

Repeal State Tax Breaks For Capital Gains

by Jeff McLynch

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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 <http://www.itepnet.org>.

Executive Summary

- At present, nine states — Arkansas, Hawaii, Montana, New Mexico, North Dakota, Rhode Island, South Carolina, Vermont, and Wisconsin — offer substantial tax breaks for income derived from capital gains. In tax year 2008, these nine states are expected to lose a total of \$663 million due to such misguided policies, with losses ranging from \$10 million to \$285 million per state. Consequently, repealing capital gains tax breaks could be an important response to projected state budget deficits.
- Capital gains are the profits one realizes from the sale of an asset, such as stocks, bonds, investment or vacation real estate, art, or antiques.
- In practice, very few low- and moderate-income taxpayers report income from capital gains. Federal data from 2006 indicate that, for the country as a whole, taxpayers with adjusted gross income (AGI) of less than \$50,000 comprised 67 percent of all federal tax returns filed,

but constituted just 3 percent of all returns with income from capital gains. Similarly, taxpayers in this income group held 23 percent of nationwide AGI in 2006, but received just 4 percent of reported capital gains income.

- As a result, the impact of repealing capital gains tax breaks would fall almost exclusively on the most affluent state residents. In fact, in the nine states highlighted in this report, 94 to 97 percent of the additional tax revenue generated by repeal would be paid by the richest 20 percent of taxpayers in those states.
- Claims that capital gains tax breaks help to promote economic growth — and that the repeal of such 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.
- Concerns about the volatility of capital gains income — and, by extension, the revenue derived from such income — are understandable, but are no reason to preserve such inefficient and inequitable 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.
- Capital gains tax preferences are costly, inequitable, and ineffective. They deprive states of millions of dollars in needed funds, benefit almost exclusively the very wealthiest members of society, and fail to promote economic growth in the manner their proponents claim. In the current fiscal and economic climate, state policymakers can not afford to maintain these tax breaks any longer.

Introduction

As state policymakers craft their budgets for the upcoming fiscal year, they must confront a pair of daunting challenges, one fiscal, the other economic.

The budget outlook for the states is, at present, the most dire in several decades. Recent Rockefeller Institute studies find that growth in personal income taxes and property taxes has slowed considerably since the end of 2007; sales taxes have declined in real terms over the same period. Consequently, after adjusting for inflation, state tax revenue dropped 5.6 percent in the fourth quarter of 2008, with much larger drops expected in the months ahead.¹ At the same time, the need for public services — particularly health care for low-wage or unemployed workers and their families — is on the rise. As a result, most states are now projecting significant budget deficits for the year ahead. The latest survey from the National Conference of State Legislatures suggests 34 states will experience budget shortfalls in fiscal year 2010 (FY10), with at least 20 of those states anticipating gaps in excess of 10 percent of their general funds. Taken together, state budget deficits are predicted to top \$84 billion in FY10 alone.²

Such fiscal stress is, of course, the result of economic developments across the United States over the past twelve to eighteen months, from the sharp downturn in housing prices, to the credit crisis on Wall Street, to the deepening national recession. The impact of these developments has been felt most keenly by low- and moderate-income households. The national unemployment rate stood at 7.6 percent in January, its highest level in 16 years, while the unemployment rate in some states, such as Michigan, Rhode Island, and South Carolina, climbed past 9 percent.³ Likewise, housing foreclosures have risen sharply in the past year; more than 2.3 million properties around the country were subject to some form of foreclosure filing in 2008, a jump of 81 percent from 2007.⁴ While the national foreclosure rate was about 11 foreclosures per 5,000 properties in January, certain states, like Arizona, California, and Florida, had rates that were at least twice as high.⁵

¹Boyd, Donald J. and Dadayan, Lucy, *State Tax Revenue Declined Sharply in Fourth Quarter*, Nelson A. Rockefeller Institute of Government, Albany, NY, March 12, 2009; Boyd, Donald J. and Dadayan, Lucy, *State Tax Revenue Falling Sharply in Fourth Quarter, Early Data Show*, Nelson A. Rockefeller Institute of Government, Albany, NY, January 2009.

²National Conference of State Legislatures, *Update on State Budget Gaps: FY 2009 & FY 2010*, Feb. 6, 2009.

³Shierholz, Heidi, "Labor market has worst month since recession began," *EPI Jobs Report*, Feb. 6, 2009; Bureau of Labor Statistics, *Regional and State Employment and Unemployment: December 2008*, Jan. 27, 2009.

⁴RealtyTrac, *Foreclosure Activity Increases 81 Percent in 2008*, Jan. 15, 2009.

⁵Data downloaded from <http://www.stateline.org/live/issues/Economy+&+Business>, Feb. 19, 2009.

In this context, then, 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 nine states — Arkansas, Hawaii, Montana, New Mexico, North Dakota, Rhode Island, 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.⁶ In tax year 2008 alone, these nine states are expected to lose a total of \$663 million due to such misguided policies, with individual losses ranging from \$10 million to \$285 million per state. Repealing these tax preferences would help states reduce their large and growing budgetary gaps, enhance the equity of their current tax systems, and remove the economic inefficiencies arising from such favorable treatment.

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 nine key states. 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 compute 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. From an economic perspective, a dollar is a dollar, regardless of how it is earned. Thus, taxing one dollar in

⁶Several other states, including Iowa and Oklahoma, provide tax preferences for capital gains from certain "in-state" assets. The nine states that are the focus of this report do not limit their preferences in this manner.

**Figure 1.
Major State Capital Gains Preferences**

State	Capital Gains Preferences	Year Enacted/ Implemented
AR	Income tax exclusion equal to 30 percent of net long-term capital gains income	1999
HI	Preferential income tax rates for income from capital gains for upper-income taxpayers	1987
MT	Non-refundable income tax credit equal to 2 percent of capital gains income	2003 / 2007
NM	Income tax exclusion equal to the greater of \$1,000 or 50 percent of net capital gains income	2003 / 2007
ND	Income tax exclusion equal to 30 percent of net long-term capital gains income for most taxpayers	2001
RI	Preferential income tax rates for income from both short- and long-term capital gains	2002 / 2007
SC	Income tax deduction equal to 44 percent of net long-term capital gains income	1991
VT	Income tax exclusion equal to 40 percent of net long-term capital gains income	2002
WI	Income tax exclusion equal to 60 percent of net long-term capital gains income	1987

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 just by reclassifying the type of income they receive.⁷

How Do States Treat Capital Gains for Tax Purposes?

Despite the ramifications for economic efficiency and individual behavior, both the federal government and a variety 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. Nine states — discussed in greater detail below — offer substantial tax breaks of their own for income derived from capital gains income, 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.⁸ It is also worth pointing out that 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.⁹ 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.¹⁰

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, nine states offer substantial tax breaks for capital gains income. In six of the nine 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, two follow the federal government’s unfortunate lead

⁸In the case of Rhode Island, short-term gains are defined as gains from assets held for fewer than five years.

⁹Data from the 2004 Survey of Consumer Finances indicate that principal residences, adjusted for outstanding mortgage debt, and retirement accounts, such as IRAs and 401(k)s, constitute 74 percent of the net worth of the bottom half of all families in the United States; for families in the fiftieth through ninetieth percentile of the wealth distribution, the comparable figure is 61 percent. For more information, see Kennickell, Arthur, *Currents and Undercurrents: Changes in the Distribution of Wealth, 1989-2004*, U.S. Federal Reserve Board, Washington, DC, Jan. 30, 2006.

¹⁰The \$500,000 exclusion is for married couples filing jointly; for single filers, the exclusion is generally \$250,000.

⁷The national debate since 2007 over the taxation of “carried interest” is just the latest instance in which some have attempted to exploit the disparate tax treatment of certain types of income. In this particular debate, private equity and hedge fund managers maintain that the compensation they receive for overseeing their clients’ assets should be treated as capital gains for federal tax purposes — and thus eligible for a maximum tax rate of 15 percent — rather than ordinary income — which would be taxed at a rate of up to 35 percent.

Figure 2.
Capital Gains Income Among Federal Taxpayers
In States with Major Capital Gains Preferences, 2006

	Income Group (Federal AGI)	AR	HI	MT	NM	ND	RI	SC	VT	WI	US
Shares of All Returns Filed	Under \$50,000	74%	67%	72%	73%	70%	66%	72%	69%	66%	67%
	\$200,000 plus	2%	2%	2%	2%	2%	3%	2%	2%	2%	3%
Share of All Returns with Capital Gains Income	Under \$50,000	9%	12%	17%	9%	17%	11%	8%	14%	15%	11%
	\$200,000 plus	75%	78%	81%	76%	79%	78%	78%	82%	79%	77%
Share of Total Adjusted Gross Income	Under \$50,000	33%	27%	30%	30%	29%	24%	30%	27%	25%	23%
	\$200,000 plus	19%	22%	22%	20%	19%	25%	22%	23%	22%	30%
Share of Total Capital Gains Income	Under \$50,000	7%	3%	8%	5%	10%	3%	4%	5%	7%	4%
	\$200,000 plus	68%	80%	67%	71%	62%	80%	77%	72%	70%	82%
Capital Gains Income As a Share of Adjusted Gross Income	Under \$50,000	1%	1%	3%	1%	2%	1%	1%	2%	2%	2%
	\$200,000 plus	20%	35%	33%	25%	21%	25%	27%	33%	22%	25%

Source: IRS, 2006 Statistics of Income (SOI)

and tax capital gains income at lower rates (or at least they do for some taxpayers), while a third provides a tax credit based on capital gains income.

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.¹¹ Data from the Internal Revenue Service's 2006 Statistics of Income demonstrate that the richest 2 to 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.

Indeed, as Figure 2 indicates, while individuals and families with federal AGI below \$50,000 represent the overwhelming 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, low- and moderate-income taxpayers comprise two-thirds of federal taxpayers; among the nine states with major capital gains preferences, they range from 66 percent of federal taxpayers living in Rhode Island and Wisconsin to 74 percent of federal taxpayers residing in Arkan-

sas. Nonetheless, these taxpayers typically constitute less than one in five of all filers reporting capital gains income. For instance, in Montana, federal taxpayers with AGI of less than \$50,000 represent only about 17 percent of all federal taxpayers with taxable capital gains income.

Moreover, 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 33 percent of all federal AGI reported by those states' residents, but just 3 to 10 percent of total capital gains income reported. As a result, capital gains income makes up only about 1 to 3 percent of total AGI for taxpayers with incomes below \$50,000 in these states. In sharp contrast, taxpayers with incomes over \$200,000 garner upwards of 80 percent of all capital gains income, with that particular type of income representing 20 to 35 out of every 100 dollars of AGI.

What Are the Consequences of Preferential Treatment for Capital Gains?

As one might expect, the impact that capital gains tax preferences can have on state budgets, on taxpayers at different income levels, and on state economies is quite substantial.

In tax year 2008, the nine states offering major capital gains tax preferences will, taken together, lose approximately \$663 million due to such misguided policies, with individual losses ranging from \$10 million to \$285 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

¹¹Survey of Consumer Finances data from 2004 further reveal that nearly 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 33 percent of the nation's net worth.

Figure 3.
Impact of Capital Gains Preferences on State Budgets, Taxpayers, and Economies — 2008

	AR	HI	MT	NM	ND	RI	SC	VT	WI
Income Tax Revenue Lost to Capital Gains Preferences (\$M)	45	21	30	51	10	49	137	35	285
Income Tax Revenue Lost to Capital Gains Preferences (%)	2%	1%	4%	5%	3%	5%	4%	7%	5%
Income Tax Revenue Lost to Capital Gains Preferences as a Share of Projected FY 2010	n/a	2%	n/a	n/a	n/a	11%	26%	16%	11%
Share of Revenue Loss by Income Group									
Bottom 80%	3%	1%	5%	4%	3%	2%	2%	2%	6%
Top 20%	97%	99%	95%	96%	97%	98%	98%	98%	94%
Top 5%	89%	96%	83%	87%	92%	88%	90%	92%	83%
Top 1%	73%	81%	62%	67%	75%	66%	72%	75%	64%
Average Tax Reduction by Income Group									
Bottom 80%	1	0	4	3	2	5	2	4	17
Top 20%	173	165	294	275	153	444	326	548	491
Top 5%	635	641	1,016	1,010	1,160	3,181	1,207	4,101	3,463
Top 1%	2,576	2,700	3,810	3,808	2,445	5,956	4,857	8,523	6,712
Percent of State Revenue Loss Offset by Higher Federal Taxes	11%	12%	9%	16%	16%	11%	16%	10%	18%
<i>Sources:</i> ITEP Microsimulation Model; data on state budget deficits taken from “Update on State Budget Gaps: FY 2009 & FY 2010, National Conference of State Legislatures.”									

instance, South Carolina’s 44 percent capital gains deduction will cost the state roughly \$137 million in tax year 2008. While that sum equals about 4 percent of total income tax revenue, it amounts to more than a quarter of South Carolina’s expected FY10 budget deficit of \$966 million.¹²

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 — 97 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 3 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 \$173. Worse still, the average tax cut for the top 1 percent of taxpayers — those taxpayers with incomes in excess of \$351,000 in 2008 — is nearly \$2,600.¹³ 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 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

¹²Due to timing issues, the full impact of any effort to repeal capital gains tax preferences may not be felt until FY 2011. 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 nine 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.

¹³For more detailed estimates on the impact of repealing capital gains tax preferences, please refer to Appendix I (p. 156).

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 Figure 3 suggests, Wisconsin's \$285 million capital gains tax cut produces a \$50 million federal tax increase — \$50 million that flows out of Wisconsin's economy. Conversely, if Wisconsin were to repeal that \$285 million tax expenditure, the higher state taxes that wealthy Wisconsinites would pay would yield a \$50 million federal tax cut — \$50 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 (D) 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.”¹⁴ 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.”¹⁵

The theory that reducing taxes on capital gains will lead to a more robust economy is nothing more than that — a theory. Rather, an array of experts — from impartial economists within the federal government to non-partisan analysts outside it — agree 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.¹⁶ Indeed, the CBO determined that, of the range of approaches it examined, capital gains tax cuts were among the least effective. 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.¹⁷ 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.

Looking back over time, rather than projecting forward, yields the same conclusion. Research by Len Burman, the Director of the joint 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.¹⁸ Likewise, a report released last year 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.¹⁹

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

¹⁶Congressional Budget Office, *Economic Stimulus: Evaluating Proposed Changes in Tax Policy*, Washington, DC, January 2002.

¹⁷Zandi, Mark, *Testimony before the US House of Representatives Committee on the Budget*, January 27, 2009.

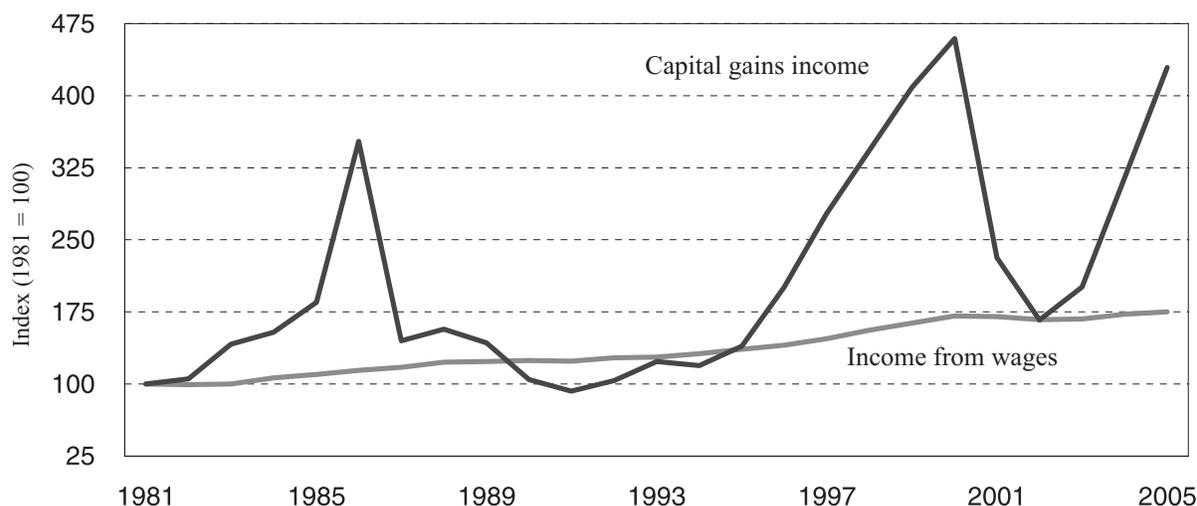
¹⁸Burman, Leonard and Kravitz, Troy, “Capital Gains Tax Rates, Stock Markets, and Growth,” *Tax Notes*, Nov. 7, 2005.

¹⁹Ettlinger, Michael and Irons, John, *Take a Walk on the Supply Side*, Center for American Progress and Economic Policy Institute, Washington, DC, September 2008.

¹⁴Governor Bill Richardson's State of the State Address, Jan. 21, 2003.

¹⁵“Gov. Signs Tax Cut Package,” *Albuquerque Journal*, Feb. 14, 2003.

Figure 4. Trends in U.S. Wage and Capital Gains Income, 1981-2005



Source: Congressional Budget Office.

slightly differently, simply because Rhode Island offers a preferential tax rate for capital gains does not make it more likely that investors living in Rhode Island will steer capital toward companies based in the Ocean State and thus spur in-state economic activity. After all, they will receive the same tax cut whether they invest in companies based in Rhode Island, located on Long Island, or situated on Easter Island. 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 under-

standable 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.

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, based on the most recent data available from the Congressional Budget Office, illustrates how capital gains income rose and fell over the twenty-five year period from 1981 to 2005.²⁰ The peaks that this type of income reached in 1986 and 2000 contrast quite clearly with the troughs that followed in 1991 and 2002; the variability of capital gains income also stands in sharp contrast with the trend exhibited by wages, which grew slowly and steadily over that same period. Yet, as Figure 5 (next page) indicates, even after accounting for such sharp declines, capital gains income has grown more rapidly than wages, over both the short-run and the long-run. Specifically, over the five year period from 2001 to 2005, wages grew by just 0.72 percent per year in real terms, while capital gains grew by 16.7 percent. Over a longer span, the difference is less marked but still noticeable — over the twenty-five year stretch from 1981 to 2005, wages grew at a real annual rate of 2.36 percent while capital gains grew

²⁰Congressional Budget Office, *Historical Effective Federal Tax Rates, 1979 to 2005*, December 2007. Data for 2006 through 2008 are not yet available.

at a rate of 6.26 percent. In short, those who bemoan the volatility of capital gains taxes are missing half the picture. For every bad year — like 2002 — there has been a good year — like 2000. On balance, the good years have outweighed the bad. Consequently, to avoid taxing capital gains would be to impair the proper operation of a state's income tax and reduce its long-run yield.

Figure 5.
Trends in U.S. Wage
and Capital Gains Income, 1981-2005
Real Average Annual Growth Rates

	Wages	Capital Gains
2001 to 2005	0.72%	16.70%
1996 to 2005	2.46%	8.83%
1991 to 2005	2.51%	11.59%
1986 to 2005	2.27%	1.04%
1981 to 2005	2.36%	6.26%

Source: ITEP calculations based on Congressional Budget Office data.

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.

Conclusion

State policymakers from Rhode Island to Hawaii are searching for solutions to mounting budget deficits, solutions that will allow them to fund vital public services without placing additional burdens on those individuals and families struggling to cope with the deepening 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, benefit-

ting almost exclusively the very wealthiest members of society, and failing to promote economic growth in the manner their proponents claim. In the current fiscal and economic climate, state policymakers can not afford to maintain these tax breaks any longer.

Appendix I. Detailed State-by-State Estimates (p. 156)

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, home-stead 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 <http://www.itepnet.org>.

Appendix I. Detailed State-by-State Estimates
Effect of Repealing State Capital Gains Tax Preferences
All estimates are based on projected 2008 income levels

Arkansas

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%	% Offset	State Tax Change (\$1000)	Federal Tax Change (\$1000)	Total Tax Change (\$1000)
Income Range	Less Than \$14,100	\$14,100-\$25,400	\$25,400-\$41,800	\$41,800-\$66,900	\$66,900-\$91,200	\$91,200-\$140,400	\$140,400-\$350,900	\$350,900 or More			
Average Income in Group	\$8,700	\$19,800	\$33,300	\$54,600	\$91,200	\$197,900	\$838,400		\$+45,000	\$-5,000	\$+40,000
Tax Change as a Percent of Income	—	—	0.0%	0.0%	0.0%	0.1%	0.3%		11%		
Average Tax Change	—	—	+1	+3	+19	+150	+2,576				
Share of Total Tax Change	—	—	1%	2%	8%	17%	73%				
Average Tax Change for Affected Taxpayers	—	—	+21	+42	+129	+519	+4,292		Percent of Arkansans Affected Total	—	7%
Percent of Income Group Affected	0%	0%	7%	8%	15%	29%	60%				

Hawaii

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%	% Offset	State Tax Change (\$1000)	Federal Tax Change (\$1000)	Total Tax Change (\$1000)
Income Range	Less Than \$17,300	\$17,300-\$33,000	\$33,000-\$48,600	\$48,600-\$82,700	\$82,700-\$168,900	\$168,900-\$386,000	\$386,000 or More				
Average Income in Group	\$10,100	\$25,000	\$40,300	\$64,100	\$114,200	\$241,500	\$1,085,800		\$-21,000	\$-2,000	\$+19,000
Tax Change as a Percent of Income	—	—	0.0%	0.0%	0.0%	0.1%	0.2%		12%		
Average Tax Change	—	—	+0	+1	+7	+125	+2,700				
Share of Total Tax Change	—	—	0%	1%	3%	15%	81%				
Average Tax Change for Affected Taxpayers	—	—	+9	+30	+52	+329	+3,595		Percent of Hawaiians Affected Total	—	5%
Percent of Income Group Affected	0%	0%	0%	3%	13%	38%	75%				

Montana

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%	% Offset	State Tax Change (\$1000)	Federal Tax Change (\$1000)	Total Tax Change (\$1000)
Income Range	Less Than \$16,300	\$16,300-\$29,300	\$29,300-\$44,800	\$44,800-\$74,700	\$74,700-\$139,100	\$139,100-\$378,700	\$378,700 or More				
Average Income in Group	\$9,200	\$21,600	\$36,100	\$58,100	\$97,400	\$214,200	\$915,000		\$+30,000	\$-3,000	\$+27,000
Tax Change as a Percent of Income	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%	0.4%		9%		
Average Tax Change	+0	+0	+3	+13	+49	+322	+3,810				
Share of Total Tax Change	0%	0%	1%	4%	12%	21%	62%				
Average Tax Change for Affected Taxpayers	+35	+18	+46	+101	+202	+741	+6,272		Percent of Montanans Affected Total	—	10%
Percent of Income Group Affected	0%	2%	7%	12%	24%	43%	61%				

New Mexico											
Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1% Or More	% Offset	State Tax Change (\$1000)	Federal Tax Change (\$1000)	Total Tax Change (\$1000)
Income Range	Less Than \$16,400	\$16,400-\$28,700	\$28,700-\$46,100	\$46,100-\$75,000	\$75,000-\$147,600	\$147,600-\$381,400	\$381,400-Or More		\$+51,000	\$-8,000	\$+43,000
Average Income in Group	\$10,100	\$22,400	\$36,100	\$58,800	\$101,700	\$213,400	\$887,300	16%			
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	+5	+8	+31	+303	+3,808				
Share of Total Tax Change	0%	0%	2%	3%	8%	21%	67%				
Average Tax Change for Affected Taxpayers	+9	+46	+112	+113	+173	+856	+6,516				7%
Percent of Income Group Affected	0%	0%	4%	7%	18%	35%	58%				
North Dakota											
Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1% Or More	% Offset	State Tax Change (\$1000)	Federal Tax Change (\$1000)	Total Tax Change (\$1000)
Income Range	Less Than \$21,100	\$21,100-\$35,200	\$35,200-\$60,900	\$60,900-\$91,500	\$91,500-\$172,200	\$172,200-\$384,200	\$384,200-Or More		\$+10,000	\$-2,000	\$+8,000
Average Income in Group	\$13,200	\$27,600	\$46,100	\$73,900	\$114,100	\$234,700	\$992,300	16%			
Tax Change as a Percent of Income	0.0%	—	0.0%	0.0%	0.0%	0.1%	0.2%				
Average Tax Change	+0	—	+1	+3	+12	+127	+2,445				
Share of Total Tax Change	0%	—	1%	2%	6%	16%	75%				
Average Tax Change for Affected Taxpayers	+33	—	+22	+36	+53	+260	+3,677				9%
Percent of Income Group Affected	0%	0%	6%	8%	23%	49%	67%				
Rhode Island											
Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1% Or More	% Offset	State Tax Change (\$1000)	Federal Tax Change (\$1000)	Total Tax Change (\$1000)
Income Range	Less Than \$15,900	\$15,900-\$30,000	\$30,000-\$50,700	\$50,700-\$84,200	\$84,200-\$164,400	\$164,400-\$400,500	\$400,500-Or More		\$+49,000	\$-5,000	\$+44,000
Average Income in Group	\$9,500	\$22,400	\$40,900	\$65,100	\$112,300	\$238,300	\$1,088,500	11%			
Tax Change as a Percent of Income	—	0.0%	0.0%	0.0%	0.1%	0.2%	0.5%				
Average Tax Change	—	+0	+3	+6	+62	+494	+5,956				
Share of Total Tax Change	—	0%	1%	1%	10%	22%	66%				
Average Tax Change for Affected Taxpayers	—	+7	+35	+53	+391	+1,182	+8,773				9%
Percent of Income Group Affected	0%	1%	8%	12%	16%	42%	68%				

South Carolina											
Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%	% Offset	State Tax Change (\$1000)	Federal Tax Change (\$1000)	Total Tax Change (\$1000)
Income Range	Less Than \$15,800	\$15,800-\$26,400	\$26,400-\$42,300	\$42,300-\$71,800	\$71,800-\$145,200	\$145,200-\$362,900	\$362,900 Or More				
Average Income in Group	\$9,700	\$21,200	\$33,700	\$55,700	\$96,600	\$208,200	\$925,400	16%	\$-137,000	\$-22,000	\$+115,000
Tax Change as a Percent of Income	—	—	0.0%	0.0%	0.0%	0.1%	0.5%				
Average Tax Change	—	—	+0	+7	+37	+295	+4,857				
Share of Total Tax Change	—	—	0%	2%	8%	18%	72%				
Average Tax Change for Affected Taxpayers	—	—	+7	+131	+190	+928	+7,590				6%
Percent of Income Group Affected	0%	0%	2%	6%	19%	32%	64%				Percent of South Carolinians Affected — Total
Vermont											
Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%	% Offset	State Tax Change (\$1000)	Federal Tax Change (\$1000)	Total Tax Change (\$1000)
Income Range	Less Than \$17,700	\$17,700-\$33,100	\$33,100-\$51,400	\$51,400-\$79,800	\$79,800-\$161,900	\$161,900-\$369,700	\$369,700 Or More				
Average Income in Group	\$11,100	\$25,300	\$41,200	\$62,800	\$105,500	\$228,400	\$1,013,100	10%	\$+35,000	\$-4,000	\$-31,000
Tax Change as a Percent of Income	0.0%	0.0%	0.0%	0.0%	0.0%	0.2%	0.8%				
Average Tax Change	+0	+0	+4	+4	+47	+483	+8,523				
Share of Total Tax Change	0%	0%	1%	1%	6%	17%	75%				
Average Tax Change for Affected Taxpayers	+6	+37	+43	+66	+199	+1,401	+10,752				10%
Percent of Income Group Affected	4%	1%	9%	6%	24%	34%	79%				Percent of Vermonters Affected — Total
Wisconsin											
Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%	% Offset	State Tax Change (\$1000)	Federal Tax Change (\$1000)	Total Tax Change (\$1000)
Income Range	Less Than \$18,700	\$18,700-\$32,600	\$32,600-\$54,000	\$54,000-\$82,200	\$82,200-\$151,900	\$151,900-\$355,800	\$355,800 Or More				
Average Income in Group	\$12,000	\$25,500	\$43,000	\$67,200	\$104,700	\$210,500	\$1,058,700	18%	\$+285,000	\$-50,000	\$+235,000
Tax Change as a Percent of Income	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%	0.6%				
Average Tax Change	+0	+0	+5	+27	+76	+489	+6,712				
Share of Total Tax Change	0%	0%	1%	5%	11%	19%	64%				
Average Tax Change for Affected Taxpayers	+17	+28	+129	+176	+373	+1,176	+9,359				10%
Percent of Income Group Affected	0%	2%	4%	15%	20%	42%	72%				Percent of Wisconsinites Affected — Total

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