Testimony on Proposals to Tax Capital Gains and Other Wealth: H7865
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In the United States, we generally tax wage and salary income at higher rates than we do income from investments, and over the last few decades we have witnessed the wealth gap grow, as the wealthiest people make sure that the tax code treats their income and wealth more favorably compared with how tax rules treat ordinary salary and wages, the major source of income for most Americans, including Rhode Islanders. Representative Ajello’s H7865 seeks to take some important steps to rectify this imbalance. The Economic Progress Institute supports three proposals contained in this omnibus legislation:

- Adding a 2% state tax surcharge on higher amounts of capital gains.
- Adding a surcharge on fees paid to financial managers, to compensate for the (mis)classification of this income – basically payment for services rendered – as capital gains investment income instead of as normal wage or salary income as.
- Adding a property tax on second homes, ones not occupied by the owners as a primary residence.

All of these measures would do something decrease the wealth and income gaps while also increasing equity and raising some revenue for the state.

Racial Equity and Tax Fairness

In a system of equitable income and wealth, we would expect Black, Latinx, and White Rhode Islanders to be distributed proportionately among the lowest and highest income groups. Yet, Rhode Islanders with the highest incomes are disproportionately White, and those with the lowest incomes are disproportionately Black and Latinx, as Figure 1 shows. Only 9% of Black and 6% of Latinx Rhode Islanders are among the top 20% of income, whereas 26% of Black and 32% of Latinx Rhode Islanders fall in the lowest 20%. And while Latinx Rhode Islanders make up 13% of the state’s population, they...
account for only 2% of those in the top 20%, White Rhode Islanders account for 89% of the top 20% although they make up only 75% of the overall population.

Decades of racist tax and other public policy – such as redlining for providing and denying mortgages – have resulted in large racial and ethnic disparities in both income and wealth across the country. Tax policies on the state and local levels play a role in maintaining or even worsening the existing wealth and income gaps. **H7865 would improve the situation by decreasing racial and ethnic disparities.**

Although Rhode Island’s Personal Income Tax is moderately progressive, the state’s overall tax structure – including property and sales taxes – is regressive. **This means that Rhode Island’s lowest income earners pay a larger percentage of their income in taxes than do the highest earners.** The bottom 20 percent pay 1.76 times as much as the top 1 percent (14.1 percent of income vs 8.0 percent), as shown in Figure 2. H7440 would prove a modest measure in reducing this gap, to 1.5 times as much, and bring the top 1% in line with the rest of the top 40%. **The federal tax system makes the situation even worse, with capital gains income, the overwhelming majority of which is owned by those with the highest wealth and highest incomes, given favorable tax treatment.**

**Rhode Islanders are Staying in the Ocean State**

Many detailed studies have found no evidence to substantiate the claim that wealthy people flee states over marginal tax rates. There is no evidence of any correlation between tax policy and interstate migration, in Rhode Island or elsewhere. **Very few people move each year, and those with the highest incomes are even less likely to move.** The wealthy have a great **motivation to stay in the places where they are already doing well and have family and social and business networks.** For 20 years from 1997-2016, less than 2.5% of Rhode Islanders moved out of state in any one year, and most of this loss was compensated for by those moving to the state. The annual average incomes of those leaving and those arriving were almost the same, between $50,000 and $51,000. When surveyed about top reasons for moving, people overwhelmingly cite jobs, housing, and family, not taxes. The wealthiest Rhode Islanders are not fleeing the state, and the decades of historical data tell us they will not.

**Capital Gains**

There is no good reason why capital gains should be taxed at a lower rate than wages and salary (and not only are they taxed at a lower rate, but the investor does not pay FICA or social security taxes on the earnings). And in many cases, capital gains can increase in value for years without being taxed and sometimes escape taxation altogether due to other features of the tax
code. Although Rhode Island does presently tax capital gains and wage/salary income at the same rate, there is still a large federal tax advantage for capital gains. This provision of H7865 would recoup for the state a small portion of the tax revenue foregone by the federal government.

**The Carried Interest Loophole**

Through the influence of the wealthy, we have something called the carried interest loophole, by which some high-end financial advisors can claim as investment income what the rest of us recognize as compensation for services rendered. This measure in the bill would only take effect if our neighboring states and New Jersey take the same action, and so long as the U. S. Congress fails to take action. It would assess an additional tax on this income to compensate for the unfairly favorable tax rate it currently receives.

**Second Homes**

The practice of wealthy individuals purchasing second or even third homes has only increased during the pandemic, raising the price of homes and making the housing market even more difficult to access on the part of ordinary Rhode Islanders. Those wealthy enough to afford second homes and not live in them can afford to pay a little extra in property taxes to help maintain the level of services and programs Rhode Islanders need for us all to share in prosperity.

**Estate Tax**

This omnibus bill does contain a fourth proposal, which would raise the exemption level for estates subject to the state version of the estate tax. Whereas this level is $1.649 million for Tax Year 2022, H7865 would increase the amount to $2.275 million. We oppose weakening the estate tax, which already affects only a few hundred of the wealthiest estates each year, a much smaller group than the top 1%, which encompasses approximately 5,000 tax filers.

**Tax Fairness and Revenue**

H7865, once enacted, would make our tax code more fair and equitable and would also likely raise tens of millions of dollars in revenue, which would help the state maintain the sorts of programs and services which benefit Rhode Islanders and the local economy. We have considerable federal pandemic assistance funds now, but if we wait for the one-time relief funds to disappear before we address Rhode Island’s revenue challenges, it will already be too late. We need to plan now, and H7865 helps accomplish this. With such funds, we will be able to build upon the successes of our investments in the state’s recovery.