Economic Policy Brief

Joint Economic Committee – Democratic Staff

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The Administration's Dividend and Capital Gains Proposal

A Costly Solution in Search of a Problem

Introduction

The centerpiece of the President's new growth package is a proposal to eliminate individual income taxes on the dividends that corporations pay to individual investors and to reduce the tax on capital gains that investors pay on the sale of corporate stock. The dividend exemption and capital gains tax relief is estimated to cost $364 billion over the next ten years, more than half of the $670 billion cost of the entire tax package.

The dividend and capital gains proposal would do little to boost consumption and stimulate the economy in the near term because it would not put money in the hands of people who need it most and will spend it quickly. It will disproportionately benefit high-income taxpayers and provide no benefit to the vast majority of families, including most senior citizens. The high cost will significantly worsen the growing federal budget deficit, weakening the prospects for long-term economic growth.

The stated aim of the dividend exemption and capital gains tax relief is to eliminate the "double tax" on corporate income, thereby promoting saving and investment. Taxing all corporate income once and at comparable rates to other business income can be a desirable improvement to federal tax policy. But the current tax system hardly taxes all corporate income twice. A significant fraction of corporate income is not taxed at all at the corporate level because of accounting loopholes and aggressive tax sheltering. Over half of corporate dividends go to institutional shareholders who do not pay tax on that income. A large fraction of the capital gains on corporate stock is never taxed at all. A dividend exemption and capital gains tax relief may have a place in a comprehensive reform of corporate tax policy, but not as part of an expensive and mislabeled economic stimulus proposal.

What the Proposal Would Do

The President's proposal would permit shareholders to exclude all corporate dividends from individual income tax provided that the corporation paying the dividends had paid corporate income tax on its earnings. Corporations choosing to retain taxable earnings rather than paying out dividends could issue credits to shareholders for the amount of those retained earnings. These credits would add to the basis of stock held by shareholders and thus would reduce future capital gains taxes when shareholders sold their shares. For example, suppose a stockholder originally purchased stock for $1,000, and that stock had now tripled in value to $3,000. Under current law, if the shareholder sold the stock, he or she would pay capital gains tax on the $2,000 difference between the sale price and the purchase price. Suppose, however, that the company had credited the shareholder with $1,200 of retained earnings on which it had paid corporate income tax. Under the Administration's proposal, if the shareholder sold the stock for $3,000 he or she would pay capital gains tax only on the $800 difference between the sale price and the purchase price adjusted for retained earnings credits.

Little or No Short-Term Stimulus

Given the uncertain economic environment faced by businesses and households, the policies that are most likely to succeed as economic stimulus are those that provide an immediate boost to consumer spending. The dividend exemption and capital gains proposal fails to do that.[1]

Although the proposal is estimated to reduce tax liabilities by $20 billion in calendar year 2003, taxpayers will not see any real change in after-tax incomes until they pay their 2003 taxes early in calendar year 2004. Tax cuts that put dollars in people's hands next year are not likely to boost consumer spending today when it is needed.

The Administration claims that the proposal would also increase consumer spending by boosting stock market prices and thereby increasing household wealth. There are at least three reasons why this is unlikely to provide significant economic stimulus.

First, the increase in stock market wealth will be modest at best. Stock prices will rise if investors increase their demand for corporate stocks because of the reduced taxes on corporate equities. But pension plans, non-profit institutions, and other tax-exempt shareholders that already do not pay individual income tax on corporate dividends and capital gains hold more than half of corporate equities. There will be no incentive for these investors to purchase more stocks. The Administration claims that stock prices would rise by 10 percent. Economists who have studied the potential effect on equity markets estimate a somewhat smaller increase in stock prices of between 5 percent and 9 percent.[2]

Second, the increase in household wealth from rising stock market prices will be partially offset by the decline in value of other household assets. To the extent that new investors rearrange their portfolios to hold more corporate stocks, the demand for other investments will fall. That would drive down the relative prices of other assets, such as corporate and municipal bonds, raising interest rates. The rise in interest rates will offset some of the increase in household wealth from rising stock prices.

Third, it is unlikely that household consumption will increase very much even if the change in wealth met the Administration's optimistic forecasts. Recent research by the Federal Reserve Board indicates that the effect of changes in household wealth on consumption is small and slow to reach its full effect. Only sustained changes in equity prices produce noticeable changes in household consumption. Even then, the evidence suggests that households increase spending by only 3 percent to 5 percent of additional wealth over the longer-term, but only by about half that amount in the first year.[3]

The net effect would be small relative to the cost of the proposal. The Federal Reserve Board estimated that household holdings of corporate equities were about $11 trillion at the end of 2001 and the total is almost surely lower now.[4] If stock prices rose by between 5 percent and 10 percent, the value of the household wealth at the 2001 level of equity holdings would increase by between $550 billion and $1.1 trillion. This ignores any offsetting decrease in household wealth from higher interest rates. If consumption spending rose by 4 percent of that increase in the long-term, the cumulative increase in spending would be between $22 billion and $44 billion—with perhaps only half of that occurring in the first year. Thus, even in the best case, the total first-year stimulus is a poor return on the ten-year $364 billion cost of the proposal of less than 10 cents on the dollar.

Unbalanced Benefits

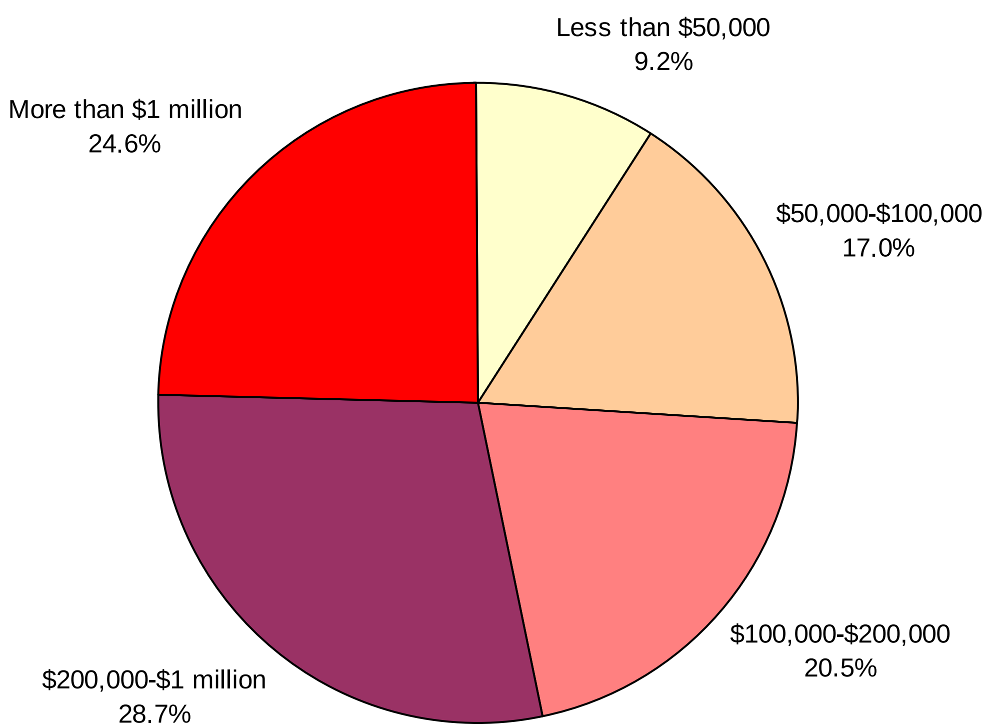
Most families have little or no direct stock ownership. Middle-class families generally own stock through pension funds and retirement accounts, and thus would receive none of the tax benefits from eliminating the tax on dividends and capital gains. The tax cut would go almost entirely to higher-income households who hold taxable corporate equities. According to the Urban-Brookings Tax Policy Center, about one-quarter of the benefits from a dividend exemption alone would go to the less than 0.2 percent of taxpayers with income of at least $1 million (see figure 1). Over half of the benefits would go to the 2 percent of taxpayers with income in excess of $200,000. These families are likely to save, not spend, the bulk of their additional after-tax income.

The Administration has made the point that a large share of the benefits will go to people aged 65 and over. While it is true that about 40 percent of the benefits from the proposal would go to seniors, not all seniors would benefit. Only about one-fifth of seniors have any taxable dividends (see table 1). The 10 percent of seniors with the highest income receive about 70 percent of all dividends paid to people aged 65 and over.

Harm to Long-Term Economic Prospects

In addition to not helping the economy today, the proposed dividend exemption and capital gains tax cut could hurt longer-term economic prospects by worsening the growing federal budget deficit. More than 95 percent of the $364 billion ten-year budget cost of the dividend exemption occurs after the first year. The high cost of the proposal will increase the budget deficit, which, if not offset by increased

Figure 1
Shares of Total Dividend Tax Savings, by Income Group



Source: Urban-Brookings Joint Tax Policy Center, "Dividend Options," January 5, 2003. www.taxpolicycenter.org

Table 1
Receipts of Dividends, by Income Group

Income group	Income range (2002 dollars)	Proportion with dividends (percent)	Share of total dividends (percent)	Average dividend (2002 dollars)
Head under age 65				
Bottom 20 percent	less than 17,900	2.1	0.7	25
Second 20 percent	17,900-33,500	6.6	3.2	119
Middle 20 percent	33,500-52,500	8.6	3.5	120
Fourth 20 percent	52,500-78,100	19.2	8.3	310
Top 20 percent	more than 78,100	33.3	84.4	2,840
All		14.2	100.0	717
Top 10 percent	more than 108,300	45.9	73.8	5,238
Top 5 percent	more than 151,800	55.6	63.5	9,054
Top 1 percent	more than 407,400	71.7	35.7	25,556
Head aged 65 or older				
Bottom 20 percent	less than 11,200	5.4	1.0	121
Second 20 percent	11,200-19,000	7.4	3.8	432
Middle 20 percent	19,000-27,900	13.9	2.9	361
Fourth 20 percent	27,900-51,300	29.3	12.3	1,335
Top 20 percent	more than 51,300	51.7	79.9	8,979
All		21.9	100.0	2,298
Top 10 percent	more than 78,100	60.1	70.5	15,015
Top 5 percent	more than 111,600	59.5	51.6	23,134
Top 1 percent	more than 327,100	63.5	18.6	41,816

Source: JEC Democratic Staff tabulations from The Federal Reserve Board's Survey of Consumer Finances, 1998.

private saving, will reduce total national saving. Over time, decreased national saving translates into reduced incomes for all Americans.

The prospect of increased future budget deficits will put upward pressure on interest rates today. While estimates vary, one recent review of a variety of evidence concluded that a permanent increase in the deficit equal to 1 percent of GDP would raise interest rates by 0.5 percentage points in the first year and by up to one full percentage point after 10 years.[5] Based on these estimates, the cost of the dividend exemption and capital gains provision alone could raise interest rates by 0.15 to 0.3 percentage points, not a tremendous amount, but not helpful for immediate stimulus. This would be in addition to increases in interest rates as a result of investors shifting their holdings from bonds to corporate equities.

The proposal is unlikely to spur strong new investment. Much of the tax benefit from the dividend exemption and capital gains tax relief would reward past investment. Any rise in stock prices that did occur would represent windfall gains to existing stockholders who bought stock at prices that reflected future taxes on dividends and now could sell at higher prices. While new investment would also benefit from the reduced tax on corporate earnings, it is unlikely that the tax change would induce the additional saving needed to finance that investment. Even if that saving were forthcoming, firms are unlikely to undertake significant new projects when existing plant and equipment remain underutilized.

Some new investment in corporations likely would occur but it would come at the cost of decreased demand for other types of investment, as households and firms rearrange investment portfolios. This could hurt other sectors of the economy such as housing, which is particularly sensitive to interest rates, and small businesses, which do not pay corporate-level taxes.

Finally, the cut in taxes at the federal level will likely cause state income tax revenues to decline as well for those states that follow the federal definition of taxable income. Rising interest rates for municipal bonds will put further pressure on state budgets, which are already under a significant strain.

Incomplete Corporate Tax Reform

Most economists support a dividend exemption or similar proposals as a way to lessen some of the inefficiencies in the current income tax system and to improve the longer-term performance of the economy. Reducing taxes on corporate dividends and retained earnings would move the tax treatment of corporate and non-corporate businesses into better balance, and would remove the tax incentive for corporations to fund new investment by selling bonds (debt) rather than issuing new stock (equity).[6] But such proposals are only effective in promoting long-term growth as part of a package that leaves total revenues unchanged—one, for example, that closed many of the existing corporate tax loopholes that allow corporations to pay little or no tax on their profits.

Rather than making the tax system more efficient, a stand-alone dividend exemption and capital gains tax relief could create many new complexities for both businesses and individuals, and may open up new opportunities for tax sheltering and further tax avoidance.

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Endnotes

[1] See, for example, Congressional Budget Office, "Economic Stimulus: Evaluating Proposed Changes in Tax Policy," January 2002. www.cbo.gov

[2] See Bob Davis and Greg Ip, " Bush Stimulus Package Needs Many Assumptions to Pan Out." *Wall Street Journal*, January 8, 2003; Mark Zandi, "Fiscal Heavy Lifting." www.economy.com, January 8, 2003; and Macroeconomic Advisors, "A Preliminary Analysis of the President's Jobs and Growth Proposals." Special Analysis, Macroeconomic Advisors, LLC, January 10, 2003.

[3] Michael Palumbo, "The Effects of Wealth on Household Consumption." Presented at The American Enterprise Institute, December 16, 2002.

[4] Total includes directly held equity shares and shares held through bank personal trusts and estates, life insurance companies, defined contribution pension plans, and mutual funds. See Federal Reserve Board, Flow of Funds Data, *Table B.100.e Balance Sheet of Households and Nonprofit Organizations with Equity Detail*. http://www.federalreserve.gov/releases/Z1/Current/z1r-6.pdf

[5] William Gale and Peter Orszag, "The Economic Effects of Long-Term Fiscal Discipline." Urban-Brookings Tax Policy Center Discussion Paper. December 17, 2002.

[6] In its 1992 study, the Treasury Department rejected a shareholder allocation plan because of its administrative complexities as a solution, but recommended further study of a comprehensive business income tax. See, U.S. Department of the Treasury, *Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once.* 1992