OCPP OREGON CENTER for PUBLIC POLICY
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No Special Treatment

Seven reasons why Oregon should not reduce or eliminate the income tax on capital gains

by Michael Leachman and Joy Margheim

Whenever the subject of tax reform comes up in Oregon, the idea of reducing or eliminating the income tax on capital gains invariably surfaces, like a sea monster in a B-movie.[1] This hard-to-kill idea, however, is a terrible one. It threatens to take a large bite out of Oregon's tax structure, hurting nearly all Oregonians except the most economically comfortable.

Capital gain is income received through an increase in the value of a capital asset, such as stocks, bonds, real estate, or antiques. When the asset is sold, the difference between the sale price and the original purchase price is taxed as individual or corporate income. Oregon currently taxes income from capital gains at the same rate as all other forms of income, including income from wages.

Proponents of giving special treatment to income from capital gains argue that it would stimulate economic growth, attract venture capital investments in the state, and stop a perceived exodus of wealthy Oregonians to Clark County, Washington, where capital gains income is not taxed. Not only are these arguments wrong, but they also overlook the harm that would occur if Oregon lost its revenue from the income tax on capital gains.

This issue brief examines seven reasons why giving special treatment to income from capital gains is a terrible idea: it would not stimulate additional economic growth, it would not attract much venture capital, it would waste millions chasing after the few Oregonians who move to Washington to avoid Oregon income taxes, it would mainly benefit the wealthiest 1 percent of Oregonians, it would blow a half–billion-dollar hole in the state budget, it would cripple or eliminate the best player on the income tax team, and it would penalize those who put in an honest day's work.

1. It would not stimulate more economic growth in Oregon's already healthy economy

Proponents of an income tax rate cut on capital gains argue that it will encourage investment, thereby stimulating economic growth and creating jobs.[2]

Although this simplistic argument gets repeated so often it takes on the air of truth, most careful and independent research shows that the effects of capital gains tax cuts on investment and employment are minimal at best. In part this is because only a portion of business growth is financed through equity that produces capital gains for investors, and only a portion of the capital gains earned by investors is taxable. The non-partisan Congressional Budget Office estimated that cutting the top federal tax rate on capital gains from 20 to 15 percent would increase U.S. Gross Domestic Product by no more than 0.2 percent over a period of 100 years, or

0.03 percent after 10 years.[3] The effect of a state capital gains tax cut would be even smaller, because the tax savings would not all be reinvested within Oregon.

Oregon's own experience demonstrates that giving special treatment to income from capital gains does not stimulate economic growth. In the late 1990s, the state experimented with a program that allowed certain investors, primarily investors in start-up companies, to defer Oregon income taxes on capital gains if the gains were reinvested in Oregon businesses. In a joint report, the Legislative Revenue Office and the Oregon Departments of Revenue and of Economic Development concluded that the program was a failure.[4] The report found that the program "has not achieved [its] goal," which was "to increase investment in Oregon." It further stated, "Given the small amount of investment under Oregon's deferral program in its first two years, and because much of that investment probably would have occurred even without the deferral, the program has created few, if any, new jobs."[5]

Finally, there is little evidence that Oregon's income tax on capital gains acts as a drag on its economy. Despite the high-tech-driven recession that struck in 2001, Oregon Gross Domestic Product has risen 45 percent this decade, faster than the 43 percent gain experienced nationally.[6] Oregon's job growth in the current expansion is beating the nation, too. Since the national recession officially ended in November 2001, Oregon has seen 8.9 percent job growth, stronger than the 5.7 percent job growth nationally.

Cutting the income tax rate on capital gains will not stimulate more economic growth for Oregon's already healthy economy. Such a tax cut is a solution in search of a problem.

2. It would not attract substantial venture capital

Tax-cut proponents also contend that giving special treatment to income from capital gains would attract more venture capital investment in Oregon.[7]

Researchers have not yet carefully measured the effects on business innovation of the income tax on capital gains, so debates on this issue remain speculative. There is good reason to believe, however, that capital gains tax rates have a minimal influence on venture capital investment. Most venture capital comes from sources not subject to the capital gains tax, such as pension funds.[8] In addition, venture capital investments are already favored under income tax policy because the gains are deferred until the investments are cashed out — an incentive to choose investments subject to income taxes on capital gains over those earning interest, dividends, or rent.[9]

Using a general reduction in the tax rate on capital gains to encourage venture capital investment is like using a butcher knife to deal with a splinter. Just as cutting off your thumb would remove the splinter at an unnecessarily high cost, the reduced tax rate would primarily impact gains from non-venture capital investments, as high-risk venture capital investments are only a sliver of the income subject to capital gains. Few individuals who would benefit from a cut in the income tax on capital gains are likely to invest their tax savings in a risky start-up company.[10]

There is little evidence that Oregon's venture capital investment is lacking or that Oregon's tax structure inhibits additional venture capital investment. Oregon ranks eighth highest among states for venture capital investment per capita, up from 17th highest in late 2005 and early 2006.[11] California, with a higher income tax rate on capital gains than Oregon, ranks second highest among states for venture capital investment per capita in 2007. Ranking first is

Massachusetts, which taxes long-term capital gains at the same rate as income from wages and taxes short-term capital gains at an even higher rate.[12]

As noted in the *2007 Competitive Index* published by the Oregon Progress Board and the Oregon Business Council, venture capital investment is not the only important measure of the strength of Oregon's culture of commercial innovation.[13] On some of the other innovation measures in the index, Oregon is also doing well. For instance, the state ranks 12th among states for new business start-ups per worker and sixth for patents granted per capita.

Other measures, however, indicate that Oregon's capacity for innovation suffers from a lack of public investment. For instance, the state ranks 26th for science and engineering doctorates awarded per capita and 23rd for per capita research and development spending at our universities and colleges. Oregon could improve its middling status only by making additional investments of tax dollars, not less. Put another way, targeted investments in Oregon's higher education system would likely be a more efficient means of producing innovation than would a cut in the state's income tax rate on capital gains.

3. It would waste millions chasing after the few who move to Clark County, Washington, to avoid Oregon income taxes

Advocates of special treatment for income from capital gains argue that it is necessary to stem a perceived exodus of wealthy Oregonians to Clark County, Washington, which they claim drains tax revenue from the state or reduces economic growth.[14] The problem with their position is that no significant exodus exists. To the extent that a few Oregonians are moving to Clark County to avoid Oregon income taxes on capital gains, the impact on Oregon is tiny. If the moves amounted to a true exodus, revenue from the income tax on capital gains would not have grown as it has over time. And when migration data is reviewed it shows the perceived exodus amounts to a trickle.

While some Oregonians — of *all* income levels — move to Clark County every year, they represent a miniscule share of capital gains taxpayers. On average, only 16 of every 10,000 full-year Oregon taxpayers with capital gains income (0.16 percent) moved to Clark County each year between 1995 and 2005. Among all taxpayers — those with and without capital gains income — just 2 of every 10,000 (0.02 percent) moved to Clark County each year on average. The total capital gains income of households that moved to Clark County represented just 1 percent of all capital gains reported by full-year Oregon taxpayers, on average, between 1995 and 2005.[15]

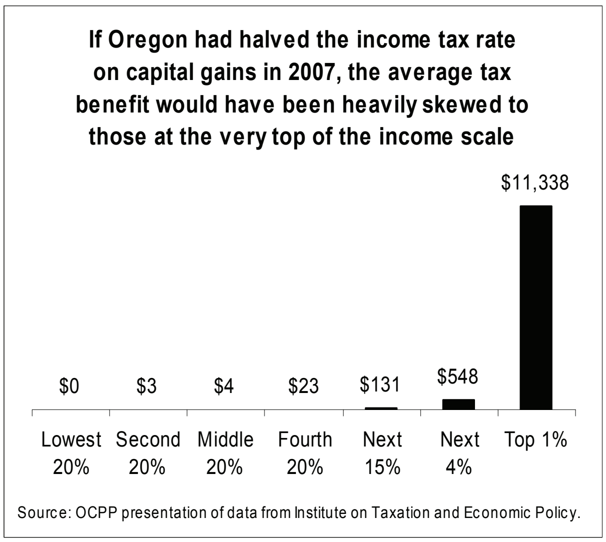
Of course, not all Oregonians with capital gains income who leave Oregon for Clark County do so to avoid taxes. Oregonians may choose to move to Clark County for many other reasons, including the affordability of housing and the quality of education.[16]

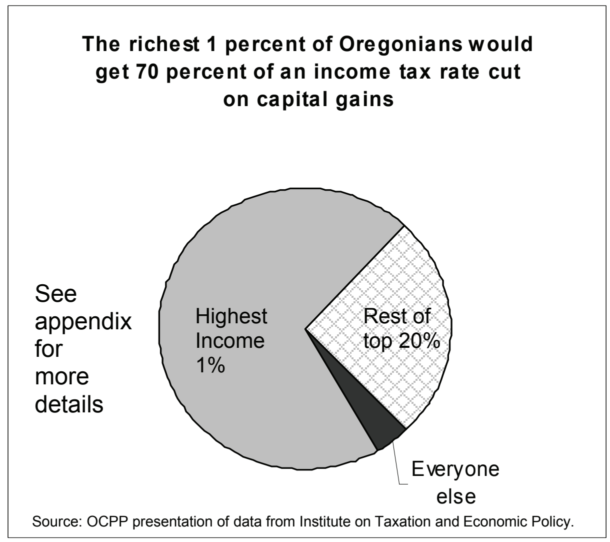
Finally, although a few Oregonians may move to Clark County before realizing large capital gains, Oregon does not necessarily lose investment capital as a result. People who have made their money in Oregon may well continue investing in Oregon in the future, even if they move a few miles across the Washington border. Oregon may lose a little tax revenue from these few migrants because capital returns on their Oregon investments will not be taxed here, but Oregon does not lose the economic growth or jobs produced by businesses located here just because their owners live across the border.

4. It would give 70 percent of the tax cut to a few Oregonians with average incomes over $1 million, not seniors or the middle class

Proponents of giving special treatment to income from capital gains suggest that it would primarily help seniors and the middle class, but such claims are simply false.[17] A rate cut in the income tax on capital gains would disproportionately benefit the wealthiest one out of 100 taxpayers, a group whose income has skyrocketed over the last generation.

If Oregon halved the income tax rate on capital gains, the richest 1 percent of Oregonians — with incomes averaging over $1 million — would get 70 percent of the tax cut. These top income earners, on average, would realize more than $11,300 a year in tax savings (see figures below and appendix). The least-well-off 60 percent of Oregonians would effectively receive nothing. Taxpayers with $49,000 to $81,000 in income — the fourth-highest 20 percent of income earners — would receive just $23 apiece on average.[18]





The great majority of Oregon taxpayers would not benefit from an income tax rate cut on capital gains because they do not own assets that are subject to capital gains taxation. Overall, only 9 percent of all Oregon households would see a reduction in their taxes from a rate cut in the income tax on capital gains.[19] Yet all Oregonians, especially the most vulnerable, would bear the burden of cuts in public programs that could stem from a reduction in state revenues.

Tax cut proponents commonly point to widespread ownership of stock as an argument for cutting capital gains tax rates. Although about half of American families now own stock, the value of stock holdings is heavily concentrated among the rich. As of 2004, 80 percent of Americans owned less than 10 percent of total stock value.[20] In Oregon, taxpayers with incomes between zero and $100,000 reported just 11 percent of all capital gains income in 2005.[21]

5. It would blow a huge hole in the state budget, harming services Oregonians depend upon or forcing a tax increase on the non-wealthy

Reducing state revenues from capital gains would leave a gaping hole in the state's biennial budget. To make up the difference, state leaders would have to either cut public services or raise other taxes.

Cutting income tax rates on capital gains in half, for example, would have meant a loss of $273 million in state revenues in 2007 alone. Over the course of Oregon's two-year budget cycle, the cost would total roughly $546 million – well over half a billion dollars.[22] To put the biennial impact in perspective, it is slightly more than Oregon's General Fund spending on the state's 17 community colleges in 2007-09.[23]

In addition to the direct revenue loss, Oregon could lose federal funding. Many state programs, particularly health care for the poor, aged, and disabled, receive federal matching funds. If Oregon chose to cut these state services rather than raise other taxes to cover the revenue lost to a cut in the income tax on capital gains, it would see a reduction in the amount of federal funds flowing into the state. For example, each dollar of reduced state spending in Medicaid results in about $2 in lost federal matching funds.

If Oregon ended up raising taxes or fees to fill the budget hole created by reducing the tax revenues from capital gains, it is likely that middle- and low-income Oregonians would pay a higher share of these new taxes and fees than they pay of today's income taxes on capital gains. In other words, middle- and low-income families would be transferring money to Oregon's rich.

Adding insult to injury, a significant amount of the lost tax revenue would go to the federal government rather than to Oregonians or investments in Oregon. Because state taxes are deductible from federal taxes, Oregonians would pay a portion of their tax cut to the federal government in the form of higher taxes.

If income tax rates on capital gains had been cut in half in 2007, Oregonians would have sent an additional $42 million to the federal government in the form of higher taxes.[24] That is, Oregon taxpayers would have sent about 15 percent of their tax reduction to the federal government.

6. It would make our income tax mediocre by trading the best player on the income tax team

In 1919, the Boston Red Sox made perhaps the worst decision in baseball history, selling the greatest home run hitter of his era, Babe Ruth (a.k.a. "the Bambino"), to the New York Yankees. In 10 of his first 12 seasons with the Yankees, Ruth hit more home runs than the entire Red Sox team.[25] After winning three World Series titles in six seasons with Ruth, the Red Sox went on an 86-year World Series title drought, until the "curse of the Bambino" finally ended in 2004.

Capital gains income is the Babe Ruth of Oregon's tax system. When the economic weather is good, Oregon's tax system — led by the income tax on capital gains — tends to bring in more funds than anticipated. For instance, when income tax revenue surged beyond expectations in 2005, capital gains accounted for one of every 11 dollars of income reported in Oregon.[26] When the economic weather is bad, revenues from the income tax on capital gains continue to provide valuable support to Oregon's weakened revenue structure. Even in 2002, after the dot-com bust had pummeled the stock market, Oregonians reported $2.5 billion in capital gains income.[27]

Cutting revenues from capital gains would make it harder for the state to be a winner in the coming century. From 1991 to 2005, capital gains income reported to the Oregon Department of Revenue rose four times faster than all other forms of personal income.[28] In 2005 alone, income from capital gains rose 56 percent, after having grown 44 percent the year before.[29]

When income tax revenue – led by the tax team's Babe Ruth, capital gains – grows at unexpectedly high rates, Oregon should save the unanticipated revenue to help the state weather the inevitable next downturn. Giving away Oregon's Babe Ruth to Oregon's richest residents would curse Oregon's income tax to mediocre performance when the economy is doing well and make it that much more difficult for Oregon to avoid the cellar when recessions hit.

7. It would create an unfair penalty for an honest day's work

The state tax structure should not penalize Oregonians who work for a living in favor of Oregonians who do not work but live off investments that produce capital gains. Yet, that is exactly what would happen if Oregon reduced or eliminated the income tax on capital gains.

Most states recognize that penalizing those living off their work compared to those living off investments, especially investments associated with capital outside the state, is unfair. Forty-two states, counting the District of Columbia as a state, levy a broad-based income tax. Of these, only 10 give significant preferential treatment for income from capital gains over income from work.[30] Moreover, in one of those 10 – Vermont – the governor has proposed returning to a system that taxes income from capital gains more equally with income from work. No state with a broad income tax excludes all capital gains from the state income tax.[31]

In announcing his 2008 plan to eliminate his state's 40 percent exemption for capital gains income, Vermont Republican Governor Jim Douglas said:

> 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.[32]

Oregon should not create a working tax penalty like the one that Vermont may eliminate.

Conclusion

Cutting income tax rates on capital gains would hurt the vast majority of Oregonians while handing a windfall to a privileged few, a group whose income has already skyrocketed. Contrary to proponents' claims, such a tax cut would not stimulate economic growth, encourage venture capital investment, or significantly increase the number of Oregonians who stay in Oregon before realizing capital gains. It would, however, leave a gaping hole in the state budget and doom Oregon's income tax to mediocre performance. Ultimately, it would penalize Oregonians who work for a living in favor of Oregonians who reap income from investments that produce capital gains.

[1] The authors wish to express their appreciation to Jeff Harvey, an intern with OCPP whose excellent work on an early draft of this issue brief is much appreciated.

[2] For example, former state Representative Tom Butler (R-Ontario) has claimed, "In the long-run, a cut in capital gains tax rates invites capital markets to return and stay in Oregon's economy — it invites investment and growth in Oregon's good jobs, family-wage incomes and our community schools." Oregon House Republicans, "House Republicans Propose Oregon Stability and Investment Plan," press release, February 2, 2007, available at www.leg.state.or.us/press_releases/scott_020207.pdf.

[3] Congressional Budget Office (CBO), *An Analysis of the Potential Macroeconomic Effects of the Economic Growth Act of 1998,* August 1998. The report assumed tax cuts that were revenue-neutral, eliminating negative effects on GDP from a reduction in revenue. See also CBO, *Capital Gains Taxes and Federal Revenues,* October 2002; Jane G. Gravelle, *Capital Gains Taxes: An Overview,* Congressional Research Service, Report 96-769, updated January 24, 2007. For an assessment of the failure of the Bush administration's capital gains tax cuts to stimulate economic growth, see Aviva Aron-Dine and Joel Friedman, *The Effects of the Capital Gains and Dividend Tax Cuts on the Economy and Revenues: Four Years Later, a Look at the Evidence*, Center on Budget and Policy Priorities, revised July 12, 2007.

[4] The Oregon Economic Development Department is now called the Oregon Economic and Community Development Department.

[5] Oregon Department of Revenue, Legislative Revenue Office, and Oregon Economic Development Department, *Oregon's Capital Gains Deferral Program: An Evaluation of the First Two Years,* March 1999, p. 1.

[6] OCPP analysis of Bureau of Economic Analysis data for state GDP growth this decade through 2006, the latest year with data.

[7] According to the Oregon Council for Knowledge and Economic Development (OCKED), "Our high personal income and capital gains tax rates inhibit entrepeneurs and venture capital investors from staying in or moving to Oregon." OCKED, *Expanding Our Capacity for Innovation,* Oregon Business Plan White Paper, January 2003, p. 4, available at www.oregonbusinessplan.org/plan_view.html.

[8] Gravelle*, Capital Gains Taxes*; CBO, *An Analysis of the Potential Macroeconomic Effects of the Economic Growth Act of 1998*, August 1998, pp. 4-6.

[9] Leonard Burman, memorandum, April 18, 2005, pp. 2-3, available at www.ocpp.org/2005/memo050420nesbitt.pdf.

[10] CBO, *Effects of Lower Capital Gains Taxes on Economic Growth,* August 1990, pp. 29-30; Daniel Sandler, "Tax Incentives and Informal Venture Capital," *NASVF NetNews,* 2004, available at www.matr.net/article-11506.html.

[11] Oregon's ranking for last year (2007) is based on OCPP's analysis of data from Thomson Financial in the PricewaterhouseCoopers/National Venture Capital Association MoneyTree(tm) Report, through the first three quarters of 2007. The fourth quarter data are not available as of this writing. The MoneyTree report is the same data source relied upon by the Oregon Progress Board and the Oregon Business Plan in measuring venture capital investment for their *2007 Competitive Index*. The *2007 Competitive Index* ranked Oregon 17th for per capita venture capital investment from the third quarter of 2005 through the second quarter of 2006. See Oregon Business Plan and Oregon Progress Board, *2007 Competitive Index: Indicators of Oregon's Global Economic Competitiveness,* available at www.oregonbusinessplan.org/pdf/2007%20Competitive%20Index.pdf. The District of Columbia is excluded from both OCPP's analysis and the analysis in the *2007 Competitive Index*. The PricewaterhouseCoopers/National Venture Capital Association MoneyTree(tm) Report is available at www.pwcmoneytree.com/MTPublic/ns/index.jsp. To estimate state populations in 2007, OCPP used the U.S. Census Bureau's Annual Estimates of the Population for the United States, Regions, States, and Puerto Rico on July 1, 2007. These data are available at www.census.gov/popest/states/NST-ann-est.html.

[12] Ranking for California and Massachusetts in 2007 is based on OCPP's analysis of data from Thomson Financial in the PricewaterhouseCoopers/National Venture Capital Association MoneyTree(tm) Report through the first three quarters of 2007. The fourth quarter data are not available as of this writing. See endnote 11.

[13] Oregon Business Plan and Oregon Progress Board, *2007 Competitive Index: Indicators of Oregon's Global Economic Competitiveness,* available at www.oregonbusinessplan.org/pdf/2007%20Competitive%20Index.pdf.

[14] For instance, during his campaign for governor in 2006, Jason Atkinson said, "I believe with all my heart that Oregon has to repeal the capital gains tax to pour more money into our economy. We have the second-highest rate in the country. That's why the second-fastest-growing 'Oregon county' is Clark County, Washington." Andy Giegerich, "Candidates Take Shots at Governor's Economic Record," *Portland Business Journal*, February 13, 2006. Consultant William Conerly, in a 2005 report funded by one of Oregon's business associations, claims that the cost to Oregon of taxpayers moving out of state to avoid Oregon's income tax on capital gains totals roughly $10 million annually. William B. Conerly, *Generating Jobs and Income Through a Capital Gains Tax Reduction*, AOI Research and Education Foundation, February 2005, pp. 4-4, 4-5.

[15] OCPP analysis of data obtained from the Oregon Department of Revenue, Research Section.

[16] Bill Graves, "Families Flee to Schools in Southwest Washington," *The Oregonian*, February 23, 2003.

[17] According to Representative Dennis Richardson (R-Central Point), "OSIP will help our retired seniors and middle class Oregonians by lowering the personal Capital Gains rate to 7% and the corporate rate to 5%." Rep. Dennis Richardson, newsletter update, "The Oregon Stability and Investment Plan — OSIP," February 2, 2007, available at www.dennisrichardson.org/lu020207.htm. During his campaign for governor in 2006, Jason Atkinson's web site called for

eliminating state income taxes on capital gains, claiming that Oregon's current income tax on capital gains "is hurting all Oregonians from first-time homebuyers to our valued retirees." See "Republicans Share Views in Q & A," *Bend Bulletin*, April 23, 2006.

[18] Estimate of the impact of a proposal to reduce Oregon's income tax rates on capital gains by 50 percent, prepared by Institute on Taxation and Economic Policy for OCPP, December 2007 (hereafter ITEP estimate).

[19] Ibid.

[20] Edward N. Wolff, *Recent Trends in Household Wealth in the United States: Rising Debt and the Middle Class Squeeze,* Levy Economics Institute, working paper no. 502, June 2007, table 13a, p. 40, available at www.levy.org/pubs/wp_502.pdf.

[21] "Income" here is adjusted gross income. OCPP analysis of Oregon Department of Revenue data from full-year tax returns.

[22]ITEP estimate.

[23] The 2007-09 Legislatively Adopted Budget included $511 million in General Funds for the Department of Community Colleges and Workforce Development. See Legislative Fiscal Office, *Budget Highlights: 2007-09 Legislatively Adopted Budget,* September 2007, p. E-2.

[24] ITEP estimate.

[25] According to baberuth.com, "the official web site of the Sultan of Swat," www.baberuth.com/flash/about/achiev.html.

[26] OCPP analysis of Oregon Department of Revenue data.

[27] Oregon Department of Revenue data.

[28] OCPP analysis of Oregon Department of Revenue data. Specifically, from 1991 to 2005, income from capital gains rose 499 percent, compared to 113 percent for all other forms of income reported on personal income tax returns.

[29] OCPP analysis of Oregon Department of Revenue data.

[30] Thirty-two states, counting the District of Columbia as a state, give either no preferential treatment to income from capital gains or only minor preferential treatment to such income. Typically, any minor special treatment is available only for capital gains on specified in-state investments. Of the remaining 10 states with broad income taxes, four (Hawaii, North Dakota, South Carolina, and Wisconsin) provide special treatment to income from long-term capital gains. The other six (Arkansas, Iowa, Montana, New Mexico, Rhode Island, and Vermont) offer significant special treatment to income from at least some forms of both short- and long-term capital gains. See *Individual Income Tax Provisions in the States*, Wisconsin Legislative Fiscal Bureau, informational paper 4, January 2007, available at www.legis.state.wi.us/lfb/Informationalpapers/4.pdf.

[31] Though no state with a broad income tax exempts all capital gains income, New Hampshire – with a narrow income tax, the base of which is income from certain interest and dividends – does exempt from income taxes income from capital gains, along with earned income from wages. Tennessee, which also has a narrow income tax also based primarily on interest and dividend income, exempts capital gains income except when it is earned from selling a mutual fund.

[32] Governor James H. Douglas, State of the State Address, January 10, 2008, available at governor.vermont.gov/speeches/state_of_the_state-1-10-08.pdf. It appears from Governor Douglas' speech that he would still exempt the first $2,500 of capital gains income from taxation.

Appendix

Impact of cutting Oregon's income tax on capital gains in half, 2007								
2007 income group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%	All
Income range	Less than $16,200	$16,200–$30,400	$30,400–$48,700	$48,700–$81,300	$81,300–$157,900	$157,900–$392,700	$392,700 or more	
Average income in group	$10,400	$22,800	$38,700	$62,200	$108,100	$ 225,100	$1,050,300	$61,800
Impact among all taxpayers								
Change as % of income	–0.0%	–0.0%	–0.0%	–0.0%	–0.1%	–0.2%	–1.1%	-0.3%
Average tax change	$0	-$3	-$4	-$23	-$131	-$548	-$11,338	-$159
Share of tax change	0%	0%	0%	3%	12%	14%	70%	
Impact among those receiving a tax cut								
Average tax cut	-$15	-$154	-$148	-$180	-$575	-$1,586	-$14,513	-$1,740
% with tax cut	0%	2%	3%	13%	23%	35%	78%	9%

Source: OCPP presentation of data from Institute on Taxation and Economic Policy.

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