An Analysis of SB 535’s Proposed Corporate and Personal Income Tax Capital Gains Tax Cut

Prepared By:

The Institute on Taxation and Economic Policy
Washington, DC 20005
www.ctj.org/itep

For:

Oregon Center on Public Policy
204 North First Street, Suite C
P.O. Box 7, Silverton, OR 97381-0007
www.ocpp.org
e-mail: info@ocpp.org

June 1999
An Analysis of SB 535’s Proposed Corporate and Personal Income Tax Capital Gains Tax Cut

In recent years, the tax treatment of capital gains income has been one of the most hotly contested issues in federal tax policy. This debate has recently spilled over onto the state level in Oregon with the consideration of SB 535.

Oregon’s personal income tax currently subjects capital gains to the same graduated rate structure as all other sources of income. SB 535 would create a separate, lower rate of 4 percent for income from capital gains, while still taxing wages, self-employment, and other income at the current higher rates. SB 535 would also reduce the corporate income tax rate on capital gains by over one third: from 6.6 percent to 4 percent. This analysis discusses the distributional and revenue implications of this legislation for Oregon residents.

Consequences of Reducing the Tax Rate on Capital Gains

Oregon currently taxes capital gains income in the same manner as other sources of income, with rates ranging from 5 to 9 percent. The proposed single-rate capital gains tax would be lower than each of the marginal rates applicable to all other sources of income. The table on the next page shows the consequences of reducing the personal income tax rate on capital gains to a single rate of 4 percent for different income groups. Because the wealthy receive a far greater share of capital gains income than do middle- and low-income families, and because the rate cut is larger for upper-bracket taxpayers, this tax cut would benefit better-off Oregonians the most. In particular:

# Fifty-three percent of the total amount of tax reduction would go to the one percent of Oregonians with income over $271,000 and an average income of $720,000. The average tax cut for this group would be $7,770. The best-off 5 percent would get 72 percent of the tax reduction.

---

1Note that the rate table shown here displays “marginal” rates on “taxable” income. Thus, the brackets are for income after exclusions (of Social Security income, for example) and deductions. Although the top rate of 9 percent starts at $11,800 of taxable income, the first $11,800 of each taxpayer’s income is taxed at lower rates.
# The poorest twenty percent of Oregonians would be effectively excluded from this tax cut, with an average reduction in taxes of just 4 cents.
# The eighty percent of Oregonians earning less than $63,000 annually would receive only 10 percent of the tax cut— an average amount of $16.
# The ninety-five percent of Oregonians with incomes under $116,000 per year would receive just 28 percent of the tax cut, with an average reduction of $41.
# The ninety-nine percent of Oregonians with incomes under $271,000 would receive less than half of the total amount of the tax reduction, with an average tax cut of $66.

## Effect of a Capital Gains Tax Cut to 4%
### Oregon Residents by Income Group, 1999

<table>
<thead>
<tr>
<th>Income Group</th>
<th>Income Range</th>
<th>Average Income</th>
<th>Tax Change as % of Income</th>
<th>Average Tax Cut ($)</th>
<th>Percent of Total Tax Cut</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lowest 20%</td>
<td>Below $13,800</td>
<td>$ 8,500</td>
<td>-0.0%</td>
<td>$ 0</td>
<td>0%</td>
</tr>
<tr>
<td>Second 20%</td>
<td>$13,800-$24,800</td>
<td>$ 19,200</td>
<td>-0.1%</td>
<td>$ 10</td>
<td>1%</td>
</tr>
<tr>
<td>Middle 20%</td>
<td>$24,800-$39,200</td>
<td>$ 30,900</td>
<td>-0.1%</td>
<td>$ 22</td>
<td>3%</td>
</tr>
<tr>
<td>Fourth 20%</td>
<td>$39,200-$62,600</td>
<td>$ 50,000</td>
<td>-0.1%</td>
<td>$ 35</td>
<td>5%</td>
</tr>
<tr>
<td>Next 15%</td>
<td>$62,600-$116,100</td>
<td>$ 80,200</td>
<td>-0.2%</td>
<td>$ 177</td>
<td>19%</td>
</tr>
<tr>
<td>Next 4%</td>
<td>$116,100-$271,000</td>
<td>$165,600</td>
<td>-0.4%</td>
<td>$ 650</td>
<td>19%</td>
</tr>
<tr>
<td>Top 1%</td>
<td>Above $271,000</td>
<td>$719,900</td>
<td>-1.1%</td>
<td>$ 7,770</td>
<td>53%</td>
</tr>
</tbody>
</table>

Addendum: Bottom 99%

<table>
<thead>
<tr>
<th>Income Group</th>
<th>Income Range</th>
<th>Average Income</th>
<th>Tax Change as % of Income</th>
<th>Average Tax Cut ($)</th>
<th>Percent of Total Tax Cut</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>$ 40,294</td>
<td>-0.2%</td>
<td>$ 66</td>
<td>47%</td>
</tr>
</tbody>
</table>

Note that these results only reflect the impact of the capital gains tax reduction in the personal income tax. The reduction in the corporate income tax exacerbates the regressive consequences of the proposal.

## Capital Gains and the Progressivity of Oregon Taxes

The corporate and personal income taxes are the only major progressive taxes levied by Oregon. Thus, they play an important role in the tax system as a whole in offsetting the regressivity of Oregon’s other taxes— consumption taxes and property taxes being the most significant. Without a progressive personal income tax and a corporate income tax, middle- and low-income families would pay a hugely disproportionate share of Oregon taxes.

Because capital gains are the most concentrated major source of income, capital gains tax reductions almost unavoidably benefit top income groups disproportionately. Profits from selling stocks, bonds, real estate, and other capital gains account for over 20 percent of the income of the wealthiest one percent of
Oregonians. Conversely, capital gains comprise a relatively small portion of the income of low- and middle-income Oregonians. Capital gains comprise less than 2 percent of income for all but the wealthiest twenty percent of Oregonians. And capital gains represent less than 5 percent of income for all but the wealthiest five percent of Oregon residents. In fact, over 50 percent of all capital gains subject to tax are realized by the wealthiest one-percent of Oregonians.

For other income groups, other forms of income are much more important. Wages, for example, constitute less than one-third of the income of the wealthiest one percent of Oregonians—well below the statewide average of 61 percent.

Thus, reducing the tax on capital gains income, as opposed to other sources of income, disproportionately benefits the best-off Oregonians, and would exacerbate the regressivity of the Oregon tax system as a whole. The share of taxes paid by Oregon’s wealthiest taxpayers would decline significantly under SB 535 and the percentage of taxes paid by the rest of Oregon taxpayers would increase.

### Interaction Between Oregon and Federal Income Taxes

The projected revenue loss from SB 535 is about $220 million per year. But the actual tax savings for Oregonians would be significantly less than that. Because state income taxes can be deducted by taxpayers itemizing deductions on their federal tax returns, any reduction in Oregon income taxes paid results in an increase in federal taxes.

---

2. This is ITEP’s projection of the cost of SB 535’s provisions when enacted at 1999 levels. The cuts outlined in SB 535 would be effective beginning in tax year 2002.

3. This deduction of state income tax from the federal personal income tax should be distinguished from Oregon’s unusual deduction for federal income taxes from its state personal income tax.
income taxes paid by Oregon residents. In other words, the effect of SB 535 is to lower state personal income tax payments by Oregonians, while increasing their federal personal income tax payments.

The result of this interaction is that 28 percent of the SB 535 tax would end up going to the federal government. Oregon would collect $220 million less in taxes, and would be forced to spend $220 million less on for government services benefitting Oregonians. But Oregonians would only receive a tax cut of $158 million because they would be paying $62 million more to the federal government. This loss of $62 million from the state obviously would have a negative impact on the state’s economy as well as hurting the ability of the state to respond to the needs of its citizens.

**Why Tax Capital Gains at a Lower Rate?**

Advocates of reducing capital gains taxes usually don’t sell the idea as a giveaway to the rich or as a way to increase federal taxes. Instead, they generally make the claim that a capital gains tax break would stimulate the economy.

Much ink has been spilled evaluating the legitimacy of the argument that capital gains tax cuts lead to increased investment and economic growth. But the empirical relationship between capital gains taxation and investment, while a major bone of contention on the federal level, is relatively meaningless for state tax policy discussions. A federal capital gains tax incentive can be said to work if it generates new investment that would otherwise not have occurred. A state-specific capital gains tax incentive, on the other hand, must encourage investment within the borders of the state. The capital gains tax cut in SB 535 would reduce capital gains taxes for investments whether the companies operate in Oregon, Washington, California, Maine, Alabama or China. Thus, any argument that such a cut is well targeted to benefit the Oregon economy is tenuous at best.

Moreover, any investment effects of a capital gains tax cut are achieved at the cost of a distortional effect on the allocation of resources. Taxing capital gains income identically to other sources of income removes artificial incentives for taxpayers to shelter their income in tax-preferred sources, and allows taxpayers to choose an allocation of income that is optimal for them— and for the economy.
Conclusion

A capital gains tax cut in the Oregon corporate and personal income taxes would disproportionately benefit the state’s wealthiest residents. A positive economic benefit from such a tax cut is unlikely. The evidence that such tax cuts, even on the federal level, have a positive economic impact is controversial. An un-targeted state-level capital gains tax cut is even less likely to have a positive impact. In addition, over a quarter of the tax cut would not go to benefit Oregonians, but would leave the state for the federal government coffers in Washington. Thus, the tax cut would lead to a reduction in state government services in Oregon that is greater than the individual benefit that Oregonians would see in lower tax payments.

Coming on the heels of recently enacted property tax cuts in Oregon, such poorly targeted tax relief mechanisms can serve only to endanger the state’s ability to adequately provide for important government services.
ITEP METHODOLOGY

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.

What the ITEP Model Does

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).

Addendum: 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:

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 on the ITEP internet site at www.ctj.org/itep/.