MBPC Montana Budget & Policy Center

Fact Sheet
03/18/2009

Ending Preferential Treatment of Capital Gains Income

Summary

The 61st Legislature is faced with the unenviable challenge of balancing the budget during a time of economic downturn and revenue uncertainty. Ending preferential treatment for capital gains income will offer fiscal security for Montana while restoring some of the progressivity of the Montana income tax system. Furthermore, extensive research shows that there is little connection between lower taxes on capital gains and higher economic growth, either in the short run or the long run.

> "Capital gains tax preferences are costly, inequitable, and ineffective. They deprive states of millions of dollars in needed funds, benefit almost exclusively the very wealthiest members of society, and fail to promote economic growth in the manner their proponents claim."
> --Institute on Taxation and Economic Policy [1]

Senate Bill 407 was More Expensive and Less Fair than Predicted at Passage.

At the time of passage, Senate Bill 407 was anticipated to cost the state of Montana $26 million in decreased revenue for tax year 2005. The Department of Revenue has reported that the actual cost was over $100 million. Furthermore, the tax relief provided by Senate Bill 407 was not distributed evenly across all income groups. Higher-income households received substantially more of the relief, and lower-income households received less of the relief, than had been predicted in 2003:

- Montana households making less than $65,000 (81% of all households) received just 7.2% of the total tax liability reduction, with an average tax reduction of $23 per household.
- Montanans with incomes between $60,000 and $75,000 received tax <u>increases</u> of more than $50.
- Montana households with incomes over $500,000 (.4% of all households) received almost half of the total tax liability reduction, with an average tax reduction of $30,499.

When the capital gains credit is analyzed independently, we find that:

- The top 20% of Montanans get 95% of the benefit of the preferential treatment of capital gains.
- Montana households with incomes over $200,000 represent 2% of total returns, but represent 81% of returns with capital gains.
- The primary assets of working Montanans are their homes and their retirement savings—neither of which are treated as capital gains when they are sold. (The first $500,000 in profit from the sale of a primary residence is exempted from taxation at both the federal and state level.)

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Taxes on the Households Affected will not Increase by the Total Amount of the Fiscal Note.
Nine percent of the increase in state taxes will be offset by a reduction in federal taxes.[1] State taxes are deductible for those who itemize on their federal income taxes. Therefore, any increase in state taxes is partially offset by a decrease in federal taxes.

Economic Arguments Support Ending Preferential Treatment for Capital Gains.
Numerous economic studies have shown that there is little connection between favorable treatment for capital gains and economic growth.[2-5] MBPC's own analysis of the effects of SB 407 on multiple measures of economic growth in Montana found that SB 407 did not expand the Montana economy.

Particularly when compared to other methods of generating economic growth, preferential treatment for capital gains falls short. Mark Zandi of Moody's Economy.com found that $1 used to give preferential treatment would only generate $.36 in increased GDP. In comparison, $1 used to improve infrastructure or extend unemployment benefits would generate $1.50 in additional GDP.[5]

Furthermore, the capital gains credit threatens to distort how economic decisions are made. For example, the capital gains credit creates favorable treatment for investment in capital over investment in labor, even when the latter may be more productive. As a method of stimulating the *Montana* economy, the capital gains credit is particularly inefficient because it creates preferential treatment for all capital gains income regardless if the capital investment happened in Montana. In other words, creating preferential treatment for capital gains income in Montana does not necessarily lead to increased investment in Montana capital or the Montana economy.

Sources Cited

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