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A CAPITAL LOSS:

Eliminating taxes on capital gains would make North Carolina's tax system more unfair and make the state's revenue challenge worse

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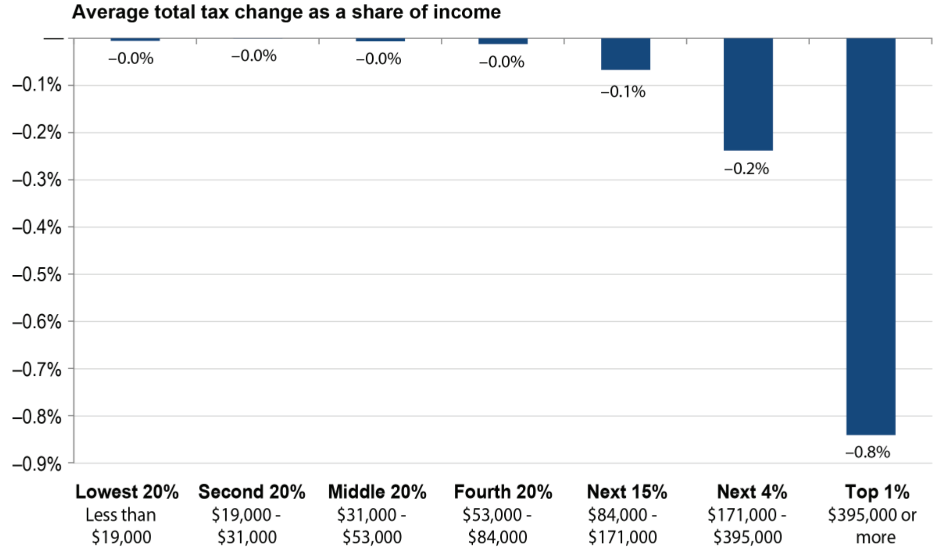
Tax cut proponents in North Carolina are pushing another plan that would benefit the wealthy at the expense of everyone else, turning their sights to eliminating the state income tax on the sale of artwork, vacation homes and other high-end capital gains that only a few North Carolinians profit from. Contrary to supporters' claims, this tax cut would not spur economic growth. It would benefit a small number of wealthy individuals and profitable corporations, wasting another half-billion dollars that could otherwise be used to bolster schools, public safety and other things average people rely on each day and that a strong economy needs to thrive. Furthermore, tax breaks for capital gains would make the state tax system even more unfair, pushing more responsibility onto middle- and low-income taxpayers.

Capital gains are profits from the sale of an asset – such as stocks, bonds, investment or vacation real estate, art, or antiques – and are not taxed until the asset is sold.[1] The capital gain is the difference between the selling price and the original purchase price for the asset.

FIGURE 1: Only the state's richest households would significantly benefit from a capital gains tax cut

Average total tax change as a share of income



All North Carolinians, 2014 Income Levels (2015 LAW)

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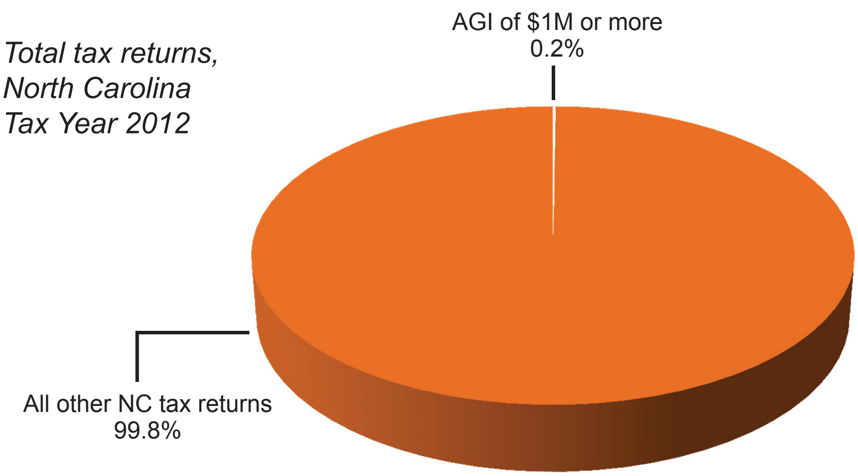
The proposal to eliminate the tax on capital gains is part of a larger push to radically alter North Carolina's tax system, to the detriment of the state and its residents. State lawmakers passed a tax plan in 2013 that shifted the responsibility of paying for schools, health care and other public investments further away from the wealthy and profitable corporations to low- and middle-income families. The cost of the tax plan is sizable and continues to grow, meaning less revenue for investments that are the foundation for economic growth. For the current fiscal year, which ends June 30, 2015, that tax plan alone could reduce revenue by more than $1 billion.[2]

FIGURE 2: North Carolina taxpayers earning $1 million or more in adjusted gross income (AGI) represent less than one percent of all taxpayers...

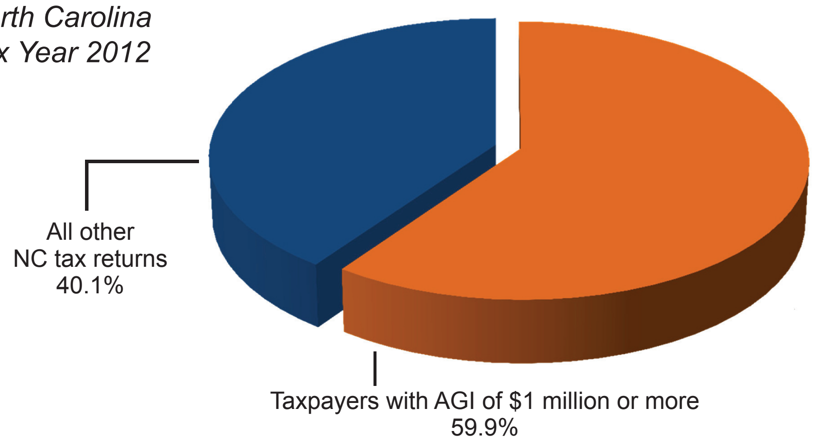
Total tax returns, North Carolina Tax Year 2012



SOURCE: IRS, Statistics of Income, Individual Income Tax data, North Carolina, Tax Year 2012

FIGURE 3: ...but account for 60 percent of total net capital gains income

Allocation of net capital gains income, North Carolina Tax Year 2012



SOURCE: IRS, Statistics of Income, Individual Income Tax data, North Carolina, Tax Year 2012

Eliminating the capital gains tax benefits the wealthy

Capital gains are highly concentrated among the wealthiest of wealthy taxpayers, meaning any "across the board" capital gains tax cut would result in the highest-earners paying less in state income taxes while the majority of low- and middle-income taxpayers would not see a tax break.[3] In combination with the tax plan passed by state lawmakers in 2013, eliminating or cutting the capital gains tax would make North Carolina's already upside-down tax system—which requires low- and middle-income earners to pay more as a share of their income than the better off do—even worse (see Figure 1, p. 1).

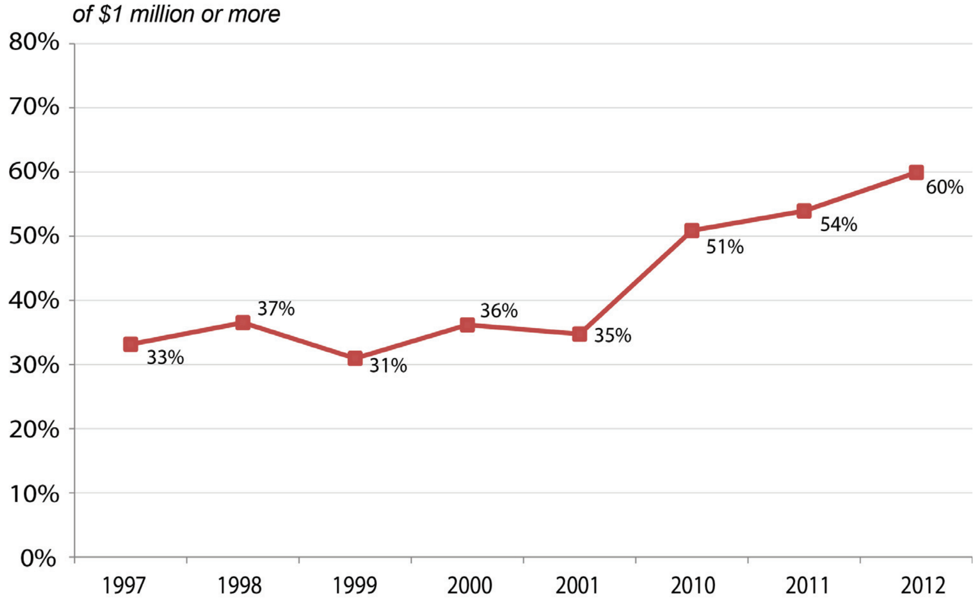
Proponents of cutting taxes on capital gains often claim that a growing number of middle-class Americans own stock. However, only a small fraction of all taxpayers in North Carolina report net capital gains as part of their adjusted gross income (AGI). Furthermore, the distribution of net capital gains is highly skewed towards the state's wealthiest income earners. For tax year 2012 (the most recent year federal income tax data is available), nearly 90 percent of North Carolina taxpayers reported AGI of less than $100,000 and accounted for only 8 percent of all net capital gains income (See Figures 2 and 3). By contrast, taxpayers with AGI of $1 million or more represented less than 1 percent of North Carolina taxpayers and accounted for 60 percent of all net capital gains income.

By eliminating or reducing the tax rate on capital gains, North Carolina's tax system would further shift the tax load to low- and middle-income taxpayers while reducing the load for the state's wealthiest taxpayers. More than two-thirds of the benefits from eliminating all capital gains income from state income taxes would flow to the top 1 percent of income earners in North Carolina, whose average income is around $957,000, according to an analysis by the Institute on Taxation and Economic Policy, a non-partisan research organization.[4]

MOST TAXPAYERS IN NORTH CAROLINA do not have capital gains as part of their income. Just one in seven taxpayers reported net capital gains on their tax return for tax year 2012. Meanwhile, the share of net capital gains flowing to the wealthy has increased over time (see Figure 4). In 1997, North Carolina taxpayers with adjusted gross income (AGI) of $1 million or more represented less than 1 percent of all taxpayers and accounted for 33 percent of all net capital gains. By 2012, their share of capital gains had nearly doubled, rising to 60 percent. The share of capital gains flowing to the wealthiest income earners has steadily increased over time. Furthermore, income from capital gains has consistently been distributed to wealthy taxpayers and not middle income taxpayers.

FIGURE 4: Majority of net capital gains goes to wealthy North Carolina taxpayers

Percent of total net capital gains going to taxpayers with Adjusted Gross Income of $1 million or more



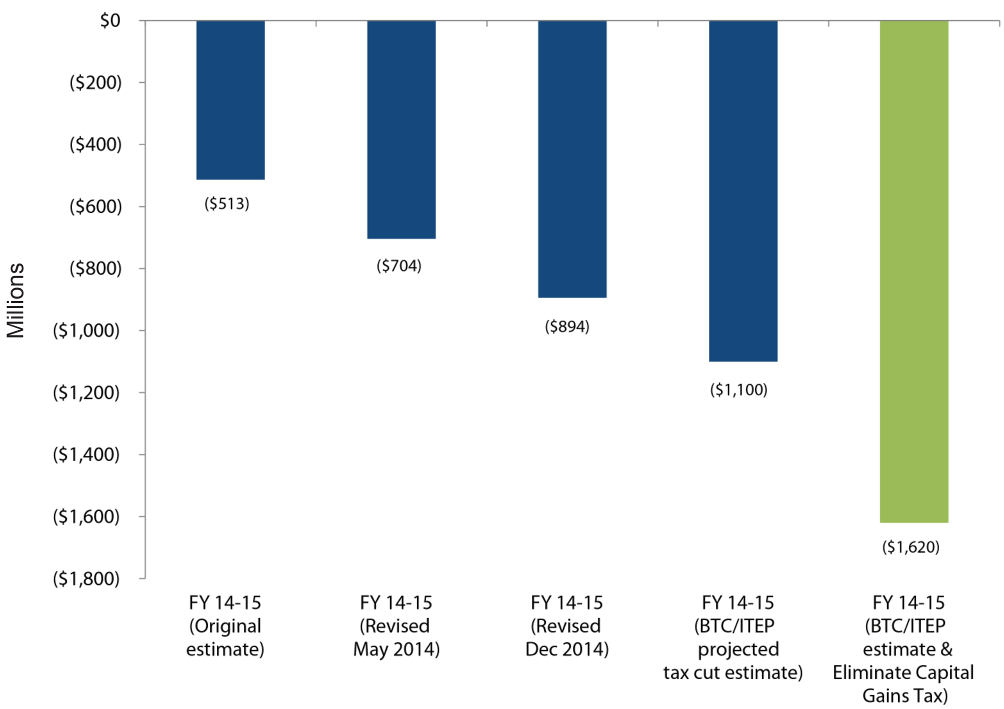
Source: Internal Revenue Service (IRS), Sources of Income data

The increasing share of capital gains going to the state's wealthiest income earners contributes to growing income and wealth inequality in North Carolina and nationally. Changes in capital gains and dividends at the federal level were the largest contributor to the increase in income inequality that occurred between 1996 and 2006, according to the Congressional Research Service.[5] Such inequality has sharply eroded economic opportunity for middle-class and low-income families and individuals, making it harder for them to make ends meet. During the first three years of recovery from the last recession, the top 1 percent of income earners captured 95 percent of the income gains nationally.[6] In North Carolina, income for the top 1 percent of income earners in the state grew by 6.2 percent from 2009 to 2011 while everyone else saw their income decline by 2.9 percent overall.[7]

Eliminating capital gains from state income tax would further benefit a small group of ultra-wealthy taxpayers following tax changes passed in 2013 that already largely benefits this group.

In contrast, state lawmakers eliminated a crucial tax break for working families, the state Earned Income Tax Credit (EITC), which helped more than 900,000 North Carolinians in 2012. The tax credit went to people who work but struggle to make ends meet due to low wages. This tax credit cost $108 million for tax year 2012 – one-fifth the estimated cost of eliminating all capital gains income.

FIGURE 5: Tax Plan Revenue Losses Higher than Expected



Source: Original, FN for HB 998; Revised, Consensus Forecast; ITEP, Using Up-to-Date Taxpayer Data; and Reported Tax Collections for the First Five Months of FY15

The High Cost of Cutting Taxes on Capital Gains Income

Eliminating capital gains from the state's personal income tax would reduce state revenue by an additional $520 million[8], worsening the state's financial problems created by the 2013 tax plan. The cost of the 2013 tax plan continues to increase, with revenue loss now at nearly $900 million for the current fiscal year (see Figure 5). The additional revenue loss from eliminating the income tax on capital gains would further increase the annual revenue loss. Allowing taxpayers to exclude a portion of capital gains income from their taxable income or taxing this income at a lower tax rate than income earned through wages and salaries would also result in a significant drop in revenue, although not as large as completely exempting capital gains from taxes.

While most states generally tax capital gains income in the same way they tax income from any other source, nine states – Arizona, Arkansas, Hawaii, Montana, New Mexico, North Dakota, South Carolina, Vermont, and Wisconsin – provide a range of tax breaks for capital gains income.[9] These breaks in these nine states resulted in about $490 million in reduced revenue for tax year 2010, with revenue losses ranging from $14 million to $151 million.[10] The capital gains tax breaks in these nine states overwhelmingly benefit the very best-off taxpayers. Between 95 and 100 percent of the tax breaks went to the richest 20 percent of taxpayers.[11] It is worth noting that no state with a broad personal income tax fully excludes capital gains from taxation.

Revenue loss from capital gains tax cuts represents a meaningful share of total income tax revenue. South Carolina, for example, allows a 44 percent capital gains deduction, which cost the state roughly $115 million in tax year 2010, despite facing a huge budget deficit in subsequent years.[12] In eight of the nine states, for tax year 2010, the revenue loss as a share of total income tax revenue ranged from 3 percent to 7 percent.[13]

For North Carolina, the $520 million cost of eliminating capital gains from state income tax would represent nearly 5 percent of income tax revenue for FY 2013-14.[14] That well exceeds the state's combined investment in Teacher Assistants in public schools and classroom textbooks for the current fiscal year.[15]

Capital Gains Tax Break Won't Boost North Carolina's Economy

Proponents often claim that capital gains tax breaks are necessary to encourage investment and spur economic growth and that doing so creates a fairer tax system.[16] However, there is little connection between lower capital gains tax rates and economic growth. Among various approaches to cutting taxes, cutting capital gains taxes was found to be among the least effective ways to provide fiscal stimulus at the federal level, based on analysis by the Congressional Budget Office (CBO).[17] The CBO notes that the benefits would largely flow to high-income households, which are more likely to save the money rather than spend it, thus thwarting efforts to boost consumption and economy activity.

The existing federal tax code heavily favors capital gains over ordinary income, with a top tax rate on capital gains that is much lower than the top tax rate on ordinary income, among other preferential tax breaks.[18] This bias for capital gains over ordinary income exists despite evidence that shows no clear economic benefit from lower federal capital gains tax rates and economic growth over time, including a reduction in the capital gain rate during the early 2000s.[19] Furthermore, no apparent correlation exists between changes in the top capital gains tax rate and saving, investment, or productivity growth.[20] However, reductions in the top capital gains tax rate over time does appear to have increased the concentration of income at the top of the income scale.[21]

Capital gains tax breaks are even less likely to promote investment, job creation, or economic growth at the state level. The tax break will not make investors in North Carolina more likely to steer capital towards companies in the Tar Heel State because they receive the tax cut whether they invest locally or elsewhere. Thus, there is likely to be no meaningful change in the level of investment or employment in the Tar Heel state as a result of capital gains tax breaks.

Furthermore, a portion of any capital gains tax break will never make it into the pockets of North Carolina taxpayers or local economies due to the interaction of federal and state income taxes. Any reduction in state capital gains taxes will be partially offset by an increase in federal income tax liability. Federal income tax law allows taxpayers to deduct state and local taxes paid from their income when determining their adjusted gross income for federal income tax. Eliminating or cutting capital gains taxes at the state level means less state and local taxes that a taxpayer can deduct when determining the amount of federal income tax owed. Accordingly, the amount of income subject to federal income tax, and thus the amount of federal income tax paid, increases.

Recognizing their ineffective and unfair nature, several states have made changes to their capital gain tax breaks in recent years. Wisconsin cut its 60 percent capital gains exclusion in half to 30 percent.[22] These sensible capital gains tax reforms have provided much needed tax revenue and have made those states' tax systems fairer.

Conclusion

North Carolina cannot afford to adopt ineffective and inequitable tax policy such as capital gains tax breaks. Such action not only ignores conventional wisdom and evidence, but also fails to promote an economy and tax code that works for all North Carolinians.

At a time when the state faces serious revenue challenges, ensuring that the state's tax system is fair and able to generate enough revenue for vital public investments – like schools, community colleges, and universities – is as important as ever. North Carolina's ability to compete for good-paying jobs in a 21st century economy and foster thriving communities requires prudent state-level tax and fiscal policy.

State policymakers should reject calls to eliminate or cut capital gains taxes and instead work to improve the state's tax system which currently favors the wealthy over average people.[23]

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