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**SUBJECT:** Economic Impact of Income Tax Rate Reduction for Capital Gains

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Georgia HB 481 makes several significant changes to Georgia's tax code. One provision is to reduce the income tax rate on long-term capital gains by 25 percent for the 2010 tax year and by 50 percent for all tax years thereafter. In this memo we provide an estimate of the revenue loss and a discussion of the likely effect on investment in the Georgia economy.

## ESTIMATED REVENUE LOSS

HB 655 proposed a 100 percent exception from the income tax (corporate and individual) of long-term capital gain realizations that are subject to federal income tax. The Fiscal Research Center developed of the revenue loss for that proposed legislation. The estimated revenue cost of a 100 percent exemption is \$927 million in CY2011 and \$463 million in FY2011 and \$965 million in FY2012. The estimated revenue loss from the exemption proposed in HB 481 is \$232 million in CY 2011 and \$116 million in FY2011 and \$482 million in FY2012. In subsequent years, the magnitude of capital gains realizations will increase given the expected recovery from the current recession. The details for how the estimate for the 100 percent exemption was developed are presented in the Addendum. (When the Fiscal Research Center prepared the fiscal analysis of the April 3<sup>rd</sup> version of HB 481, given the rush to prepare something, the analysis of HB 655 was not used.)

## TAX EFFECTS ON REALIZATIONS

Capital gains are only taxed when they are realized. And, because they are taxed, investors are thought to delay their realization. It is possible that reducing the tax rate on capital gains will increase realizations, which will have an offsetting effect on tax revenue.

A considerable academic literature has emerged to examine the effect that capital gains tax rates have on capital gains realizations. In theory, reducing capital gains tax rates should have both transitory and permanent effects on capital gains realizations. The transitory effect occurs because investors do not pay taxes on capital gains until the gains are realized; actual and expected changes in tax rates cause investors to alter the timing of their gains realizations. For example, the federal Tax Reform Act of 1986 passed in September 1986 increased the federal maximum tax rate on capital gains from 20 percent to 28 percent effective in January 1987. As a result of the act, capital gains realizations increased tremendously during the final months of 1986 and then fell off at the start of 1987 (Burman et al., 1994). This suggests that in anticipation of the cut in the state capital gains tax rate, investors will delay capital gains realizations until the tax cut takes affect. That is, the revenue from capital gains will fall during the 2009 tax year and increase in subsequent years. But this is a timing issue, not a permanent change.

The reduction in Georgia's tax rate on capital gains could reduce the likelihood of individuals with substantial capital gains from moving to, say, Florida, to avoid paying any state income tax on the capital gains.

#### EFFECT ON INVESTMENT

Permanent effects of reducing capital gains tax rates on capital gains realizations are expected to occur because lowering the tax rate might encourage greater investment. Greater investment would result in greater capital gains in the long run, and presumably greater realized capital gains. However, the empirical evidence is mixed as to whether capital gains tax rates actually have permanent effects on capital gains realizations. Most of the analysis conducted to examine the effects of capital gains tax rates has been done at the federal level, but the effects at the state level might differ from those at the federal level. In one of the seminal studies in the literature, Burman and Randolph (1994) use variations in capital gains tax rates over time and across states and find that the permanent effects on capital gains realization are likely very small. And, this effect could be from a reduced holding period of an asset, not just from increased investment.

Because of how states tax capital gains, the effect of a cut in Georgia's tax on capital gains will likely provide little incentive to increase investment in Georgia. Capital gains on stocks and similar financial assets are taxed by place of residence. Thus, whether a Georgia resident invests in a Georgia company or a New York company, the treatment of capital gains by Georgia will be the same.

Capital gains on investment in assets like land or through a partnership are taxed in the state in which the asset or business is located and in the state of residence, with a credit on the tax paid in the non-resident state. Thus, unless an individual faced a lower tax rate in his or her home state than Georgia's tax rate, that individual would pay the same tax on the capital gains. The only change would be the split in the tax between Georgia and the individual's home state. Thus, most nonresidents of Georgia would not enjoy an increased incentive to invest in Georgia.

Corporate capital gains classified as business income, which is most corporate capital gains, would be apportioned. This includes, for example, capital gains earned from sales of business assets, from sales of stock of subsidiary business entities that are part of a unitary business with the parent entity seller, from sales of short term investments of working capital, etc. The tax treatment would not be dependent upon where the assets were located. Thus, there is no incentive from the lower capital gains tax rate to invest in Georgia. (To tax capital gains obtained from Georgia investment at a lower tax rate than capital gains from non-Georgia assets would likely violate the Interstate Commerce Clause.)

Corporate capital gains from assets held purely for investment purposes would not be apportioned but would be allocated to the corporate taxpayer's commercial domicile. For firms not domiciled in Georgia, reducing the Georgia tax rate on capital gains would have no effect on the firm's taxes. And, since all capital gains, regardless of where the asset was located, of Georgia domiciled firms would be taxed at the Georgia tax rate, there is no incentive for these firms to increase its investment in Georgia.

The only situation in which lowering the tax rate on capital gains would have an incentive to increase investment in Georgia, would be a resident of Georgia or a partnership located in

Georgia. In that case, the tax would fall from a total federal (currently 15 percent) plus state tax (currently 6 percent) of 21 percent to 18 percent, a reduction of 14 percent. Given that these assets might be held for a long period of time, the present value of the tax benefit is likely to be small.

## ADDENDUM

The data used for this revenue estimate come from the Internal Revenue Service Statistics of Income (SOI), the Congressional Budget Office (CBO), and the Bureau of Economic Analysis (BEA). The latest year of detailed data on capital gains realizations is 2006. For that year, the IRS reports \$17.9 billion in realized capital gains by individuals who reside in Georgia out of a national total of \$771 billion in capital gains realizations for individuals (or 2.3 percent). If the same individuals file Georgia state income tax returns, at a marginal tax rate of 6 percent, those realized gains represent up to \$1 billion in Georgia income tax revenue in 2006. Some of those gains are not taxed currently due to the income exemption for retirees. It is assumed that 20 percent of those gains are not currently taxed.

Realized capital gains for corporations are reported at the national level and are \$235 billion in 2006. Assuming that Georgia's share of the federal realized gains is 3 percent (based on the relative level of economic activity), at a 6 percent marginal tax rate, this represents up to \$424 million in Georgia corporate income tax revenue in 2006.

The economic downturn from 2007 to the present will increase the incidence of capital losses and reduce the level of positive capital gains. Capital losses are limited under the federal income tax, and therefore are also limited under Georgia's income tax. Losses that cannot be taken against income can be carried forward. It is difficult to determine the timing of those losses and the potential length that losses would be reported once economic recovery is established. The impact of the 2001 recession on individual capital gains realizations is used to establish the potential level of capital gains realizations in 2011 and 2012. There is a lot of volatility in capital gains realizations, but in the non-recession years between 1996 and 2008, at the national level, individual capital gains realizations were roughly 5 percent of gross domestic product (GDP) and 47.5 percent of corporate profits (data from the Bureau of Economic Analysis). Corporate capital gains are approximately 27 percent of individual capital gains. These rough averages do not include the recovery years of 2002 and 2003. In the recovery period, the capital gains to GDP ratio was 2.6 percent in 2002 and 2.9 percent in 2003 (the profits to capital gains ratio was 30.3 and 33.6 for 2002 and 2003 respectively). For the 2001 recession it appears that 2 to 3 years of recovery were needed to bring capital gains realizations for tax purposes back to historic levels.

Based on the 2001 recession-capital gains experience, it is likely that the 2007+ recession will result in depressed capital gains for a longer time period. If the recovery begins in late 2009, capital gains realizations as a share of corporate profits or GDP may remain relatively low until 2012 (or longer).

The revenue estimate for this bill assumes that individual realized capital gains will remain at 33 percent of forecasted corporate profits (forecasted by the Congressional Budget Office) and that corporate capital gains will hold at 27 percent of individual capital gains. Based on CBO's forecast of corporate profits, this suggests that total realized capital gains (nationally) in 2011 will reach \$653 billion, in 2012 they will reach \$719 billion, and in 2013 they will reach \$778 billion. These forecasted capital gains realizations are the basis for the revenue estimated presented above, assuming that 20 percent of individual gains are already exempted due to the current retiree exemption.

## REFERENCES

Burman, Leonard E., Kimberly Clausing and John O'Hare (1994). "Tax Reform and Realizations of Capital Gains in 1986." *National Tax Journal* 47(1): 1-18.

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