Executive Summary

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February 20, 2003

The Wrong Answer for Oregon's Economy:
Cutting Taxes on Capital Gains Income

By Jeff Thompson

Oregon's slow-growing recovery has prompted policy makers to pursue efforts to stimulate the economy. Despite claims by the Oregon Council on Knowledge and Economic Development (OCKED) and the Oregon Business Council (OBC), economic research suggests that cutting the capital gains tax is not likely to generate significant jobs or investment in Oregon:

Capital gains tax cuts have little impact on the cost of capital and little influence on investment and savings decisions. Half of capital gains income is already exempt. Most taxable gains are already realized annually, even without a tax cut, or held for bequests. Capital gains taxes influence the timing of asset sales, not fundamental investment decisions.

State-level tax cuts have an especially small impact. Windfall gains from a tax cut that are spent or re-invested in other states do nothing to benefit Oregon. If revenue losses from a tax cut are not offset by other tax increases, vital public services will have to be reduced. Increased federal taxes and lost federal matching funds, triggered by a state tax cut and related spending cuts, would have a larger economic impact than the tax cut itself.

Oregon's tax on capital gains income has not harmed the economy. Oregon's economy grew faster than nearly every other state in the 1990s, with 30,000 new businesses and 415,000 jobs. Oregon's economy declined steeply in 2001 because the national economy declined, and Oregon had become dependent on a volatile high-tech industry. Since 2001, Oregon's economy has been recovering, growing faster than most other states.

Low capital gains taxes are not necessary to attract venture capital. California has a higher capital gains tax rate than Oregon, but is home to the largest venture capital community in the world, consistently receiving 40 percent of all US venture capital investment. The *New Economy Index* shows that Oregon is among the top ten states for venture capital, and an Oregon Progress Board study written for the OBC shows Oregon ranks "favorably" among states for venture capital. Only 12 percent of venture capital is from sources subject to the capital gains tax. Previous efforts to spur investment through capital gains tax incentives have failed.

Capital gains income already receives considerable preferential tax treatment. The top federal tax rate on capital gains held more than one year is just 20 percent, compared to 38.6 percent on regular income. Half of capital gains from the sale of "small" businesses, with assets under $50 million, are exempt from federal taxes, and federal taxes on gains reinvested in other small businesses are deferred entirely.

Capital gains tax cuts overwhelmingly benefit those with very high incomes. Most households own no assets that generate *taxable* capital gains. Most of the rest own little. The richest 5 percent of Oregonians would receive about 73 percent of a capital gains tax cut, while the lowest-income 80 percent would get about 9 percent.

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"The first priority should be to reduce capital gains rates, which would propel economic growth…" -- Oregon Business Council

"Politicians love to promise more and better jobs for voters, and so do advocates of tax reform… Aside from the natural tendency of interested parties to exaggerate, do such claims about jobs have any economic content? In a word—no." -- Joel Slemrod and John Bakija, authors of Taxing Ourselves[1]

Oregon's slow-growing recovery and continued budget shortfall have prompted policy makers to pursue efforts to stimulate the economy. The Oregon Council on Knowledge and Economic Development (OCKED), with prodding from some influential business organizations, including the Oregon Business Council (OBC), Associated Oregon Industries (AOI), and the National Federation of Independent Businesses (NFIB), has claimed that reducing the tax on income from capital gains would generate jobs and investment in Oregon.[2] Several bills have been introduced in the 2003 legislature that would apply special low rates to capital gains income, including Senate Bills 91 and 361 and House Bills 2505 and 2488. It is almost certain that the legislature will be considering these and other proposals to reduce taxes on income from capital gains income.

Despite the claims of some powerful political actors, economic research suggests that cutting the capital gains tax is not likely to generate more jobs or investment in Oregon. By reducing revenue to fund education and public safety programs, such a tax cut would more likely weaken the economy.

A review of economic research and available data relevant to any capital gains tax cut proposal shows:

1. Cutting capital gains taxes, particularly at the state-level, cannot be expected to generate significant economic growth;
2. Cutting capital gains taxes in Oregon would result in increased federal taxes and lost federal matching funds, both of which have a larger and more certain economic impact than the tax cut;

3. Under current tax law, Oregon's economy grew faster than nearly every other state during the 1990s. Oregon's economy declined in the 2001 recession because the volatile high-tech industry collapsed, not because of the state's tax laws. Over the past year, Oregon's economy has grown more than in most other states;
4. Low capital gains taxes are not necessary to attract venture capital. Nearly ninety percent of venture capital income is not subject to the tax on capital gains, and states with relatively high capital gains taxes have not had difficulty attracting venture capital investment;
5. Previous efforts to spur new investments and attract venture capital to Oregon through capital gains tax incentives have failed;
6. Capital gains income already receives considerable preferential treatment compared to other types of income;
7. Capital gains tax cuts overwhelmingly benefit those with very high incomes. Most households with stock-holdings keep them in tax-sheltered retirement savings plans, and;
8. Despite claims by some advocates, cutting the capital gains tax will not result in additional revenue for state programs.

The New Push to Cut the Capital Gains Tax - OBC and OCKED.

Capital gains are income that is realized when an asset that has increased in value is sold. Currently Oregon taxes capital gains at the same rate as other sources of income. Sales of owner-occupied housing and stock held in retirement savings plans are generally exempt from capital gains taxes, with most taxable gains coming from directly held stocks and investment real estate.

In recent months influential business groups have called for reductions in Oregon's tax on the income from capital gains. Both the Oregon Business Council and the Oregon Council on Knowledge and Economic Development claim that reducing capital gains taxes will generate economic growth in Oregon:

"The first priority should be to reduce capital gains rates, which would propel economic growth…" -- Oregon Business Council.[3]

"Our high personal income and capital gains tax rates inhibit entrepreneurs and venture capital investors from staying in or moving to Oregon." -- Oregon Council on Knowledge and Economic Development.[4]

Instead of conducting any research to support their claims, both the OBC and OCKED simply repeat the assertions that anti-tax advocates have been making for many years. (Claims made by AOI have been reviewed in a separate OCPP study, *Empty Promises and False Hopes: The Reality of Capital Gains Tax Cuts in Oregon*.)

Research Suggests No Economic Growth from a Capital Gains Tax Cut

Advocates of cutting the capital gains tax claim that a lower rate will create jobs and stimulate economic growth. According to research by economists at the Brookings Institution, however, "the data suggest these claims are false."[5]

In 1998, the Congressional Budget Office (CBO) reviewed several leading economic models developed to project the economic growth response to cuts in the federal capital gains tax. Through its research, CBO found that reducing the federal capital gains tax by five percentage points would have "only a modest effect" on the US Gross Domestic Product.[6] The models that did not rely on "extreme or unwarranted assumptions" yielded only "small increases in GDP – well below 0.1 percent after ten years."[7] One of the models even projected that a capital gains tax cut would reduce economic growth.[8]

Why Cutting the Capital Gains Tax Does Not Generate Growth

An important reason that capital gains tax cuts have little impact on economic growth is that taxable capital gains represent a small share of capital income.[9] Because it does not impact investment raised through debt, returns paid through dividends, or the large share of capital gains that already go untaxed, a tax cut would have only a small impact on the "cost of capital," resulting in little increase in saving or investing.[10] The CBO estimates that cutting the federal capital gains tax by up to 30 percent would reduce the cost of capital by less than one percent.[11] If not made revenue neutral by offsetting tax increases, a federal capital gains tax cut would reduce economic growth by generating deficits, which would result in higher interest rates.[12]

The realities of capital gains and their taxation make it clear that the claims of tax-cut advocates are over-stated:[13]

- One-half of capital gains producing assets are already tax-exempt, including IRAs and 401(k)s;[14]
- One-half of taxable capital gains are realized (sold) each year already, and are not "caused" by a tax cut;[15]
- Capital gains income already receives considerable preferential tax treatment;
- The vast majority of venture capital is from institutional or overseas investors not subject to the tax on capital gains, and;[16]
- A considerable share of taxable capital gains are never taxed because they are held until death and transferred through bequests, and thus are not impacted by a tax cut.[17]

Studies of capital gains taxes tend to show that changes in the tax rate can influence the timing of the sale of assets, but do not affect fundamental investment decisions.[18] As economist Alan Auerbach has explained, "Capital gains taxes have a strong impact on the way investors time the realizations of long-term capital gains."[19] Instead of generating new investment, cuts in the capital gains tax deliver windfall gains to already existing investments.[20]

Even Less at the State level

Even the meager response to a federal tax cut is larger than what can reasonably be expected from a state tax cut. A federal capital gains tax incentive succeeds if it generates a significant level of new investment that would otherwise not have occurred. On the

otherwise not have occurred. On the other hand, a state-specific capital gains tax incentive must encourage investment *within the borders of the state* if it is to provide increased economic activity and benefits to the state.

Since many capital gains are from investments in firms outside of Oregon, and will likely be reinvested out of the state, a state capital gains tax cut is limited in its ability to influence new investment and growth. Windfalls from cutting Oregon's capital gains tax rate that are invested in Texas, Arkansas, or China do nothing to create jobs in Oregon. Reviewing research on investors' responses to state-level capital gains taxes, economist Leonard Burman showed that "the new research found the measured response to differences in state tax rates – the permanent effect – to be small and not statistically different from zero."[21]

Lost Federal Matching Funds and Increased Federal Taxes

The state-level impacts of reducing taxes on capital gains are further dampened by lost federal matching funds and higher federal taxes.

Oregon is constitutionally required to have a balanced state budget. Any revenue lost to an income tax cut must be offset by other tax increases, or spending on state programs must be reduced. Because many state programs, particularly health care, receive federal matching dollars, reduced state spending results in fewer federal dollars flowing into Oregon. Each dollar of reduced state spending results in nearly $.40 less in federal matching funds in Oregon.[22] Oregon's Legislative Revenue Office estimates that reducing the tax on capital gains income by five percentage points, to 4 percent, would reduce state revenue by $319 million in the 2005-07 biennium.[23] The spending reductions required to finance such a tax cut would cost Oregon $128 million in federal matching funds if implemented across the board. The impact of this reduction in federal matching funds is equivalent to 0.04 percent of Oregon's projected Gross State Product (GSP).[24]

Because of the interaction between the state and federal income tax codes, reducing Oregon's capital gains tax triggers higher federal income taxes. Tax filers who itemize can deduct state income taxes from federal taxes. Reducing Oregon's tax on capital gains to 4 percent, for example, would result in approximately $70 million in higher federal taxes paid by Oregonians in 2005-07.[25] The increase in federal taxes is equivalent to 0.02 percent of Oregon's projected GSP. If taxed in Oregon, this revenue would be spent in Oregon. Taxed by the federal government, only a small share will be spent in Oregon.

The economic impacts of reduced federal matching funds and higher federal income taxes are larger than the economic growth that might result from cutting the capital gains tax. In its analysis, discussed earlier, the Congressional Budget Office found that in the *tenth* year following the implementation of a five percentage point reduction in the *federal* capital gains tax, the most optimistic finding from a model that didn't rely on "extreme or unwarranted" assumptions was 0.03 percent of GDP.[26]

Ignoring the fact that the small federal results are larger than what Oregon could expect, Oregon's economy would lose more income due to lost federal matching funds and higher federal taxes than it might eventually hope to

generate by cutting state taxes on capital gains income.

The Economic Growth Record in Oregon.

Supporters of cutting taxes on income from capital gains claim that it has limited economic growth and made the recession worse in Oregon. Economic data demonstrate that each of these claims is implausible.

Oregon's outstanding record in the 1990s suggests that the tax on capital gains income did not impede economic growth. Between 1995 and 2000, Oregon's economy grew faster than any other state, based on per-capita Gross State Product.[27] As recently as 2000, Oregon had the third fastest growing state economy in the country. Between 1989 and 2000, 30,000 new businesses and 415,000 jobs were created in Oregon. During those years Oregon's population expanded by 650,000 (23 percent), largely due to people moving to Oregon.

During this period of rapid growth, Oregon's capital gains tax rate was 9 percent, the current rate. Oregon's economy grew faster than states with lower capital gains tax rates and those with no capital gains tax. Oregon's record demonstrates that a low tax rate on capital gains is not a requirement for rapid economic growth. Thousands of companies undertook substantial investments in Oregon under the current tax, including those now calling for a tax cut.[28] In its 2002 *State Technology and Science Index*, the Milken Institute ranked Oregon among the top 10 states for new businesses.[29] Given that Oregon saw the 11th fastest population growth in the country over the 1990s, the concern that capital gains taxes prevent people from moving to or staying in Oregon is misplaced, at best.

As the economy turned to recession in 2001, Oregon's fortunes were reversed. On top of the world in the 1990s boom, Oregon found itself scraping bottom in the recession. In 2001, Oregon's unemployment rate was higher than all but two other states. Seizing on the bad economic news, tax cut advocates have claimed that Oregon's tax on capital gains income is partly to blame. Given that the two states with even higher unemployment in 2001, Alaska and Washington, do not have income taxes, it is highly unlikely that Oregon's tax on capital gains income has anything to do with its unemployment ranking.[30]

Oregon was hit harder during the 2001 recession not because of its tax on capital gains, but in part because it was so successful in attracting high-tech investment during the 1990s. As Robert Parry, President of the Federal Reserve Bank of San Francisco, has noted: Oregon's "high-tech success in the 1990s [was] a mixed blessing," because it "propelled strong growth during the expansion," but left the state "more exposed to the downturn."[31]

> *Oregon's* **"high-tech success in the 1990s [was] a mixed blessing,"** *because it* **"propelled strong growth during the expansion,"** *but left the state* **"more exposed to the downturn."**
>
> *-- Robert Parry, President and CEO, Federal Reserve Bank of San Francisco*

According to the Oregon Employment Department: "The primary reasons why some states have weathered the current recession better than Oregon include the presence of energy- or defense-related industries; little growth during the 1990s, few jobs to lose during the recession; little or no population growth; and heavy dependence on ... industries not impacted by the current recession. These are all factors that are either impossible to duplicate here or that many Oregonians would find ... undesirable to replicate."[32]

Oregon's economy fell harder than other states in 2001, but it has recovered since then. Not only is Oregon's economy growing, but it is growing faster than most other states. Between December 2001 and December 20002, Oregon's unemployment rate declined 0.8 percent, more than in all but four states.[33] The national average unemployment rate climbed 0.2 percent, as 25 states experienced rising unemployment. Employment in Oregon increased 2.3 percent, more than in all but twelve states between December 2001 and December 2002. Nation-wide employment grew 0.8 percent, with 14 states losing jobs between December 2001 and December 2002.

> **"Oregon ranks favorably to other states for V[enture] C[apital] activity."**
> *--Oregon Progress Board*

Oregon's tax on capital gains income did not prevent rapid economic growth during the 1990s boom or exacerbate the 2001 recession, and has not prevented economic recovery since.

Limited Impacts on Venture Capital.

One particular claim made by supporters of cutting the tax on capital gains, including the Oregon Council on Knowledge and Economic Development (OCKED), is that it would help attract venture capital to Oregon. With the late 1990s' boom in e-business and dot-com startups, many policymakers have become interested in the role of venture capital in helping their states adapt to the "new economy." The reality, however, is that cutting Oregon's capital gains tax will do little or nothing to attract venture capital to Oregon.

Capital gains taxes have little impact on venture capital because most venture capital is from pension funds, foundations, endowments, and foreign investors, none of which are subject to the tax. According to economist Jane Gravelle, just 12 percent of all venture capital comes from investors subject to the capital gains tax.[34]

An important fact ignored by tax cut advocates is that California manages to house the largest and most dynamic high-tech venture capital community in the world, yet levies capital gains taxes higher than in Oregon.[35] Home to the Silicon Valley, California consistently receives 40 percent of all venture capital investment nation-wide.[36] The only state to receive a higher score than California for venture capital in the Progressive Policy Institute's *2002 State New Economy Index* is Massachusetts.[37] Oregon is ranked tenth.

The Oregon Progress Board conducted a study for the Oregon Business Council to assess Oregon's business climate.[38] Reviewing a range of indicators on venture capital, the Oregon Progress

Board found that "Oregon ranks favorably to other states for V[enture] C[apital] activity." The OBC and OCKED apparently chose to ignore this finding and push ahead with their calls for capital gains tax cuts.

Limited research has examined the impact of capital gains taxes on the demand for and supply of venture capital. In one study, economists Paul Gompers and Josh Lerner measured the impact of state level capital gains taxes and found that there was not a significant relationship.[39] Thomas Hellman, a Stanford University business professor and expert on venture capital and entrepreneurship in the Silicon Valley, commented on this research:

> I have yet to meet the entrepreneur who tells me about a new innovative idea, but then says the only thing preventing the enterprise from going forward is the capital gains tax the entrepreneur will have to pay in that otherwise blissful case of actual success. …[I]n the entrepreneurial context, the distortions of ex-ante investment incentives induced by capital gains taxation are of tertiary importance at best. These taxes only seem to come to people's mind once they have accumulated wealth and are directly affected by the distributional consequences.[40]

Expansion of venture capital networks would certainly benefit emerging high-tech companies in Oregon. The expected impact on jobs and economic growth in Oregon is uncertain and possibly quite small, however. Since these sectors are volatile and risky, failure is common. A recent survey by *The Oregonian* newspaper found that more than one quarter of $2.5 billion in venture capital invested in the Portland between 1999 and 2001 went to firms that no longer exist.[41] Many of the surviving firms "have shown little return on investment and are operating on shoestring budgets…"[42]

"I have yet to meet the entrepreneur who tells me about a new innovative idea, but then says the only thing preventing the enterprise from going forward is the capital gains tax the entrepreneur will have to pay in that otherwise blissful case of actual success...These taxes only seem to come to people's mind once they have accumulated wealth and are directly affected by the distributional consequences."

--Thomas Hellman, Stanford University

Failed Tax Incentives

Regardless of the importance of venture capital in creating jobs in Oregon, cutting the tax on income from capital gains is not necessary for attracting more of it. Oregon has already experimented with tax incentives to attract venture capital and generate growth. These experiments have failed.

In 1995 the Oregon Legislative Assembly implemented a tax deferral on capital gains that were reinvested in small Oregon companies. In a study of the impacts of the deferral, the Legislative Revenue Office and the Oregon Department of Revenue and the Oregon Department of Economic and

Community Development concluded it was a failure (hereafter referred to as "the LRO-DOR-OECD Report").[43] Designed to spur job-creating new investments, the LRO-DOR-OECD Report found that the deferral had few takers.[44] Far from stimulating development in cutting-edge industries, the most common deferral was for dairy cattle. The legislature phased out the deferral in 1999.

Most, if not all, of the investments qualifying for deferral would have happened even without the deferral. In 1996 and 1997 Oregon gave up nearly $8 million in capital gains tax revenue to reward investments, chiefly in agricultural and timber land, agricultural equipment and buildings, and restaurants, which were going to happen anyway.[45] An important reason for the limited use of the program is that capital gains from small businesses constitute a tiny portion of all capital gains.[46]

The LRO-DOR-OECD Report concluded that Oregon's capital gains taxes are not an important factor in attracting venture capital to the state. The study concluded that other factors, such as the relatively small size of Oregon's economy and limited resources at state universities to support start-up companies, are the reason more venture capital is not available in Oregon.

Capital Gains Already Get Special Treatment.

Capital gains already receive favorable treatment. In the federal tax code, capital gains are taxed at lower rates and are not taxed until the asset is sold, or not at all in the case of inherited wealth.[47] The top rate for capital gains held more than one year is just 20 percent, compared to 38.6 percent for other income.[48]

The limited capital gains of middle-income people are taxed at even lower rates. In the 15 percent federal income tax bracket, which includes 46 percent of income tax filers and 66 percent of tax payers, long-term capital gains are taxed at just one-half or less of the maximum rate of 20 percent.[49] Gains from assets held between one and four years are taxed at 10 percent, while gains from assets held five or more years are taxed at 8 percent.[50]

Small businesses with capital gains also receive preferential treatment under the existing tax code. Capital gains from the sale of stock from small businesses with assets under $50 million are eligible for a 50 percent exclusion from the federal capital gains taxes. Gains from the sale of small business stock that are reinvested in other small business ventures are excluded altogether.[51]

Since the federal tax on capital gains is more than twice Oregon's, if any special treatment is going to influence investor behavior, it will be the federal code. Additional breaks through the state tax code will be gravy for high-income households.

Distribution of a Capital Gains Tax Cut.

Reducing Oregon's tax on capital gains income would deliver a large cut to high-income households and very little to anyone else. If it had been implemented in 2002, cutting the tax to 5 percent would have reduced state taxes on middle-income taxpayers by an average of $10.[52] The highest-income one percent of Oregonians, with an average income nearly $800,000, would have realized a state tax cut of $5,634. The lowest-income fifth of taxpayers would have received nothing from cutting the capital gains tax. The richest five percent of Oregon households would have reaped 73 percent of the cut, while the bottom 80 percent of households would have received just 9 percent.

Unequal Distribution of Capital Gains Assets

High-income households reap most of the benefit of capital gains tax cuts because middle-income and low-income households own relatively little of the assets that generate taxable capital gains, such as equities (stock) or investment property. Capital gains make up 18 percent of the income of the richest one percent of Oregon households, but provide only one percent of the income of middle-income Oregonians.[53] The chief asset of most middle-income households is their home. Gains from the sale of owner-occupied housing, however, are generally exempt from the capital gains tax.[54] Overall, about half of all assets producing capital gains are held in a tax-exempt form.[55]

The most common asset that yields taxable capital gains is corporate stock.[56] While half (52 percent) of American households own some form of stock, much of it is in retirement savings and pension plans that are not subject the tax on capital gains.[57] Just 21 percent of households own stock directly.[58] Many of the households with direct stock holdings own very little. Only 14 percent of households directly hold stock worth more than $5,000.[59]

Stock ownership became more widespread in the last decade, but a minority of upper-income households continues to hold the most stock and would benefit most from a capital gains tax cut. In 1998, the bottom 80 percent of American households owned just 1.7 percent of all non-pension/retirement plan stock.[60] The average value of all stocks owned by the least wealthy 60 percent of stock-owning households was just $4,200, while the average among the richest one percent was $2.5 million.[61]

Other assets that produce taxable capital gains are even more unequally distributed than stocks. The wealthiest 10 percent of American households own 82 percent of all stock, but they own more than 91 percent of the assets from businesses that are not publicly traded.[62] The most equally distributed capital gains producing asset is investment real estate. The bottom 90 percent of American households own 25.5 percent of non-residential real estate, while the richest one percent of households own 43 percent.[63]

Can A Tax Cut Raise Revenue?

Some advocates have claimed that a capital gains tax cut will actually generate additional revenue.[64] Common sense and solid research show capital

gains tax cuts cannot be expected to generate additional revenue. In his review of the literature on the revenue impacts of capital gains tax cuts, economist Leonard Burman concluded, "As for its effect on revenues, a capital gains preference almost surely reduces tax revenues."[65]

During the 2001 legislative session, the Oregon's Legislative Revenue Office (LRO) analyzed a proposal that would have reduced the capital gains tax to six percent.[66] The LRO analysis assumed the existence of some revenue generated from "portfolio turnover" and new investment. Even with these assumptions they estimated that the tax cut would cost the state hundreds of millions of dollars each year.[67]

Changes in the capital gains tax do influence when investors sell capital assets. The types of changes typically thought to generate increased capital gains realizations, however, are *temporary* reductions in the tax rate, which prod investors into action before they lose the opportunity, and tax rate *increases*, which prompt investors to sell before they face a higher rate. Permanent reductions in the rate provide less incentive for investors to sell in the short term.

Attempting to generate revenue by cutting the tax on capital gains income is not sound fiscal policy. Even a *hypothetical* short-term revenue boost is actually a disguised form of high-interest rate borrowing, substituting slightly more revenue today for far less in the future. Counting on revenue from a short-term boost in sales of capital gains assets has been called "about as good an idea as asking your neighborhood loan shark to float you some money to pay your mortgage."[68]

Conclusion.

Oregon's economy fell into recession in 2001 due to global and national forces far beyond the control of elected officials in Oregon. The current recovery has also been discouraging, characterized by slow growth. It is understandable that state officials want the economy to grow faster, but cutting the capital gains tax is not the solution. Economic research suggests that the economic impact of capital gains tax cuts is quite small, even at the federal level. Economic growth, if any, from cutting Oregon's capital gains tax would be considerably smaller, with the benefits swamped by increased federal taxes and reduced federal matching funds.

The revenue loss from providing further special treatment for capital gains income is considerable, especially in the face of the deep budget cuts that will be made in the 2003-05 state budget. By reducing state revenues available for education, public safety, and other public services, a capital gains tax cut will be damaging over the long run.

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Endnotes

[1] Slemrod, Joel and John Bakija, *Taxing Ourselves: A Citizen's Guide to the Great Debate over Tax Reform*, MIT Press, Cambridge, 2000, page 122.

[2] See *Stepping Up: A Plan for Growing Quality Jobs and Statewide Prosperity*, Oregon Business Council, January 20, 2003.

[3] OBC, "Providing Stable and Adequate Funding for Public Services," available at www.oregonbusinessplan.org.

[4] OCKED, Council Report, November 2002.

[5] Aaron, Henry, William Gale, and James Sly, "The Rocky Road to Tax Reform," in *Setting National Priorities: The 2000 Election and Beyond*, eds. Henry Aaron, et. al, Brookings Institution, Washington, D.C., 1999, page 246.

[6] Congressional Budget Office (CBO), "An Analysis of the Potential Macroeconomic Effects of the Economic Growth Act of 1998," August 1998. Gross Domestic Product is "the output of goods and services produced by labor and property located in the United States," according the Bureau of Economic Analysis. Available at www.bea.gov/bea/newsrel/gdpnewsrelease.htm.

[7] CBO, page 10.

[8] CBO, page 12. See OCPP, *Empty Promises and False Hopes: The Reality of Capital Gains Tax Cuts in Oregon*, page 7 for further discussion of this finding.

[9] CBO estimates that taxable capital gains represent just one quarter of income from business capital stock. CBO, page v.

[10] The "cost of capital" is "the tax adjusted real return that firms must provide to compensate their investors for the returns they forgo by investing money in the firms' projects and the depreciation rate on new capital." Fazzari, Steven and Benjamin Herzon, "Capital Gains Tax and Economic Growth," Jerome Levy Economics Institute, 1996, pages 26-27.

[11] Congressional Budget Office, "Capital Gains Taxes and Federal Revenues," October 9, 2002. These estimates are similar to Fazzari and Herzon's research, which showed that reducing the highest bracket of the federal capital gains tax from 28 percent to 19.8 percent would reduce the average cost of capital by 1.1 percent. Fazzari and Herzon, page 7.

[12] Fazzari and Herzon, page 28.

[13] The basic reasons behind the lack of an impact on economic growth are laid out in Burman, Leonard, *The Labyrinth of Capital Gains Tax Policy*; Gravelle, Jane, *Economic Effects of Taxing Capital Income*; Gravelle, Jane "Capital Gains Taxes, Innovation and Growth," and Fazzari, Steven and Benjamin Herzon, "Capital Gains Taxes and Economic Growth."

[14] CBO, page 17.

[15] Gravelle, Jane, "Limits to Capital Gains Feedback Effects," *Tax Notes*, 363, 1991, page 364.

[16] Gravelle, Jane, "Capital Gains Taxes, Innovation, and Growth," *Tax Notes*, 1999.

[17] Gravelle, "Limits to Capital Gains Feedback Effects." Under current law, the beneficiaries of bequests receive them on a "stepped up basis," and are able to avoid tax on any capital gains which accrued before the bequest.

[18] Research by economists Leonard Burman and William Randolph concluded that there is no measurable response to permanent changes in the capital gains tax. The only identifiable response is to temporary changes in the capital gains tax rate, with investors already holding assets timing asset sales to take advantage of lower tax rates. See Burman, Leonard and William Randolph, "Measuring Permanent Response," *American Economic Review*, 1994.

[19] Auerbach, Alan, "Capital Gains Taxation in the United States: Realizations, Revenue, and Rhetoric," *Brookings Papers on Economic Activity*, 1988.

[20] The response to the federal capital gains tax increase in 1986 demonstrates investors' ability to adjust the timing of realization of capital gains. To beat the new higher rates to be implemented in 1987, thousands of investors sold their investments in 1986. Slemrod, Joel and Jon Bakija, *Taxing Ourselves: A Citizen's Guide to the Great Debate over Tax Reform*, MIT Press, Cambridge, 2000, pp. 126 and 246.

[21] Burman, Leonard, *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed*, Brookings Institution, Washington, D.C., 1999, page 62.

[22] This projection assumes that budget cuts are implemented across the board.

[23] Estimated by Legislative Revenue Office. Personal communication with Lizbeth Mahar, February 12, 2003.

[24] The most recent Gross State Product data, from the Bureau of Economic Analysis, shows that Oregon's GSP was $118.6 billion in 2000. See http://www.bea.gov. OCPP has projected gross state product for 2006 and 2007, based on Oregon Office of Economic Analysis projections of total personal income. In 2000, total personal income accounts for nearly 80 percent of GSP. Growing at the same rate as total personal income, GSP would be $159 billion in 2006 and $169 billion in 2007.

[25] The $70 million in higher federal taxes is based on 22 percent of the state tax decrease being offset by increased federal income tax increases. Previous estimates by ITEP and LRO of the federal offset have ranged between 19 percent and 25 percent of state tax cut.

[26] By the tenth year following the enactment of the tax cut, any impact on growth is thought to be fully incorporated into the economy. In the first year following enactment, the optimistic, yet realistic, model analyzed by CBO projected a 0.01 percent increase in GDP.

[27] OCPP analysis of BEA data.

[28] Sickinger, Ted, "State Must Risk to Keep Tech Edge," *The Oregonian*, February 4, 2003.

[29] Devol, Ross, *State Technology and Science Index*, Milken Institue, September 2002, page 78. The ranking is for business starts per 100,000 people and is based on 1999 data. Oregon is ranked 8th among states by this measure.

[30] The most recently available data show that Alaska had the highest unemployment rate in December 2002, followed by Oregon and Washington.

[31] Speech by Robert Parry on August 2, 2002, at Embassy Suites in Portland. Text available at www.frbsf.org/news/speeches/index.html.

[32] *ibid*, page 7.

[33] The ranking of Oregon's current unemployment rate is poor measure of the state of its economy. Oregon has relatively high unemployment in good and bad economic times. More accurate measures of the state's economy are growth in employment and unemployment. Between December 2000 and December 2001, Oregon's unemployment rate increased and employment decreased more than in any other state. See Thompson, Jeff, *Boom, Bust, and Beyond: The State of Working Oregon 2002*, for further explanation. Available at www.ocpp.org.

[34] Jane Gravelle, "Capital Gains Taxes, Innovation and Growth," *Tax Notes*, 1999. "Informal" venture capital are not included in this measure, but are thought to be not very sensitive to capital gains taxes.

[35] California's maximum tax rate on capital gains is 9.3 percent, while Oregon's is 9.0 percent.

[36] OCPP analysis of PricewaterhouseCoopers MoneyTree database on venture capital. Available at http://www.pwcmoneytree.com.

[37] Atkinson, Robert, *The 2002 State New Economy Index: Benchmarking Economic Transformation in the States*, Progressive Policy Institute, June 2002.

[38] Oregon Progress Board, "Background Data: How is Oregon Doing?," Summer-Fall 2002, page 24.

[39] Gompers, Paul and Josh Lerner, "What Drives Venture Capital Fundraising?" *Brookings Papers*: Microeconomics, 1998. For additional analysis of the Gompers-Lerner research and advocates misuse of their findings see *Empty Promises and False Hopes*, available at www.ocpp.org.

[40] Thomas Hellman, "Comment on Gompers and Lerner," *Brookings Papers*: *Microeconomics*, 1998.

[41] Koseff, Jeffrey, "Laid-back Image Scares Away Venture Capital," *The Oregonian*, February 9, 2003.

[42] *ibid.*

[43] Oregon Department of Revenue and Legislative Revenue Office, "Oregon's Capital Gains Deferral Program," 1999.

[44] The agencies noted that there is some movement of taxpayers to Washington state to avoid Oregon capital gains taxes, but this does not necessarily mean that investments in Oregon leave the state or that deferral stops the flow of people and their tax dollars. The study noted that "[t]he movement of Oregon residents to Clark County, Washington, even if it is to avoid Oregon's income tax on capital gains, does not necessarily lead to less investment in Oregon." The agencies found "no evidence that, in its first two years, Oregon's capital gains deferral program has slowed the movement of taxpayers to Clark County."

[45] ibid.

[46] Gravelle, Jane, "Capital Gains Taxes, Innovation, and Growth," Congressional Research Service, 1999. Only 17 percent of all capital gains accrue to partnerships and S corporations. Only 9 percent of the assets of non-financial corporations were held by firms with less than $50 million. Small businesses account for an incredibly small portion of capital gains.

[47] Example of benefits of deferred taxation from Brookings, "The Rocky Road to Tax Reform," page 229, note 26. "A simple example illustrates the size of this differential. Suppose that a person in the 28 percent bracket invests $1,000 in a thirty-year bond yielding 10 percent annually in taxable interest and invests the interest earnings in bonds also yielding 10 percent. At the end of thirty years the investment will have grown to $8,051. Suppose instead that the investor buys an appreciating asset that grows at an annual rate of 10 percent, sells the asset after thirty years, and pays the capital gains tax of 20 percent on the appreciation. The investor will realize $14,160 after paying tax, a value 76 percent larger than on the bond. The annual tax rate equivalent of the capital gains tax is only 7.6 percent."

[48] A 28 percent rate does apply to gains from the sale of some small business stock held more than five years, but the tax only applies to half of the gain, excluding the other half entirely from taxation. Sales of collectibles, including antiques, are taxed at the 28 percent rate.

[49] In 1999 a couple filing jointly with up to $43,000 in taxable income is in the 15 percent bracket. Brookings, "The Rocky Road to Tax Reform," page 216.

[50] Burman, *Labyrinth*, page 12.

[51] Oregon Department of Revenue and the Legislative Revenue Office, "Oregon's Capital Gains Deferral Program," 1999, pp. 10-11.

[52] For complete analysis of the distribution of reducing Oregon's tax on capital gains to five percent, see *Cutting Capital Gains Taxes Will Hurt, Not Help, Oregon's Economy.*

[53] ITEP, October 2002.

[54] Homeowners are allowed to exclude from taxation a capital gain on the sale of their home up to $500,000 (for joint filers, half that for single), as long as the house was the primary residence for at least two of the last five years.

[55] Congressional Budget Office, "An Analysis of the Potential Macroeconomic Effects of the Economic Growth Act of 1998," August 1998, page 17.

[56] In 1998 more than half (56 percent) of taxable capital gains were from corporate stock. CBO, November 2002, page 2.

[57] Mishel, Lawrence, Jared Bernstein, and Heather Boushey, *The State of Working America 2002-03*, Economic Policy Institute, Washington, D.C., 2002, page 290.

[58] Aizcorbe, Ana, Arthur Kennickel, and Kevin Moore, "Recent Changes in US Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances," *Federal Reserve Bulletin*, January 2003. Available at www.federalreserve.gov/pubs/bulletin/2003/0103lead.pdf.

[59] *State of Working America*, page 287.

[60] Poterba, James, "Stock Market Wealth and Consumption," *Journal of Economic Perspectives*, Spring 2000, page 102.

[61] *State of Working America*, page 288.

[62] Kennickel, Arthur, "An examination of Changes in the Distribution of Wealth from 1989 to 1998: Evidence from the Survey of Consumer Finances," Working Paper No. 307. Jerome Levy Economics Institute, July 2000, page 18.

[63] ibid.

[64] *The Oregonian* quotes Republican Gubenatorial candidate Kevin Mannix: "'I believe that within six months the economy would be so improved that the regular income taxes coming in would make up for any cash reductions from the reduction in capital gains.'" Nokes, Gregory, "Governor's race offers no quick fix for economy," *The Oregonian*, October 7, 2002.

[65] Burman, *Labyrinth*, page 146.

[66] LRO analysis of Senate Bill 67 available at www.leg.state.or.us/comm/sms/SMS01Frameset.html.

[67] LRO analysis of Senate Bill 67 showed that it would costs $250 million per year when fully implemented. Projected revenue losses from a capital gains tax cut in 2003 will be smaller than a similar size cut in 2000 because the stock market collapse has eliminated a considerable amount of anticipated capital gains.

[68] Burman, Leonard, "The Answer Isn't Capital Gains," *The Houston Chronicle*, September 30, 2001.