Capital Gains Tax Credit
Valuing Wealth Over Work in Montana
March 2013

In 2003, the Montana Legislature passed a capital gains tax credit that benefits a very narrow portion of our population at the great expense of our collective ability to adequately invest in public programs, from education to health care. Currently, Montana is one of just nine states offering a significant tax break for capital gains income. Since 2003, this tax break has proven to be unaffordable, unfair to working-class Montanans, and has not helped the economy. In fact, the tax credit costs the state tens of millions of dollars in state revenue each year. This reduction in revenue jeopardizes our collective ability to invest in schools, families, and communities all across this state. It's time to take a hard look at the usefulness of this costly tax break that predominantly benefits the wealthiest Montanans.

Key Findings

- The capital gains credit lowers the effective tax rate for individuals who make money from investments compared to those who earn income from wages.
- Montana is one of only nine states that offer capital gains tax breaks to supplement the already sizeable tax reduction granted by the federal government.
- Ninety-four percent of the credit goes to the richest 20% of taxpayers in Montana. Middle and lower income Montanans rarely benefit from the capital gains credit because they are much more likely earn their income on the job, and not through investments.
- The capital gains credit has proven to be unaffordable, and it limits our ability to fund services like education, health care, and clean air and water.
- Rolling back the capital gains tax break would free up new revenue to support growth-oriented public investments, like education, work support, and infrastructure improvements.
- 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.

What Are Capital Gains?

Capital gains are profits from the sale of stocks, bonds, 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 taxes on the appreciation of that asset until it is sold. The capital gains are calculated by taking the difference between the original purchase price and the price at the time of sale.

How Does Montana Treat Capital Gains?

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

Both the federal and state 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 2013, capital gains will be taxed at a maximum of 20% federally, compared to a maximum rate of 39.6% for earned income.

Tax Fairness

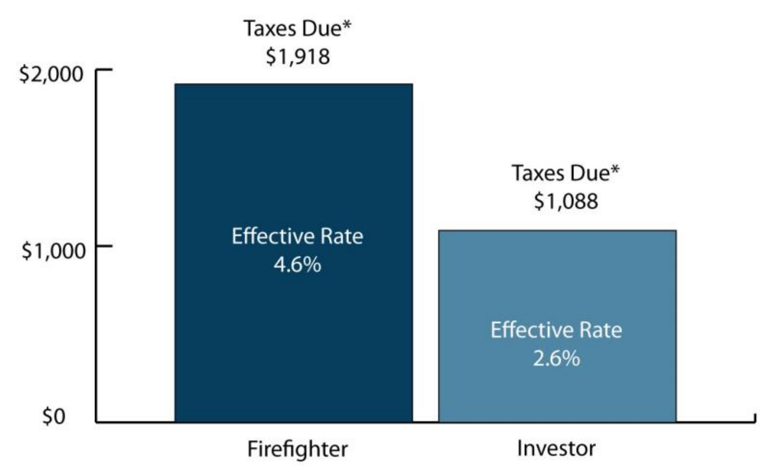
Preferential treatment of capital gains income has created a tax system that favors wealth over work. Capital gains tax breaks mean individuals with incomes from wages pay higher tax rates than people whose income comes from growth in assets.

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 ten to six.
- 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.

Chart 1 illustrates the different taxes paid by two individuals with the same amount of income: a firefighter who earned income of $41,520 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 $830. The firefighter pays $1,918 in state income taxes, while the investor pays $1,088.

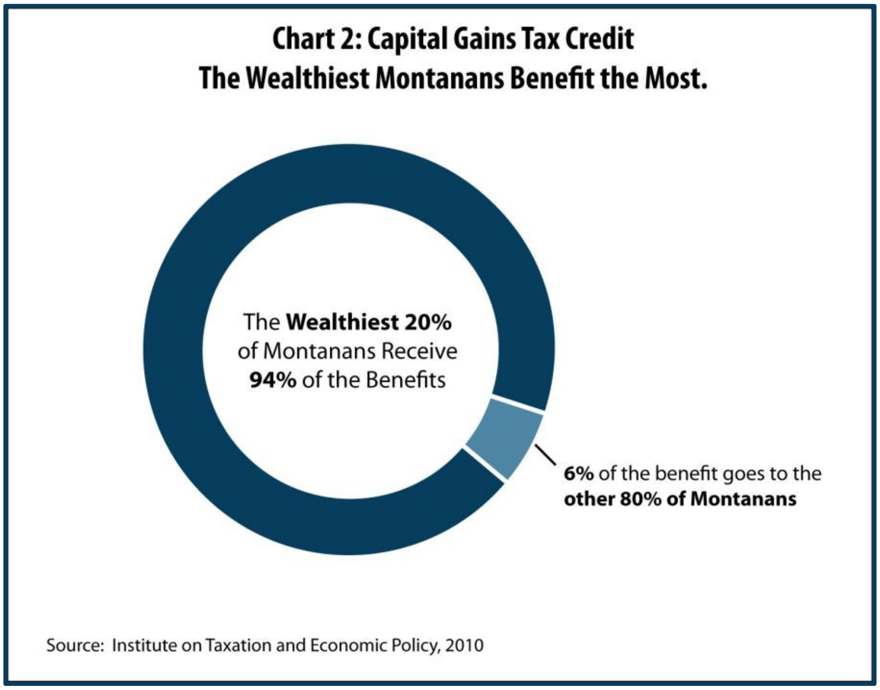
Chart 1: Capital Gains Tax Credit Values Wealth Over Work



** Montana Income Taxes Paid on $41,520 of Income*

Source: Bureau of Labor Statistics and Montana Department of Revenue

Only a small number of Montanans can take advantage of the capital gains credit (Chart 2). Ninety-four percent of the credit goes to the richest 20% of taxpayers.[3] The other 80% of taxpayers only receive six percent of the credit's benefits. Middle- and lower-income Montanans do not benefit from the capital gain credit because they are much more likely to earn their income on the job rather than through large sales of assets. Furthermore, the most common assets owned by most Montanans—houses and retirement funds—are generally not treated as taxable capital gains when they are sold.[4]



Montana Cannot Afford the Capital Gains Tax Credit

The capital gains credit has proven to be unaffordable and hurts our ability to fund services like education, health care, infrastructure, and clean air and water. 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 does; giving people who sell assets a tax break means the state collects less money. 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 of the capital gains credit to the state depends solely on individuals' decisions to buy or sell assets, and is therefore effectively unlimited.

Why Montana Should Treat Capital Gains Like Other Types 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 support, and infrastructure improvements.

Furthermore, the capital gains credit favors investment in capital over investment in labor, creating potential distortions in investment decisions. As Montana's workforce slowly rebuilds from the recent recession, we cannot afford policies that might further reduce investment in human capital.

In addition, Montana's capital gains credit does not distinguish between in-state or out-of-state capital investments and therefore does not create incentives to invest in Montana. In fact, taxpayers can claim the credit when they sell the stock of a company that has never done business in our state.

> *"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

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.[8] Although the credit costs the state $34 million, taxpayers' bills are only reduced by $29 million. In other words, five million dollars that was lost to the state is now paid in federal income taxes.

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

Now, more than ever, Montana needs to invest in ways that build our workforce and our economy. 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 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.[9] Particularly when compared to other methods of generating economic growth, preferential treatment for capital gains falls far short. Here are just a couple of examples:

- Mark Zandi of Moody's Analytics studied the federal budget and found that $1 used to give preferential tax treatment would generate $0.36 in increased GDP. While $1 used to improve infrastructure or extend unemployment benefits would generate $1.50 in additional GDP.[10]

- Robert Lynch, in an extensive review of the literature on state economic growth policies, 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: an educated workforce, good roads, public health and safety.[11]

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

Conclusion

Since its passage in 2003, the capital gains credit has cost Montana hundreds of millions of dollars that could have been invested in schools, families, and communities all across this state. Only a small percentage of Montanans benefited; 94% of the benefit went to the 20% of families making over $80,000 per year, while only six percent of the benefit went to the other 80% of families. Continuing preferential treatment for capital gains income is unfair to hardworking Montanans who earn their income through wages and salaries. We can no longer afford such a costly credit that benefits so few Montanans.

Taxing investment income like we tax income from wages will help 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 aspects 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 coefficients that represented time after implementation were all not significantly different than zero.

The table on the following page 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 identify 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 identify 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 identify 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.						

[1] In order to receive preferential treatment federally and in Montana, the asset must be held at least one year, known as long-term capital gains.
[2] $41,520 is the average annual wage in Montana for fire fighters.
[3] Institute on Taxation and Economic Policy. 2011. *Impact of repealing montana's capital gains tax credit*.
[4] ITEP. 2011. *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. Governor's Office of Budget and Program Planning. 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. 2011. *Impact of repealing montana's capital gains tax credit*.
[8] Institute on Taxation and Economic Policy. 2011. *Impact of repealing montana's capital gains tax credit*.
[9] 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 us house of representatives committee on the budget*. Moody's Economy.com.
[10] Zandi, Mark. 2009. *Testimony before the us house of representatives committee on the budget*. Moody's Economy.com.
[11] Lynch, Robert. 2004. *Rethinking growth strategies: How state and local taxes and services affect economic development*. Washington, DC: Economic Policy Institute.