

The High Burden of State and Federal Capital Gains Tax Rates

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Key Findings

- The United States' average top marginal capital gains tax rate ranks sixth in the OECD at a rate of 28.7 percent.
 - The United States' tax rate on capital gains is over 10 percentage points higher than OECD average of 18.2 percent.
 - California's top marginal tax rate of 33 percent is the third-highest tax rate on capital gains in the industrialized world, behind only Denmark and France.
 - The capital gains tax is a non-neutral tax that creates a bias against savings, slows economic growth, and harms U.S. competitiveness.
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Savings in an economy is important. It leads to higher levels of investment, a larger capital stock, increased worker productivity and wages, and faster economic growth. However, the United States currently places a heavy tax bias against saving and investment. One way it does this is through a high top marginal tax rate on capital gains.

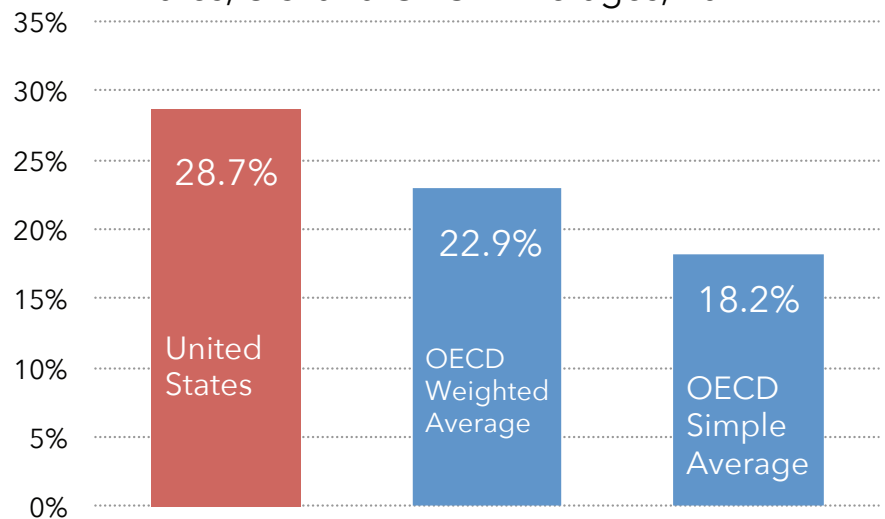
Currently, the United States' top marginal tax rate on long-term capital gains income is 23.8 percent. In addition, taxpayers face state-level capital gains tax rates as low as zero and as high as 13.3 percent. As a result, the average combined top marginal rate in the United States is 28.7 percent. This rate exceeds the average top capital gains tax rate of 18.2 percent faced by taxpayers throughout the industrialized world. Even more, taxpayers in some U.S. states face top rates on capital gains over 30 percent, which is higher than most industrialized countries. In fact, California's top marginal capital gains tax rate of 33 percent is the third highest in the industrialized world.

Capital Gains Taxes in the United States

The current federal top marginal tax rate on long-term¹ capital gains in the United States is 20 percent plus a 3.8 percent tax on unearned income to fund the Affordable Care Act for a total of 23.8 percent for taxpayers with an adjusted gross income of \$200,000 (\$250,000 married filing jointly) or more. In addition, states levy taxes on capital gains income,² which range from zero percent in states with no individual income tax such as Florida, Texas, South Dakota, and Wyoming to 13.3 percent in California. (See Table 1.)³

An individual who has capital gains income is subject to both federal and state capital gains rates. Taking into account the state deductibility of federal taxes and the phase-out of itemized deductions,⁴ top marginal tax rates on capital gains range from 25 percent⁵ in the nine states that do not levy a tax on

Figure 1. Top Individual Capital Gains Tax Rates, U.S. and OECD Averages, 2014



Source: Ernst and Young, Deloitte, Tax Foundation, and Author's Calculations

- 1 Assets held for more than one year.
- 2 Most states tax capital gains as ordinary income.
- 3 Tax Foundation, *Facts & Figures 2014: How Does Your State Compare?* (forthcoming). See also Commerce Clearing House *Intelliconnect* database.
- 4 The Pease limitation on itemized deductions reduces many deductions by 3 percent for taxpayers with adjusted gross income exceeding \$250,000 (\$300,000 married filing jointly).
- 5 Assuming individuals facing the top marginal rate have itemized deductions against which the Pease limitation is applied.

personal income to 33 percent in California. The average across the United States is 28.7 percent.⁶

How the United States Compares to the OECD

The United States' average top marginal tax rate on capital gains of 28.7 percent is the 6th highest rate in the OECD and is more than 10 percentage points higher than the simple average of 18 percent across the 34 countries (Table 2).⁷ The highest rate on capital gains is 42 percent in Denmark. Nine OECD countries do not tax capital gains.

It is also worth noting that taxpayers in many U.S. states face much higher marginal tax rates on capital gains than taxpayers in most OECD countries (Table 3). Comparing U.S. states with individual countries in the OECD, U.S. states have six of the top ten capital gains tax rates in the OECD. California, with a top rate of 33 percent, has the third-highest capital gains tax rate in the industrialized world, while even taxpayers in states without taxes on capital gains, such as Florida, Texas, South Dakota, and Wyoming, face top rates higher than the OECD average.

The Impact of a High Tax Burden on Capital Gains

The United States' high tax burden on capital gains has long-term negative implications for the economy. This non-neutral tax creates a bias against savings, slows economic growth, and harms U.S.'s competitiveness.

Capital Gains Tax is One of Many Taxes on the Same Dollar

Capital gains taxes represent an additional tax on a dollar of income that has already been taxed multiple times. For example, take an individual who earns a wage and decides to save by purchasing stock. First, when he earns his wage, it is taxed once by the federal and state individual income tax. He then purchases stock and lets his investment grow. However, that growth is smaller than it otherwise would have been due to the corporate income tax on the profits of the corporation in which he invested.⁸ After ten years, he decides to sell the stock and realize his capital gains. At this point, the gains (the difference between the value of the stock at purchase and the value at sale) are taxed once more by the capital gains tax. Even more, the effective capital gains tax rate

6 The U.S. average is the combined federal, state, and local rates on capital gains, taking into account the Pease limitation and state/federal deductibility of income taxes weighted by capital gains income in each state. For capital gains income data, see Internal Revenue Service, *Statistics of Income, Historic Table 2*, <http://www.irs.gov/uac/SOI-Tax-Stats--Historic-Table-2>.

7 Ernst & Young, *2013-2014 The worldwide personal tax guide*, <http://www.ey.com/GL/en/Services/Tax/The-worldwide-personal-tax-guide---Country-list>. See also Deloitte, *Deloitte International Tax Source, Country Guides and Highlights*, <https://www.dits.deloitte.com/Administration/ManageHomePage/Popup.aspx?ChildPage=Country%20Guides%20and%20Highlights>.

8 For an explanation of "integrated tax rates on capital gains," see Ernst & Young LLP, Robert Carroll & Gerald Prante, *Corporate Dividend and Capital Gains Taxation: A comparison of the United States to other developed nations* (Feb. 2012), http://images.politico.com/global/2012/02/120208_asidividend.html.

could be even higher on your gains due to the fact that a significant difference in the value of the stock is due to inflation and not real gains.⁹

Creates a Bias Against Saving

These multiple layers of taxation encourage present consumption over savings. Suppose someone makes \$1,000 and it is first taxed at 20 percent through the income tax. This person now has a choice. He can either spend it all today or save it in stocks or bonds and spend it later. If he spends it today and buys a television, he would pay a state or local sales tax. However, if he decides to save it, delaying consumption, he is subject to the multiple layers of taxation discussed previously plus the sales tax when he eventually purchases the television. This lowers the potential rate of return on an investment, which discourages the savings. As an individual, to avoid the multiple layers of taxation on the same dollar, it makes more sense to spend it all now rather than spend it later and pay multiple taxes.

Slows Economic Growth

As people prefer consumption today due to the tax bias against savings, there will be less available capital in the future. For investors, this represents less available capital for factories, machines, and other investment opportunities. Additionally, capital gains taxes create a lock-in effect that reduces the mobility of capital.¹⁰ People are less willing to realize capital gains from one investment in order to move to another when they face a tax on their returns. Funds will be slower to move to better investments, further slowing economic growth.

Harms U.S. Competitiveness, Raises the Cost of Capital

Relatively high capital gains taxes also harm the competitiveness of U.S. corporations by raising the cost of capital. As corporations seek higher returns, corporate investment will move to countries that have lower capital gains tax rates.¹¹ Following the reduction of capital gains tax rates in the U.S. in 1978 from 39 percent to 20 percent, the ability of firms to raise funds through equity offerings greatly increased. As a result, the daily volume of the New York Stock Exchange increased from 28.6 million shares to 85 million shares in five years.¹² Higher rates also slows down the productivity of workers due to less investment in new machinery and software.

Conclusion

The United States currently places a heavy tax burden on saving and investment with its capital gains tax. Its top marginal tax rate on capital gains, combined

⁹ John L. Aldridge & Kyle Pomerleau, *Inflation Can Cause an Infinite Effective Tax Rate on Capital Gains*, TAX FOUNDATION FISCAL FACT NO. 406 (Dec. 17, 2013), <http://taxfoundation.org/article/inflation-can-cause-infinite-effective-tax-rate-capital-gains>.

¹⁰ Bruce Bartlett, *The Case for Ending the Capital Gains Tax*, 41 FINANCIAL ANALYSTS JOURNAL 22-30 (June-July 1985).

¹¹ Chris Edwards, *Advantages of Low Capital Gains Tax Rates*, CATO INSTITUTE TAX & BUDGET BULLETIN No. 66 (Dec. 27, 2012), <http://www.cato.org/publications/tax-budget-bulletin/advantages-low-capital-gains-tax-rates>.

¹² See Bartlett, *supra* note 10.

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with state rates, far exceeds rates faced throughout the industrialized world. Increasing taxes on capital income would further the bias against savings, lead to lower levels investment, and slower economic growth. Lowering taxes on capital would the reverse effect, increasing investment and leading the greater economic growth.

Table 1. Top Marginal Tax Rate on Capital Gains, by U.S. States, 2014

Rank	State	State Rate	Combined Rate
1	California	13.3%	33.0%
2	New York*	8.8%	31.5%
3	Oregon	9.9%	31.0%
4	Minnesota	9.9%	30.9%
5	New Jersey	9.0%	30.4%
5	Vermont	9.0%	30.4%
7	Maryland*	5.8%	30.3%
8	Maine	8.0%	29.8%
9	Iowa*	9.0%	29.6%
10	Idaho	7.4%	29.4%
10	Hawaii*	7.3%	29.4%
12	Nebraska	6.8%	29.1%
13	Connecticut	6.7%	29.0%
13	Delaware	6.6%	29.0%
15	West Virginia	6.5%	28.9%
16	Georgia	6.0%	28.6%
16	Kentucky	6.0%	28.6%
16	Missouri	6.0%	28.6%
16	Rhode Island	6.0%	28.6%
20	North Carolina	5.8%	28.5%
20	Virginia	5.8%	28.5%
22	Ohio*	5.4%	28.3%
23	Wisconsin*	7.7%	28.2%
23	Oklahoma	5.3%	28.2%
25	Massachusetts	5.2%	28.1%
26	Illinois	5.0%	28.0%
26	Mississippi	5.0%	28.0%
26	Utah	5.0%	28.0%
29	Arkansas*	7.0%	27.9%
29	Montana*	6.9%	27.9%
29	Louisiana*	6.0%	27.9%
29	Kansas	4.8%	27.9%
33	Indiana*	3.4%	27.8%
33	Michigan*	4.4%	27.8%
33	Colorado	4.6%	27.8%
36	Arizona	4.5%	27.7%
37	Alabama*	5.0%	27.4%
38	South Carolina*	7.0%	27.3%
39	Pennsylvania	3.1%	26.8%
40	New Mexico*	4.9%	26.5%
41	North Dakota*	3.2%	26.3%
42	Tennessee	0.0%	25.0%
42	New Hampshire	0.0%	25.0%
42	Alaska	0.0%	25.0%
42	Florida	0.0%	25.0%
42	Nevada	0.0%	25.0%
42	South Dakota	0.0%	25.0%
42	Texas	0.0%	25.0%
42	Washington	0.0%	25.0%
42	Wyoming	0.0%	25.0%
	D.C.	9.0%	30.4%
	U.S. Average		28.7%

Table 1. Top Marginal Tax Rate on Capital Gains, by U.S. States, 2014

Source: Tax Foundation, Commerce Clearing House, and author's calculations

*These states either allow a taxpayer to deduct their federal taxes from state taxable income, have local income taxes, or have special tax treatment of capital gains income.

Table 2. Top Marginal Tax Rate on Capital Gains, by OECD Nation, 2014

Rank	Country	Rate
1	Denmark	42.0%
2	France	38.0%
3	Ireland	33.0%
4	Finland	32.0%
5	Sweden	30.0%
6	United States	28.7%
7	Portugal	28.0%
7	United Kingdom	28.0%
9	Norway	27.0%
9	Spain	27.0%
11	Austria	25.0%
11	Germany	25.0%
11	Israel	25.0%
11	Slovak Republic	25.0%
15	Australia	22.5%
15	Canada	22.5%
17	Estonia	21.0%
18	Chile	20.0%
18	Iceland	20.0%
18	Italy	20.0%
18	Japan	20.0%
22	Poland	19.0%
23	Hungary	16.0%
24	Greece	15.0%
25	Mexico	10.0%
26	Belgium	0.0%
26	Czech Republic	0.0%
26	Korea	0.0%
26	Luxembourg	0.0%
26	Netherlands	0.0%
26	New Zealand	0.0%
26	Slovenia	0.0%
26	Switzerland	0.0%
26	Turkey	0.0%
	OECD Simple Average	18.2%
	OECD Weighted Average	22.9%

Source: Ernst & Young, Deloitte

Table 3. Top Marginal Tax Rate on Capital Gains, by OECD Nation and U.S. State, 2014

Rank	State/Country	Rate	Rank	State/Country	Rate
1	Denmark	42.0%	53	New Hampshire	25.0%
2	France	38.0%	53	Austria	25.0%
3	California	33.0%	53	Germany	25.0%
3	Ireland	33.0%	53	Israel	25.0%
5	Finland	32.0%	53	Slovak Republic	25.0%
6	New York	31.5%	53	Alaska	25.0%
7	Oregon	31.0%	53	Florida	25.0%
8	Minnesota	30.9%	53	Nevada	25.0%
9	New Jersey	30.4%	53	South Dakota	25.0%
9	Vermont	30.4%	53	Texas	25.0%
9	D.C.	30.4%	53	Washington	25.0%
12	Maryland	30.3%	53	Wyoming	25.0%
13	Sweden	30.0%	66	Australia	22.5%
14	Maine	29.8%	66	Canada	22.5%
15	Iowa	29.6%	68	Estonia	21.0%
16	Idaho	29.4%	69	Chile	20.0%
16	Hawaii	29.4%	69	Iceland	20.0%
18	Nebraska	29.1%	69	Italy	20.0%
19	Connecticut	29.0%	69	Japan	20.0%
19	Delaware	29.0%	73	Poland	19.0%
21	West Virginia	28.9%	74	Hungary	16.0%
22	United States	28.7%	75	Greece	15.0%
23	Georgia	28.6%	76	Mexico	10.0%
23	Kentucky	28.6%	77	Belgium	0.0%
23	Missouri	28.6%	77	Czech Republic	0.0%
23	Rhode Island	28.6%	77	Korea	0.0%
27	North Carolina	28.5%	77	Luxembourg	0.0%
27	Virginia	28.5%	77	Netherlands	0.0%
29	Ohio	28.3%	77	New Zealand	0.0%
30	Wisconsin	28.2%	77	Slovenia	0.0%
30	Oklahoma	28.2%	77	Switzerland	0.0%
32	Massachusetts	28.1%	77	Turkey	0.0%
33	Portugal	28.0%		OECD Simple Average	18.2%
33	United Kingdom	28.0%			
33	Illinois	28.0%			
33	Mississippi	28.0%			
33	Utah	28.0%			
38	Arkansas	27.9%			
38	Montana	27.9%			
38	Louisiana	27.9%			
38	Kansas	27.9%			
42	Indiana	27.8%			
42	Michigan	27.8%			
42	Colorado	27.8%			
45	Arizona	27.7%			
46	Alabama	27.4%			
47	South Carolina	27.3%			
48	Norway	27.0%			
48	Spain	27.0%			
50	Pennsylvania	26.8%			
51	New Mexico	26.5%			
52	North Dakota	26.3%			
53	Tennessee	25.0%			

Source: Ernst and Young, Deloitte, Tax Foundation, and author's calculations

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