



Taxation of Capital Gains Income

Jon Peacock, updated June 22, 2009

Wisconsin is one of nine states that provide a broad tax break for capital gains. That tax exclusion has become a key budget issue after the state Senate voted on June 17 to eliminate the tax break for such income, in lieu of creating a new oil company tax. The Governor and Assembly recommended smaller changes than the Senate relating to capital gains taxation, and the issue will have to be resolved in upcoming budget negotiations.

The following issue brief provides some basic information relevant to the debate about taxing capital gains.

How would the budget bill change taxation of capital gains?

Under current Wisconsin law, 60 percent of the net income gained from selling assets is exempt from state income taxes. The Governor proposed reducing that tax break to a 40 percent exclusion, and the Joint Finance Committee and Assembly accepted the Governor's proposal, which would generate about \$170 million in the 2009-11 biennium.

The Senate bill would eliminate the current 60 percent exclusion for capital gains. As a result, capital gains would be taxed the same as wages and most other income. That change would generate an estimated \$315 million more than the Governor's proposal. The Senate bill uses \$260 million of that additional revenue to fund transportation spending, replacing the \$260 million oil company assessment that was recommended by the Governor and (in a somewhat different form) by the Assembly.

How does Wisconsin compare to other states in taxing capital gains?

Wisconsin is one of only nine states with an income tax system that provides a broad

exemption for capital gains income, though some other states offer targeted exemptions (often focused on assets located in the state). Among the nine states, Wisconsin's 60 percent exclusion is the largest.¹ The other eight states, which account for only 4.6 percent of the U.S. population, are: Arkansas, Hawaii, Montana, New Mexico, North Dakota, Rhode Island, South Carolina, and Vermont (which just eliminated most of its capital gains tax break²).

A March 2009 analysis by the Institute on Taxation and Economic Policy (ITEP) found that in the nine states with "substantial" capital gains tax breaks, those provisions together reduced taxes by an estimated \$663 million in 2008.³ Wisconsin's tax break for capital gains accounted for 43 percent of that total.

Who benefits from the exclusion of capital gains income?

LFB data indicate that the top 1.9 percent of Wisconsin tax filers – those with incomes of \$200,000 or more – get 51 percent of the benefit of the capital gains exclusion. The bottom 67 percent, those with adjusted gross income under \$50,000, get only 15 percent of the benefit.⁴

How does the capital gains exclusion affect a taxpayer's total state and federal taxes?

Although the capital gains exclusion reduced Wisconsin tax collections by an estimated \$285 million in 2008, the net tax break for Wisconsin was smaller. That's because the reduction in state income taxes also reduces the amount taxpayers can deduct from their income for federal tax purposes. Taking that factor into account, the Institute on Taxation and Economic Policy estimated that Wisconsin's 60 percent exclusion increases the federal taxes owed by Wisconsin taxpayers by about \$50 million. So the net benefit for mostly high income taxpayers

was \$235 million, while the other \$50 million from the state tax break left the Wisconsin economy.

Would taxing capital gains slow economic growth?

In light of the fact that relatively few other states treat most capital gains differently than ordinary income, it's a stretch to argue that eliminating the exclusion would make Wisconsin uncompetitive. Of course, almost any tax increase or spending cut will take money out of the economy and could be said to dampen economic growth. But since spending cuts and/or tax increases are currently unavoidable, one needs to look at the relative pluses and minuses of the different options. During a recession, spending cuts typically have a larger and more immediate negative effect on the economy, whereas tax increases on the wealthy, who save much of their income, generally have a much smaller effect.⁵

At the national level, Mark Zandi, the Chief Economist of Moody's economy.com, analyzed a wide range of options Congress might consider for alleviating the current recession. He concluded that each dollar spent by the federal government to make President Bush's capital gains and dividend tax cuts permanent would boost the nation's Gross Domestic Product (GDP) by just 38 cents. He calculated that spending measures such as increasing food stamp benefits, boosting infrastructure spending and increasing unemployment benefits would each yield a return of more than \$1.50 in increased GDP per dollar spent.⁶

At the state level, the argument that state tax income cuts like a capital gains exclusion will

help the economy (or tax increases will hurt it) is further weakened by the interrelationship between state and federal income tax laws. As noted above, Wisconsin's \$285 million tax break for capital gains resulted in increased federal tax payments of about \$50 million in 2008, taking those funds out of Wisconsin. Conversely, if the state removes the current exclusion, the total tax increase is reduced by increased itemized deductions on federal returns, which mitigates the economic effect. (That mitigating effect does not apply to increases in sales or excises taxes that aren't deductible on federal returns.)

How do the economic effects of the Senate and Assembly tax proposals compare?

The Senate's capital gains tax proposal is an alternative to generating roughly \$260 million over the next two years through an oil company franchise tax. Comparing the economic effects of removing the capital gains exclusion with the effects of an oil company tax is difficult because it depends to some degree on whether the oil tax is passed on to consumers. The Governor's proposal seeks to preclude that, but many people argue that the anti-pass through provision he proposed would not be enforceable, and the Assembly removed that provision from the bill. As a result, the Assembly budget bill would create a tax that would be spread over all consumers, and it would have a much more direct and rapid effect in taking dollars out of the local economy than a tax on capital gains.

Of course, both the Senate and Assembly plans spend the dollars raised, which has the positive economic effects cited by Mark Zandi.

¹ Legislative Fiscal Bureau, Budget Paper #557, May 27, 2009. <http://www.legis.state.wi.us/lfb/2009-11Budget/Budget%20Papers/356.pdf>

² Vermont passed legislation in June 2009 ending its 40% capital gains exclusion and replacing it with a flat exemption that provides much less of a tax break for higher income taxpayers.

³ Institute on Taxation and Economic Policy, *A Capital Idea: Repealing State Tax Breaks for Capital Gains Would Ease Budget Woes and Improve Tax Fairness*, March 2009. http://www.itepnet.org/A_Capital_Idea.pdf

⁴ Wisconsin Budget Project analysis of the data in Table 4 in LFB Budget Paper #557.

⁵ Peter Orszag and Joseph Stiglitz, "Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive than the Other during a Recession?" Center on Budget and Policy Priorities, revised November 6, 2008 <http://www.cbpp.org/archiveSite/10-30-01sfp.pdf>.

⁶ Mark Zandi, testimony before the US House of Representative Committee on the Budget, January 27, 2009.