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BALANCED BUDGET TALKING POINTS #8: HOW A CAPITAL GAINS TAX CUT WOULD BOOST STATE REVENUES

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The vetoed congressional budget plan would significantly cut effective taxes on capital gains, both for individuals and for businesses. The Heritage Foundation estimates that this important tax cut could cause millions of taxpayers to declare billions of dollars in capital gains during the first year of the lower effective rates. Because 40 states require taxpayers to report all capital gains declared on their federal tax forms, this sudden growth in capital gains may create a one-year state income tax windfall of $9.5 billion.

If taxpayers were to "unlock" appreciated assets during the first year of lower capital gains taxes under the congressional budget plan, states that tax capital gains would likely see their income tax revenues increase by an average of 11.6 percent.

Some states might experience an especially high one-time percentage increase in their income tax receipts. For example:

State	Percent Increase in Income Tax Revenues
California	16.01%
Connecticut	21.28%
Iowa	18.92%
New Mexico	27.28%
Ohio	12.24%

The reason for this state tax "windfall" actually is quite simple. Reducing the tax rate for capital gains actually increases tax revenues from taxpayers who own appreciated assets. Experience over the last 25 years with changes in capital gains tax rates strongly indicates that rate decreases produce more declarations of capital gains and more capital gains taxes. Owners of appreciated assets who face high tax rates generally hold on to or "lock up" their assets in anticipation of lower future rates. When the rates come down, the amount of capital gains declarations goes up.

Economists estimate that trillions of dollars in unrealized or "locked up" capital gains (perhaps has high as $7.5 trillion) exists in the portfolios of American taxpayers.[1] Some economists have estimated that significant capital gains rate changes could produce substantial economic benefits and create revenue windfalls for federal and state governments.[2] In an article last year for the *American Economic Review*, Leonard Burman and William Randolph, two leading tax economists on the staff of the Congressional Budget Office, estimated the response of taxpayers to rate reductions as being in the order of 6 to 1. That is, for every one percent drop in the rate, capital gains realizations rose by 6 percent.[3]

The accompanying table shows three different state "windfall" scenarios, representing the range of expert opinion on how declarations are affected by a change in the rate. Each scenario uses the actual capital gains declarations by individuals as reported in the IRS's Public Use File for 1991.[4] The first set of columns shows the low estimate, which is calculated by multiplying the drop in the effective tax rate by 0.17. This means a 50 percent decrease in the effective capital gains tax rate results in a 51 percent increase in capital gains declarations. The third set of columns shows the high estimate, which multiplies the 50 percent decrease by the "transitory tax elasticity" estimated by Burman and Randolph: 6.42. While Burman and Randolph offer solid evidence for this strong level of taxpayer response to a change in the capital gains tax rate (which in the table leads to a 321 percent increase in declarations), it is probably imprudent for states to budget on this optimistic outcome. Thus, the second set of columns shows the midpoint between the low and high responses. The midpoint estimates reflect an increase in declarations of 156 percent for a 50 percent drop in the tax rate.

As always, the difficult part of estimating tax revenues from capital gains is forecasting the value of the appreciated assets taxpayers will liquidate and the time of their liquidation. No particularly good and reliable revenue model exists for this purpose. Thus tax analysts are left with calculating historical responses to tax changes and assuming that the future will be very much like the past.

Thus, these Heritage "mid-point" estimates, based as they are on data from a slow economic year and a mid-range level of taxpayer response, should give state revenue officers a reasonable number for incorporating into their state income tax forecasts. These middle estimates also illustrate conservatively that what happens to capital gains at the federal level has important implications for the revenues of 40 states. Besides the good economic effects on state economies resulting from a balanced budget with tax cuts, the congressional budget plan actually supplies the states with additional revenue that they can use to meet their additional responsibilities. If, on the other hand, the capital gains cut were to be pared back or eliminated in the negotiations over a budget, that would reduce or eliminate the revenue benefit to states with a capital gains tax.

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1 See, for example, Jude Wanniski's testimony before the Senate Finance Committee on March 15, 1995, as cited in Stephen Moore and John Silvia, "The ABCs of the Capital Gain Tax," Cato Institute *Policy Analysis* No. 242, October 4, 1995.

2 For an overview of how the economy likely will react to the tax and spending policy changes contained in the congressional budget plan, see William W. Beach and John S. Barry, "What a Balanced Federal Budget with Tax Cuts Would Mean to the Economy," Heritage Foundation *F.Y.I.* No. 69, November 14, 1995.

3 Leonard E. Burman and William C. Randolph, "Measuring Permanent Responses to Capital-Gains Tax Changes in Panel Data," *American Economic Review*, Vol. 84, No. 4 (September 1994), p. 803.

4 Because the economy performed poorly in 1991 and the year saw weak growth in the value of stocks and other capital assets, the Heritage estimates of state revenue increases probably are understated. The Public Use File for 1991 is the only publicly available source of detailed taxpayer information extracted from actual tax returns. The Public Use File for 1992 was not available at the time Heritage performed this analysis. Thus, Heritage is using the most recent, detailed tax data supplied to the general public by the IRS.

Chart 1

Estimated One-Time State Revenue Windfall from Capital Gains Tax Cuts in the Congressional Plan

(Estimates Reflect the Possible Capital Gains Declarations from a 50% Reduction in U.S. Effective Tax Rate)

States	Low Estimate: Dollar Increase in Individual Income Tax Revenues	Low Estimate: Percent Increase in Revenues	Mid-Point Estimate: Dollar Increase in Individual Income Tax Revenues	Mid-Point Estimate: Percent Increase in Revenues	High Estimate: Dollar Increase in Individual Income Tax Revenues	High Estimate: Percent Increase in Revenues
Alabama	7,533,095	0.64%	130,782,903	11.14%	268,680,396	22.88%
Alaska	0	0.00%	0	0.00%	0	0.00%
Arizona	10,786,428	0.87%	187,264,375	15.03%	384,715,931	30.88%
Arkansas	4,548,869	0.57%	78,973,413	9.95%	162,242,979	20.44%
California	155,097,431	0.92%	2,692,663,733	16.01%	5,531,808,373	32.89%
Colorado	7,962,217	0.54%	138,232,927	9.43%	283,985,725	19.37%
Connecticut	5,816,343	1.23%	100,978,177	21.28%	207,449,566	43.71%
Delaware	1,457,085	0.32%	25,296,609	5.48%	51,969,353	11.26%
DC	3,189,210	0.52%	55,368,225	8.99%	113,748,482	18.47%
Florida	0	0.00%	0	0.00%	0	0.00%
Georgia	14,751,984	0.50%	256,110,828	8.69%	526,154,085	17.85%
Hawaii	5,610,924	0.64%	97,411,867	11.16%	200,122,940	22.93%
Idaho	3,858,120	0.86%	66,981,242	15.01%	137,606,264	30.84%
Illinois	14,033,483	0.31%	243,636,851	5.37%	500,527,546	11.03%
Indiana	7,094,706	0.32%	123,171,972	5.64%	253,044,499	11.59%
Iowa	14,640,163	1.09%	254,169,504	18.92%	522,165,829	38.86%
Kansas	6,980,442	0.79%	121,188,222	13.76%	248,969,083	28.27%
Kentucky	8,135,410	0.48%	141,239,755	8.34%	290,162,953	17.14%
Louisiana	6,867,028	0.85%	119,219,229	14.84%	244,923,984	30.48%
Maine	4,237,460	0.73%	73,567,010	12.67%	151,136,065	26.02%
Maryland	9,021,993	0.31%	156,631,816	5.34%	321,784,402	10.98%
Massachusetts	0	0.00%	0	0.00%	0	0.00%
Michigan	16,197,016	0.43%	281,198,203	7.42%	577,693,588	15.25%
Minnesota	17,092,545	0.57%	296,745,573	9.98%	609,634,105	20.49%
Mississippi	0	0.00%	0	0.00%	0	0.00%
Missouri	11,468,196	0.63%	199,100,618	10.88%	409,032,311	22.36%
Montana	3,850,865	1.36%	66,855,294	23.63%	137,347,516	48.54%
Nebraska	4,639,335	0.77%	80,544,017	13.35%	165,469,629	27.44%
Nevada	0	0.00%	0	0.00%	0	0.00%
New Hampshire	0	0.00%	0	0.00%	0	0.00%
New Jersey	17,476,986	0.52%	303,419,893	8.95%	623,345,829	18.38%
New Mexico	5,805,653	1.57%	100,792,579	27.28%	207,068,275	56.05%
New York	49,180,189	0.34%	853,822,727	5.88%	1,754,093,411	12.07%
North Carolina	21,422,754	0.61%	371,922,819	10.52%	764,078,240	21.62%
North Dakota	1,748,615	1.53%	30,357,896	26.57%	62,367,261	54.58%
Ohio	29,729,688	0.70%	516,140,423	12.24%	1,060,358,885	25.14%
Oklahoma	6,763,424	0.56%	117,420,563	9.64%	241,228,805	19.80%
Oregon	14,016,131	0.71%	243,335,610	12.27%	499,908,678	25.20%
Pennsylvania	12,168,256	0.37%	211,254,438	6.45%	434,001,117	13.25%
Rhode Island	4,514,543	1.05%	78,377,487	18.26%	161,018,710	37.51%
South Carolina	6,405,125	0.46%	111,200,079	8.02%	228,449,442	16.47%
South Dakota	0	0.00%	0	0.00%	0	0.00%
Tennessee	0	0.00%	0	0.00%	0	0.00%
Texas	0	0.00%	0	0.00%	0	0.00%
Utah	4,325,586	0.61%	75,096,978	10.50%	154,279,232	21.58%
Vermont	2,785,669	1.08%	48,362,313	18.78%	99,355,536	38.58%
Virginia	13,940,717	0.43%	242,026,340	7.48%	497,218,913	15.37%
Washington	0	0.00%	0	0.00%	0	0.00%
West Virginia	3,060,439	0.53%	53,132,613	9.22%	109,155,640	18.94%
Wisconsin	5,992,429	0.20%	104,035,217	3.46%	213,729,951	7.12%
Wyoming	0	0.00%	0	0.00%	0	0.00%
Total & % Change	544,206,548	0.67%	9,448,030,339	11.61%	19,410,033,528	23.86%

Note: States with zero effect do not tax gains on capital assets.
Source: IRS Public Use File for 1991. These estimates assume capital gains tax reductions as described inthe Balanced Budget Act of 1995.