OREGON CENTER FOR PUBLIC POLICY

Executive Summary

204 N. First St., Suite C • PO Box 7 • Silverton, OR 97381 • www.ocpp.org • 503-873-1201 • fax 503-873-1947

April 9, 2001

Empty Promises and False Hopes:
The Reality of Capital Gains Tax Cuts in Oregon

By Jeff Thompson

The Oregon Legislative Assembly is currently considering several proposals to cut the tax on capital gains. Two introduced at the request of the state's large business lobby, Associated Oregon Industries (AOI), Senate Bill 67 and House Bill 2486 ("the AOI bills") would cut Oregon's capital gains tax rate by more than half. The AOI bills carry a considerable price tag, costing the state more than $400 million per biennium. Since capital gains income is heavily concentrated at the top of the income distribution, capital gains tax cuts would primarily benefit the most economically comfortable families.

Data reviewed for this study show:

- The highest-income one-percent of Oregonians would reap 55 percent of the gains from the tax cut, while the bottom 95 percent get just 25 percent.
- The average tax cut for the bottom 80 percent would be just $26, while the average tax cut for the top one-percent would be nearly $13,400.
- The average tax cut for the top one-percent is 50 percent higher than the average annual income of the bottom 20 percent.
- The biennial revenue loss of $440 million is equivalent to the Governor's proposed general fund budget for the State Police and the Department of Environmental Quality combined.

The revenue lost from the capital gains tax cuts in SB 67 and HB 2486 will further constrain Oregon's ability to address public needs. The gains to recipients of the tax cut, however, are far less than the total amount of the tax cut. Approximately $60 million of the capital gains tax cut, more than one-quarter of the total cut, will go to the federal government in the form of higher federal income taxes each year.

Advocates for the tax cuts, particularly Associated Oregon Industries, claim that a capital gains tax cut will produce considerable economic growth and could possibly generate enough additional tax revenue to pay for itself. A review of the research on capital gains taxes suggests otherwise. Cutting the state capital gains tax cannot be expected to generate significant economic growth, and will most certainly not generate enough revenue to pay for itself.

204 N. First St., Suite C • PO Box 7 • Silverton, OR 97381 • www.ocpp.org • 503-873-1201 • fax 503-873-1947

April 9, 2001

Empty Promises and False Hopes:
The Reality of Capital Gains Tax Cuts in Oregon

By Jeff Thompson

Several bills have been introduced into the Oregon Legislative Assembly that would reduce Oregon's tax on capital gains. Capital gains are profits reflecting increased values of stocks, bonds, investment real estate and other "capital assets." Capital gains are not taxed at all unless and until they are "realized" at the sale of an appreciated asset.

These proposals to lower the tax on capital gains come on the heels of voter approval of two legislative referrals that cut taxes primarily for upper income Oregonians. One increased the deductibility of federal income taxes. The other enshrined in the state constitution an automatic, across the board tax cut when revenues exceed projections. With a not very rosy economic forecast adding to its woes, the legislature is now facing a budget shortfall in the coming biennium and the need to cut popular programs such as higher education, public safety, welfare-to-work efforts, and child care. Lowering the capital gains tax rate would further reduce available resources and would pointedly target tax relief toward Oregon's most economically comfortable taxpayers who have benefited the most from the prosperity of the 1990s.

While the findings and economic analysis are generally applicable to all the proposals under consideration by the Legislature, [1] this paper specifically analyzes the impacts of bills introduced at the request of the state's large business lobby, Associated Oregon Industries (AOI), Senate Bill 67 and House Bill 2486 ("the AOI bills"). These bills would cut Oregon's capital gains tax rate by more than half.

The AOI bills would cost the state over $200 million annually. While few Oregonians would receive any benefit from capital gains tax cuts, many Oregonians would be impacted by the necessary reduction in state services that would follow. In addition, more than one-quarter of the lost state tax revenue would flow directly to the federal government in the form of increased federal income taxes. In dollar terms, the cuts to programs would exceed the cut in taxes.

AOI commissioned a report by a private consultant, William Conerly, to provide arguments in support of their legislative package. [2] The AOI/Conerly report claims that capital gains tax cuts will generate economic growth benefiting all Oregonians. A critical assessment of their claims reveals that this is not the case. [3] Cuts in the capital gains tax rate are not expected to generate significant economic growth at the state level, and will most certainly not pay for themselves in increased tax revenue.

Current Rates and Proposed Changes

Oregon's personal income tax currently subjects capital gains to the same graduated rate structure as all other sources of income. The AOI bills would create a separate, lower rate of 4 percent for income from capital gains, while still taxing wages, self-employment, and other income at the current higher rates. The AOI bills would also reduce the corporate income tax rate on capital gains by over one third: from 6.6 percent to 4 percent.

Consequences of Reducing the Tax Rate on Capital Gains

Because high-income families receive a far greater share of capital gains income than do middle- and low-income families, and because the rate cut is larger for upper-bracket taxpayers, cutting capital gains tax rates would benefit the best-off Oregonians the most. Table 1 shows the consequences of AOI's proposal to reduce the personal income tax rate on capital gains to a single rate of 4 percent for different income groups.[4] In particular:

- Fifty-five percent of the total tax reduction would go to the one percent of Oregonians with incomes over $341,100 and an average income of $923,000. The average tax cut for this group would be $13,384. The best-off 5 percent would get 75 percent of the tax reduction.
- The size of the tax cut going to the top one-percent of Oregonians is nearly 50 percent higher than the total average annual income of the lowest-income twenty percent.
- The poorest twenty percent of Oregonians would be effectively excluded from this tax cut, with an average reduction in taxes of just 6 cents.
- The eighty percent of Oregonians earning less than $68,900 annually would receive only 8 percent of the tax reduction, cutting their taxes by an average of only $26.
- The ninety-five percent of Oregonians with incomes under $137,400 per year would receive just 25 percent of the tax cut, and the ninety-nine percent of Oregonians with incomes under $341,100 would receive less than half of the total amount of the tax reduction.

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

Table 1. Effects of a Capital Gains Tax Cut to 4%
Oregon Residents by Income Group, 2000

Income Group	Income Range	Average Income	Oregon Tax Change as a % of Income	Average Tax Change	Percent of Total Tax Cut
Lowest 20%	Below $14,700	$ 9,000	0.0%	$ –0	0%
Second 20%	$14,700-$26,900	$ 20,700	-0.1%	$ –16	1%
Middle 20%	$26,900-$43,500	$ 33,900	-0.1%	$ –26	2%
Fourth 20%	$43,500-$68,900	$ 55,200	-0.1%	$ –62	5%
Next 15%	$68,900-$137,400	$ 91,000	-0.3%	$ –251	16%
Next 4%	$137,400-$341,100	$ 195,400	-0.6%	$ –1,229	20%
Top 1%	Above $341,100	$ 923,000	-1.5%	$ –13,384	55%
Addendum: Bottom 99%			**–0.2%**	**$ –109**	**45%**

Source: Institute on Taxation and Economic Policy, 2/20/01

Capital Gains and the Progressivity of Oregon Taxes

The personal income tax is the only major progressive tax levied by Oregon, taxing higher incomes at higher rates than lower incomes. Thus, it plays an important role in the tax system as a whole in offsetting the regressivity of Oregon's other taxes—property taxes and consumption taxes such as the gas tax being the most significant. Without a progressive personal income tax, middle- and low-income families would pay a disproportionate share of Oregon taxes.

Capital gains are the most unequally distributed major source of income. Over 50 percent of all capital gains income subject to taxation goes to the richest one-percent of Oregonians. The most affluent five percent of Oregonians receive 74 percent of taxable capital gains.

Profits from selling stocks, bonds, real estate, and other capital gains account for over 30 percent of the income of the highest-income one percent of Oregonians. Conversely, capital gains comprise a relatively small portion of the income of low- and middle-income Oregonians; for all but the highest-income five percent of Oregonians, capital gains represent less than 3 percent of income.

For low- and middle-income Oregonians, other forms of income are much more important. Wages, for example, constitute 64 percent of the income of the bottom 95 percent of Oregonians, but less than one-fourth of the income of the top one percent.

Oregon's overall tax system is somewhat regressive, with low-income families paying a larger share of their income in state taxes than those with high incomes. The Legislative Revenue Office has shown through its Oregon Tax Incidence Model that the poorest 17 percent of taxpayers in Oregon pay 13.1 percent of their income in state and local taxes, while the richest 16 percent pay just 11.9 percent.[5] By reducing the tax burden of Oregon's highest-income households and leaving the burdens of middle and low-income families essentially unchanged, the AOI bills would exacerbate the regressivity of the Oregon tax system as a whole.

A reduction in the capital gains tax rate would significantly lower the share of taxes paid by Oregon's wealthiest taxpayers. The percentage of all taxes paid by the rest of Oregon taxpayers would increase.

Table 2. Capital Gains in Oregon: Shares and Composition of Income
All Oregon Taxpayers, 2000 levels

		Composition of Income by Income Class	
Income Group	**Share of Total Capital Gains**	**Capital Gains**	**Wages**
Lowest 20%	**0.1%**	**0%**	**51%**
Second 20%	**1.7%**	**2%**	**62%**
Middle 20%	**2.0%**	**2%**	**69%**
Fourth 20%	**6.4%**	**3%**	**71%**
Next 15%	**15.5%**	**6%**	**68%**
Next 4%	**21.9%**	**15%**	**47%**
Top 1%	**52.3%**	**31%**	**24%**
Addendum: Bottom 95%	**25.8%**	**2%**	**64%**
ALL	**100%**	**10%**	**57%**

Source: ITEP Model, March 2001

Doesn't Everyone Benefit?

In selling the capital gains tax cut, the AOI/Conerly report argues that most people benefit from cuts in the capital gains tax rates because most households own assets that accrue capital gains. While it is true that most households do own at least some asset that accrues capital gains, the AOI/Conerly report ignores that most of these assets are not subject to capital gains taxes. The value of taxable capital gains assets held by most families is quite small.

The chief asset of most households is their home. Gains from the sale of owner-occupied housing, however, are almost entirely exempt from the capital gains tax.[6] Excluding owner-occupied housing, slightly less than half of American households own any type of asset that can be expected to earn capital gains.[7] Just 40 percent of all savings produce any capital gain, and most capital gains assets pay part of their return in ways that are not taxed by the capital gains tax, such as dividends and rent.[8]

In addition, not all non-housing assets that yield capital gains are taxed on those gains. An important example is pensions, including IRAs and 401(k)s, which are a primary non-housing source of wealth for middle-class families.[9] Pensions and retirement savings plans account for one-fifth of family wealth, and may hold capital gains producing assets, but do not face the tax on the capital gains.[10] Overall, about half of all capital gains producing assets are held in a tax-exempt form.[11]

The asset most likely to yield taxable capital gains is corporate stock. While 93 percent of families in the top two-percent of the income distribution own stock, only 18 percent of families in the bottom 40 percent of the income distribution own any stock.[12] In addition, the stock holdings of most households are in retirement savings and pension plans, which are not taxed by the capital gains tax. While slightly less than half of all households own any stock, only 19 percent own stock directly – as opposed to through retirement savings and pension plans.[13]

Even among those with any holdings, many households own very little stock. Less than 14 percent of American households directly held stocks worth $5,000 or more. The average value of the stocks owned (directly or through retirement savings and pension plans) by the least wealthy 60 percent of stock-owning American households was just $4,200. The average stock-holdings of the wealthiest one-percent were $2.5 million.[14] The bottom 80 percent of American households owned only four percent of stocks, and just 1.7 percent of non-pension/retirement plan stock.[15]

The notion that capital gains are primarily the provenance of the rich is accurate.
--Leonard Burman, economist.

Other assets that produce 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 business assets.[16]

Since few non-wealthy families own significant assets that generate taxable capital gains, capital gains tax cuts deliver very little to the non-wealthy. Economist Leonard Burman has noted, "the notion that capital gains are primarily the provenance of the rich is accurate."[17]

What About Grandma?

In an attempt to put a compassionate and politically appealing face on a regressive tax cut proposal, the AOI/Conerly report claims that the elderly are particularly harmed by Oregon's tax on capital gains and have much to gain from a capital gains tax cut. In doing so, the report paints a misleading picture of the situation of typical Oregon seniors. While the elderly are more likely to own capital gains

Table 3. Effects of a Capital Gains Tax Cut to 4% on Older Oregonians Elderly Oregon Residents by Income Group, 2000					
% of taxpayers in group	**Income Range**	**Average Income**	**Oregon Tax Change as a % of Income**	**Average Tax Change**	**Percent of Total Tax Cut**
25%	Below $15,000	$ 9,700	0.0%	$ –0	0%
27%	$15,000-$30,000	$ 21,900	0.0%	$ –5	0%
17%	$30,000-$50,000	$ 38,900	-0.3%	$ –97	4%
22%	$50,000-$100,000	$ 66,300	-0.3%	$ –231	11%
9%	$100,000 or more	$ 263,400	-1.7%	$ –4,370	85%
Addendum: Bottom 91%		**$ 32,400**	**–0.2%**	$ –75	15%

Source: Institute on Taxation and Economic Policy, 4/6/01

producing assets than the young, many of those assets are not taxed. Like most households, the most important asset for the elderly is their home. The capital gains in the retirement savings and pension plans of the elderly also are not taxed by the capital gains tax.

As shown in Table 3, the taxable capital gains income of the elderly is highly concentrated among those with upper-incomes. The typical older Oregonian has very little taxable capital gains income and would get little from a tax cut. Fully 85 percent of the capital gains tax cut going to older Oregonians would go to the highest-income nine percent, who have an average income of $263,400. The top nine-percent of seniors would receive average tax cuts of $4,370, while the lowest-income 91 percent would receive an average cut of just $75. The lowest-income 69 percent of older Oregonians get just four percent of the proposed capital gains tax cuts, averaging $26.

Because the capital gains income of older Oregonians is so highly concentrated at the top of the income ladder, most Oregon seniors would get very little or nothing from the tax cuts in SB 67 and HB 2486.

The limited capital gains of low- and middle-income people, both elderly and non-elderly, are already treated preferentially in the federal tax code. For taxpayers in the 15 percent income tax bracket, long-term capital gains are taxed at just one-half or less of the maximum rate of 20 percent.[18]

Budget Implications of the Tax Cut

The projected revenue loss from the capital gains tax cuts proposed by the Legislature is about $220 million per year, or $440 million per biennium.[19] Because of a projected budget shortfall, the 2001 Legislative Assembly is already crafting budgets that include deep cuts to many state services and limiting new investments in programs such as those targeted at early childhood development and the development of an engineering program in higher education. Cutting capital gains taxes will only make current and future cuts deeper. The tax cuts in SB 67 and HB 2486 are equivalent to twice the 2001-03 Governor's proposed general fund budget for the State Police and the Department of Environmental Quality combined.[20] The size of the tax cut is also equal to more than 85 percent of the 2001-03 Governor's proposed general fund budget for the Senior and Disabled Services Division in the Department of Human Services. The tax cut is greater than one-half of the general fund budget proposed for the Department of Higher Education.

Interaction Between Oregon and Federal Income Taxes

While the projected revenue loss from the proposed tax cut is about $220 million per year, the actual tax savings for Oregonians would be significantly lower. State income taxes can be deducted by taxpayers itemizing deductions on their federal tax returns. Therefore, any *reduction in Oregon* income taxes paid results in an *increase in federal* income taxes paid by Oregon residents. [21] In other words, the AOI bills and other efforts to cut capital gains taxes effectively increase the federal taxes Oregonians pay.

Twenty-eight percent of the capital gains tax cuts proposed by AOI in SB 67 and HB 2486 would end up going to the federal government.[22] Oregon would *collect* $220 million less in taxes, and would be forced to spend $220 million less for government services benefiting Oregonians. But Oregonians would only receive a tax cut of $158 million because they would be paying $62 million more to the federal government. This loss of $62 million from the state would have a negative impact on the state's economy and would hurt the ability of the state to respond to the needs of its citizens.

Why Cut Capital Gains Taxes?

The Associated Oregon Industries and other advocates for reducing capital gains taxes usually don't sell the idea as a giveaway to the rich or as a way to increase federal taxes. Instead, they generally make the claim that a capital gains tax break would stimulate the economy. The AOI/Conerly report also claims that there is no need to worry about cutting the capital gains tax because it will generate enough new tax revenue from the assumed increased economic activity to pay for itself. A critical review of the arguments made by, and the studies cited in, the AOI/Conerly report shows that Oregonians can expect neither economic growth nor additional revenue from cuts to Oregon's capital gains tax.

Economic Growth Response to a Capital Gains Tax Cut

Advocates for a capital gains tax cut believe it will unleash new economic activity that will create jobs, boost productivity, and raise wages. Recent research on this "growth response" to capital gains tax cuts, however, finds that they have little impact on investment and growth at the federal level. Even the meager responses to federal tax cuts are larger than what can reasonably be expected from a state tax cut. A federal capital gains tax incentive can be said to work if it generates new investment that would otherwise not have occurred. A state-specific capital gains tax incentive, on the other hand, must encourage investment *within the borders of the state* if it is to provide increased economic activity and benefits to the state. The tax cut in the AOI bills would reduce capital gains taxes for investments whether the companies operate in Oregon, California, Alabama, or China.

Despite having high capital gains taxes relative to other states, Oregon has enjoyed strong economic growth. Like Oregon, California is a "high" capital gains tax state. In addition, California has a highly

The tax cut in the AOI bills would reduce capital gains taxes for investments whether the companies operate in Oregon, California, Alabama, or China.

developed venture capital market. If capital gains taxes have not limited the growth in these areas, there is little reason to believe that a cut would significantly improve Oregon's economic activity. The argument that cutting Oregon's capital gains tax will generate economic growth is tenuous at best, especially given the evidence of such cuts at the national level.

Limited Impacts Nationally

In 1998 the Congressional Budget Office (CBO) reviewed several leading economic models that had been developed to predict the economic growth response to cuts in the federal capital gains tax. Through its review CBO found that reducing the capital gains tax would have "only a modest effect" on the US Gross Domestic Product. Of the four models reviewed, CBO found that two yielded "small increases in GDP – well below 0.1 percent after ten years."[23] To put this level of growth into perspective, with GDP growing at 3.5 percent per year, 0.03 percent (the higher of the two estimates) is roughly the economic growth that occurs in one-half of one week. It is doubtful that many Oregonians felt much richer on October 26th than they did on October 23rd. Estimates of economic growth resulting from cutting the federal capital gains tax are so small as to be essentially unnoticeable.[24]

Essentially, the growth prediction used in the AOI/Conerly report depends on monetary policy changes from the Federal Reserve Board, not changes in the capital gains tax.

The CBO also reviewed two additional models that generated larger growth estimates, but "those results depend on extreme or unwarranted assumptions. Correcting those assumptions changes the results from large to trivial."[25] One of the models using extreme assumptions was developed by DRI, an economic consulting firm. The AOI/Conerly report uses the DRI model results to justify its claims that capital gains tax cuts will generate economic growth. As the CBO noted, however, the DRI model includes questionable assumptions about Federal Reserve Board monetary policy responses in conjunction with capital gains tax cuts.[26] After correcting DRI's assumption that the Federal Reserve Board relaxes its stance on inflation, the CBO found that the DRI model shows that a capital gains tax cut reduces economic growth, rather than increases it.[27] Essentially, the growth prediction used in the AOI/Conerly report depends on monetary policy changes from the Federal Reserve Board, not changes in the capital gains tax.

After taking unrealistic assumptions into account, the models reviewed by CBO show that very little economic growth would result from cutting the capital gains tax.

Limited Impacts for Oregon

Even the meager growth projections from federal tax cuts are larger than what can be expected from cutting state-level capital gains taxes in Oregon. Since many of the gains benefiting from the tax cut are on investments in firms outside of Oregon, a capital gains tax cut is limited in its ability to influence new investment and growth in the state. This process, referred to as "exporting" the benefits from a tax-cut, occurs at the federal level as well, but the degree of exporting from a state level tax cut is considerably larger. Oregonians can invest their money in other countries and 49 other states. Windfalls from cutting Oregon's capital gains taxes that are invested in Texas, Arkansas, China, or Japan do nothing to create jobs in Oregon.

Also, because Oregon's tax rate on capital gains is much lower than the federal rate, similar size cuts will have even less of an impact at the state level than at the federal level.[28] A 50 percent reduction in a 9 percent tax is worth much less than a 50 percent reduction in a 20 percent tax. The AOI/Conerly report ignores the distinction between federal and state capital gains taxes, addressing instead the combined federal-state rate. The behavioral responses to changes in state and federal capital gains taxes, however, are different. This research finding is supported by studies that are cited in the AOI/Conerly report.[29]

Reviewing recent research on investors' response to capital gains tax changes, 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."[30]

Because much of the revenue from a state-level tax cut will be exported to other states, and state-level capital gains tax rates are so much lower than federal tax rates, growth predictions from studies of federal tax cuts cannot simply be "scaled down" to fit Oregon. Scaling the size of the projected impact of a federal tax cut down to fit the size of Oregon's economy does not adequately address the differences between federal and state taxes or the exporting of benefits from the tax cut, and will likely overstate the growth that Oregon might reasonably experience following a capital gains tax cut.

Because the growth impacts from federal tax cuts are so small to begin with, Oregon cannot expect significant growth from cutting the capital gains tax.

Limited Impacts in Increasing Venture Capital

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 AOI/Conerly paper attempts to appeal to this interest by claiming that cutting the capital gains tax will boost venture capital development and availability. The reality, however, is that cutting Oregon's capital gains tax will do little or nothing to attract venture capital to Oregon.

The AOI/Conerly report ignores an important issue; it never address how the state of California manages to house the largest and most dynamic high-tech venture capital community in the world, yet levies capital gains taxes higher than Oregon's.[31] The simple explanation is that capital gains taxes have very little effect on venture capital. Economist Jane Gravelle has shown that just 12 percent of all venture capital comes from investors subject to the capital gains tax.[32] Most venture capital is from pension funds, foundations, endowments, and foreign investors, none of which are subject to the tax on capital gains.

Trying to avoid the implications of the fact that so little venture capital is impacted by the capital gains tax, the AOI/Conerly report asserts that capital gains tax cuts increase venture capital funding by increasing the number of start-up businesses demanding funding from venture capitalists. The AOI/Conerly report points to a single study by Paul Gompers and Josh Lerner backing its claim.[33] The findings from this study, though, have been criticized. A leading authority on this research, Thomas Hellman, a Stanford University business professor and expert on venture capital and entrepreneurship in the Silicon Valley, noted:

> 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.[34]

The AOI/Conerly report's reliance on the Gompers and Lerner study is curious, at best. AOI and Conerly assert that because the authors find that the "combined federal-state capital gains tax rate" impacts venture capital funding, it is implied that cutting Oregon's tax rate will spur venture capital growth. Gompers and Lerner, on the other hand, specifically found that state-level tax changes have no significant impact on venture capital, and that all of the impact of the combined federal-state rate is due to changes in the federal rate. AOI and Conerly's assertion that this research supports their claims about state-level capital gains tax cuts is simply wrong.

Oregon's Experiment with Cutting Capital Gains to Spur Investment

A 1995 Oregon law allowed a tax deferral for capital gains reinvested in small Oregon companies. Deemed a failure by the Oregon Department of Revenue and the Legislative Revenue Office, the program was phased out in 1999. The study of this program sheds light on the impacts of state-level capital gains tax changes on venture capital. [35]

According to a legislatively mandated study by the Oregon Department of Revenue and Legislative Revenue Office (the Revenue-LRO study), most if not all of the investments qualifying for deferral would have happened even if the deferral did not exist. In 1996 and 1997, Oregon gave up nearly $8 million in capital gains tax revenue to support investments, chiefly in agricultural and timber land, agricultural equipment and buildings, and restaurants, which were going to happen anyway.

The deferral program was specifically targeted toward capital gains generated from small businesses and reinvested in small businesses, and was supposed to spur job-creating new investments. Despite the promised benefits of the program, there were few takers. The most common deferral was for dairy cattle. 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.[36]

The Revenue-LRO study found 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 behind the limited levels of venture capital in Oregon.

Oregon's economic history teaches that producing consistently strong rates of economic growth does not require cutting capital gains taxes or even having low tax rates.

Preferential Treatment of Small Businesses

The AOI/Conerly report claims that these tax cuts will help foster small business growth. Yet, small businesses with capital gains already 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 federal capital gains taxes. Gains from the sale of small business stock that are reinvested in other small business ventures can be rolled over altogether.[37]

Strong Growth without Cutting Capital Gains Taxes

Oregon has experienced high levels of growth over the last decade and a half without cutting its capital gains tax. Oregon taxes capital gains at a rate higher than many other states, but it was the fastest growing state in the country in 1997. After adjusting for inflation, Oregon's economy, measured by Gross State Product, grew 7.2 percent in 1998, the most recent year for which data are available. Oregon's economy grew faster than the US in every year from 1988 through 1998.[38] It also grew faster than the average of Western states in all but one of those years. Oregon's economic history teaches that producing consistently strong rates of economic growth does not require cutting capital gains taxes or even having low tax rates.[39]

The Revenue Response to a Capital Gains Tax Cut

The AOI/Conerly report claims that decreasing capital gains taxes could actually *increase* revenue to the state. The argument goes as follows: when the tax cut goes into effect, people who had been holding on to their capital gains will be induced to sell, resulting in an increase in overall revenue collections from capital gains. A number of studies have been conducted over the last twenty years attempting to figure out if this actually happens.

While the question has not been fully resolved, there is very little reason to think that capital gains tax cuts will pay for themselves.[40] Reviewing the literature, economist Leonard Burman has concluded, "As for its effect on revenues, a capital gains preference almost surely reduces tax revenues. Careful econometric studies find that capital gains are relatively unresponsive to statutory changes in tax rates."[41]

Moreover, any additional capital gains generated due to a tax cut are achieved at the cost of a distortion in the allocation of resources. Taxing capital gains income identically to other sources of income removes artificial incentives for taxpayers to shelter their income in tax-preferred sources, and allows taxpayers to choose an allocation of income and investment that is optimal for them and for the economy. Reducing taxes on capital gains encourages gaming that can act as a drag on economic growth.

It's All In the Timing

It is not that taxpayers with capital gains do not respond at all to changes in the tax rate, it is that they do not alter their long-term investment behavior. 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."[42] Instead of effectively influencing new investment, cuts in the capital gains tax deliver a windfall to already existing investments.[43] Investors' ability and sensitivity to timing the realization of capital gains was demonstrated by the response to the federal capital gains tax increase in 1986. To beat the new higher rates to be implemented in 1987, thousands of investors sold their investments in 1986.[44]

Other economists, such as Leonard Burman and William Randolph, have concluded that there is no measurable response to permanent changes in the capital gains tax. [45] The only identifiable response is to temporary changes in the capital gains tax rate as explained above. Investors already holding assets are likely to time when they sell to take advantage of a lower tax rate.

Limited Policy Relevance of Many Studies

Most of the studies looking into the impacts of changes to capital gains taxes use economic models to determine the response of capital gains realizations to changes in the capital gains tax. Some of the economic models used in this research, however, contain assumptions that do not accurately reflect the real world. The findings from such studies, while of academic interest, are not particularly relevant for policy making. By not paying attention to the assumptions built into these models, some capital gains tax cut proponents draw unsupported conclusions from the research. The AOI/Conerly report provides a good example of this kind of error.

In trying to support the idea that cutting Oregon's capital gains tax will pay for itself by generating additional revenue, the AOI/Conerly report cites a study by economists Gerald Auten, Leonard Burman, and William Randolph.[46] The AOI/Conerly report calls this study its "preferred" estimate of the responses to changes in capital gains taxes. One of the authors of the study has noted, however, that use of those findings to support capital gains tax cuts is misplaced.[47] Burman indicates that it is "very unlikely" that capital gains tax cuts can pay for themselves, and that the "optimistic assumptions" used in the model "are not supported by the empirical evidence." Using unrealistic assumptions, the model yields unrealistic results. Nevertheless, the AOI/Conerly report relies upon the study to reach their desired conclusion, ignoring the fact that one of the study's own authors gives little credence to the assumptions used.

A "Reality Check"

The size of the tax revenue response to a capital gains tax cut (or any change in the tax code) is called the "elasticity." A ratio between change in revenues and change in taxes, an elasticity of one or more implies (assuming that the model actually reflects the way the economy works) that capital gains realizations would increase enough to make the additional revenue from those induced sales offset the direct effect of the reduction in the tax rate.[48] While some studies of the revenue impacts of capital gains tax changes have yielded elasticities as high as 4 percent, how realistic are these findings?

Other researchers have tried to provide a reality check on the results from models yielding high elasticities. Research by economist Jane Gravelle shows that elasticities of even 0.5, which fall far short of the "paying for itself" mark, are unrealistically high.[49]

The only investors that can be expected to "respond" to a capital gains tax cut are those who hold taxable gains and who would not have otherwise sold assets to realize their gains. The primary reasons behind the limited potential response to a tax cut is that one-half of capital gains are from exempted assets or are held by exempted investors, and nearly one-half of all taxable capital gains accruals are already realized each year.[50] In addition, many taxable capital gains are held until death for the purposes of bequests and would not be realized even if the capital gains tax were eliminated entirely.

Essentially, the pool of taxable capital gains that are not already realized each year and will likely be realized is considerably smaller than is typically assumed in the economic models.

Gravelle's research demonstrates that to generate enough additional revenue to produce an elasticity of even 0.5, sales of capital gains assets must rise so high that they become equal to accruals of capital gains.[51] In other words, all assets with taxable capital gains would have to be sold each year forever. The historical record of capital gains transactions and common sense both suggest that such a behavioral response to cuts in the capital gains tax is impossible. The AOI/Conerly report ignores this impossibility and relies on studies using elasticities much higher than 0.5.

Robbing Peter to Pay Paul

Not only do capital gains tax cuts not pay for themselves, but some of the increased realization of capital gains under a tax cut simply represents additional gaming of the tax system.[52] Some of the anticipated "increased revenue" from cutting the capital gains tax is actually money that would have otherwise been collected as income taxes.[53] Faced with a lower capital gains tax, many investors and business owners can choose to reward themselves with capital gains income instead of wage and salary or dividend income to take advantage of the new tax rates. Rather than generating new economic activity, this response to tax changes is simply gaming the tax system. Such "additional" capital gains tax revenues can hardly be counted as a "benefit" from cutting capital gains taxes.

Further gaming of the tax system not only may mask the cost of a tax cut, but also can hurt the economy. As economist Alan Auerbach has explained, "A tax cut that increases [capital gains] realizations through increased arbitrage actually may reduce efficiency…"[54] Cutting the capital gains tax lower than taxes on other types of income provides an incentive for investors to shelter income in ways that are tax-preferred, but less productive.

Conclusion

A capital gains tax cut in Oregon corporate and personal income taxes would disproportionately benefit the state's most economically comfortable residents. Economic benefits from such a tax cut are unlikely. Recent research finds that such tax cuts have limited impacts even at the federal level. An un-targeted state-level capital gains tax cut will have even less of an impact. In addition, over a quarter of the tax cut would not go to benefit Oregonians, but would leave the state for the federal government coffers in Washington. Thus, the tax cut would lead to a reduction in state government services in Oregon that is greater than the individual benefit that Oregonians would see in lower tax payments.

Endnotes.

[1] The bills dealing with capital gains taxes include: HB 3942, HB 2125, HB 3325, HB 2486, HB 3080, HB 2323, HB 2073, HB 2125, SB 468, HB 2555, HB 3695.

[2] See *Capital Gains in Oregon: Economic Effects of a Tax Cut*, William B. Conerly, Conerly Consulting LLC, A Report for The AOI Foundation, January 31, 2001, available at http://www.aoi.org/aoi-home/publications/news-rel/CapGains5.pdf, hereafter referred to as "the AOI/Conerly report."

[3] Special thanks to Matt Gardner of the Institute for Taxation and Economic Policy, Dean Baker, Co-director of the Center for Economic Policy Research, and Michael Mazerov of the Center on Budget and Policy Priorities for their help.

[4] The analysis of the distribution of capital gains taxes was calculated for the OCPP by the Institute for Taxation and Economic Policy using its micro-simulation model. Details on the ITEP model can be found on the web at www.ctj.org/itep.

[5] OCPP analysis of Legislative Revenue Office OTIM data, "The Oregon Tax Incidence Model," LRO Research Report Number 1-01.

[6] 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.

[7] Burman, Leonard and Peter Ricoy, "Capital Gains and the People Who Realize Them," *National Tax Journal*, 1997, no. 3, pg. 428.

[8] Burman, Leonard, The *Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed*, Brookings Institution, Washington, D.C., 1999, pg. 55.

[9] Congressional Budget Office, "An Analysis of the Potential Macroeconomic Effects of the Economic Growth Act of 1998," August 1998, page 9.

[10] Burman and Ricoy, "Capital Gains and the People Who Realize Them," *National Tax Journal*, 1997, no. 3, pg. 430.

[11] CBO, 1998, pg. 17.

[12] *State of Working America 2000-01*, Economic Policy Institute, pg. 269.

[13] *State of Working America*, pg. 267.

[14] *State of Working America*, pg. 268.

[15] Poterba, James, "Stock Market Wealth and Consumption," *Journal of Economic Perspectives*, Spring 2000, pg. 102. Though less important for capital gains, non-equity financial assets (including life insurance) are distributed a little more evenly than stock. The lowest-income 80 percent of American households own 14 percent of non-equity financial assets.

[16] 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, pg. 18. "Business" assets refer to all types of businesses except corporations with publicly-traded stocks.

[17] Burman, *Labyrinth*, pg. 147. Burman finishes his quote with the words "even when the data are examined over many years." Burman finds that single-year snapshot data are a suitable measure of the degree to which capital gains taxes disproportionately impact the rich.

[18] For taxpayers in the 15 percent income tax bracket, capital gains on assets held between one and four years are taxed at 10 percent and gains on assets held five or more years are taxed at 8 percent. Burman, *Labyrinth*, pg. 12.

[19]The Institute for Taxation and Economic Policy (ITEP) has estimated that the tax cuts in HB 67 and SB 2486 would cost $220 million annual after implemented in 2002. The Oregon Legislative Revenue Office (LRO) estimates that the in its first full year, the tax cuts in SB 67 and HB 2486 will cost $206 million. The tax cuts will grow rapidly in following years, reaching $311 million by 2007.

[20] Governor's proposed General Fund budget figures for 2001-03 are from the Governor's Budget.

[21]This deduction of state income tax from the federal personal income tax should be distinguished from Oregon's unusual deduction for federal income taxes from its state personal income tax.

[22] The share of the tax cut that will go back to the federal government in increased federal income taxes is calculated by ITEP.

[23] CBO 1998, pp 10-11.

[24] Even these low growth estimates are optimistic, however, since they depend on the assumption that the policy is revenue neutral. Because capital gains tax cuts do not pay for themselves, these models assume that a separate tax is enacted to replace the lost revenue from the capital gains tax cut. Without the additional revenue, deficit spending occurs, adding to the national debt and actually reducing economic growth in the long run.

[25] CBO 1998, pg. 11.

[26] The DRI model assumes that nominal interest rates remained fixed and that the tax cut roughly paid for itself. "By holding nominal interest rates fixed, DRI assumed that the central bank accommodated the greater demand for consumption and investment by creating more money and allowing the inflation rate to rise." The model also ignores the fact that one-half of capital gains producing assets are held in tax-exempt forms. CBO, 1998, pg. 17.

[27] CBO, 1998, pp. 17-18.

[28] It is standard practice in the capital gains literature for cuts from higher tax rates to produce larger responses. Gravelle, *Economic Effects of Taxing Capital Income*, pg. 144. Burman, *Labyrinth*, pgs. 62 and 148.

[29] See the next section for the discussion of the Gompers-Lerner study.

[30] Burman, *Labyrinth*, pg. 62.

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

[32] 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.

[33] Gompers, Paul and Josh Lerner, "What Drives Venture Capital Fundraising?" *Brookings Papers*: Microeconomics, 1998.

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

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

[36] 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.

[37] ODR/LRO pp. 10-11.

[38] Oregon Center for Public Policy, *Prosperity in Perspective*, 2000, pg. 8.

[39] Oregon's economic growth has been consistently strong even after accounting for population growth. See *Prosperity in Perspective*, OCPP, 2000, pg. 8.

[40] Supporting this interpretation of the research findings are some of the major contributors to the literature on capital gains, including Leonard Burman, Joel Slemrod, Jane Gravelle, and Alan Auerbach among others.

[41] Burman, *Labyrinth*, pg. 146.

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

[43] Slemrod, Joel and Jon Bakija, *Taxing Ourselves: A Citizen's Guide to the Great Debate over Tax Reform*, MIT Press, Cambridge, 2000, pg. 246.

[44] Slemrod and Bakija, *Taxing Ourselves*, pg. 126.

[45] Burman, Leonard and William Randolph, "Measuring Permanent Response," American Economic Review, 1994.

[46] Auten, Gerald, Leonard Burman, and William Randolph, "Estimation and Interpretation of Capital Gains Realization Behavior: Evidence from Panel Data," *National Tax Journal*, September 1989.

[47] Burman, "Why Capital Gains Tax Cuts (Probably) Don't Pay for Themselves," *Tax Notes*, 1990.

[48] Burman, *Labyrinth*, pg. 59.

[49] Gravelle, Jane, *The Economic Effects of Taxing Capital Income*, MIT Press, Boston, 1994.

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

[51] Burman, *Labyrinth*, pg. 58.

[52] While there is evidence that arbitrage does occur due to capital gains taxes being lower than taxes on other types of income, the extent of that arbitrage is not thought to be very great. Auerbach, Alan, Leonard Burman and Jonathan Siegel, "Capital Gains Taxation and Tax Avoidance: New Evidence from Panel Data," *Does Atlas Shrug? The Economic Consequences of Taxing the Rich*. Edited by Joel Slemrod, Russel Sage Foundation, New York, 2000.

[53] Auerbach, "Capital Gains Taxation in the United States: Realizations, Revenue, and Rhetoric," *Brookings Papers on Economic Activity*, 1988, pg. 596.

[54] Auerbach, 1988, pp. 621-22.