Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

November 9, 2005

ECONOMIC EVIDENCE FOR EXTENDING CAPITAL GAINS AND DIVIDEND TAX CUTS IS WEAK

By Joel Friedman and Aviva Aron-Dine

In the next few weeks, Congress is expected to consider tax reconciliation legislation that allows for approximately $70 billion in tax cuts between fiscal years 2006 and 2010. The reconciliation bill will likely include extensions of a mix of tax cuts that currently are set to expire at some point during the five-year period that reconciliation covers (2006-2010). A number of these tax cuts, including relief from the Alternative Minimum Tax, are slated to expire in 2005, but other provisions expire in later years. In particular, the capital gains and dividends tax cuts, enacted in 2003, are not slated to expire until the end of 2008.

Proponents of extending the capital gains and dividend tax cuts now, a full three years before they are set to expire, argue that extending these tax cuts is essential for the health of the economy today. They maintain that these tax cuts have been instrumental in producing a strong economic recovery and are behind the recent jump in revenues. Failure to extend these tax cuts now, they contend, could harm investor confidence and derail the economy, particularly as it struggles to deal with the impact of the recent hurricanes.

Yet the economic evidence supporting these claims is quite weak. Much more solid is the evidence that these tax cuts are costly measures that increase the deficit and provide the bulk of their benefits to high-income taxpayers.

- The key assertion by supporters of the capital gains and dividend tax cuts is that they have been a driving force behind a robust recovery. Yet the current recovery is far from dazzling. When assessed across a broad range of economic indicators, this recovery is worse than the average recovery in the post-World War II period. In the current recovery, the economy has *underperformed* in terms of GDP growth and growth of fixed non-residential investment, and its performance has been particularly poor in terms of employment and wage growth. Only in one area — corporate profits — have the results been above average for a recovery.

- Given the below-average recovery, there is no reason to believe that the capital gains and dividend tax cuts are crucial to the economy's health. Further, the issue is not whether to change current law by *canceling* the tax cuts today. The key question is whether, given the tax cuts' high cost, action should be taken now to extend them.

- The proposed two-year extension of the capital gains and dividend tax cut is sometimes said to cost $21 billion. In fact, the Joint Congressional Committee on Taxation has said that this extension would reduce revenues by $51 billion, with $21 billion of this amount falling within the five-year time frame of the reconciliation bill, and the other $30 billion in cost occurring between 2011 and 2015. Similarly, while a one year extension of the capital gains and dividend tax cuts would cost $10 billion within the five-year time frame of the reconciliation bill, it would reduce revenues by $26 billion by 2015.

- Moreover, proponents of this extension are not interested in extending these tax cuts for just another year or two. Their goal is to make them permanent. A permanent extension of the capital gains and dividend tax cuts would cost $162 billion over the next ten years ($189 billion when the added interest costs on the debt are included).

- Because these costs would add to deficits, they would have a negative impact on long-term economic growth that would mitigate and most likely outweigh any positive impact these measures might otherwise have. The Congressional Research Service has concluded, for instance, that making the dividend tax cut permanent would likely *harm* long-run economic growth if it is deficit-financed.

- Finally, the benefits of extending these tax cuts would go overwhelmingly to high-income households. According to the Urban Institute-Brookings Institution Tax Policy Center, more than half — *53 percent* — of the benefits of capital gains and dividend tax cuts in 2005 will flow to the *0.2 percent* of households with incomes over $1 million. Three-quarters of the gains are going to the 3.3 percent of households with incomes over $200,000. Some 90 percent of the gains are going to households over $100,000.

At the very least, the economic case for acting now to extend the dividend and capital gains tax cuts could make sense only if two conditions were met. First, the positive consequences of the tax cuts' long-run impact on investment would have to outweigh the negative consequences of their long-run impact on deficits. Second, the tax cuts would have to have short-run effects that necessitated their immediate extension. With the evidence for both of these claims extremely weak, there is no compelling economic rationale for extending the tax cuts in the forthcoming reconciliation bill. Doing so would provide another unaffordable tax break to those who are already very well-off, while further adding to the deficit.

Economic Effects of Capital Gains and Dividend Tax Cuts

Theoretically, capital gains and dividend tax cuts could boost economic growth in two ways. First, by increasing the after-tax return on investment, they could promote investment and saving. Second, they could improve the efficiency of corporate financing decisions and reduce distortions that deter investment in the corporate sector. Supporters of extending the capital gains and dividend tax cuts claim that such economic gains have, in fact, materialized and that the 2003 tax cuts, along with those enacted in 2001, have led to strong economic growth in the past few years.

Evidence Points to a Weak Recovery

Data on a wide range of economic indicators indicate, however, that growth during the current economic recovery (which began in November 2001) has not been especially robust. GDP, consumption, investment, net worth, employment, and wages and salaries have all risen less rapidly than their average rates of growth during comparable periods of other post-World War II recoveries. Corporate profits have increased dramatically, but those gains have not translated into high GDP growth rates, nor have they led to improvements in the economic well-being of most Americans. Workers have fared poorly, with employment and wage and salary growth well below historical norms.[1]

The weakness of investment growth casts particular doubt on tax cut boosters' claims. Reducing tax rates on capital gains and dividends increases the after-tax return on investment, which is supposed to increase investment and thus spur growth. But fixed non-residential investment — investment in non-residential buildings, equipment, and software — has grown at an average annual rate of 3.8 percent during this economic recovery, as compared with an average 6.4 percent growth rate in past recoveries.[2] In addition, investment growth has been slower in this recovery than during the recovery of the early 1990s, which occurred in years following a significant tax *increase*.

Also notable, personal savings rates have continued their general pattern of decline since the tax cuts. As many economists have observed, efforts to increase personal savings by reducing tax rates on capital income (whether by cutting tax rates on capital gains and dividends or by introducing new tax-preferred savings accounts) have so far proven ineffectual. This further undermines the argument that capital gains and dividend tax cuts should be extended to promote saving and investment.

Little Evidence Yet of Economic Efficiency Gains

The available data do not support claims that cutting capital gains and dividends taxes has led to exceptional economic performance. There also is reason to doubt claims that these tax cuts have greatly enhanced economic efficiency in ways that would yield positive economic effects over the long run.

The theory behind the dividend tax cut was that by reducing the "double tax" burden on dividends (which can result because dividends can be taxed at both the corporate and shareholder levels), this tax cut would reduce the difference in tax rates on different forms of investment. That would diminish distortions that deter corporate sector investment and cause corporations to rely too heavily on debt financing, thereby enhancing the efficiency of investment decisions and boosting the economy.

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[1] For detailed comparisons between this and other recoveries and an explanation of the methodology used, see Isaac Shapiro, Richard Kogan, and Aviva Aron-Dine, "How Does This Recovery Measure Up?" Center on Budget and Policy Priorities, August 9, 2005, available at http://www.cbpp.org/8-9-05bud.pdf.

[2] Total investment has also grown more slowly in this recovery than in other recoveries. Fixed non-residential investment is highlighted because it is considered a better indicator of the nation's stock of productive capital, changes in which significantly affect prospects for economic growth over the long term.

Economists disagree, however, about the extent to which lowering dividend taxes actually improves the efficiency of investment decisions, rather than simply providing windfall gains to shareholders.[3] A study of the 2003 tax cut by economists Alan Auerbach and Kevin Hassett found some evidence for the view that dividend tax cuts do not affect investment decisions.[4] Hassett commented at a recent American Enterprise Institute forum that the study implied it was "not likely that tinkering with the dividend tax rate will have much effect on investment."[5] Similarly, in a study of British firms' responses to 1997 dividend tax changes, economists found evidence of changes in dividend pay-outs but "no evidence of any change in investment behavior," a conclusion that undermines claims that dividend tax cuts improve investment decisions and make the allocation of investment capital more efficient.[6]

Even economists who believe that dividend tax cuts can enhance efficiency typically estimate that the resulting effects on economic growth would be small.[7] Moreover, to the extent that there are potential efficiency benefits from changing dividend and capital gains taxation, the capital gains and dividend tax reductions enacted in 2003 were poorly designed to capture them. Not only did the tax measures provide windfall gains for investments that had already been made, but they failed to take steps to ensure that all corporate income is taxed at least once, instead allowing corporations to use loopholes to avoid taxation of some income entirely.

It also is important to distinguish between behavioral responses to the tax cuts in the short run and their potential impact on the economy over the long run. Reductions in tax rates, particularly if they are temporary, are likely to encourage investors and companies to act in ways that maximize their tax benefits. If they are perceived to be temporary, the reaction can sometimes be even larger. Not surprisingly, several studies have found that some companies increased dividends, or started to pay new dividends, in response to the dividend tax cut. What is not clear, however, is whether these dividend payments will have the desired effect on the economy. Their economic impact would be muted if, as some studies suggest, many of the newly initiated dividend payments are in the form of one-time dividends rather than regular dividends, or if firms have simply substituted dividend payments for other forms of shareholder compensation, such as share repurchases.[8]

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[3] For discussion of theories of how dividend tax cuts affect investment (in the context of the 2003 tax cuts), see Alan Auerbach and Kevin Hassett, "The 2003 Dividend Tax Cuts and the Value of the Firm: an Event Study," OTPR/Burch Center Conference, May, 2005. http://emlab.berkeley.edu/users/auerbach/03divtax.pdf.

[4] Alan Auerbach and Kevin Hassett, "The 2003 Dividend Tax Cuts and the Value of the Firm: An Event Study."

[5] Kevin Hassett, Presentation at American Enterprise Institute Forum, "How Did Firms Respond to the Dividend Tax Cuts?" November 8, 2005.

[6] Stephen Bond, Michael Deveruex, and Alexander Klemm, "Dissecting Dividend Decisions: Some Clues about the Effects of Dividend Taxation from Recent UK Reforms," Institute for Fiscal Studies, June 27, 2005, http://www.ifs.org.uk/wps/wp0517.pdf.

[7] Former CEA Chair Glenn Hubbard suggested in a speech at the American Economic Association in January 2004 that gains resulting from the tax cuts' effects on the allocation of investment would raise the long-term level of GDP by 0.2 percentage points. Cited in William Gale and Peter Orszag, "Bush Administration Tax Policy: Effects on Long-Term Growth," *Tax Notes,* October 18, 2004.

[8] For further discussion of these issues, see Joel Friedman, "Dividend and Capital Gains Tax Cuts Unlikely to Yield Touted Economic Gains: Benefits of these Tax Cuts Flow Disproportionately to the Well-Off," Center on Budget and Policy Priorities, revised October 7, 2005, http://www.cbpp.org/3-10-05tax.pdf.

Similarly, investors may accelerate the realization of capital gains (i.e., the sale of stocks or other assets that produce capital gains) to ensure that they can take advantage of the lower capital gains tax rate while it is in effect (since the lower rate might not last). Such timing decisions have no significant effect in boosting the economy. Increases in capital gains realizations can have some impact on revenues in the short run, and the added revenue from a short-term increase in realizations may temporarily outweigh the revenue losses from a reduction in capital gains rates. But this should not be confused with improving the economy. Whether behavioral reactions translate into improvements in the economy will depend on whether funds are reinvested in more productive areas and (as discussed below) whether any gains from a more efficient allocation of investment capital outweigh the economic harm that results from the increase in deficits that these tax cuts cause over time.

Borrowing to Pay for Tax Cuts Undercuts Their Positive Effects

Studies show that the contribution of the capital gains and dividends tax cuts to higher deficits is likely to mitigate, and possibly outweigh, any of the positive effects the tax cuts would otherwise have on the economy. All else being equal, deficits lower national saving, thus lowering national investment and long-run economic growth.

The Joint Committee on Taxation estimates that the capital gains and dividend tax cuts enacted in 2003 will cost $148 billion between 2003 and 2010. Extending these tax cuts through 2009 would cost an additional $26 billion; extending them through 2010 would cost an additional $51 billion. When the added interest costs are included, the total increase in the deficit that would result from extending these tax cuts would be $35 billion (for an extension through 2009) and $68 billion (for an extension through 2010)**.**

The Congressional Research Service has analyzed the 2003 dividend tax cut under a variety of assumptions and concluded that, in the long-run, "the dividend relief proposal would *harm long-run growth as long as it is based on deficit finance*" (emphasis added).[9] Similarly, Brookings Institution economists William Gale and Peter Orszag concluded that even if the more optimistic assumptions about the positive effects of the dividend and capital gains tax cuts on the economy proved accurate, as long as these tax cuts continued adding to the deficit, "the net effects would be roughly a zero effect on long-term growth."[10]

In a detailed new study, Gale and Orszag emphasize the importance of incorporating tax cuts' contributions to deficits into estimates of their effects on the economy. Many previous analyses of the effects of tax cuts on the economy included the assumption that the cost of the tax cuts would be offset and would *not* add to the deficit; these analyses concluded that tax cuts can encourage investment. Gale and Orszag show, however, that if it is instead assumed that tax cuts add to the deficit, the resulting increase in interest rates will undermine or overwhelm the positive economic effects of the tax cuts.[11] In other words, capital gains and dividend tax cuts that are *not* paid for, and

[9] Jane Gravelle, "Dividend Tax Relief: Effects on Economic Recovery, Long-Term Growth, and the Stock Market," Congressional Research Service, March 28, 2003.

[10] William Gale and Peter Orszag, "An Economic Assessment of Tax Policy in the Bush Administration, 2000-2004," Boston College Law Review, Vol. 45, No. 4, 2004.

[11] William Gale and Peter Orszag, "Deficits, Interest Rates, and the User Cost of Capital: A Reconsideration of the Effects of Tax Policy on Investment," Urban-Brookings Tax Policy Center, August 19, 2005.

thus increase the deficit, have the potential to reduce investment once the negative effects of higher interest rates are taken into account.

Extending the Tax Cuts in the Wake of Katrina

Many of the arguments for extending the 2003 tax cuts focus on short-term, rather than long-term, economic considerations. Senate Finance Committee Chairman Charles Grassley has suggested that extending the capital gains and dividend tax cuts is important in the wake of Hurricane Katrina because, "I would think in a time when we have some question about the ripple effect of what happened with Katrina affecting the whole economy of the United States, you don't want to do anything to discourage investment in America."[12] The fear is that a failure to extend these tax cuts could depress investor confidence and derail the economy.

As discussed above, however, the evidence that the capital gains and dividend tax cuts have had a significant positive impact on the economy is weak. Further, if capital gains and dividend tax cuts were to affect economic growth positively, the effects would primarily be felt over the long term, not the short term. In short, the argument that the recent hurricanes necessitate action now to extend the capital gains and dividend tax cuts beyond 2008 does not withstand scrutiny.

Some may still argue that failing to extend the capital gains and dividend tax cuts now would damage the economy by depressing investor confidence, even if the tax cuts themselves have little impact on growth. But one must question the wisdom of extending costly tax cuts on the basis of nebulous claims about effects on investor confidence. Furthermore, unpaid for tax cuts that worsen deficits could lower investor confidence and increase the expectation of higher interest rates and taxes in the future, thus deterring investment.

Concerns about negative effects on the stock market may be especially overblown. A recent Tax Policy Center study indicates that capital gains tax rates and stock market values are only weakly correlated. It concludes that "capital gains tax rates can *increase* significantly, as they did following the 1986 Tax Reform Act, and have little apparent effect on the stock market" (emphasis added).[13] There is some evidence that the dividend tax cut pushed up stock prices. But to the extent that the tax cut was perceived to be temporary, failure to extend it now, three years before it is due to expire, would not be expected to greatly affect stock values. Moreover, according to the Congressional Research Service, appreciation in stock values after a dividend tax cut indicates that the tax cut is providing windfall gains to shareholders, rather than encouraging new investment.[14]

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[12] Associated Press, "GOP Tax Cuts Delayed by Katrina," September 14, 2005.

[13] Troy Kravitz and Leonard Burman, "Capital Gains Tax Rate, Stock Markets, and Growth," *Tax Notes,* November 7, 2005, available online at http://www.urban.org/UploadedPDF/1000851_Tax_Fact_11-7-05.pdf.

[14] CRS noted, "a belief in a large permanent effect on the stock market is only consistent with a belief that there is little to gain in efficiency effects from dividend tax relief." Jane Gravelle, "Dividend Tax Relief: Effects on Economic Recovery, Long-Term Growth, and the Stock Market."

Do These Tax Cuts Pay for Themselves?

Extending the capital gains and dividend tax cuts would be costly. According to the Joint Committee on Taxation, a two-year extension of these tax cuts would cost $51 billion through 2015; making these tax cuts permanent would cost $162 billion through 2015. Despite these estimates, some proponents of these measures downplay the costs, suggesting these tax cuts have the ability to *increase* revenues and citing the recent uptick in federal revenues in 2005 as evidence. The implication is that there is no need to worry about the contribution of these tax cuts to deficits because these tax cuts "pay for themselves."

Although these and other tax cuts can sometimes increase revenue *in the short run*, when investors temporarily change their behavior to take advantage of a lower tax rate, these higher revenues are not sustained over time. The historical record shows that tax cuts — including capital gains and dividend tax cuts — have consistently lost revenue.

The following table shows the effect of the tax cuts enacted in 2003, of which the capital gains and dividend tax cuts are the centerpiece. It compares the actual levels of revenue in 2003, 2004, and 2005 with the "predicted" levels of revenue. The predicted levels equal Office of Management and Budget revenue projections at the start of 2003 that do *not* include the effects of the 2003 tax cuts, as reduced by the Joint Committee on Taxation's estimates of the revenue losses from the tax cuts that have been enacted since that time.

As the table indicates, the Joint Committee's estimates of the amount of revenue that these tax cuts would lose have proved to be fairly accurate. If tax cuts for investment had generated large revenue and economic gains, revenues would have been well above the predicted levels. *Instead, revenues over the past three fiscal years have been $316 billion lower than what OMB predicted they would be without these tax cuts* (or relatively close to the $289 billion revenue loss that the Joint Committee predicted).

In other words, the capital gains and dividend tax cuts have lowered revenues and increased deficits. The bottom line is that an extension of the capital gains and dividend tax cuts would lose further revenue and contribute to still-higher deficits, thereby likely harming — rather than improving — long-term economic growth.

Revenue Losses From Tax Cuts Materialize as Projected
(billions of dollars)

	2003	2004	2005	Three-Year Total
OMB Projection in January 2003	1,867	2,031	2,235	6,133
Actual Revenue Collections	1,782	1,881	2,154	5,817
Difference	**-85**	**-150**	**-81**	**-316**
JCT Projection of Revenue Loss	**-53**	**-132**	**-104**	**-289**

In a recent study, the Economic Policy Institute evaluated the effects of the actual expiration of another investment tax cut, the "bonus depreciation" tax cut enacted in 2002. EPI found little difference in investment behavior before and after this tax cut expired.[15] This is the latest example showing that the impact of tax cuts on business confidence and decision-making may be less than advocates of such tax cuts often claim.

[15] Lee Price, "The Boom that Wasn't."

The Distribution of Capital Gains and Dividend Tax Cuts

While there may be uncertainty about the economic impact of capital gains and dividend tax cuts, there is no question about who benefits from them. The benefits of these tax cuts flow overwhelmingly to those with the highest incomes.

- In 2005, some 53 percent of the benefits of the dividend and capital gains tax cuts will flow to the 0.2 percent of households with incomes over $1 million, according to an analysis by the Urban Institute-Brookings Institution Tax Policy Center. These households will receive an average tax cut from these measures of nearly $38,000 in 2005. (These tax-cut benefits are in addition to the generous gains that such high-income households are receiving from other tax cuts enacted since the start of 2001.)

- The Tax Policy Center data also show that households with incomes over $200,000 will receive more than three-quarters of the dividend and capital gains tax-cut benefits. Households with incomes above $100,000 will receive 90 percent of the benefits. Only 10 percent of the benefits of the dividend and capital gains tax cuts will flow this year to the 86 percent of households with incomes under $100,000.

Supporters of these tax cuts may try to argue that the benefits are more widespread, pointing to the growing number of families that own stock. But despite this growth, stock ownership remains highly concentrated at the top of the income spectrum. Furthermore, high-income households are much more likely to hold stocks in *taxable accounts* than are middle-income families, who hold a larger share of their savings in retirement accounts that are not subject to tax and thus are not directly affected by capital gains and dividend tax cuts. Data from the Federal Reserve's 2001 Survey of Consumer Finances show that households in the top five percent of the income spectrum own nearly 60 percent of all stocks held in taxable accounts.

Conclusion

Advocates of extending the capital gains and dividend tax cuts are proposing an expensive, deficit-increasing tax break primarily for wealthy investors while failing to demonstrate that the tax break's benefits outweigh its costs. Evidence on the economy's recent performance and on firm responses to dividend tax cuts provides little if any indication that the tax cuts have contributed either to short-run economic growth or to long-run economic efficiency. The negative economic consequences of increasing deficits, by contrast, are clear. Given these considerations, extending the tax cuts now would be an irresponsible decision – especially when viewed alongside program cuts currently being debated in Congress that would significantly burden low- and moderate-income households.