. Instead, states could take steps to manage revenue streams better and to expand the overall base of their tax systems. For example, states could smooth out revenue fluctuations through the use of well-designed reserve or "rainy day" funds, depositing surplus revenue during prosperous times to be drawn upon in times of need. Furthermore, most states could expand the base of at least one of the taxes they levy, whether by broadening the sales tax to include services, repealing property tax assessment limitations, or employing combined reporting as part of the corporate income tax. Each of these reforms would leave states less vulnerable to economic downturns and the revenue fluctuations they induce.

The Tide is Turning Against State Capital Gains Tax Breaks

Since 2009, several states have acted to pare back existing capital gains tax breaks. In Rhode Island, a preferential capital gains tax rate was eliminated in 2010 to help the state balance its budget. This action came in the wake of a recommendation from Rhode Island Governor Donald Carcieri's Tax Policy Strategy Group, which noted that "by eliminating this distinction, the proposed personal income tax system would treat all sources of income equally and provide increased vertical equity in the tax system."¹⁶

Until 2009, Vermont allowed a 40 percent capital gains exclusion. In January 2008, Republican Governor Jim Douglas spoke out against this tax break in his "State of the State" address, saying:

"Our current tax structure taxes earned income – that is, your hourly wage or salary – at a higher rate than it taxes unearned income. What this means is that a working man or woman in Vermont making \$50,000 a year pays nearly 50 percent more tax than someone who does not work and simply lives off investment or trust fund capital gains income in the same amount. Our state is one of only a few that has such an unfair penalty for doing an honest day's work. This is grossly unfair. We must close this loophole and eliminate this working tax penalty."¹⁷

In June 2009, lawmakers voted to replace Vermont's percentage-based exclusion with a flat dollar amount of \$2,500 which will be increased to \$5,000 in 2011. Capital gains generated from sales of standing timber and farms were still allowed the 40 percent exclusion. Unfortunately, in 2010, Vermont lawmakers partially backtracked on these changes and created new rules allowing taxpayers

¹⁵ Congressional Budget Office *Average Federal Taxes by Income Group*, June 2010. Accessed here: <http://www.cbo.gov/publications/collections/collections.cfm?collect=13>. Data through 2010 are not yet available.

¹⁶ *Report of the Governor's Tax Policy Strategy Workgroup*. March 6, 2009. <http://www.dor.ri.gov/Workgroup%20Meetings/Tax%20Report%20Final%20203-6-09.pdf> accessed October 5, 2010.

¹⁷ Douglas, James H., Vermont State of the State Address: January 10, 2008 <http://governor.vermont.gov/speeches/speeches.html> accessed Oct 5, 2010

with capital gains from the sale of certain business assets held for more than 3 years to once again exclude 40 percent of the net gain from income starting in tax year 2011.

Until 2009, Wisconsin offered the most generous capital gains tax break in the nation, an exclusion for 60 percent of capital gains income. Governor Jim Doyle recommended cutting the exclusion to 40 percent in his budget proposal. The Governor argued that making this change would “put our state in a position to move forward and be able to make some valuable investments today. We can help grow our businesses, get people back to work and strengthen the engines that drive Wisconsin’s economy.” The legislature ultimately cut the capital gains tax break in half, to 30 percent.

In these states, a growing bipartisan recognition that state capital gains tax breaks are inequitable and ineffective helped to prompt sensible capital gains tax reforms and provided needed tax revenue. This trend suggests that even in states that have previously enacted these tax breaks, lawmakers recognize that these capital gains tax cuts simply don’t deliver the economic benefits suggested by their supporters.

Conclusion

State policymakers from Vermont to Hawaii are searching for solutions to budget deficits, solutions that will allow them to fund vital public services without placing additional pressures on those individuals and families struggling to recover from the recession. In a number of states, one such solution can be found in the elimination of tax preferences for capital gains. Such preferences are costly, inequitable, and ineffective, depriving states of millions of dollars in needed funds, benefitting almost exclusively the very wealthiest members of society, and failing to promote economic growth in the manner their proponents claim. State policymakers cannot afford to maintain these tax breaks any longer, and lawmakers considering introducing these regressive loopholes should understand the fairness and revenue implications before allowing this seriously flawed policy into their tax code. Lawmakers considering introducing these regressive loopholes should understand the fairness and revenue implications before allowing this seriously flawed policy into their tax code.

Appendix I. Detailed State-by-state Estimates

All estimates are based on projected 2010 income levels

ARKANSAS

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than \$15,300	\$15,300 - \$27,100	\$27,100 - \$44,600	\$44,600 - \$71,200	\$71,200 - \$139,500	\$139,500 - \$352,100	\$352,100 - Or More
Average Income in Group	\$ 9,500	\$ 21,500	\$ 35,700	\$ 57,000	\$ 93,200	\$ 200,800	\$ 902,000

Tax Change as a Percent of Income	—	0.0%	0.0%	0.0%	0.0%	0.1%	0.4%
Average Tax Change	—	+0	+1	+3	+20	+157	+3,174
Share of Total Tax Change	—	0%	0%	1%	7%	15%	76%

Average Tax Change for Affected Taxpayers	—	+4	+15	+44	+146	+520	+5,416
Percent of Income Group Affected	0%	0%	7%	7%	13%	30%	59%

% Offset	State Tax Change (\$1000)	Federal Tax Change (\$1000)	Total Tax Change (\$1000)
----------	---------------------------	-----------------------------	---------------------------

10%	\$ +53,000	\$ -5,000	\$ +48,000
-----	------------	-----------	------------

Percent of Arkansans Affected - Total			6%
---------------------------------------	--	--	----

HAWAII

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than \$19,200	\$19,200 - \$35,200	\$35,200 - \$51,300	\$51,300 - \$86,300	\$86,300 - \$171,100	\$171,100 - \$374,900	\$374,900 - Or More
Average Income in Group	\$ 11,300	\$ 26,500	\$ 42,500	\$ 67,100	\$ 118,200	\$ 235,300	\$ 934,500

Tax Change as a Percent of Income	—	0.0%	0.0%	0.0%	0.0%	0.0%	0.6%
Average Tax Change	—	+0	+0	+1	+4	+93	+5,809
Share of Total Tax Change	—	0%	0%	0%	1%	6%	93%

Average Tax Change for Affected Taxpayers	—	—	+4	+24	+37	+252	+9,285
Percent of Income Group Affected	0%	0%	2%	3%	12%	37%	63%

% Offset	State Tax Change (\$1000)	Federal Tax Change (\$1000)	Total Tax Change (\$1000)
----------	---------------------------	-----------------------------	---------------------------

9%	\$ +39,000	\$ -4,000	\$ +35,000
----	------------	-----------	------------

Percent of Hawaiians Affected - Total			5%
---------------------------------------	--	--	----

MONTANA

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than \$17,200	\$17,200 - \$30,800	\$30,800 - \$47,900	\$47,900 - \$79,500	\$79,500 - \$143,800	\$143,800 - \$385,700	\$385,700 - Or More
Average Income in Group	\$ 10,000	\$ 23,500	\$ 37,900	\$ 60,900	\$ 101,700	\$ 221,800	\$ 980,900

Tax Change as a Percent of Income	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%	0.5%
Average Tax Change	+0	+0	+4	+14	+60	+347	+4,817
Share of Total Tax Change	0%	0%	1%	4%	12%	19%	65%

Average Tax Change for Affected Taxpayers	+43	+13	+51	+124	+269	+789	+7,900
Percent of Income Group Affected	0%	2%	8%	12%	22%	44%	61%

% Offset	State Tax Change (\$1000)	Federal Tax Change (\$1000)	Total Tax Change (\$1000)
----------	---------------------------	-----------------------------	---------------------------

6%	\$ +35,000	\$ -2,000	\$ +33,000
----	------------	-----------	------------

Percent of Montanans Affected - Total			10%
---------------------------------------	--	--	-----

Impact of Repealing State Capital Gains Tax Preferences

All estimates are based on projected 2010 income levels

NEW MEXICO

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than \$17,900	\$17,900 - \$30,200	\$30,200 - \$48,500	\$48,500 - \$79,600	\$79,600 - \$155,500	\$155,500 - \$393,200	\$393,200 - Or More
Average Income in Group	\$ 10,700	\$ 24,000	\$ 38,400	\$ 61,700	\$ 106,200	\$ 219,400	\$ 893,700

Tax Change as a Percent of Income	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.4%
Average Tax Change	+0	+1	+5	+8	+27	+292	+3,734
Share of Total Tax Change	0%	0%	2%	3%	7%	21%	67%

Average Tax Change for Affected Taxpayers	+9	+70	+100	+114	+158	+820	+6,535
Percent of Income Group Affected	0%	1%	5%	7%	17%	36%	57%

% Offset	State Tax Change (\$1000)	Federal Tax Change (\$1000)	Total Tax Change (\$1000)
----------	---------------------------	-----------------------------	---------------------------

14%	\$ +48,000	\$ -7,000	\$ +41,000
-----	------------	-----------	------------

Percent of New Mexicans Affected - Total			7%
--	--	--	----

NORTH DAKOTA

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than \$22,900	\$22,900 - \$38,600	\$38,600 - \$68,800	\$68,800 - \$93,600	\$93,600 - \$177,500	\$177,500 - \$406,400	\$406,400 - Or More
Average Income in Group	\$ 14,400	\$ 30,700	\$ 51,000	\$ 79,000	\$ 120,600	\$ 245,800	\$ 1,108,700

Tax Change as a Percent of Income	—	0.0%	0.0%	0.0%	0.0%	0.1%	0.3%
Average Tax Change	—	+0	+3	+5	+18	+185	+3,471
Share of Total Tax Change	—	0%	1%	2%	6%	16%	75%

Average Tax Change for Affected Taxpayers	—	+24	+19	+49	+73	+441	+4,985
Percent of Income Group Affected	0%	0%	16%	11%	25%	42%	70%

% Offset	State Tax Change (\$1000)	Federal Tax Change (\$1000)	Total Tax Change (\$1000)
----------	---------------------------	-----------------------------	---------------------------

14%	\$ +14,000	\$ -2,000	\$ +12,000
-----	------------	-----------	------------

Percent of North Dakotans Affected - Total			12%
--	--	--	-----

SOUTH CAROLINA

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than \$16,300	\$16,300 - \$27,600	\$27,600 - \$43,200	\$43,200 - \$73,400	\$73,400 - \$142,200	\$142,200 - \$345,700	\$345,700 - Or More
Average Income in Group	\$ 10,000	\$ 21,800	\$ 34,600	\$ 56,600	\$ 96,400	\$ 201,900	\$ 859,100

Tax Change as a Percent of Income	—	0.0%	0.0%	0.0%	0.0%	0.1%	0.5%
Average Tax Change	—	+0	+0	+7	+30	+256	+3,961
Share of Total Tax Change	—	0%	0%	3%	8%	18%	71%

Average Tax Change for Affected Taxpayers	—	—	+8	+61	+127	+760	+6,342
Percent of Income Group Affected	0%	1%	5%	12%	23%	34%	62%

% Offset	State Tax Change (\$1000)	Federal Tax Change (\$1000)	Total Tax Change (\$1000)
----------	---------------------------	-----------------------------	---------------------------

11%	\$ +115,000	\$ -13,000	\$ +102,000
-----	-------------	------------	-------------

Percent of South Carolinians Affected - Total			9%
---	--	--	----

Impact of Repealing State Capital Gains Tax Preferences

All estimates are based on projected 2010 income levels

VERMONT

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than \$19,900	\$19,900 - \$35,800	\$35,800 - \$53,400	\$53,400 - \$86,300	\$86,300 - \$161,500	\$161,500 - \$365,700	\$365,700 - Or More
Average Income in Group	\$ 12,300	\$ 27,600	\$ 44,300	\$ 66,100	\$ 110,500	\$ 228,200	\$ 973,200

Tax Change as a Percent of Income	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%	0.8%
Average Tax Change	+0	+2	+10	+13	+59	+536	+7,933
Share of Total Tax Change	0%	0%	2%	2%	8%	19%	69%

Average Tax Change for Affected Taxpayers	+41	+121	+108	+176	+288	+1,448	+10,720
Percent of Income Group Affected	0%	1%	9%	7%	21%	37%	74%

% Offset	State Tax Change (\$1000)	Federal Tax Change (\$1000)	Total Tax Change (\$1000)
----------	---------------------------	-----------------------------	---------------------------

3%	\$ +34,000	\$ -1,000	\$ +33,000
----	------------	-----------	------------

Percent of Vermonters Affected - Total			9%
--	--	--	----

WISCONSIN

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than \$20,300	\$20,300 - \$35,100	\$35,100 - \$55,600	\$55,600 - \$83,900	\$83,900 - \$151,900	\$151,900 - \$353,100	\$353,100 - Or More
Average Income in Group	\$ 13,200	\$ 27,300	\$ 44,700	\$ 69,100	\$ 106,900	\$ 210,400	\$ 1,033,800

Tax Change as a Percent of Income	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.4%
Average Tax Change	+0	+0	+2	+12	+39	+226	+3,951
Share of Total Tax Change	0%	0%	1%	4%	10%	16%	69%

Average Tax Change for Affected Taxpayers	+13	+14	+67	+88	+200	+574	+5,475
Percent of Income Group Affected	0%	2%	4%	14%	19%	39%	72%

% Offset	State Tax Change (\$1000)	Federal Tax Change (\$1000)	Total Tax Change (\$1000)
----------	---------------------------	-----------------------------	---------------------------

10%	\$ +151,000	\$ -15,000	\$ +136,000
-----	-------------	------------	-------------

Percent of Wisconsinites Affected - Total			9%
---	--	--	----

Appendix II. The ITEP Microsimulation Model

The Institute on Taxation & Economic Policy has engaged in research on tax issues since 1980, with a focus on the distributional consequences of both current law and proposed changes. ITEP's research has often been used by other private groups in their work, and ITEP is frequently consulted by government estimators in performing their official analyses. Over the past several years, ITEP has built a microsimulation model of the tax systems of the U.S. government and of all 50 states and the District of Columbia.

Microsimulation Model

The ITEP model is a tool for calculating revenue yield and incidence, by income group, of federal, state and local taxes. It calculates revenue yield for current tax law and proposed amendments to current law. Separate incidence analyses can be done for categories of taxpayers specified by marital status, the presence of children and age.

In computing its estimates, the ITEP model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to three quarters of a million records. To forecast revenues and incidence, the model relies on government or other widely respected economic projections.

The ITEP model's federal tax calculations are very similar to those produced by the congressional Joint Committee on Taxation, the U.S. Treasury Department and the Congressional Budget Office (although each of these four models differs in varying degrees as to how the results are presented). The ITEP model, however, adds state-by-state estimating capabilities not found in those government models.

Below is an outline of each area of the ITEP model and what its capabilities are:

The Personal Income Tax Model analyzes the revenue and incidence of current federal and state personal income taxes and amendment options including changes in:

- rates—including special rates on capital gains,
- inclusion or exclusion of various types of income,
- inclusion or exclusion of all federal and state adjustments,
- exemption amounts and a broad variety of exemption types and, if relevant, phase-out methods,
- standard deduction amounts and a broad variety of standard deduction types and phase-outs,
- itemized deductions and deduction phase-outs, and
- credits, such as earned-income and child-care credits.

The Consumption Tax Model analyzes the revenue yield and incidence of current sales and excise taxes. It also has the capacity to analyze the revenue and incidence implications of a broad range of base and rate changes in general sales taxes, special sales taxes, gasoline excise taxes and tobacco excise taxes. There are more than 250 base items available to amend in the model, reflecting, for example, sales tax base differences among states and most possible changes that might occur.

The Property Tax Model analyzes revenue yield and incidence of current state and local property taxes. It can also analyze the revenue and incidence impacts of statewide policy changes in property tax—including the effect of circuit breakers, homestead exemptions, and rate and assessment caps.

The Corporate Income Tax Model analyzes revenue yield and incidence of current corporate income tax law, possible rate changes and certain base changes.

Local taxes. The model can analyze the statewide revenue and incidence of aggregate local taxes (not, however, broken down by individual localities).

Data Sources

The ITEP model is a “microsimulation model.” That is, it works on a very large stratified sample of tax returns and other data, aged to the year being analyzed. This is the same kind of tax model used by the U.S. Treasury Department, the congressional Joint Committee on Taxation and the Congressional Budget Office.

The ITEP model uses the following micro-data sets and aggregate data:

Micro-Data Sets: IRS Individual Public Use Tax File, Level III Sample; IRS Individual Public Use Tax File; Current Population Survey; Consumer Expenditure Survey; U.S. Census, 1990.

Partial List of Aggregated Data Sources: Miscellaneous IRS data; Congressional Budget Office and Joint Committee on Taxation forecasts; other economic data (Commerce Department, WEFA, etc.); state tax department data; data on overall levels of consumption for specific goods (Commerce Department, Census of Services, etc.); state specific consumption and consumption tax data (Census data, Government Finances, etc.); state specific property tax data (Govt. Finances, etc.); American Housing Survey 1990; 1990 Census of Population Housing; etc.

A more detailed description of the ITEP Microsimulation Tax Model can be found at www.itepnet.org.