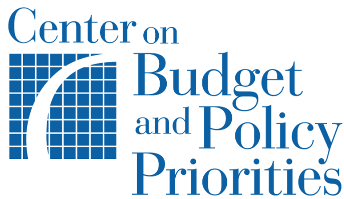

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Testimony Regarding
H.B. No. 7415(RAISED) AN ACT CONCERNING A SURCHARGE ON CAPITAL GAINS

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Finance, Revenue, and Bonding Committee
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Senator Fonfara, Representative Rojas, Senator Witkos, Representative Davis, and esteemed members of the Finance, Revenue, and Bonding Committee, I appreciate the opportunity to speak to you in support of H.B. 7415.

My name is Elizabeth McNichol. I'm a senior fellow with the State Fiscal Project of the Center on Budget and Policy Priorities in Washington DC. The Center is a leader in analyzing a broad range of budget and policy issues that affect low- and moderate-income families and individuals in the United States. The Center's State Fiscal Project prepares analyses and provides technical assistance on state tax and budget issues.

A historically large share of the nation's wealth is concentrated in the hands of a few. As a result, millions of American families have less wealth and therefore fewer opportunities, than they otherwise would. Further, since wealthy people are overwhelmingly white, this extreme wealth concentration reinforces barriers that make it harder for people of color to make gains. One way Connecticut can build more broadly shared prosperity is by strengthening its taxes on wealth and the proceeds of wealth like capital gains. H.B. 7415 would do that by levying a modest (two percent) surcharge on capital gains of the wealthiest taxpayers – individuals with incomes above $500,000 and couples with incomes above $1 million. (Capital gains are the profits an investor realizes when selling an asset that has grown in value, such as shares of stock, mutual funds, real estate, or artwork.)

The Center supports H.B. 7415 for four main reasons.

- A surcharge on capital gains would raise money to invest in good schools and local services that will fuel Connecticut's future prosperity and could reduce Connecticut's long-term obligations.
- This tax (or other taxes) on the wealthy would address income, wealth, and racial inequality in the state as they would be paid by the small number of taxpayers who can best afford the cost and who have done extraordinarily well in recent decades as wealth has become increasingly concentrated at the top.
- A capital gains tax would offset the upside-down nature of current tax system by boosting the state's income tax -- one of only two state taxes that fall more on the state's wealthiest. (The other is the estate tax.) Without this type of offset the state's tax system could become even more tilted to those least able to pay due to the heavier reliance on sales taxes proposed by the governor.
- A surcharge on capital gains would do considerably more good than harm to the state's economy as research and real world experience show that the dire predictions of millionaire flight and economic slowdowns are vastly overblown. Any small negative effect on the economy would be more than offset by the investments the tax would allow.

A surcharge on capital gains would raise much-needed revenues. Connecticut faces a projected $4 billion deficit in the upcoming biennial budget. The state has squeezed programs and services since the recession, cutting medical care for low-income adults, reducing the state's earned income tax credit, and cutting support for colleges and universities. Additional cuts that reduce incomes for families in the state, harm our schools, or weaken our infrastructure will further dampen Connecticut's future economic growth.

A surcharge on capital gains also would reduce inequality and improve the state's upside-down tax system. Incomes in Connecticut are the third most unequal of the fifty states. The wealthiest one percent earned average incomes almost 40 times those of the bottom 99 percent. Families in the bottom and middle have faced the highest barriers to recovery after the Great Recession. Between 2009 and 2015, the top one percent captured 134.2 percent of the total income growth in the state while the share of income of the rest *dropped.* [1]

Connecticut's upside down tax system makes this imbalance worse. Connecticut's tax system takes a much higher share of income from low- and moderate income families than from wealthy families. The lowest- and middle-income taxpayers face a tax rate some 50 percent higher than the wealthiest taxpayers, on average. Middle-income families pay 12 percent and the lowest income taxpayers pay 11.5 percent of their income in state and local taxes in Connecticut, on average, while the top one percent of Connecticut taxpayers (those with income above $1 million) pay just 8 percent.[2]

In addition, the governor has proposed an expansion of the sales tax to address the state's deficits. While these revenues are needed, they will make the state's tax system even more upside-down. Replacing a portion of the sales tax increase with taxes like the proposed

capital gains surcharge would help address this imbalance by shifting some more taxes to the wealthy at the same time.

Connecticut's wealthy can afford to contribute more. Connecticut is one of the wealthiest states. Per capita personal income is the highest in the country.

There is a perception that Connecticut asks more in taxes of its residents than other states because of rankings like the Tax Foundation's. But this ranking overstates Connecticut's taxes by including taxes levied by other states but paid by Connecticut residents like Alaska's taxes on oil and taxes paid to New York by Connecticut residents and by ignoring higher fees and charges levied by other states.

Connecticut's tax rates are not out of line with many other wealthy states. Connecticut's top income tax rate is lower than 12 states, DC, NYC. Its sales tax rate is lower than 11 states (and 8 of these have local sales taxes).

Connecticut also relies more on taxes and less on fees and licenses than other states. There are advantages to this. Fees and licenses are levied without regard for ability to pay and also are generally not adjusted for inflation so over time fall short of the costs of the services they are designed to fund. When you take fees as well as taxes into account, Connecticut is second lowest in total state and local own source revenue as a share of personal income.[3]

And taxes for high-income residents have declined as a result of the 2017 federal tax changes. Wealthy taxpayers in Connecticut and all states received windfall gains from the 2017 federal tax legislation. The new law's heavy tilt to the top largely reflects several large provisions that primarily benefit the most well-off. Its core provision is a deep cut in the corporate tax rate, which will mostly benefit shareholders and highly compensated employees such as CEOs. The law also showers large tax benefits on heirs to multi-million-dollar estates, cuts the top income tax rate, and provides a special deduction for certain business owners who are disproportionately high income. In 2025, when the new law will be fully phased in and before many provisions in it are scheduled to expire, it will boost the after-tax incomes of households in the top 1 percent by 2.9 percent, or roughly triple the 1.0 percent gain for households in the bottom 60 percent.[4]

Only a small share of Connecticut's taxpayers – the very wealthiest – would be affected by a surtax on capital gains. Capital gains are generated by wealth. Because wealth is highly concentrated, so is capital gains income. About 80 percent of capital gains go to the wealthiest 5 percent of taxpayers; 69 percent go to the top 1 percent of taxpayers, nationally.[5] Wealthy households are disproportionately white: white families are three times likelier than families of color to be in the top 1 percent.[6]

In Connecticut, taxpayers with more than $1 million in adjusted gross income received over $8 billion in net capital gains in 2016 – some three-fourths of all capital gains received by the state's taxpayers.[7]

In addition, under H.B. 7415 the proposed capital gains surcharge would apply only to taxpayers in the top income tax bracket which starts at $500,000 for individuals and $1 million for couples.

A capital gains tax or similar tax on high incomes would help not hurt Connecticut's economy. Evidence indicates taxes on the highest incomes can generate substantial revenue for public investments that boost a state's productivity in the long run, without harming economic growth in the short term.

High-income tax increases can generate substantial revenues for investments in people and communities that provide economic and social benefits over the long term. For example, raising personal income tax rates has allowed states to prevent or minimize harmful budget cuts or invest in ambitious new initiatives such as expanding early education, boosting access to college, improving infrastructure, and strengthening "rainy day" funds to prepare for the next recession. Evidence indicates that sustained support for public building blocks of growth can help states improve their residents' well-being, expand opportunity and racial equity, and build more prosperous economies over time.

Real-world experience also suggests that raising income taxes on the wealthy is unlikely to harm Connecticut's economy in the short run, contrary to some claims. In six of eight states (including the District of Columbia) that enacted millionaires' taxes since 2000, private-sector economic growth met or exceeded that of neighboring states since enacting the tax increases. Seven of the eight states had per capita growth in personal incomes at least as strong as nearby states, and five of the eight added jobs at least as quickly as their neighbors.[8]

It must be noted that Connecticut is the exception to this pattern. It was the only state that raised its state income tax rates that has seen markedly weaker growth than its neighbors. But this is likely for reasons other than state tax levels. For instance, Connecticut has relied on an outdated economic growth model that depended on providing a bedroom community for New York City residents at a time when tastes for urban living were growing. Connecticut has not been able to take advantage of this trend as it lacks any city with population of more than 150,000 people. In addition, Connecticut's high concentration of investors and financial companies complicated the state's recovery from the Great Recession. Connecticut has also had to devote most new revenues to addressing past fiscal mistakes, rather than to pro-growth investments like schools and public transportation. But this pattern can change if the state raises sufficient revenues going forward to both pay down past liabilities and invest in the state. Continuing to neglect investments will only be a recipe for further slow growth.

The bulk of mainstream academic research finds that interstate differences in taxes, including differences in top personal income tax rates, have minimal effects on states. Fifteen of the 20 major studies published in academic journals since 2000 that examined the broad economic effect of state personal income tax levels found no significant effects and one of the others produced internally inconsistent results.[9] As a pair of university researchers described in a comprehensive literature review in 2018, "The vast majority of the academic studies that examined the relationship between state and local taxes and economic growth found little or no effect."[10]

Claims of widespread flight by millionaires due to taxes appear unfounded. Opponents of raising income taxes often argue that higher rates will cause affluent residents to flee to lower-tax states, weakening the state's economy and undercutting revenues. But mainstream research does not support these claims. A landmark analysis in 2016 by researchers from Stanford University and the U.S. Treasury Department reviewed tax returns for all million-dollar earners nationwide over 13 years and found that millionaires rarely move from one state to another, and when they do, it's usually not because of taxes.[11] Of the roughly 500,000 households that report income of $1 million or more, only about 12,000, or 2.4 percent, move to a new state in any given year, compared to 2.9 percent among the general population. "The most striking finding of this research is how little elites seem willing to move to exploit tax advantages across state lines," the researchers note. "Millionaire tax flight is occurring, but only at the margins of statistical and socioeconomic significance."[12]

The primary reasons cited for low migration are family obligations, such as the desire to remain close to grandchildren, and business needs, such as a company's founder needing to stay close to existing professional networks and customers. As one expert put it following California's 2013 income tax hikes: "Moving out of state is actually one of the most costly responses [millionaires] could make. . . . Moving to Nevada or Texas or Florida is a very big life change, and means leaving behind family, friends, colleagues and business connections." Another carefully designed study reviewed New Jersey's 2004 personal income tax increase on high-income households, finding that it "raises nearly $1 billion per year, and tangibly reduces inequality, with little cost in terms of tax flight."[13] A later replication of the study by a group of skeptical researchers found that slightly more millionaires may have moved than originally thought, though not nearly enough to sizably reduce the policy's revenue gains.[14]

An additional tax on capital gains could result in somewhat more revenue volatility but it is manageable. Virtually all state taxes are volatile, albeit to varying degrees. Most major state taxes, including the sales tax, are subject to ups and downs with the economy. Indeed, under some circumstances, sales taxes can decline faster in recessions than income taxes.

Rather than not relying on a tax that will experience ups and downs like a surcharge on capital gains, or an income or estate tax, for example Connecticut can reduce the volatility of its overall tax collections and improve its fiscal health by adopting better budget practices.[15]

Reserve funds, such as the rainy day fund, smooth out the ups and downs of tax collections when a recession hits. Some proceeds of income or other tax revenues that rise rapidly in good times can be deposited in a rainy day fund for use during economic downturns. A redesigned volatility cap could address this. There are significant advantages to saving money in good times to have around in bad times which the volatility cap is intended to do. For example, this type of measure identifies the resources available for ongoing spending while leaving it up to policymakers to decide how to spend the funds. In addition, they address the perceived volatility of income taxes – the primary tax that serves to moderate the fact that most state taxes fall more heavily on low-and moderate-income taxpayers – while retaining the tax.

But there are significant problems with the current Volatility Cap as designed that would need to be addressed. The current formula which replaced a different one that was due to go into effect in 2020 is capturing more than the surplus above normal trend growth due to its low starting point (FY17 which was below trend) and its flawed formula. In effect it will force spending cuts and operate as a tax limit not just a check on volatility.

The cap, as designed, can require deposits to the budget stability fund in years when deficits are projected, a bad time to restrict the amount of revenue available. Finally, rather than serving to make the income tax more appealing by smoothing out its ups and down, its current design may create an incentive to raise taxes other than income taxes simply to avoid future skimming of the income tax.

Connecticut should also avoid new long-term spending or tax-cut commitments that are funded in the short term through unsustainable revenue spikes. Instead, when a tax such as an income tax is growing at above-normal rates, the revenue — if it is to be spent rather than placed in reserve — should be set aside for expenditures that are one-time in nature, such as infrastructure, early retirement of debt, improved pension funding, or shoring up unemployment insurance trust funds.

Connecticut relies on a variety of taxes that each respond differently to economic changes which further smooths out total tax collections without sacrificing the advantages of the income tax, such as its progressivity. The proposed surcharge on capital gains would be only a small share of Connecticut's revenues. Capital gains are only 7 percent of adjusted gross income in the state and the revenue that the proposed tax is estimated to raise ($224 million) would make up just 1.4 percent of total state taxes. A broader surcharge that also included an additional tax on dividend and interest income would likely be less volatile. This type of surcharge would equal 3.3 percent of state revenues.[16]

[1] Estelle Sommeiller and Mark Price, *The new gilded age: Income Inequality in the U.S. by state, metropolitan area, and county*, Economic Policy Institute, July 19, 2018. https://www.epi.org/files/pdf/147963.pdf
[2] *Who Pays: A Distributional Analysis of the Tax Systems of All 50 States*, Sixth Edition, Institute on Taxation and Economic Policy, October 2018.
[3] CBPP analysis of data from Census Survey of Government Finances, Bureau of Economic Analysis.
[4] Chuck Marr, Brendan Duke, and Chye-Ching Huang, New Tax Law is Fundamentally Flawed and Will Require Basic restructuring, Center on Budget and Policy Priorities, Updated August 14, 2018. https://www.cbpp.org/research/federal-tax/new-tax-law-is-fundamentally-flawed-and-will-require-basic-restructuring
[5] Tax Policy Center, T18-0231 - Distribution of Long-Term Capital Gains and Qualified Dividends by Cash Income Percentile, 2018, November 16, 2018, https://www.taxpolicycenter.org/model-estimates/distribution-individualincome-tax-long-term-capital-gains-and-qualified-30
[6] "[W]hile 1.2 percent of White families earn enough to place them among the top 1 percent of earners, just 0.4 percent of Latino and Black families are members of this group." Meg Wiehe et al., "Race, Wealth, and Taxes," Institute on Taxation and Economic Policy and Prosperity Now, https://prosperitynow.org/sites/default/files/resources/ITEPProsperity_Now-Race_Wealth_and_Taxes-FULL%20REPORT-FINAL_5.pdf.
[7] CBPP analysis of IRS data, 2016.
[8] Wesley Tharpe, *Raising State Income Tax rates at the Top a Sensible Way to Fund Key Investments, Center on Budget and Policy Priorities*, February 7, 2019.
[9] Michael Leachman and Michael Mazerov, "State Personal Income Tax Cuts: Still a Poor Strategy for Economic Growth," Center on Budget and Policy Priorities, updated May 14, 2015, https://www.cbpp.org/research/state-budgetand-tax/state-personal-income-tax-cuts-still-a-poor-strategy-for-economic.
[10] Dan S. Rickman and Hongbo Wang, "U.S. State and Local Fiscal Policy and Economic Activity: Do We Know More Now?" August 7, 2018, https://mpra.ub.uni-muenchen.de/88422/1/MPRA_paper_88422.pdf.
[11] For example, see Ross Marchand, "Raising Millionaires' Taxes Will Drive Them Away," Foundation for Economic Education, January 20, 2018, https://fee.org/articles/raising-millionaires-taxes-will-drive-them-away/; Kari Jahnsen, "Millionaire's Tax Would Revive 'Taxachusetts,'" Tax Foundation, June 13, 2017, https://taxfoundation.org/millionairestax-massachusetts/.
[12] Cristobal Young et al., "Millionaire Migration and Taxation of the Elite: Evidence from Administrative Data," American Sociological Review, Vol. 81 No. 3, 2016, https://web.stanford.edu/~cy10/public/Jun16ASRFeature.pdf.
[13] Cristobal Young and Charles Varner, "Millionaire Migration and State Taxation of Top Incomes: Evidence from a Natural Experiment," National Tax Journal, June 2011.
[14] See Roger S. Cohen, Andrew E. Lai, and Charles Steindel, "A Replication of "Millionaire Migration and State Taxation of Top Incomes: Evidence from a Natural Experiment," 2014, https://journals.sagepub.com/doi/abs/10.1177/1091142114537893?journalCode=pfrb; and Cristobal Young and Charles Varner, "A Reply to 'A Replication of Millionaire Migration and State Taxation of Top Incomes: Evidence from a Natural Experiment,'" 2015, https://web.stanford.edu/~cy10/public/Reply-Public-Finance-Review-2015.pdf.
[15] Elizabeth McNichol, *Strategies to Address the State Volatility Question*, Center on Budget and Policy Priorities, April 18, 2013.
[16] CBPP calculations of ITEP revenue estimates and IRS Statistics of Income data and Connecticut Office of Policy and Management data.