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A Capital Reform: Using capital gains to fuel job creation and economic prosperity in Washington state

By Andy Nicholas

Introduction

To create jobs, spur long-term economic growth, and foster prosperity, Washington state desperately needs to rebuild its eroding education, public health, and community safety infrastructure. Our state has a powerful, but untapped resource to accomplish this: capital gains. A modest tax on some capital gains would help fuel economic recovery and opportunity for future generations of Washingtonians.

Enacting a small tax on capital gains would:

- ***Generate up to $1 billion a year in new resources for job creation***: Once in place these resources would immediately be put to use building the high-quality, health, education, and community safety systems Washington will need to be a prosperous and competitive state in the coming years.
- ***Benefit all, though few would pay***: Setting a reasonable exemption – up to $10,000 for married couples – on capital gains subject to taxes would ensure that 97 percent of Washingtonians would not pay any additional taxes.
- ***Establish a sustainable, long-term stream of resources for economic growth:*** Using fast-growing capital gains resources would allow our state to maintain the quality levels of health care, education, and other important priorities that in the long run are crucial to attracting jobs. Our current revenue structure can't do that.
- ***Reduce the impact of future recessions by building a more robust rainy day fund***: With an amendment to the State Constitution, up to 50 percent of revenues from the Capital Reform proposal would be dedicated to our state Budget Stabilization Account or "Rainy Day Fund." Saving more of our resources when times are good would help Washington better withstand future recessions, reducing the need to impose damaging service cuts when our public health and education systems are most needed.
- ***Create an opportunity to lower taxes for the vast majority of Washingtonians***: Some of the revenues from a capital gains tax could be used to lower the state sales tax rate and finance a rebate for working families with children. Doing so would result in a net tax cut for the vast majority of Washingtonians while leaving significant additional resources to help rebuild our state economy.

A capital gains tax is *not* a state income tax. The paychecks of Washingtonians would not be reduced by one penny.

The Capital Reform proposal is a reasonable approach for Washington state. It would create a new, long-term stream of resources needed to help put Washingtonians back to work, build first-rate health and education systems, and maintain safe and vibrant communities in our state. We face economic problems that threaten our future; now is the time to take sensible action to foster long-term growth and prosperity.

Capital gains: a powerful but untapped resource

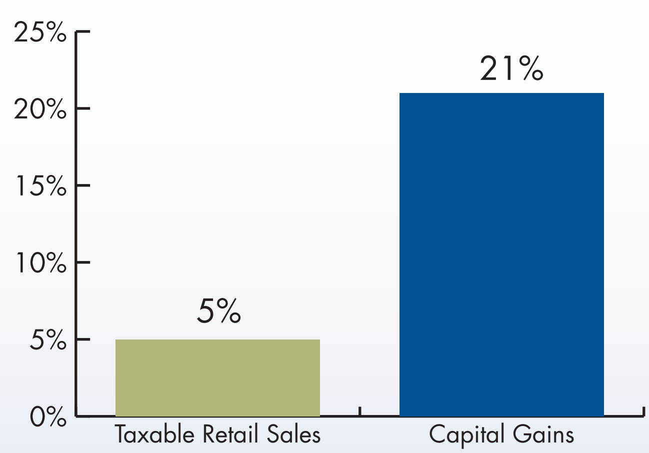
A capital gain occurs when shares of stock or other financial assets are sold at a profit – that is, when the selling price exceeds the original purchase price. Common transactions that result in a capital gain include the sale of stocks, bonds, and vacation homes. Capital gains are an abundant and rapidly growing economic resource in Washington. In 2009, during the deepest part of the Great Recession, nearly $6 billion were generated from the sale of capital assets in our state.[1]

A resilient and rapidly growing resource

A key attribute of capital gains is that they grow quickly over time. As shown in Figure 1, capital gains grew much more rapidly during the last economic cycle compared to other types of activities. Here in Washington state, capital gains grew to $23.7 billion in 2007 from $7.4 billion in 2001 – an average annual growth rate of 21 percent. By contrast, the largest component of our current revenue system, taxable retail sales, grew by about five percent each year. As discussed in more detail below, at this growth rate, our existing revenue system fails to keep pace with ongoing costs of educating our children, caring for the growing number of seniors, and maintaining other important public priorities.

Figure 1: Capital gains grow much faster than retail sales

Average annual growth of capital gains and taxable retail sales in Washington state between 2001 and 2007



Source: Budget & Policy Center Analysis: Data from IRS and ERFC

Unlike other parts of the economy, capital gains are highly resilient following recessions. Table 1 compares the recovery rates of four national economic indicators since 2009 – the stock market, consumer purchases, employment, and wage and salary disbursements. The table shows that the stock market (as represented by the Dow Jones Industrial Average) has recovered far more quickly than the other parts of the economy since the recession bottomed out in the summer of 2009. The Dow Jones Industrial Average grew by 47 percent between 2009 and 2011. By contrast, consumer spending has grown by 9.1 percent since 2009, and employment by less than one percent. Income from wages and salaries has grown by approximately two percent following the deepest part of the recession.

Capital assets are concentrated among the wealthiest households

The vast majority of capital gains wealth flows to the richest households in Washington. In 2007, at the peak of the last economic cycle, only 21 percent of federal tax returns filed in Washington state reported any taxable capital gains.[2] And, as Table 2 shows, 81 percent of capital gains that *were* filed under federal income tax returns were held by the wealthiest three percent of households. Three out of every four filers with adjusted gross income over $200,000 reported some kind of capital gains. On average, capital gains accounted for about 30.4 percent of total annual earnings among this group.

Table 1: Stock market has grown much faster than other economic indicators since 2009

	Percent growth by indicator			
Period	**Dow Jones Industrial Average**	**Personal Consumption Expenditures**	**Employment**	**Wage and Salary**
2009-10	15.7%	4.1%	-0.2%	1.9%
2010-11	27%	4.8%	1%	4%
2009-11	**47%**	**9.1%**	**0.7%**	**1.8%**

Source: Budget & Policy Analysis: Data from BLS, BEA, NBER, DJIA

By contrast, only 13 percent of residents making less than $75,000 per year reported any kind of capital gains at all. Only 5.7 percent of total capital gains in Washington came from these households. Furthermore, capital gains represented a negligible 1.9 percent of earnings among these families. As a matter of perspective, the median income in Washington state in 2010 was $55,631.[3]

Implementing a capital gains tax in Washington state

Washington's revenue system does not leverage the power of capital gains. A small tax on capital gains would provide our state the resources we need to help create jobs and build first-rate education, health, and other public structures proven to foster long-term economic growth and prosperity. Because capital assets are concentrated among the wealthiest households, excluding even a modest amount of capital gains would exempt a large majority of Washingtonians from paying the tax. For example, excluding just the first $10,000 of capital gains for joint filers from taxation ($5,000 for singles) would mean that only 3.2 percent of Washington households would pay any additional taxes under the Capital Reform proposal.[4,5]

Simple and cost-effective to administer

A tax on capital gains would be easy for taxpayers to calculate and would entail low administration costs for the state Department of Revenue (DOR). The tax would use the same definition of capital gains as the

Internal Revenue Service; information that taxpayers from Washington already enter in Schedule D of their federal income tax return would be used on the state form. Washingtonians would simply use total capital gains reported on their federal returns, subtract the amount excluded from taxation in Washington state, and apply the state rate to the remainder. Using federal capital gains definitions would also allow for a cost-effective state administration process in which DOR would make use of IRS data to verify the accuracy of state returns filed each year.

Table 2: Vast majority of capital gains income goes to the wealthiest Washingtonians

Adjusted Gross Income (AGI) in dollars	Less than $75,000	$75,000 - $200,000	Greater than $200,000
Percent of total returns	77%	19.7%	3.3%
Percent of Capital Gains	5.7%	13.0%	81.4%
Returns with Capital Gains	13.4%	40.4%	79.6%
Gains as share of AGI	1.9%	4.2%	30.4%

Source: Budget & Policy Analysis: Data from IRS, Statistics of Income Data. Tax year 2007

Not a tax on paychecks or the most common investment activities

A capital gains tax is not a state income tax. Under the proposal paycheck income from Washingtonians' salaries and wages would not be reduced in any way. Furthermore, the use of federal IRS definitions would ensure that other common investment activities, such as selling a residence or saving for retirement, would also be excluded from the tax.

In addition to paycheck income, other common investment activities that would *not* be taxed under the Capital Reform proposal include:

- ***Ordinary home sales***: Using the federal capital gains definition would ensure that the vast majority of home sales would not be covered under a capital gains tax. Under federal tax law, for a married couple the first $500,000 ($250,000 for single residents) in profit from the sale of primary residences is completely exempt from taxation. Because of this high exemption, only 2.8 percent of homes sold in the United State in 2007 were subject to any federal capital gains taxes.[6] The median price of homes sold in Seattle, Tacoma, and Bellevue in 2010 was $295,700 – far below the amount that would trigger a taxable capital gain under the proposal.[7]

- ***Retirement savings and income***: Coupling to federal capital gains definitions means that Washingtonians' retirement savings through 401k and pension plans would not be taxed under the proposal. Retirement income would also remain untaxed in Washington because distributions from retirement plans are not taxed as capital gains under federal law.

- ***Inherited investments***: At the federal level, a capital asset held until death does not face the capital gains tax. Anyone who inherits a capital asset is merely responsible for paying taxes on gains occurring after taking ownership of the asset.

Few would pay

Very few Washingtonians would owe any capital gains tax under the Capital Reform proposal. Even if all capital gains were subject to the tax – that is, if no exemption or threshold were applied – only 11.9 percent of residents would owe any additional taxes, according to estimates from the Institute on Taxation and Economic Policy (ITEP). If a couple's first

$10,000 of capital gains were excluded from taxation, only about 3.2 percent of residents would pay any tax in Washington. Under a tax rate of 5 percent and a $10,000 exemption, the wealthiest one percent of families in Washington – those whose income averages more than $1.4 million a year – would see their taxes rise by only about nine-tenths of one percent of their annual incomes.

Table 3 compares how a capital gains tax structured in this way would affect two hypothetical taxpayers in Washington state.

Taxpayer A – who receives $79,500 in paycheck income, and $7,000 in capital gains each year – would pay nothing additional under the proposal. Taxpayer B – with $330,600 in paycheck income and $130,000 in capital gains – would pay $6,000. This comes to only 1.3 percent of Taxpayer B's adjusted gross income. And, because the $6,000 in capital gains taxes paid to Washington state would be deductible from federal income, Taxpayer's B's federal income tax would be *reduced* by $2,100. In essence then, when the federal deduction is taken into account, Taxpayer B would see their taxes rise by about $3,900 in 2011 under the proposal.[8]

Options and revenue potential

In a single year, a tax on capital gains would generate hundreds of millions of dollars in new resources.

Exactly how much the state could raise would be determined by two factors: the level of capital gains to be excluded from any tax, and the rate levied on gains that are taxed. Information on the amount of revenue that could be generated at different tax rates and exemption levels appears in Tables 4 and 5.

A capital gains tax with a modest five percent rate and a $10,000 exemption ($5,000 for singles), would generate over $500 million in state revenue in the coming year. (As Box 1 explains, a five percent rate on capital gains would be quite low relative to rates applied by other states.) As a matter of perspective, if a capital

Table 3: How would a tax on capital gains affect taxpayers in Washington state?

	Taxpayer A	Taxpayer B
Paycheck Income	$79,500	$330,600
Capital gains	$7,000	$130,000
Current state capital gains tax due	**$0**	**$0**
New tax on capital gains above $10,000:		
Amount above $10,000 threshold	$0	$120,000
multiplied by 5% tax rate	$0	$6,000
State taxes	$0	**$6,000**
Tax increase as a share of total Adjusted Gross Income	*0%*	*1.3%*

Source: Budget & Policy calculations

Table 4: Potential capital gains tax revenues by tax rate in FY2012

Capital gains tax rate (%)	Exemption level ($)	Annual tax revenues
1.0	$5,000	$106 million
3.0	$5,000	$319 million
5.0	$5,000	$532 million
7.0	$5,000	$745 million
9.0	$5,000	$958 million
10.0	$5,000	$1.1 billion

Source: Institute on Taxation and Economic Policy

Table 5: Potential capital gains tax revenues by exemption level in FY2012

Capital gains tax rate (%)	Exemption level	Annual tax revenues	Share of households affected (%)
5.0	$0	$582 million	11.9
5.0	$5,000	$532 million	4.0
5.0	$10,000	$505 million	3.0
5.0	$15,000	$484 million	2.4
5.0	$20,000	$466 million	2.1
5.0	$40,000	$409 million	1.4
5.0	$60,000	$370 million	1.1
5.0	$80,000	$339 million	0.9
5.0	$100,000	$315 million	0.6

Source: Institute on Taxation and Economic Policy

Box 1: Majority of states tax capital gains at a higher rate than the Capital Reform proposal

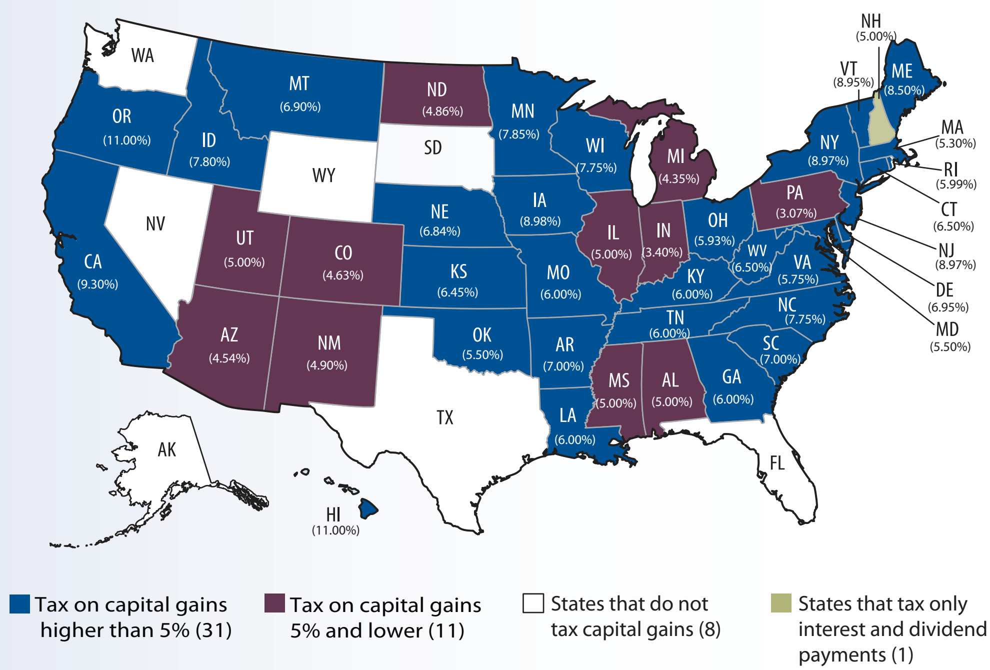
As the map below shows, a modest five percent rate applied to capital gains is considerably lower than the top rates applied in most other states. In 31 states, capital gains are taxed at a rate higher than five percent. Another 11 apply a rate at five percent or lower, and Washington is one of only eight states that do not tax capital gains at all. Notably, five percent is much lower than the 11 percent rate applied in Oregon and the 7.8 percent rate in Idaho.

New Hampshire and Tennessee

Most of states that tax capital gains do so through their state income tax systems. Like Washington, New Hampshire and Tennessee do not tax paycheck income. Unlike Washington, these states do tax high-end dividend and interest payments. In New Hampshire, the five percent tax on these investment activities has been in place since 1923. Between 2007 and 2009 the tax generated more than $100 million each year in resources for public priorities such as health care and education. Only nine percent of tax filers in New Hampshire actually owe the tax, and the average amount owed was $147.[a]

Tennessee levies a six percent tax on some capital gains, dividends, and interest payments, which has been in place since 1929. The tax generates about $287 million in state revenues each year and impacts about four percent of the state's population that is over 20 years of age.[b,c]

Majority of states tax capital gains rates higher than 5 percent



Source: Budget & Policy Center analysis of Federation of Tax Administrators data

[a] *An overview of New Hampshire's tax system*, New Hampshire Fiscal Policy Institute December 2010.
[b] Tennesse Department of Revenue, Fiscal Year 2008 revenue statistics.
[c] Budget & Policy Center calculations; data from TN Department of Revenue and U.S. Census Bureau.

gains tax had been in place between fiscal years 1996 and 2012, our state would have generated more than $9 billion in additional state revenues.[9] All of these resources could have been used to develop high-quality health, education, and other public systems that are crucial to long-term economic growth and prosperity.

Fixing our revenue system to foster long-term prosperity

Washington's revenue system does not adequately or equitably support education, public health, and other structures essential to making the state favorable for job creation and long-term prosperity. Even in normal economic times our revenue structure does not support consistent levels of these important investments. As shown in Figure 2 below, in four of the last six bienna (9 of the last 12 fiscal years), state tax revenues have fallen short of the amount spent on health care, education, and other important priorities.

This ongoing gap between Washington's investments and the resources available to pay for those investments is commonly referred to as our "structural deficit." Due to a number of factors that are beyond the state's control, the cost of maintaining our public systems rises each year. Rising energy prices continually make it more expensive to heat class rooms and to fuel police cars, ambulances, and school buses. The rapidly growing price of health care services (in addition to growing demand for these services) has made it more expensive for our state to provide adequate medical care for seniors, children, and laid-off workers.

The major cause behind the structural deficit is Washington's slow-growing revenue system, which fails to keep pace with these costs. By introducing a rapidly growing revenue source, the Capital Reform proposal would represent a dramatic step toward creating a more robust and adequate revenue system in Washington state.

Figure 2 also shows that had a modest five percent capital gains tax (with a $10,000 exemption) been in place, in five out of the last six biennia (9 of the last 12 fiscal years) state revenues would have met or *exceeded* spending on health care, education, and other core public structures. The result would have been a more balanced and sustainable system of financing these and other important public priorities.

What if a Capital Reform had been enacted in 1995?

Washington state would have...

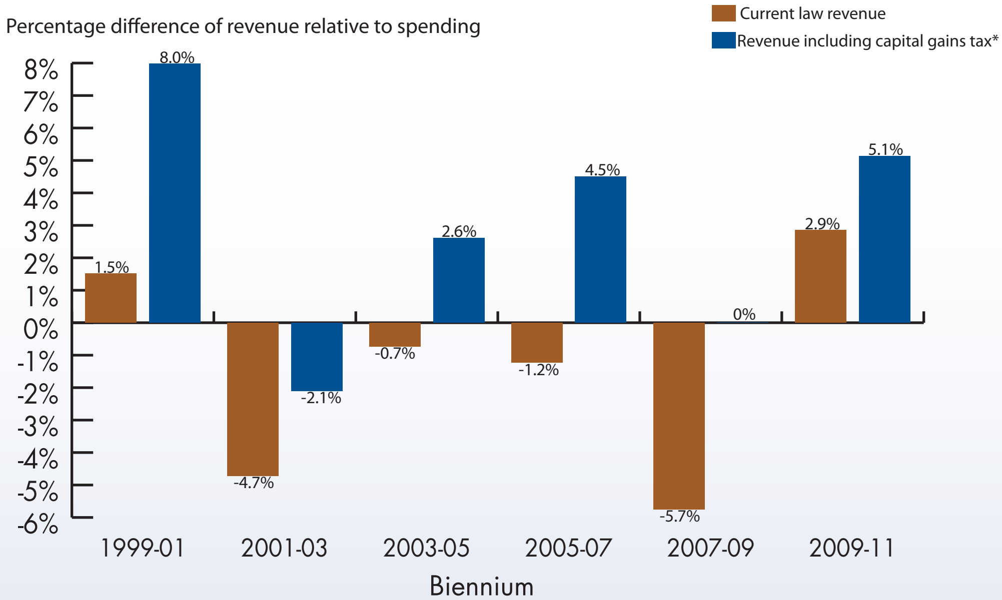
- ***Had a more rapid economic recovery***: Job-creating state revenues would be growing by 2.2 percent this year and would be poised to grow rapidly in the coming years. Under our existing system, available resources will grow by only 1.2 percent this year – far lower than what is needed to maintain core public structures.
- ***Enacted far fewer cuts to essential public structures***: The state Rainy Day Fund would have achieved a balance of $1.4 billion by 2009, all of which would have been used to maintain essential health and education systems that are critical to long-term economic growth and prosperity. Without the Capital Reform proposal, the RDF would have achieved a balance of only $261 million by 2009 (see Figure 4, p.10).
- ***Had more resources to invest quality education & health systems***: The Capital Reform proposal would have allowed our state to invest an additional $9 billion in our job-creating education and health systems between 1995 and 2012.

A five percent capital gains tax with a $10,000 exemption would have many positive impacts on our shared economic investments and would greatly improve our flawed revenue system. These benefits are described in the following sections.

Speedier economic recoveries

While capital gains can decline rapidly at the onset of a recession – something that is appropriately addressed with a robust rainy day fund (see below)

Figure 2: Capital gains tax would create a more sustainable state budget



Source: Budget & Policy Center analysis; Data from LEAP and ITEP
* 5% tax on capital gains tax with a $10,000 exemption

– they also recover much more quickly following recessions compared to other parts of the economy. Taxable retail sales, the largest component of Washington state's present revenue structure, fell by 4.2 percent between July of 2009 and July of 2011. By contrast, the Dow Jones Industrial Average increased by over 47 percent during the same period.[10]

A capital gains tax would have significantly hastened the pace of Washington's recovery from the Great Recession. State tax revenues are currently projected to grow by 1.4 percent in the current fiscal year. Had a capital gains tax been in place state tax resources would be growing by about 2.2 percent this year and would be poised to grow rapidly in the coming years.[11]

Other states that tax capital gains have benefited from the stock market's rapid growth over the past two years. A recent report from the Center on Budget and Policy Priorities found that of the 28 states that recently experienced faster than expected revenue growth, the accelerated growth in 23 was due to high-end corporate and individual earnings – including capital gains.[12]

Stabilizing funding for economic investments

The Capital Reform proposal would stabilize funding for Washington's core public health and education investments. Upon enacting the capital gains tax, policymakers and voters should amend the State Constitution to dedicate up to 50 percent of the new revenues to the state Budget Stabilization Account, commonly referred to as the "rainy day fund" or RDF.[13] Wisely saving more of our resources during good economic times would reduce the need for tax increases or severe cuts to essential public structures in future recessions. Figure 3 shows that billions of dollars in economically-damaging cuts to our health and education infrastructure could have been avoided, had the proposal been in place since fiscal year 1996.

Figure 3 shows the amount of savings that would have accumulated between fiscal years 1995 and 2009 under three scenarios: 1) annual deposits to the RDF under current law; 2) current law deposits plus 25 percent of capital gains tax revenues; 3) and current law deposits plus 50 percent of capital gains tax revenues. (It's important to note that Washington's Rainy Day Fund was first enacted in 2007.) As the graph shows, under current law, which mandates that one percent of general fund tax revenues be deposited into the RDF each year, the fund would have achieved a balance of $677 million prior to the "dot com" bust recession of the early 2000s. It would have reached a balance of only $261 million before the Great Recession.

By contrast, with 25 percent of capital gains tax revenues devoted to it, the RDF would have achieved a balance of about $1.5 billion prior to the "dot com" bust recession and $823 million before the Great Recession. Had 50 percent of capital gains tax revenues been devoted to the RDF, savings would have reached $2.2 billion in the early 2000s and $1.4 billion by 2009. To put this in perspective, since the start of the Great Recession, Washington state has enacted about $10 billion in economically-damaging cuts to our public health, education, and community safety systems.[14] Under the Capital Reform proposal all of these savings could have been used to avert the worst of the service reductions imposed on Washingtonians throughout the recession.

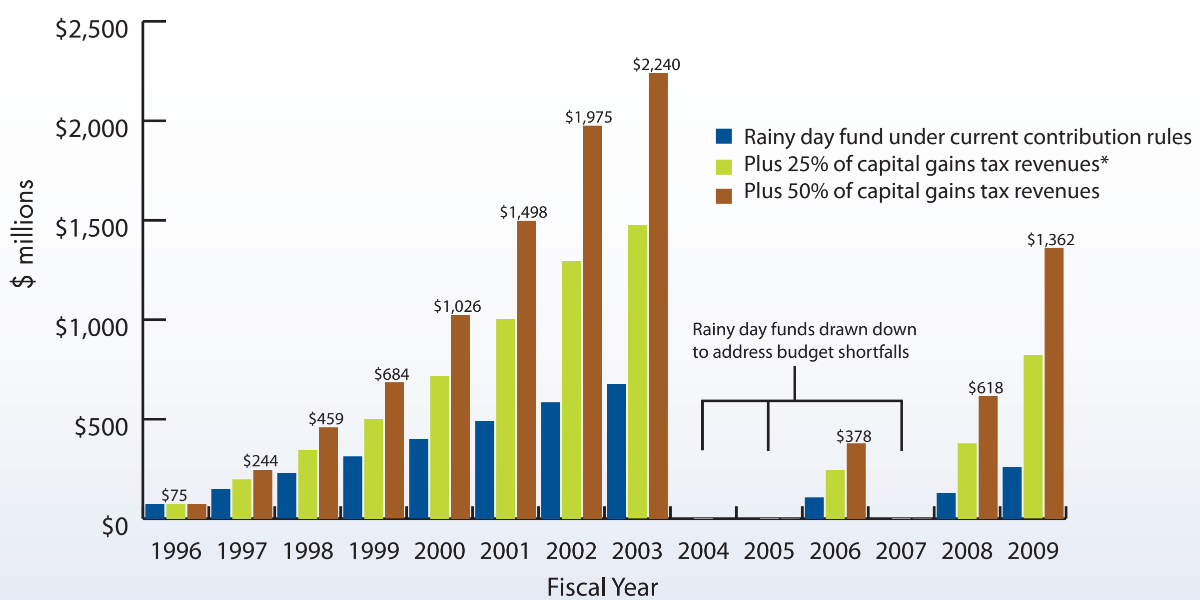
Path to a better balanced, more equitable tax system

The Capital Reform proposal offers Washingtonians the opportunity to rebalance our system of financing public investments by lowering taxes for lower-and middle-income families while increasing them only modestly for the wealthiest households. We all have a responsibility to help maintain the public systems and structures that build a competitive economy and help make sure that prosperity is widely shared. However, our current revenue structure is upside-down: Washington state and local taxes take a larger share of the income of the lowest income households than from the highest.

For example, families in Washington with average earnings of about $11,000 per year pay 17.3 of their income in state and local taxes. Families whose

Figure 3: Capital gains tax would bolster Washington's rainy day fund

Starting year balance for the state's rainy day fund



Source: Budget & Policy Center analysis: Data from LEAP, ITEP, and DOR

* 5% tax on capital gains tax with a $10,000 exemption

incomes average $59,900 each year pay 10.8 percent. And those with annual incomes averaging $1.8 million – Washington's richest 1 percent – pay just 2.6 percent of earnings.[15]

Our excessive reliance on the state sales tax is the major culprit behind Washington's inequitable tax system. That's because lower-and moderate-income families spend a large portion of their incomes on household necessities like soap, toothpaste, and toilet paper – all of which are included in the sales tax.

Some or all of the revenues generated by a capital gains tax could be used to lower the state sales tax rate and fund a Working Families Tax Rebate (WFTR). Used this way, the Capital Reform proposal would significantly lower taxes for the vast majority of Washingtonians, while leaving significant additional resources to reinvest in education, health care, and other job-creating public structures. The impact would be most pronounced among working families with children. Figure 4, shows how the proposal would benefit families in Washington state if all of the revenues were used to lower existing state taxes.

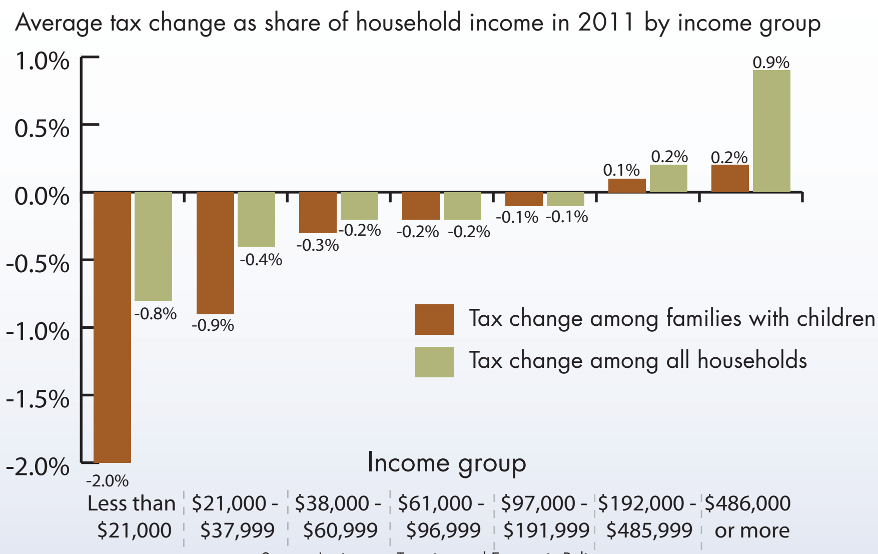
As the graph shows, families with children in Washington making less than $13,000 would see their state taxes reduced on average by two percent of their annual incomes, or $294 per year. Middle-income families with children – those with earnings between $38,000 and $61,000 per year – would also experience a reduction, averaging three-tenths of one percent of annual incomes, or $162 each year. Even households with earnings just under $192,000 would experience a net tax cut, due to the reduction in the state sales tax rate. On average, households with incomes in excess of $486,000 per year would see their state taxes increase by an average of only nine-tenths of one percent of their incomes, or $12,610 a year.

Conclusion

It's time for Washington state to create new jobs through smart investments in our shared health, edu-

Figure 4: Capital gains tax revenues could be used to *lower* taxes for vast majority of Washingtonians

Impact of enacting a new tax on capital gains, lowering the state sales tax rate, and funding the Working Families Tax Rebate (WFTR)*



Source: Institute on Taxation and Economic Policy

*5% tax on capital gains with a $10,000 exemption; state sales tax lowered to 6.1% from 6.5%; WFTR funded at 10% of EITC.

cation, community safety, and other public systems that foster long-term economic growth and prosperity.

For too long we have been losing ground. The Capital Reform proposal would generate the resources to help rebuild our economy through a modest tax on capital gains – a powerful but untapped economic resource. Depending on the structure, a tax on capital gains could generate up to $1 billion each year in much needed resources. The tax would improve our entire revenue structure, making it a more robust and sustainable system of financing important public priorities.

Wisely devoting up to 50 percent of the resources created under the proposal to our state Rainy Day Fund would lessen the severity of future recessions by maintaining vital public health and family support systems when they are most needed.

Finally, resources from a capital gains tax could be used to lower taxes for the majority of Washingtonians – especially lower-and middle income families. Through sensible actions we can rebuild our economic prosperity. A Capital Reform should be the first step.

Acknowledgments

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Endnotes

1. Internal Revenue Service, Statistics of Income for Washington state Tax Year 2009.
2. Internal Revenue Service, Statistics of Income for Washington state Tax Year 2007.
3. U.S. Census Bureau, 2010 American Community Survey.
4. Institute on Taxation and Economic Policy (ITEP), Custom estimates for FY2012.
5. For more information on ITEPs methodology visit http://itepnet.org/about/ITEP_tax_model_full.php.
6. Budget & Policy Center calculations; Data from IRS and the National Association of Realtors.
7. National Association of Realtors, http://www.census.gov/compendia/statab/2012/tables/12s0977.pdf.
8. The federal Alternative Minimum Tax (AMT) would limit the amount of the deduction for some taxpayers.
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10. Budget & Policy Center calculations; Data from the Economic and Revenue Forecast Council (ERFC), September 2011 revenue forecast and Dow Jones Industrial Average.
11. Budget & Policy Center calculations; Data from ERFC and ITEP.
12. Elizabeth McNichol, Michael Leachman and Dylan Grundman, "Better-Than-Expected State Tax Collections Highlight Importance of Income Taxes," Center on Budget and Policy Priorities. July 11, 2011. http://www.cbpp.org/cms/index.cfm?fa=view&id=3530.
13. Revenues from the proposed capital gains tax could also be dedicated to the RDF by statute. However, a Constitutional amendment can only be enacted via a supermajority vote of the legislature plus a vote of the people. As such, an amendment would be a more effective long-term mechanism for building a robust RDF.
14. Budget & Policy Center calculations; Data from Legislative Evaluation and Accountability Program (LEAP) Committee.
15. The Institute on Taxation and Economic Policy, "Who Pays? A Distributional Analysis of the Tax Systems in all 50 States," 3rd ed. November 2009. http://www.itepnet.org/state_reports/whopays.php.