MBPC
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As a result of the Great Recession state revenues in Montana, like all other states, are plummeting, and important public services like health care and education are facing cuts. The governor has already cut over $40 million from state programs, and the nonpartisan Legislative Fiscal Division estimates that the next legislature may face a $370 million deficit. Montana deserves a balanced approach to this revenue crisis that looks not just at dramatic and harmful cuts to public services, but also targeted efforts to increase revenue. This brief is one in a series of MBPC reports that explores potential policies to raise revenue in the state.

Capital Gains Tax Reform Will Strengthen Montana

In 2003, the Montana legislature passed a capital gains credit that benefits a very narrow part of our population, at the expense of public programs from education to health care. Montana is one of just nine states offering a significant tax break for capital gains income.

This tax break has proven to be unaffordable, is unfair to Montanans who earn income through wages, and has not helped the economy. In fact, if it is allowed to continue, it may actually harm Montana's economy. The tax credit costs the state of Montana tens of millions of dollars in revenue each year and is one of the rarely discussed factors contributing to Montana's current revenue crisis. This reduction in revenue jeopardizes our investments in schools, families, and communities all across this state. With Montana facing the potential of severe and damaging cuts to public programs, services and infrastructure, it's time to take a hard look at the usefulness of this costly tax break that mostly benefits the wealthiest Montanans.

> **"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

Key Findings

- The capital gains credit lowers the effective tax rate for people who make money from investments, compared to those who earn income from wages. This creates a tax system that favors wealth over work.
- Sixty-two percent of the capital gains credit goes to the richest 1% of taxpayers (who make over $400,000 per year), and 95% goes to the richest 20% of taxpayers in Montana.
- The capital gains credit hurts funding for services like education, health care, and environmental protections by reducing state revenue. The credit is expected to cost Montana $34 million in 2012.
- Tax credits cost the state much like spending on services do. However, unlike the cost of spending on public services, the cost of the capital gains credit to the state is difficult to predict and impossible to control.
- Economic theory and experience teach us that treating capital gains more favorably than wages will not help the economy and may actually prevent growth in the short-term by forcing state budget cuts.
- Rolling back the capital gains tax break would restore revenue to support growth-oriented public investments, like education, work supports, and infrastructure improvements.

What are Capital Gains?

Capital gains are profits from the sale of stocks, bonds, investment real estate, art, antiques, or other assets. These profits are usually not taxed until they are "realized," that is, until the asset is sold. This means that a stock or vacation home can become more and more valuable, but the investor will not pay income taxes on the appreciation of that asset until she sells it. The capital gains are calculated by taking the difference between the original purchase price and the sale price.

How Does Montana Treat Capital Gains?

In 2003, the legislature passed Senate Bill 407, which created the capital gains credit along with some other tax cutting provisions. The credit reduced effective rates on capital gains by giving a nonrefundable credit on capital gains of 1% in 2005 and 2006 and 2% starting in 2007.

In addition to the capital gains credit, SB 407 reduced taxes for the wealthiest Montanans and shrunk state revenue primarily by:

- Reducing the number of tax brackets from 10 to 6.
- Lowering the top bracket rate from 11% to 6.9%.
- Reducing the income level at which the top rate is effective from $82,400 to $13,900.

Both the federal and Montana tax codes give capital gains income preferential treatment. The federal government taxes capital gains at much lower rates than earned income.[1] For tax year 2012, capital gains will be taxed at a maximum of 20% federally, compared to a maximum rate of 39.6% for earned income. Montana is one of only nine states that offers capital gains tax breaks to supplement the already sizeable tax reduction granted by the federal government.

Tax Fairness

Preferential treatment for capital gains income has created a tax system that favors wealth over work. Individuals with incomes from wages pay higher tax rates than people whose income comes from growth in assets.

Figure 1 illustrates the different taxes paid by two individuals with the same amount of income: a firefighter who earned income of $41,171 and an investor who sold stock with the same amount of appreciation.[2] The investor's taxes are over 40% less than the firefighter's. The capital gains credit reduces the investor's tax bill by $823. The firefighter pays $1,931 in state income taxes while the investor pays $1,107.

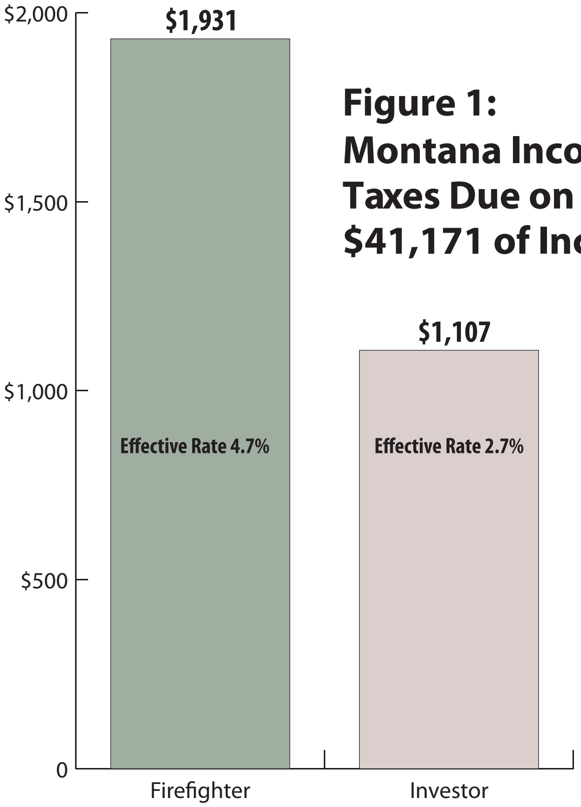

Figure 1: Montana Income Taxes Due on $41,171 of Income

Source: Montana Department of Labor and Industry and Montana Department of Revenue

Only a small number of Montanans can take advantage of the capital gains credit (See Figure 2 on the next page). Sixty two percent of the credit goes to the richest 1% of taxpayers, and 95% goes to the richest 20%.[3] The other 80% of taxpayers only receive 5% of the credit's benefits. Middle and lower income Montanans do not benefit from the capital gains credit because they are much more likely to earn their income on the job, rather than through large sales of assets. Furthermore, the assets owned by most Montanans—primary residences and retirement funds—are generally not treated as taxable capital gains when they are sold.[4]

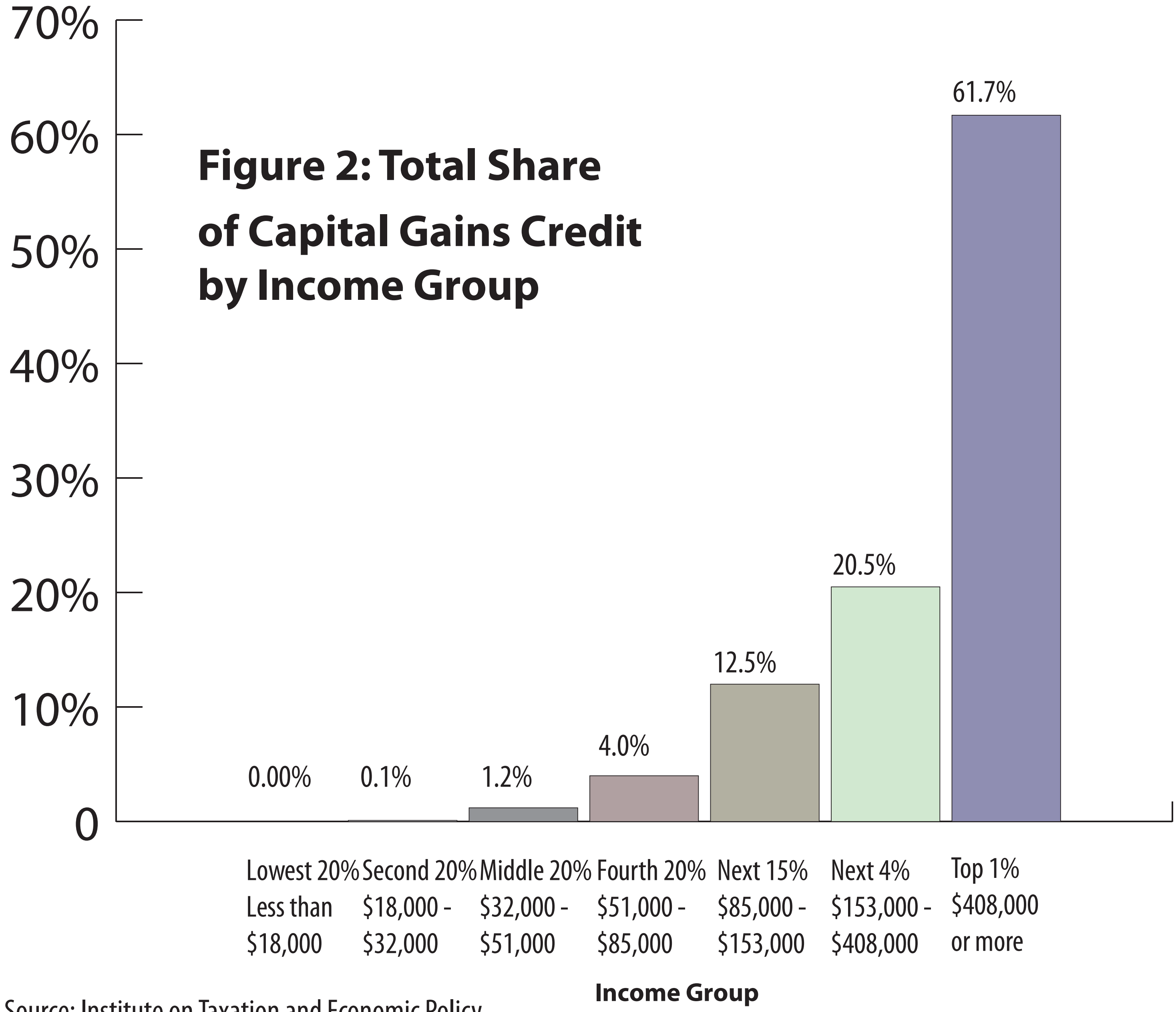

Figure 2: Total Share of Capital Gains Credit by Income Group

Source: Institute on Taxation and Economic Policy

Montana Cannot Afford the Capital Gains Credit

The capital gains credit has proven to be unaffordable and hurts our ability to fund crucial services like education, health care, and environmental protections. When SB 407 passed, the legislature expected the bill to cost $26 million in 2005, the year its provisions went into effect.[5] In fact, the combined cuts in SB 407 cost the state $100 million in 2005.[6] The capital gains credit alone is expected to cost $34 million in 2012.[7]

Tax credits cost the state much like spending on services do. However, unlike the cost of spending on public services, the cost of the capital gains credit to the state is difficult to predict and impossible to control. For example, when Montana decides to invest in higher education, the legislature limits the amount the state contributes to universities, community colleges, and technical training centers. In contrast, the full cost to the state of the capital gains credit depends solely on individuals' decisions to buy or sell assets and is therefore effectively unlimited.

When Montana had a budget surplus, we could arguably absorb the revenue lost by the credit. However, as the effects of the Great Recession come to bear, Montana's revenue situation continues to worsen. Reports indicate that Montana may face a budget gap of hundreds of millions of dollars in the next budget cycle, and we can no longer afford to absorb the losses created by the capital gains credit.[8]

Why Montana Should Treat Capital Gains Like Other Kinds of Income

Economic theory and experience indicate that treating capital gains more favorably than earned income will not help the economy grow, and may actually prevent growth in the short-term by forcing state budget cuts. In contrast, rolling back this tax break would restore revenue to help support growth-oriented public investments, like education, work supports, and infrastructure improvements.

In addition, the capital gains credit creates preferential treatment for all capital gains income regardless if the capital investment happened in Montana or elsewhere. Creating preferential treatment for capital gains income in Montana does not lead to preferences for capital in Montana. In fact, taxpayers can claim the credit when they sell stock for a company that did not have any activity in the state.

Furthermore, the capital gains credit favors investment in capital over investment in labor, creating potential distortions in investment decisions. In March 2010, Montana recorded the highest unemployment rate in 23 years.[9] We cannot afford policies that might further reduce investment in human capital.

To make matters worse, Montanans don't get the full benefit of the credit. Rather, the state credit leads taxpayers to pay less to Montana and more to the federal government. Because state income taxes are deductible on federal tax returns, when taxpayers pay less to the state, they pay more to the federal government. In the case of Montana's capital gains credit, 14% of the tax benefit goes directly to the federal government.[10] Although the credit costs the state $34 million, taxpayers' bills are only reduced by $29 million.

Why Montana Needs to Restore Revenue Lost from the Capital Gains Credit

The capital gains credit is contributing to declining revenues in the state spurred on by the current recession. Without intervening action by the legislature, the revenue crisis will result in cuts to public programs, services, and infrastructure that can further harm our already weak economy. Basic economics demonstrates that carefully chosen tax increases are preferable to spending cuts when the economy is weak.

Nobel Prize winning economist Joseph Stiglitz and Peter Orszag, now the director of the federal Office of Management and Budget, have weighed in on the issue of state spending during a recession. In the midst of the last recession they wrote that spending cuts could be more harmful for a state's economy during a recession than tax increases.

"[E]conomic analysis suggests that tax increases would not in general be more harmful to the economy than spending reductions. Indeed, in the short run (which is the period of concern during a downturn), the adverse impact of a tax increase on the economy may, if anything, be smaller than the adverse impact of a spending reduction, because some of the tax increase would result in reduced saving rather than reduced consumption."[11]

Stiglitz recently reiterated his insight in a letter to New York Governor David Paterson, who is facing significant budget challenges.[12] Over 200 economists signed a similar letter addressed to state governors and legislators across the nation.[13]

Furthermore, decreasing the quality of education, job training, and health and human services decreases the strength of our human capital. Companies now research the entire country for places to set up operations. When they see a state with poorly trained workers and a crumbling infrastructure, they usually look elsewhere. We need to attract investment more than ever, and we don't want to be overlooked because we didn't invest in our communities.

Numerous economic studies have shown that there is little connection between favorable treatment for capital gains and economic growth in either the short or long run.[14] Particularly when compared to other methods of generating economic growth, preferential treatment for capital gains falls short.

Here are just a couple of examples:

- Mark Zandi of Moody's Economy.com studied the federal budget and found that $1 used to give preferential tax treatment would generate $.36 in increased GDP. While $1 used to improve infrastructure or extend unemployment benefits would generate $1.50 in additional GDP.[15]

- In an extensive review of the literature on state economic growth policies, Robert Lynch found little evidence to support the claim that tax cuts lead businesses to relocate to a state. Instead, it is much more important that adequate revenue is available to pay for infrastructure improvements that have a more direct tie to economic growth, such as investments in an educated workforce, good roads, public health and safety.[16]

- Our own study of the effects of SB 407 on economic growth in Montana found that the tax breaks did not lead to improvements in the economy (see Appendix for details).

Conclusion

Since the capital gains credit passed in 2003, it has cost Montana over a hundred million dollars that could have been invested in schools, families, and communities all across this state. Only a small percentage of Montanans have benefited from the credit; 62% of the benefit went to the 1% of families making over $400,000 per year, and 82% of the benefit went to the 5% of families making over $153,000 per year.

Even if the economy and state revenues were robust, continuing preferential treatment for capital gains income would be unfair to Montanans who earn their income through wages and salaries. With the economic crisis hampering our ability to fund job-creating programs and services, we can no longer afford such a costly credit that benefits so few Montanans.

Taxing investment income like we tax income from wages will bring revenue back to our state, helping us to create jobs and protect our land, people, and the services that make them stronger.

Appendix

Determining Effects of Policy on Economic Growth

In order to determine if a policy change has affected economic growth, it is not sufficient to see if the economy grew after the policy was implemented. The economy may have grown without the policy implementation. Likewise, a decline in the economy is not sufficient to say a policy has hurt the economy. The economy may have declined even further without the policy change.

The key to determining the effect of a policy change is to estimate how the economy would have grown without the policy change and see if the actual growth is significantly different than what would have been expected.

In the case of SB 407, the income tax provisions were implemented in two stages. The income tax bracket and rate changes were effective for tax year 2005. The capital gains credit was phased in at 1% in 2005 and increased to 2% in 2007 and beyond. Using regression analysis, we estimated the effect of the tax law changes on five measures of economic growth controlling for growth across the country and the faster economic growth occurring in the mountain states. Regression analysis is a statistical tool that allows us to isolate the effects of the implementation of the capital gains credit.

We found no evidence that the capital gains credit has helped the state economy, as measured by Montana's unemployment rate, income per capita, jobs, wages or gross state product after either the initial implementation of the credit in 2005 or the full implementation in 2007.

The following table shows the coefficients for each equation.

Coefficients Generated by Regression Analysis

		Growth in GSP Coefficients	Growth in Jobs Coefficients	Growth in Wages Coefficients	Growth in Per Capita Income Coefficients	Growth in Unemployment Rate Coefficients
Percent change for US	Controlling for growth across the US will help isolate growth.	0.9306054	0.9972761	0	0.9522244	0.9782426
Mountain State?, 1- yes, 0=no	This variable was included because the mountain states have recently had faster economic growth than the rest of the nation.	0.0170447	0.0146641	0	0	0
Montana?, 1= yes, 0=no	This variable was included to indentify if Montana was simply growing faster than other states, before and after the change.	0	0	0	0.0183861	-0.1335893
2005 or after?, 1=yes, 0=no	This variable was included to identify if there was a change for all states after 2005.	0	0	0.0059236	-0.0050425	0
2007 or after, 1=yes, 0=no	This variable was included to identify if there was a change for all states after 2007.	0	0	0.0056168	0	0
After initial implementation?, 1=yes, 0=no	This variable was included to indentify if the initial implementation of the capital gains credit had an effect.	0	0	0	0	0
After complete implementation?, 1=yes, 0=no	This variable was included to indentify if the complete implementation of the capital gains credit had an effect.	0	0	0	0	0
Intercept	Initial starting level.	0	0	0.0221804	0.0059126	0

Coefficients are reported as 0 if they are not significantly different than 0 at the 95% confidence level.

Endnotes

1. In order to receive preferential treatment federally and in Montana, the asset must be held at least one year.

2. $41,171 is the average annual wage in Montana for fire fighters. Montana Department of Labor and Industry.

3. Institute on Taxation and Economic Policy. 2010. *Impact of repealing Montana's capital gains tax credit*.

4. ________. 2009. *A capital idea: Repealing state tax breaks for capital gains would ease budget woes and improve tax fairness*. Washington, DC.

5. The capital gains credit was 1% for 2005 and 2006 and 2% for 2007 and beyond. Legislative Fiscal Division. 2003. *Fiscal note: Sb0407*. Helena.

6. Montana Department of Revenue. 2006. *The revenue and taxpayer impacts of the income tax provisions of SB 407*. Helena.

7. Institute on Taxation and Economic Policy. 2010. *Impact of repealing Montana's capital gains tax credit*.

8. Legislative Fiscal Division. 2010. *Preliminary budget outlook for the 2013 biennium*. Helena.

9. Bureau of Labor Statistics, *Local Area Employment Statistics*, www.bls.gov.

10. Institute on Taxation and Economic Policy. 2010. *Impact of repealing Montana's capital gains tax credit*.

11. Orszag, Peter and Joseph Stiglitz. 2001. *Budget cuts vs. Tax increases at the state level: Is one more counter-productive than the other during a recession?* Washington, DC: Center on Budget and Policy Priorities.

12. Stiglitz, Joseph. 2008. Letter to New York Governor David A. Paterson, New York Senate Majority Leader Joseph l. Bruno, and New York State Assembly Speaker Sheldon Silver.

13. "Economists letter" http://www.montanabudget.org/sites/default/files/reports/Economist%20 letter%20press%20release.pdf

14. Congressional Budget Office. 2002. *Economic stimulus: Evaluating proposed changes in tax policy*. Washington DC, Burman, Leonard and Tony Kravitz. 2005. *Capital gains tax rates, stock markets, and growth*. *Tax Notes*, Ettlinger, Michael and John Irons. 2008. *Take a walk on the supply side*. Washington DC: Center for American Progress, Zandi, Mark. 2009. *Testimony before the U.S. House of Representatives Committee on the Budget*. Moody's Economy.com.

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