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MEMORANDUM

TO: Tim Nesbitt, Oregon AFL-CIO

FROM: Chuck Sheketoff

DATE: April 20, 2005

RE: AOI and Conerly Capital Gains Claims

We have conducted an initial review of Bill Conerly's most recent report on Oregon's income tax on capital gains. I also sent the recent and prior Conerly papers to one of the country's foremost authorities on capital gains, Len Burman, co-director of the Tax Policy Center, a joint venture of the Urban Institute and the Brookings Institution and a Senior Fellow, Urban Institute. While I call your attention primarily to the key findings of Len Burman, attached, I offer a few comments on the Conerly report:

1. Mr. Conerly does not distinguish between investments in Oregon vs. investments anywhere else in the world.
2. If Oregon's income tax on capital gains is bad for our economy, then why did Oregon's Gross State Product growth outpace the nation each year from 1988 through 2000? Between 1995 and 2000, Oregon was the fastest growing state for GSP with our current income tax on capital gains. There is no evidence that Oregon's income tax on capital gains impedes our economy.
3. The idea that lowering Oregon's capital gains would result in venture capital investment going up by $300 million a year is preposterous. Mr. Conerly is unable (or unwilling) to explain why California manages the largest and most dynamic high-tech venture capital community in the world despite a high tax on capital gains. Mr. Conerly's analysis makes little sense when put in perspective.[1] As OCPP has reported, authorities on venture capital have noted

[1] Oddly, Mr. Conerly cites Idaho as an example of proof that lowering the tax on capital gains results in big improvements in venture capital, "with its best year ever in 2003," and cites Virginia as an example of what goes wrong when capital gains taxes are increased (not an issue under consideration). According to the Oregon Business Plan's "Competitive Index," Idaho ranks 27th with capital venture investments in just three businesses, and ranked 36th with only $4 million invested in April-September, 2004. Oregon, on the other hand, ranks 16th both for the number of companies receiving venture capital (21) and the total dollar amount of venture capital invested ($113.9 million). Virginia, Mr. Conerly's example of what goes wrong when capital gains taxes are allegedly increased, outperformed Oregon, ranking 10th with investments in 32 companies and ranking 14 with $122.5 million in total investments. In other words, the Oregon Business Plan presents a very different picture than Mr. Conerly.

that state level taxes on capital gains are not related to the level of venture capital investment in a particular state.

4. How is Mr. Conerly able to claim that the average capital gains income of taxpayers with income of $0 to $20,000 averages a whopping $5,600? That's because his table of income from capital gains and his calculations of capital gains by income group includes "negative returns" with those who have $0 to $20,000 in AGI.

   Including "negative returns" skews the distribution to give Mr. Conerly the result he wants. As we note on page 14 of *In the Shadows of the Recovery*, about 2 percent of Oregon tax returns reported adjusted gross incomes (AGI) that were less than zero in 2002. A taxpayer can calculate and report a negative AGI under a variety of tax code provisions allowing the taxpayer to count certain losses against income, such as losses from business operations, farming, partnerships, S-Corporations, or real estate investments. These taxpayers generally differ from other households in the bottom quintile because they typically have significant assets and other income. Similar to analyses by the Congressional Budget Office, the OCPP and others properly exclude the negative returns from the bottom quintile. While taxpayers with negative incomes account for about 8 percent of the returns in the bottom quintile, their losses are so significant that including them paints an inaccurate picture of the income of the lowest income group. Mr. Conerly's analysis paints that inaccurate picture.

5. Mr. Conerly continues the myth that there is a flood of people moving to Washington to avoid Oregon's income tax on capital gains, in the face evidence to the contrary. Mr. Conerly apparently only looked at data about people moving to Clark County, Washington. As OCPP documented in our 2003 report *The Capital Gains Tax Bird Does Not Fly*, a significant percent of the movement to Clark County (60 percent) is offset by migration from Clark County to Oregon, and Oregon enjoys significant in-migration from other states. A very small share of Oregon households with capital gains income have moved to Clark County in recent years. Also, households moving to Clark County from Oregon between 1993 and 2001 (the latest data when we completed our study) were *less likely* to have capital gains income than Oregon households generally. Those moving to Clark County had similar incomes to those remaining in Oregon. In sum, a thorough analysis of migration data provides no evidence of a significant net exodus of wealthy households with capital gains income. Recall the recent *Oregonian* story about Oregon's booming housing prices due to people with significant resources moving to Oregon; those new Oregonians able to afford expensive homes likely also have capital gains income from investments and our current income tax on capital gains is not dissuading them from moving to Oregon.

6. Question Mr. Conerly's assumptions. For instance, after noting that it is difficult to say how much of the capital gains realized by Oregon taxpayers constitute sales of taxable Oregon property located in Oregon versus stocks and mutual funds located out of state, Mr. Conerly assumes that capital gains located in Oregon are half of all capital gains taken.

7. As we noted in our 2001 report, economic growth assumptions in Mr. Conerly's first report depend on monetary policy changes from the Federal Reserve Board, not changes in capital gains tax rates.

8. Mr. Conerly fails to note or account for the increased federal taxes that would be paid by Oregonians who would have their Oregon taxes reduced as a result of the reduction in the income taxes on capital gains. Sending more money to Washington, D.C., as opposed to sending money to Oregon state government where it is spent in Oregon and can draw into Oregon federal matching funds, makes little economic sense.

The Burman Memo

Attached is a copy of the memo from Len Burman. Mr. Burman notes that many of Mr. Conerly's arguments are overstated or wrong, and that other factors argue against a large differential between the tax rates on capital gains and other income. In particular, he notes that a large differential as proposed by Mr. Conerly and AOI would promote "unproductive tax sheltering." You will also see that Mr. Conerly wrongly cites Burman's research in support of the AOI analysis.

Burman was Treasury Deputy Assistant Secretary for Tax Analysis from 1998 to 2000, where he developed major proposals to expand access to savings for low-income families. He also teaches at Georgetown University and was a senior analyst at the Congressional Budget Office from 1989 to 1997. He is author of *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed*.

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April 18, 2005

To: Chuck Sheketoff, Oregon Center for Public Policy

From: Len Burman

Re: Generating Jobs and Income Through a Capital Gains Tax Reduction in Oregon

I read William Conerly's pamphlet, "Generating Jobs and Income Through a Capital Gains Tax Reduction," and have some quick comments on it.

In summary, these are Mr. Conerly's main points about the effects of capital gains taxes in Oregon:

1. Oregon's capital gains tax rate is high by national standards and a larger share of the federal capital gains tax rate now than before the federal rate was cut in 2003.
2. High capital gains tax rates retard economic growth and reduce employment in Oregon.
3. High capital gains tax rates diminish venture capital investment in Oregon (a point related to point 2).
4. In the short run, the economic benefits of cutting capital gains tax rates (jobs and growth) would exceed the costs in terms of lost revenues; in the long-run, revenues would increase because people would realize more gains.
5. Much of capital gains represents inflation, not a real return on investment, and thus should not be subject to tax.
6. Corporate income has already been subject to federal and state tax at the company level; thus capital gains on corporate stock (and, implicitly, dividends) should not be subject to an additional layer of tax.
7. Many people of modest incomes realize capital gains and some people appear to have high income simply because they realize a one-time capital gain on the sale of a small business or other "lumpy" asset. Thus, the progressivity of capital gains taxation is overstated by proponents.

These arguments mimic arguments made about the appropriate differential between the federal tax rate on capital gains and other income, although there are some special considerations that apply at the state level. My book, *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed* (Washington, DC: Brookings, 1999), concluded that some of these arguments are overstated or wrong, and that other factors (most notably, the relationship between a capital gains differential and unproductive tax sheltering) argue against a large differential between the tax rates on capital gains and other income.

Before commenting on the points made above, I'd note that it is important to realize that all feasible taxes have drawbacks—and the tax on capital gains is no exception—so any criticism of taxing capital gains should be compared to an alternative taxation source. Oregon has a high capital gains tax rate relative to other states, because it also has a comparatively high income tax. But, at the same time, Oregon is one of the few states that have no sales tax. The income tax, like all taxes, places a drag on the economy, but the lack of a sales tax tends to encourage productive activity. The reliance on income taxes rather than sales taxes also means that Oregon's tax system is more progressive than most states'. Given Oregon's current constrained fiscal situation, cutting capital gains tax rates would require increasing other taxes. So the only possible efficiency gains from cutting capital gains tax rates could come from replacing it with a less distorting tax. In practice, such an alternative may be hard to find.

Here are comments relevant to each point:

1. Oregon's income tax rate is high by national standards, but it has no sales tax. The most apt comparison is probably with its neighbors—California and Washington. California has an even higher income tax rate and it also imposes sales taxes. Washington levies no income tax, but levies a substantial sales tax. Theoretically the tax system encourages retail businesses to locate on the Oregon side of the border, and encourages passive investors to favor Washington over Oregon, but Oregon over California. Note, however, that many factors affect individuals' choice of location, including quality of life and public services (e.g., schools, roads, and public safety). It's unlikely that capital gains taxes would even make it into the top 10 for most people.

   The fact that Oregon's rate became a larger percentage of the federal rate when the federal rate was cut is utterly irrelevant. Whatever incentive effects arise from taxing capital gains come from the difference between the combined federal and state tax rates on capital gains and other income, which was unchanged when the federal rate declined.

2&3. These points are related. How could the tax rate on capital gains in Oregon affect economic growth and jobs in Oregon? The primary avenue is through increased investment, which presumably would increase productivity. But, as noted in the Conerly report, much investment in Oregon comes from sources that are unaffected by Oregon's capital gains tax rates. For example, investors from California may be influenced by California's income tax structure, but they are not subject to Oregon tax on their capital gains. Similarly, nontaxable entities such as pension funds, life insurers, and foreign investors are indifferent to Oregon (and U.S. federal) capital gains taxes in their investment decisions.

   Mr. Conerly argues that much of the capital that fuels new investment (venture capital) comes from friends, relatives, and "angels," who are Oregon residents and thus sensitive to Oregon capital gains tax rates. A couple of points are relevant here. First, venture capital investments are highly favored under an income tax, even one with full taxation of capital gains. The main investment made by entrepreneurs is their own labor, which is effectively allowed an immediate deduction—a substantial tax subsidy. (To see why, suppose an engineer earning $100,000 per year is considering leaving her job and starting her own business. For the first few years until the business becomes profitable, she expects to earn only $20,000 per year. Her taxable income declines by $80,000—the value of her labor investment in her own business. Eventually, she hopes to earn back the $80,000 plus in capital gains, but that income will only be taxed when she chooses to sell the business—or never, if she holds it until death. Effectively, her investment of sweat equity is treated at least as generously as an IRA—fully deductible up front and only taxable (if at all) when the profits are returned to her in cash years hence.)

Second, although the entrepreneur's friends might wish that they did not owe capital gains tax on their eventual profits, where else will they put the money? If they invest in some other appreciating asset, that too is subject to capital gains tax. If they invest in bonds or CDs or rental real estate, their income is taxed every year under the income tax (in other words, not eligible for the deferral of tax allowed for capital gains). While it is true that preferential taxation of capital gains would make venture capital investments even more attractive, they are already tax-advantaged relative to bonds and CDs because of the value of deferral.

Another possibility raised by proponents of capital gains tax breaks is that people may simply save less. In this case, the entrepreneur's friends might decide to take more vacations rather than invest in their friend's enterprise. The economic evidence suggests that, on balance, saving is unresponsive to its tax rate. Although some people choose to save less when taxes are higher—deterred by the lower after-tax rate of return—others choose to save more because they are trying to reach a certain after-tax target for future income (the so-called income effect). For a given population, the tax rate on capital gains in Oregon is unlikely to have much effect on overall savings.

Some advocates of lower tax rates on capital gains argue that they spur the economy because people, having higher after-tax incomes, will spend more. There are at least two problems with this argument. First, since Oregon has to balance its budget, lost tax revenues from capital gains must be made up by increased revenue from other sources. Overall, Oregonians will not have higher after-tax incomes. Second, it cannot both be true that cutting capital gains tax rates encourages saving and consumption at the same time. Income is the sum of consumption, saving, and taxes. Holding income and taxes constant, consumption and saving cannot simultaneously increase.

Mr. Conerly reports the findings from a study of the relationship between capital gains tax preferences (the difference between tax rates on wages and capital gains) and employment growth. He concludes that there is a remarkably strong positive correlation, but I do not read his evidence the same way. The problem with his equation is that there are many factors that affect both employment and tax rates that vary by state. For example, states experiencing strong economic growth (and thus high tax revenues) are more likely to cut taxes (including taxes on capital gains) than states that are stagnating. In this case, the exogenous factors leading to higher economic growth and the lower tax rate on capital gains introduced a spurious correlation between the two variables. No causal relationship is established. States that attract more high-income individuals (and whose income and employment grow as a result) may face political pressure to cut taxes at the top, but that doesn't mean that the introduction of a capital gains preference *caused* the economic growth. Arguably, causality went the other way. A similar critique applies to the venture capital regression.

Moreover, many other variables that affect employment and venture capital investment are excluded from the regression results shown. I do not think that any valid economic inferences may be drawn from them.

4. There are two related questions here. (1) What are the economic benefits of cutting capital gains tax rates? (2) What are the effects on revenue of cutting capital gains tax rates?

On the first point, I argued above that there is unlikely to be a big effect on investment or employment. There is also an issue that a large differential between the tax rate on capital gains and other income induces unproductive tax sheltering activity. Basically, tax shelters aim to apply the low capital gains tax rate to other income that would otherwise be taxed at higher rates. The simplest example (which is not legal because it's simple enough for the IRS to identify and stop) is this. Suppose you could borrow money at a 6 percent interest rate and invest it in a capital gains producing asset that produces a return at 6 percent per year. If interest is fully deductible at say a 45 percent combined federal and state rate, while capital gains are only taxed at a 25 percent combined rate, you could reduce your tax by 20 cents for every dollar invested in the shelter and held for a year. (Because capital gains taxes are deferred until the asset is sold, the tax benefits grow the longer you hold the asset.) You could even make money after taxes if the capital gains asset paid a lower pre-tax rate of return, say 5 percent.

Real tax shelters are much more complicated than this (because lawmakers and the IRS have shut down the obvious ones), but the point is that tax-shelter investments can look profitable after tax even if they are unprofitable before tax. As a result, high-income investors face an incentive to take money that could be productively invested and instead divert it to unproductive tax shelter investments, which reduces the overall productivity of the economy. Similarly, all of the money spent engineering tax shelter investments is a loss to society. (The lawyers, accountants, and finance specialists who design tax shelters could do productive work if otherwise occupied.) The larger the differential between tax rates on capital gains and on other income, the more incentive there is to invest in tax shelters and the larger the drain is on the economy—and on tax revenues.

On point 2, Mr. Conerly argues that lower capital gains tax rates can increase revenues because investors will be more prone to sell appreciated assets at a lower tax rate. While this is theoretically true, the empirical evidence for a "lock-in effect" large enough for a capital gains tax cut to be self-financing is very weak. Mr. Conerly cites a 1989 study that I coauthored with Bill Randolph and Jerry Auten as evidence in support of his contention, but he cited the wrong study. Our 1989 study argued that we were likely to be measuring primarily timing effects—individuals choosing to sell more when their own tax rate was artificially low and less when their rate was high—rather than the response to an across-the-board statutory tax change. (Martin Feldstein, Joel Slemrod, and Shlomo Yitzhaki, in their influential 1978 study, were among the first to observe that this might be a problem.) In other words, those results (and much of the published cross-section evidence) are not relevant to the effect of statutory capital gains tax rates on revenues.

In a 1994 study, published in the *American Economic Review* (one of the top 3 economics journals), Bill Randolph and I looked at variation in tax rates across states to try to measure how capital gains tax rates affect realization decisions. That study found that timing is very sensitive to year-to-year changes in capital gains tax rates—even more sensitive than found in previous studies—but that the response to permanent changes in rates is quite modest, at least at the rates prevailing in 1981 (and now). Cutting capital gains tax rates reduces tax revenues.

5. It is true that much of capital gains represents inflation, but that is not an argument for cutting capital gains tax rates alone. It is an argument for indexing the tax system with respect to inflation—something that would be impractical for a state to do unless the federal income tax were indexed at the same time. My book explains why the inflation penalty on capital gains is smaller than the penalty on assets producing current income, such as bonds, so the argument for an adjustment for gains is less compelling than that for other assets. Moreover, if capital gains are to be adjusted for inflation, then interest expense must also be indexed—that is, only the real (over and above inflation) portion of interest should be deductible. Otherwise, investors will be able to design tax shelters that take advantage of the difference in tax rates.

6. Corporate income is taxed and this may provide a rationale for some relief from taxation for capital gains and dividends on corporate stock. It is not a rationale for cutting taxes on all capital gains (nearly half are on assets other than shares of stock). Moreover, the relief should be limited to the taxes actually paid at the corporate level. Many corporations do not pay taxes for many years; for them, the individual level tax on capital gains and dividends represents the only level of taxation.

7. The capital gains tax is about the most progressive component of the individual income tax. High-income people realize a disproportionate share of capital gains. That result is not an artifact of modest-income people realizing occasional capital gains. Even if you look at average income over a ten-year period, most gains are realized by a few high-income taxpayers. For example, from 1979 to 1988, 57 percent of capital gains were realized by the highest-income one percent of taxpayers, ranked by average income. (Burman, 1999, p. 98) Similarly, the vast majority of gains (93 percent) were on returns with multiple asset sales—rather than the one-time sale of an appreciated asset. (p. 106)

   The Tax Policy Center recently estimated that the 0.2 percent of returns with incomes over $1 million will report 54 percent of capital gains in 2005; the 13 percent of returns with incomes over $100,000 will account for 90 percent of all gains. (See Table T05-0009, available at www.taxpolicycenter.org/estimates.)

Sources

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