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The High Burden of State and Federal Capital Gains Taxes

By
Kyle E. Pomerleau

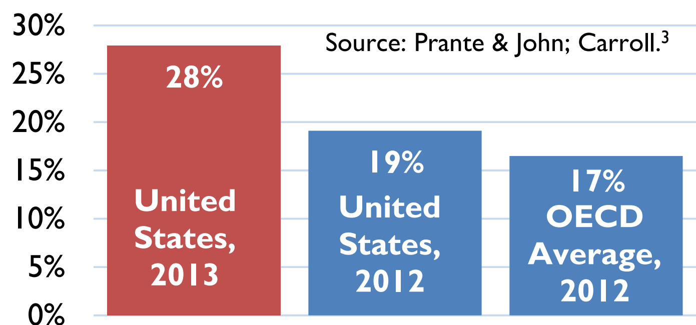
Introduction

As Congress begins to debate tax reform in the coming months, there is one tax that they should pay close attention to: the capital gains tax. The capital gains tax is a tax on profit through the sale of property or investments. At the beginning of this year, the top marginal statutory capital gains tax rate was increased to 23.8 percent from 15 percent. Although lower than the tax on ordinary income, states also tax capital gains, some of them as high as 13.3 percent, adding an additional tax burden to savers and investors. Some taxpayers could pay up to a 33 percent tax on capital gains, a rate that far exceeds rates throughout the world. This high tax rate has long-term negative implications for the economy as people save and invest less and capital seeks higher returns in other countries. Lawmakers should consider the negative economic impacts of such a high tax on investment and look to lower it in any tax reform package.

How the States Compare

On January 1, the Senate passed H.R. 8, the American Taxpayer Relief Act of 2012. Among a number of major changes to the tax code in 2013, America's top marginal statutory tax rate for capital gains increased from 15 percent to 20 percent, plus a 3.8 percent surtax for the Affordable Care Act.[1] This increased the U.S. average rate (average of state capital gains tax rates + federal rate) to 27.9 percent from 19.1 percent,[2] a rate that far exceeds the Organization for Economic Cooperation and Development (OECD) average of 16.4 percent. (See Figure 1.)

Figure 1. Top Individual Capital Gains Tax Rates
U.S. and OECD averages 2012 and 2013



[1] Joseph Henchman, *Details of the Fiscal Cliff Deal*, TAX FOUNDATION TAX POLICY BLOG, Jan. 1, 2013, http://taxfoundation.org/blog/details-fiscal-cliff-tax-deal.

[2] Gerald Prante & Austin John, *Top Marginal Effective Tax Rates by State and by Source of Income, 2012 Tax Law vs. 2013 Scheduled Tax Law (as enacted in ATRA)* (Feb. 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2176526.

However, this average rate hides the variability of capital gains rates within the U.S. State capital gains tax rates range from 0 percent, in states such as Florida, Texas, South Dakota, and Wyoming, to as high as 13.3 percent in California.[4] (See Table 1, below.)

An individual who has capital gains income is subject to both federal and state-level capital gains rates. Taking into account the state deductibility of federal taxes and the phase out of personal exemptions for high income earners, one can calculate the specific rates that taxpayers will pay for tax year 2013 for capital gains.[5] (See Table 1, below.)

Compared to individual countries in the OECD, seven of ten of the top capital gains rates are U.S. states. (See Table 2, below.) California, with a top rate of 33 percent, is the second highest capital gains tax rate in the world, a rate higher than France, Finland, and Sweden.[6] Eleven OECD countries have no capital gains tax at all.

Since the fiscal cliff deal, capital gains tax rates have risen substantially. Taxpayers in every state are subject to a top capital gains tax rate higher than the OECD average. American lawmakers should recognize the combined burden of both state and federal capital gains taxes and the drag that they create on the economy. There are several reasons high capital gains taxes are problematic in terms of economic growth and fairness.

Capital Gains Tax is One Tax of Many 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.[7] 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 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, not real gains.[8]

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[3] *Id. See also* Ernst & Young, Robert Carroll, et al., *Corporate Dividend and Capital Gains Taxation: A Comparison of Sweden to Other Member Nations of the OECD and EU, and BRIC Countries* (Oct. 2012), http://www.svensktnaringsliv.se/multimedia/archive/00033/Corporate_Dividend_a_33823a.pdf.

[4] Prante & John, *supra* note 2.

[5] *Id.*

[6] Carroll, et al., *supra* note 3.

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

[8] Arthur P. Hall, *Issues in the Indexation of Capital Gains*, TAX FOUNDATION SPECIAL REPORT NO. 47 (Apr. 1995), http://taxfoundation.org/sites/taxfoundation.org/files/docs/dafa29992e4cfa82276853f47607c84d.pdf.

Creates a Bias Against Saving

These multiple layers of taxation encourage present consumption over savings. Suppose someone makes $1000 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. 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, the capital gains taxes create a lock-in effect that reduces the mobility of capital.[9] 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.[10] Following the reduction of capital gains tax rates in the U.S. in the late 1970s from 35 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.[11] Higher rates will also slow down the productivity of businesses as there is less investment in new machinery and software. Having a relatively high capital gains tax rate compared to the rest of world is a clear drag on the competitiveness of U.S. businesses.

Lowering the Rate Will Not Necessarily Harm Federal Revenues

In 2009, revenue from capital gains was $37 billion, which is nearly a 20-year low.[12] Many claim that if the government were to lower the rate further, tax revenue would fall even farther. However, history has shown that this is not necessarily true. In fact, revenue collected from realized capital gains increases in years following a drop in the tax rates. (See Figure 2.) Even more, the CBO, in a review of the literature, found

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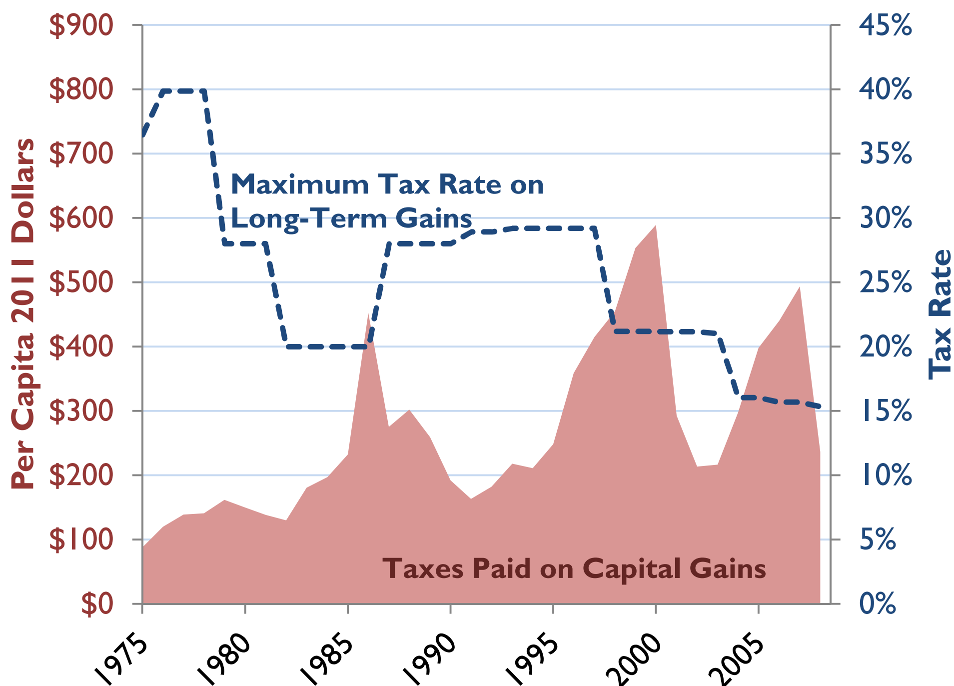
[9] Bruce Bartlett, *The Case for Ending the Capital Gains Tax*, 41 FINANCIAL ANALYSTS JOURNAL 22-30 (June-July 1985).
[10] Chris Edwards, *Advantages of Low Capital Gains Tax Rates*, TAX & BUDGET BULLETIN (Dec. 2012), http://www.cato.org/publications/tax-budget-bulletin/advantages-low-capital-gains-tax-rates.
[11] *See* Bartlett, *supra* note 8.
[12] U.S. Department of the Treasury, *Capital Gains and Taxes Paid on Capital Gains for Returns with Positive Net Capital Gains, 1954-2009*, http://www.treasury.gov/resource-center/tax-policy/Documents/OTP-CG-Taxes-Paid-Pos-CG-1954-2009-6-2012.pdf.

that capital gains realizations are extremely sensitive to tax rates and raising rates wouldn't necessarily result in additional revenue.[13] What seems to be more important to capital gains revenue is economic growth.



Conclusion

As Congress begins debating tax reform, members need to take a serious look at the U.S. capital gains tax rate. There is not much lawmakers in Washington can do about state tax policy, but they can be mindful of the combined effects of state and federal policies. With an average rate of 27.9 percent and a top rate of 33 percent in California, investment in the U.S. is at a severe competitive disadvantage. Investors could easily start looking for higher rates of return in other countries with much lower tax rates or simply choose to reduce domestic investment and instead consume more. The United States risks losing its competitive edge as other countries continue to reform their tax systems to attract businesses and promote economic growth. Policy makers here in Washington need to recognize that a high tax burden on capital gains harms growth and prosperity. Most of the world's leaders have and as a consequence the United States is falling farther behind.

[13] Tim Dowd, Robert McClelland, & Antiphat Muthitacharoen, *New Evidence on the Tax Elasticity of Capital Gains*, Joint Working Paper of the Staff of the Joint Committee on Taxation and the Congressional Budget Office (June 2012), http://www.cbo.gov/sites/default/files/cbofiles/attachments/43334-TaxElasticityCapGains.pdf.

Table 1. Effective Long-term State and Combined Top Marginal Capital Gains Rate by State

Rank	State	Long-term State Capital Gains Rate, 2013	Combined State and Federal Long-term Capital Gains Rate, 2013
1	California	13.3%	33.0%
2	New York	8.8%	31.4%
3	Oregon	9.9%	31.0%
4	New Jersey	9.0%	30.4%
5	Vermont	9.0%	30.4%
6	District of Columbia	9.0%	30.4%
7	Maryland	5.8%	30.3%
8	Maine	8.5%	30.1%
9	Minnesota	7.9%	29.7%
10	North Carolina	7.8%	29.7%
11	Iowa	9.0%	29.6%
12	Idaho	7.4%	29.5%
13	Hawaii	7.3%	29.4%
14	Delaware	6.8%	29.1%
15	Nebraska	6.8%	29.1%
16	Connecticut	6.7%	29.0%
17	West Virginia	6.5%	28.9%
18	Ohio	5.9%	28.7%
19	Georgia	6.0%	28.6%
20	Kentucky	6.0%	28.6%
21	Missouri	6.0%	28.6%
22	Rhode Island	6.0%	28.6%
23	Virginia	5.8%	28.5%
24	Wisconsin	5.4%	28.3%
25	Massachusetts	5.3%	28.2%
26	Oklahoma	5.3%	28.2%
27	Illinois	5.0%	28.0%
28	Mississippi	5.0%	28.0%
29	Utah	5.0%	28.0%
30	Arkansas	4.9%	27.9%
31	Kansas	4.9%	27.9%
32	Louisiana	6.0%	27.9%
33	Montana	4.9%	27.9%
34	Colorado	4.6%	27.8%
35	Indiana	3.4%	27.8%
36	Arizona	4.5%	27.7%
37	Michigan	4.3%	27.7%
38	Alabama	5.0%	27.4%
39	South Carolina	3.9%	27.4%
40	Pennsylvania	3.1%	26.8%
41	North Dakota	2.8%	26.7%
42	New Mexico	2.5%	26.5%
43	Alaska	0.0%	23.8%
44	Florida	0.0%	23.8%
45	Nevada	0.0%	23.8%
46	New Hampshire	0.0%	23.8%
47	South Dakota	0.0%	23.8%
48	Tennessee	0.0%	23.8%
49	Texas	0.0%	23.8%
50	Washington	0.0%	23.8%
51	Wyoming	0.0%	23.8%
	U.S. Average	5.1%	27.9%

Table 2. Effective Long-term State and Capital Gains Rate by State and OECD Country, 2013

Rank	Country/ State	Combined Federal and State Long-term Capital Gains Rate, U.S. States and OECD (Simple Averages), 2013
1	**Denmark**	**42.0%**
2	California	33.0%
3	**France**	**32.5%**
4	**Finland**	**32.0%**
5	New York	31.4%
6	Oregon	31.0%
7	Delaware	30.4%
8	New Jersey	30.4%
9	Vermont	30.4%
10	Maryland	30.3%
11	Maine	30.1%
12	**Ireland**	**30.0%**
13	**Sweden**	**30.0%**
14	Idaho	29.7%
15	Minnesota	29.7%
16	North Carolina	29.7%
17	Iowa	29.6%
18	Hawaii	29.4%
19	District of Columbia	29.1%
20	Nebraska	29.1%
21	Connecticut	29.0%
22	West Virginia	28.9%
23	Ohio	28.7%
24	Georgia	28.6%
25	Kentucky	28.6%
26	Missouri	28.6%
27	Rhode Island	28.6%
28	Virginia	28.5%
29	Wisconsin	28.3%
30	Massachusetts	28.2%
31	Oklahoma	28.2%
32	Illinois	28.0%
33	Mississippi	28.0%
34	**Norway**	**28.0%**
35	**United Kingdom**	**28.0%**
36	Utah	28.0%
37	**U.S. Average**	**27.9%**
38	Arkansas	27.9%
39	Kansas	27.9%
40	Louisiana	27.9%
41	Montana	27.9%
42	Colorado	27.8%
43	Indiana	27.8%
44	Arizona	27.7%
45	Michigan	27.7%
46	Alabama	27.4%
47	South Carolina	27.4%
48	**Spain**	**27.0%**
49	Pennsylvania	26.8%
50	North Dakota	26.7%
51	New Mexico	26.5%
52	**Austria**	**25.0%**
53	**Germany**	**25.0%**
54	**Israel**	**25.0%**

55	**Portugal**	**25.0%**
56	Alaska	23.8%
57	Florida	23.8%
58	Nevada	23.8%
59	New Hampshire	23.8%
60	South Dakota	23.8%
61	Tennessee	23.8%
62	Texas	23.8%
63	Washington	23.8%
64	Wyoming	23.8%
65	**Australia**	**22.5%**
66	**Canada**	**22.5%**
67	**Estonia**	**21.0%**
68	**Iceland**	**20.0%**
69	**Italy**	**20.0%**
70	**Poland**	**19.0%**
71	**Slovak Republic**	**19.0%**
72	**Chile**	**18.5%**
73	**OECD Average**	**16.4%**
74	**Hungary**	**16.0%**
75	**Japan**	**10.0%**
76	**Belgium**	**0.0%**
77	**Czech Republic**	**0.0%**
78	**Greece**	**0.0%**
79	**Korea**	**0.0%**
80	**Luxembourg**	**0.0%**
81	**Mexico**	**0.0%**
82	**Netherlands**	**0.0%**
83	**New Zealand**	**0.0%**
84	**Slovenia**	**0.0%**
85	**Switzerland**	**0.0%**
86	**Turkey**	**0.0%**

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National Press Building
529 14th Street, N.W., Suite 420
Washington, DC 20045

202.464.6200
www.TaxFoundation.org

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