The Benefits for States of Reducing the Taxes on Capital Gains

Ike Brannon

Executive Summary:

The states have been buffeted by financial pressures over the last five years. The financial crisis and ensuing recession dramatically reduced revenue for nearly every state in the union, and the depth and severity of the downturn increased the costs of providing various welfare benefits and a host of other programs as well. At the same time, most states saw the costs associated with their public pension systems markedly increase just as the value of the pension assets fell precipitously.

The states responded first by attempting to staunch the revenue decline via various short-term revenue gimmicks, and then moved on to find ways to reduce spending. But few states considered ways to increase economic growth.

One possible way for states to boost economic growth is to reduce the tax burden levied on capital gains. Although proponents of higher capital gains taxes argue the tax is progressive, in reality it is possibly the worst way for a state to extract income from the wealthy. At the federal level the capital-gains tax deters savings and investment, which in turn lowers productivity and economic growth. At the state level, however, it also acts to reallocate investment from states with high capital-gains tax rates to states with low capital-gains rates, such as Florida or Texas.

Imposing a high capital-gains tax is especially costly for a state because the taxpayers with the most money to invest are also the most mobile cohort. A new retiree who sells off a successful business, for example, need not abandon the state to avoid capital gains taxes — merely living in another state for more than half the year will suffice, something that is hardly a burden for most rust-belt residents.

States need revenue, certainly, but they need to collect it in a way so as to, in the words of Jean Baptiste Colbert, extract the most feathers from the goose with the least hissing. Taxing capital gains income produces a lot of hissing for relatively few feathers. A state that abolishes taxation of capital gains can increase investment, employment, and economic growth with a relatively low opportunity cost.

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Introduction

Few would dispute the fact that our federal tax code is in need of reform. It does more to reward persistent lobbying and politically important industries than to encourage long-term economic growth. Since the historic tax reform act of 1986, the number of special deductions, exclusions, tax credits, and various and sundry other tax benefits has grown almost exponentially. The same problems with the federal tax code plague state tax codes as well.

The accretion of special tax breaks — either at the federal or the state level — is not necessarily, or even primarily, the result of corrupt politicians or powerful lobbying groups. Rather, it is the inevitable outcome of the organic political pressures that inevitably develop in an economy. The problem is that the benefits of economic growth — much like free trade — accrue to nearly everyone, albeit slowly and almost invisibly, at least from year to year. However, a provision that increases the tax breaks for a narrowly targeted industry can greatly impact its profitability — and unlike the populace at large, that industry is well aware of it and highly motivated to do something about it. Hence, a few vociferous backers of, say, timber harvesting, can successfully agitate for a tax break, and few if any of the citizenry can muster much effort to oppose it.

What would a pro-growth tax code look like? First and foremost, it would encourage investment and lightly tax the returns to capital, whether it be corporate income, dividends, capital gains, or any other form of what the Marxists like to call “unearned” income. This money was already taxed once when a worker received the money as wages from his employer. He paid the taxes due on his income and then saved it in some way, such as by investing in the stock of a company. The company used that money to expand its operations, or improve its productivity, or in some other way that increased profits.

The company then pays taxes on its profits — at an average combined tax rate of 39.3% at the Federal, state, and local levels, which is the highest rate in the OECD. What is left over after paying taxes can either be retained by the company and re-invested or else paid back to the shareholder — who must then pay a portion of that income back to the federal government — and in most places the state government as well.

No economist thinks this is a sensible way to run a tax code. There is a wealth of evidence suggesting that taxing capital income harms any economy by reducing economic growth. At the state level, the slowdown in growth is compounded by the ability of individuals to move to other states with lower or non-existent capital gains taxes.
Taxing Investment Deters Investment

A central question in any tax code is how to treat savings, since savings rates determine how much capital is available for investment, which in turn influences productivity and future economic growth. Glenn Hubbard and Jonathan Skinner⁵ have identified a variety of ways in which increasing savings rates benefits the economy, from increasing the size of the capital stock to improving household financial health and decreasing government welfare spending in the future. Yet the federal tax code is not especially kind to savings. About half of U.S. savings is not taxed immediately — money put into retirement accounts, health savings accounts, and various educational accounts compose most of this — but the other half faces a formidable tax rate, due in large part to federal and state capital-gains taxes.

An investor who uses after-tax income to invest is taxed again on any income derived from that investment in addition to any increase in the value of the investment itself. Former Treasury official Bruce Bartlett once argued that capital gains should not be taxed as a matter of principle, since they do not actually represent income, but rather the capitalized value of an income stream that has already been taxed.³ Regardless of principle, however, this double-taxation of capital income clearly decreases the return on investment and saving, and a wealth of economic research has established that individual saving levels are responsive to this rate of return. In particular, economists calculate high values for the “interest elasticity of saving,” which is the measure of the sensitivity of personal savings rates to the return on saving. Former Treasury Secretary Larry Summers, for example, studied the topic intently during his days as an academic economist and concluded that the interest elasticity of saving remains high under most realistic scenarios, suggesting that a 1% change in the rate of return to saving yields a change in saving greater than 1%.⁴ The implication is that increasing the rate of return to saving substantially increases saving.⁵

The economist Allen Sinai suggests that there are a variety of ways by which reductions in capital-gains taxes impact the economy.⁶ A capital-gains tax cut causes the after-tax return on equity to rise, increasing the demand for equity, which in turn raises stock prices, equity asset values, and household wealth and consumption. The flow of funds shifts toward investments in new enterprises, research and development, technology, and innovations in order to take advantage of the increased return on capital investment. The cost of equity decreases for companies looking to raise money, creating a shift away from debt and toward equity financing.

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³ Bruce Bartlett, “Why the Correct Capital Gains Tax Rate is Zero,” *Tax Notes* (September 1999).
The result of lower capital gains tax rates is higher production, greater output, and more jobs. A study by the Joint Economic Committee of Congress provides a wealth of evidence suggesting that decreasing capital-gains tax rates encourages capital formation and results in higher wages, rising living standards, and job creation in any economy.\(^7\)

A number of other studies show that decreasing capital gains taxes reduces inefficiency and encourages investment. Lowering capital-gains tax rates reduces economic distortions; because the investor only pays capital gains taxes once he sells an asset, he has an incentive to hold onto assets he would otherwise sell. Martin Feldstein, Joel Slemrod and Shlomo Yitzhaki find that corporate stock sales and the realization of capital gains are extremely sensitive to tax rates.\(^8\) In reviewing a variety of studies on the subject, Treasury economists Gerald Auten and Joseph Cordes note that virtually all of the studies find realizations of capital gains to be responsive to capital-gains tax rates.\(^9\) In addition to locking in assets, capital gains taxes alter the allocation of investments, encouraging investment in tangible assets not subject to the tax, or in the words of economist and author Bruce Bartlett, “illiquid, nonfinancial and nonproductive assets.”\(^10\)

A number of economists, such as Cristophe Chamley\(^11\) as well as Andrew Atkeson, V. Chari, and Patrick Kehoe,\(^12\) argue that the economically optimal tax rate on capital income (including capital gains) is zero.\(^13,14\) Atkeson, Chari, and Kehoe explain that a constant tax rate on capital income is the same as an ever-increasing tax rate on consumption, which leads to economic distortions that favor consumption in the present rather than in the future. Allen Sinai estimated that eliminating the national capital-gains tax would increase growth by roughly a quarter of a percentage point per year, create 1.3 million jobs, and improve productivity growth by 0.5 percentage points a year, which would be a 20% increase over its long-term average.\(^15\)

Chicago economist and Nobel Laureate Robert Lucas once opined that removing the taxes on capital gains and other capital income is the closest thing to a free lunch he has seen in this world. He estimated that our capital stock would be at least 50% greater without such taxes, with trillions of dollars of additional output, income, and tax revenue as well.\(^16\)

A Capital Gains Tax Destroys Wealth More than it Redistributes It

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\(^7\) “The Economic Effects of Capital Gains Taxation,” Joint Economic Committee (June 1997).


\(^13\) Atkeson, Chari, and Kehoe, “Taxing Capital Income.”

\(^14\) Chamley, “Optimal taxation.”

\(^15\) Sinai, “Capital Gains Taxes and the Economy.”

Given the importance of investment for creating economic growth, reducing the return on investment through capital taxation is a singularly harmful way of achieving other societal goals such as raising revenue or achieving progressivity in the tax code.

Arguing that a capital gains exemption goes solely to the wealthy and thus can be eliminated without any effects on the working class is extremely short-sighted, and it overlooks the fact that the savings of the wealthy — and middle class — capitalize businesses, enable economic growth, and ultimately create jobs. It also overlooks the fact that the wealthy are free to move to states with lower taxes, and do. For instance, a study by the Wisconsin Policy Research Institute17 shows that people and money are leaving the state of Wisconsin and that those who leave cite high taxes as a reason for doing so. What’s more, another Wisconsin Policy Research Institute Study found that those who left the state were concentrated among those who had science or technical degrees — precisely the people the state would most like to retain, and who are more likely to start a new business.18 A 2008 study from Princeton’s Woodrow Wilson School indicates that there is a strong inflow of low-income individuals to Wisconsin, and a large outflow of high-income individuals.19

The migratory outflow goes beyond the well-educated young college graduates: Thousands of Wisconsin retirees obtain housing in Florida and locate there for the requisite 183 days in order to make themselves Florida residents and thus avoid Wisconsin’s taxes. This outflow isn’t unique to the state — virtually all rustbelt states face a similar emigration (see table below).

### Migration Patterns of Midwestern States

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<th>Illinois</th>
<th>Indiana</th>
<th>Michigan</th>
<th>Ohio</th>
<th>Wisconsin</th>
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<td>9,711</td>
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</table>

Reduced capital-gains taxes alone aren’t enough to arrest this trend, but it would alter the calculus for a specific group of retirees — those who are most predisposed to actually investing in the state.

The Midwestern states all see themselves in competition to attract more “angel” investors — the sort of financier who has $20 to $50 million and has the business experience and the type A personality that make him want to do more than just put his money in an index fund and earn a market rate of return. This is someone who may have sold his successful business and be technically “retired,” but has every intention of continuing to be engaged in commerce.

The prototypical angel investor wants to make investments into companies he knows well, can interact with, and can contribute more to than just his capital. Because of this — and the ties of friends and family — the fact is that there is no real competition between Midwestern states for angel investors. The real competition for these investors and their money is, in reality, Florida.

A lower capital-gains tax rate won’t induce anyone to move from one state to another, but it will cause angel investors to think twice about where they invest and where they call their primary residency. If they know that their investment in a company will be taxed much more lightly in Wisconsin than elsewhere, they’ll be much more inclined to skip the pretense of moving to Florida and will keep their money and efforts in Wisconsin — to Wisconsin’s benefit.

A political problem with lowering the capital-gains tax rate, at least from the perspective of the liberals, is that a lower rate confers benefits to a relatively small group of taxpayers. Even so, if a primary goal of a tax code should be to transfer wealth from the wealthy to the rest of us, a high capital-gains tax does this spectacularly poorly. I argue most emphatically that the transfer of wealth should not be a primary, or even secondary, goal of the tax code. A tax code for any level should be designed first and foremost to acquire the revenue needed to fund the government at the least cost to society in terms of foregone economic growth. High capital-gains taxes, by deterring investment, are an especially costly way to raise revenue.

By no means should a tax code, whether at the state or the federal level, impose the same proportional burden on each taxpayer — such a code would be unpalatable to nearly every citizen regardless of their party. But taxing consumption, rather than capital, is a much better way to raise revenues in a progressive fashion while minimizing the negative impact on economic growth. There have been myriad proposals to do so via a progressive consumed income tax of the sort proposed by economists Alan Viard and Robert Carroll,20 which

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essentially collects taxes from individuals as they earn it but exempts all returns to saving from the tax base.

Reducing Capital-Gains Taxes Encourages Entrepreneurship

Capital-gains taxes deter saving and investment. Even more important from the perspective of a state, this tax also discourages entrepreneurial activity.

Economists have documented a variety of ways in which reductions in capital-gains tax rates make it easier for entrepreneurs to operate business. In particular, reducing capital-gains tax rates lowers impediments to risk-taking, reduces tax-induced distortions on the decisions of entrepreneurs, and makes it easier for small businesses to raise capital.

William Gentry, an economist at Williams College, notes that by taxing capital gains the government reduces upside returns to investment, but does not also commensurately mitigate the losses associated with projects that fail.\(^{21}\) This asymmetric treatment of potential profit and loss discourages risk-taking. The effect is particularly acute for entrepreneurs; unlike shareholders in publicly traded firms with diversified portfolios, entrepreneurs tend to invest largely in their own businesses, and therefore have fewer means to mitigate potential losses.

In addition to reducing the incentive to become an entrepreneur, capital-gains taxes make it difficult for an entrepreneur to make the best business choices. The incentive to lock in assets rather than face capital-gains taxes is larger for entrepreneurs than for the typical investor because their assets tend to be larger and more likely to be concentrated in a small number of assets. Taxing the capital gains of privately-held businesses means that owners are less likely to sell these businesses. The economists Ricardo Cavalcanti and Andres Erosa suggest that as a result, businesses may not be sold to those who could operate them most efficiently.\(^{22}\) Capital-gains taxes may also induce firms to remain privately held, which results in firms missing the opportunity to fully access capital markets and achieve growth opportunities by becoming a publicly traded entity.

Lower capital-gains taxes in a state mean that small businesses that do participate in an IPO can raise even more money. Unlike large firms, which can more easily raise debt or equity from tax-exempt or foreign investors, small firms are more likely to raise money from sources that face the capital-gains tax, such as taxable investors. This suggests that reducing capital-gains taxes can lower the cost of capital obtained through an IPO.\(^{23}\) David Guenther and Michael Willenborg find that a reduction in the capital-gains tax for small businesses in 1993 increased the share price for small businesses undergoing initial public offerings.

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Taxes on entrepreneurial assets are significant, amplifying the perverse incentives induced by capital-gains taxes. Gentry uses the Federal Reserve’s triennial Survey of Consumer Finance to show the importance of actively managed business assets in household portfolios. Previous work based on IRS data on capital-gains realizations, such as research by former Council of Economic Adviser member Alan Auerbach,24 gives the impression that entrepreneurial assets are a small part of the capital-gains tax base. Gentry documents that this in fact is not the case, pointing out that the total unrealized capital gains on active business assets are almost six times larger than the total unrealized capital gains on directly held stock.

A number of studies confirm that capital-gains taxes have a significant effect on entrepreneurial activity. Paul Gompers and Josh Lerner find that a reduction in capital-gains tax rates is associated with an increase in venture-capital funding in a state — consistent with the hypothesis that a lower capital-gains tax rate encourages entrepreneurs to obtain venture-capital funding to start their businesses.25 Gentry updates these findings and comes to the same conclusion, suggesting that capital-gains taxes reduce the volume of entrepreneurs who start businesses that seek external funding. Clearly, there is scope for tax policy to influence entrepreneurial decision-making.

Conclusion

States don’t set tax policy in a vacuum; they need to take into account what other states are doing. With regards to capital-gains taxes, it’s a mistake to think that neighboring states are the primary competitors: in reality, those who are impacted the most are not deciding between two neighboring states but whether or not to relocate to a jurisdiction with no capital-gains tax, such as Florida, Nevada, or Texas.

While the cohort with the ability and inclination to move is quite small, they can have a disproportionate impact on investment in the state. Keeping these people in the state and inducing them to invest in the state can have a large effect on not only investment but also income and economic growth as well.

From a populist perspective it can be a difficult sell, but it is important to realize that taxing capital investment is not only a costly way to collect revenue, in terms of the foregone growth that results from such a tax, but that the workers bear the brunt of all taxes on capital income. One of the first rules of economics is that the person who writes the check is never the same person who bears the burden, and nowhere is this truer than in the realm of capital taxation.

In the equity-efficiency tradeoff inherent in much of tax policy, capital-gains taxation achieves little of either.

BIBLIOGRAPHY


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