CENTER ON BUDGET AND POLICY PRIORITIES

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Dividend Tax Cut: Ineffective Stimulus Now, Bigger Deficits Later

The full report can be viewed at http://www.cbpp.org/1-6-03tax.pdf

The Center on Budget and Policy Priorities has released a report, *Exempting Corporate Dividends from Individual Income Taxes,* that examines the centerpiece of the Bush Administration's proposed "growth package." As the Center's report explains, eliminating the taxes that individuals pay on dividend payments they receive from corporations would have little short-term stimulative effect on the economy and would impose long-term economic costs by swelling the federal budget deficit.

Advocates of the proposal argue it is needed to end the "double taxation" of corporate dividends, which can face taxation at both the corporate and individual levels. This ignores the significant and growing problem of corporate tax avoidance, which causes large amounts of corporate profits not to be taxed even *once.* Indeed, a recent analysis published by the National Bureau for Economic Research finds that increased use of tax shelters lies behind the growing unexplained gap between the profits that corporations report to their shareholders and the much lower profit figures they report to the IRS; Citizens for Tax Justice estimates that in 2002 less than half of corporate profits were subject to the corporate income tax. A reduction in dividend taxes should be considered only as part of a *deficit-neutral* corporate tax reform package that also curbs corporate tax avoidance and closes unproductive tax shelters. The Administration has rejected this balanced approach in favor of a one-sided approach that will impose long-term costs on the economy.

In addition, the proposal has a number of specific weaknesses, such as:

- **Not an effective stimulus.** Although the proposal's stated goal is to address the weakness in the economy now, most investors would not receive a tax cut from it until well over one year from now (when they file their 2003 taxes in early 2004). More than 90 percent of the tax cut's ten-year cost of $364 billion would not be incurred until *after 2003* — that is, until after the economy is expected to have recovered from the current downturn. Further, most of the benefits would flow to high-income individuals, who are likely to save rather than spend more of a tax cut than moderate- and lower-income families would; yet only if the dollars are spent will they stimulate the economy. Overall, as a recent Congressional Research Service study concludes, "using dividend tax reductions to stimulate the economy is unlikely to be very effective."
- **Skewed toward the wealthy.** Claims that the proposal's benefits would be spread broadly across a growing "investor class" are misleading. Many middle-class investors

hold the bulk of their investments in tax-deferred retirement accounts; yet only taxable accounts are directly affected by the proposal. According to preliminary Urban-Brookings Tax Policy Center estimates, nearly two-thirds of the tax-cut benefits would flow to the top five percent of the population, since they own the lion's share of stocks in taxable accounts. Tax filers with incomes over $1 million — the top 0.2 percent of tax filers, with an average income that exceeds $3 million — would receive nearly 30 percent of the benefits, reflecting an average tax cut of more than $27,700 from this proposal. In contrast, those with incomes between $30,000 and $40,000 would see an average tax cut of $29. It is worth noting that the 2001 tax-cut package, like this proposal, also gave the bulk of its benefits to high-income taxpayers.

- **Harmful to states.** The proposal would worsen the fiscal crisis in the states, which already face their largest budget shortfalls in the last half-century. Because of the linkages between state and federal tax codes, cutting or eliminating the individual tax on dividends would likely reduce *state* revenues by more than $4 billion per year. This would force states to raise taxes or cut spending to compensate, which in turn would undercut efforts to stimulate the economy.

- **Potentially harmful to small businesses and interest-sensitive parts of the economy.** By making dividend-paying corporate stocks a more attractive investment, the proposal would cause investment dollars to shift away from other sectors of the economy, such as small businesses. Further, some funds can be expected to shift from bonds into stocks, causing interest rates to rise as the bond market attempts to attract new investment. Higher interest rates will make home mortgages and car loans more expensive for consumers and will impose a burden on borrowers, such as states and some businesses.

- **Not a big boost to the stock market.** Supporters of the proposal claim it will significantly buoy the stock market (by making dividend-paying stocks more valuable) and thereby bolster both consumer confidence and the overall economy. This claim is likely exaggerated. Over half of dividends are paid to tax-exempt accounts such as pension funds and thus would not be directly affected by the proposal. In any event, attempting to stimulate the economy via an increase in the stock market is a very indirect approach to boost consumer spending and much less efficient than direct measures such as program increases or tax cuts aimed at lower- and middle-income individuals.

- **Unlikely to promote long-term economic growth.** The preponderance of economic research indicates that sustained budget deficits reduce national savings, which results in less investment and ultimately lowers the nation's income. Sustained budget deficits would become more likely under the proposal because of the substantial and permanent revenue losses it would cause.

If the goal is providing an immediate economic stimulus, the Center's report states, measures that extend and strengthen unemployment benefits, provide temporary fiscal assistance to the states, or direct a one-time tax cut to lower- and moderate-income working families would be far more effective than eliminating individual taxes on corporate dividends. Moreover, these temporary economic stimulus proposals would not worsen the long-term budget outlook, unlike the permanent dividend tax cut.