
Revised July 12, 2007

THE EFFECTS OF THE CAPITAL GAINS AND DIVIDEND TAX CUTS ON THE ECONOMY AND REVENUES Four Years Later, A Look at the Evidence

By Aviva Aron-Dine

Summary

With the fourth anniversary of the 2003 capital gains and dividend tax cuts just past and the Office of Management and Budget's Mid-Session Review released today, supporters of making these tax cuts permanent are reiterating their claim that the tax cuts boosted the economy and increased federal revenues. For example, a release from the Senate Republican Policy Committee contends that the tax cuts "contributed to today's strong pro-growth economy" and "have also led to a surge in tax receipts" and that allowing these tax cuts to expire as scheduled would "have devastating consequences for the economy."¹

Claims like these raise three basic questions. First, has the economic and revenue growth of the past few years really been unusually strong? Second, are there good reasons to think that the capital gains and dividend tax cuts *caused* whatever economic and revenue growth has occurred, as opposed to just *coinciding* with it? Third, would extending these tax cuts boost economic and revenue growth on a longer-term basis?

The last four years of data, as well as some important new academic research, suggest that the answer to each of these questions is No.

Economic and Revenue Growth Unexceptional

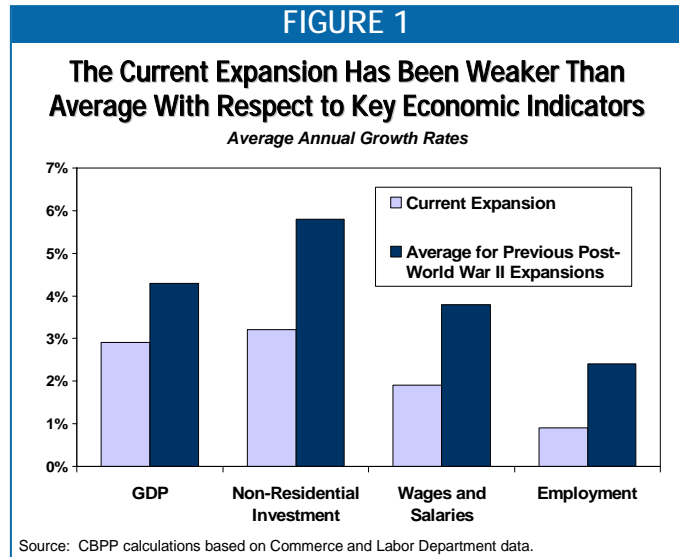
Since supporters of the capital gains and dividend tax cuts routinely appeal to the economic and revenue growth of the past few years as evidence of these tax cuts' success, one might assume that the recent economic performance has been stronger than typical. In fact, the opposite is the case.

- Growth in key indicators such as the Gross Domestic Product (GDP), non-residential investment, wages and salaries, and employment has been *below average* during the current economic expansion, relative to previous post-World War II expansions. (See Figure 1.) The current recovery has also been weaker overall than the equivalent period of the 1990s, during

¹ Senate Republican Policy Committee, "Marking the 4th Anniversary of the 2003 Tax Relief Law: A Boon to Taxpayers, Tax Receipts, and the Economy," May 15, 2007.

which there were tax *increases* rather than tax cuts.²

- Those who argue that the capital gains and dividend tax cuts had powerful economic effects often discount the first two (very weak) years of the current economic expansion and focus on growth since 2003. But even since 2003, the growth in GDP, wages and salaries, and employment has been below average for a post-World War II recovery. Growth in non-residential investment has only matched the historical norm.



- Despite claims that the tax cuts have generated a revenue surge and have thus “paid for themselves,” revenues, too, have grown at below-average rates — exactly as one would expect in the aftermath of two large tax cuts. Based on the new Office of Management and Budget projections, revenues at the end of fiscal year 2007 will be only 3.1 percent higher than when the current business cycle began in 2001, after adjusting for inflation and population growth. This is far below the 12 percent average revenue increase over comparable periods of previous post-World War II business cycles and the 16 percent increase during the 1990s. (Revenue growth since 2003 is discussed below.)

Tax Cuts Coincided With Improvement in the Economy But Didn't Cause It

Advocates of the 2003 tax cuts frequently emphasize that the economy's performance improved around the time that these tax cuts were enacted, and they imply that the tax cuts *caused* the improvement in the economy. But as nine out of ten prominent economists told the *New York Times* in a recent informal survey, the economy's improvement was most likely attributable to factors other than the tax cuts.³

- Asked to name the main reason for stronger growth after 2003, several economists cited “super-low interest rates caused by the Federal Reserve.” Others chalked the growth up to the “regular business cycle,” with economist Robert Hall of the Hoover Institution pointing out that, “the U.S. economy recovered from every single recession it ever had, so the growth in 2003-2006 was generally part of the normal cyclical recovery.”
- The 1990s recovery provides a useful comparison. Like the current recovery, the 1990s

² Specifically, GDP growth in the 1990s recovery was slightly stronger than in the current recovery, while growth in investment, wages and salaries, and employment was substantially stronger. For more detailed comparisons, see Aviva Aron-Dine, Chad Stone, and Richard Kogan, “How Robust Is the Current Economic Expansion?” Center on Budget and Policy Priorities, revised June 28, 2007, <http://www.cbpp.org/8-9-05bud.htm>.

³ Daniel Altman, “Pop Quiz: Did the Tax Cuts Bolster Growth?” *New York Times*, May 13, 2007, <http://www.nytimes.com/2007/05/13/business/yourmoney/13view.html?ex=1336708800&en=5b14a30788f7df80&ei=5124&partner=permalink&expprod=permalink>.

recovery was initially relatively weak, with investment growth in particular resuming only about eighteen months into the recovery. But in the 1990s, investment growth recommenced without any tax cuts — and then strengthened modestly following a tax *increase*. Moreover, overall investment growth during the 1990s business cycle, with its large tax increases in 1990 and 1993, was substantially stronger than during the current business cycle, with its large tax cuts in 2001 and 2003. If major economic developments were generally attributable to tax policy, then the 1990s experience could lead one to conclude that tax increases provide more potent economic stimulus than tax cuts. The more appropriate lesson to draw, however, is probably that weak recoveries tend to return to historical norms, whether taxes are cut, increased, or left unchanged.

- There is particular reason to doubt that the capital gains and dividend tax cuts were responsible for the 2003 economic improvement given that these tax cuts were not expected to yield short-run economic gains. For example, conservative economist and Nobel Laureate Gary Becker, a strong supporter of the dividend tax cut, wrote that it “will not yield immediate benefits... Any short-run stimulus from eliminating the dividend tax would be too weak to have a significant benefit to the economy.”⁴

Claims that the *revenue* growth (as distinguished from the economic growth) that has occurred since 2003 was due to the tax cuts are even less believable. In large part, stronger revenue growth after 2003 resulted from the stronger economy. But since, as discussed above, the tax cuts were not responsible for the improvement in the economy, they could not have been responsible for the portion of the revenue increase due to stronger economic growth.

Apart from the stronger economy, several other factors also have helped increase revenues since 2003. But these factors appear to have been independent of the capital gains and dividend tax cuts, and in some cases they reflect developments for which supporters of these tax cuts are unlikely to want to claim credit.

- A recent Congressional Budget Office analysis attributes a significant share of the remaining revenue growth (the growth not due to a growing economy) to a large increase in the share of national income going to corporate profits.⁵ When corporate profits increase at the expense of other forms of income, some of which are not subject to tax or are taxed at very low rates, revenues rise. In addition, new data from economists Thomas Piketty and Emmanuel Saez show that the share of the nation’s pre-tax income going to the top 1 percent of households jumped dramatically between 2003 and 2005 (the latest year for which data are available). Increased income concentration tends to raise revenues because it puts more income in the hands of those who pay taxes at higher rates.

Supporters of the capital gains and dividend tax cuts cannot claim credit for the revenue growth that resulted from these developments unless they also claim credit for the developments themselves. That is, they would have to argue that the tax cuts caused the share of the nation’s

⁴ Gary S. Becker, “The Dividend Tax Cut Will Get Better With Time,” *Business Week*, February 10, 2003, http://www.businessweek.com/magazine/content/03_06/b3819038.htm.

⁵ Letter from Congressional Budget Office Director Peter R. Orszag to Senate Budget Committee Chairman Kent Conrad, May 18, 2007, <http://cbo.gov/ftpdocs/81xx/doc8116/05-18-TaxRevenues.pdf>.

income going to corporate profits and high-income households to increase — and consequently caused the share going to employee compensation and middle- and low-income households to fall. Tax-cut supporters have been notably silent on this score.

- CBO’s analysis does attribute a small share of the increase in revenues since 2003 to an increase in capital gains receipts resulting from higher capital gains realizations; much of this increase likely reflects the growth in the stock market that has occurred since 2003. Here, too, the challenge is to determine whether stock market growth that *followed* the capital gains and dividend tax cuts was *caused by* these tax cuts. A careful study by three Federal Reserve economists refuted this contention, finding that the tax cuts were *not* the reason the stock market rose in 2003. The study compared the performance of taxable stocks in the United States to the performance of European stocks, which did not benefit from the tax cuts. It found that European markets, which were unaffected by the U.S. capital gains and dividend tax cuts, behaved similarly to the U.S. market, casting serious doubt on the idea that the tax cuts were a crucial factor behind the improvement in the U.S. market.⁶

Making Tax Cuts Permanent Would Likely Have Negligible Economic Impact, But Would Cost About \$30 Billion A Year

While most of the debate among policymakers and journalists has focused on whether the capital gains and dividend tax cuts boosted the economy in the short run, the more credible argument for these tax cuts has always been that they might boost *long-run* growth by inducing Americans to increase personal saving or investment at the expense of consumption or by making the allocation of investment more efficient. The evidence on these arguments remains inconclusive, however, and early studies of the 2003 tax cut raise fresh doubts about such claims. In addition, the tax cuts thus far enacted — and most proposals to extend them — rely on deficit financing, which has negative long-term economic effects potentially large enough to outweigh any economic gains from the tax cuts.

- Early evidence on the capital gains and dividend tax cuts’ impact on savings, investment, and efficiency is not especially encouraging. Investment growth since 2003 has been average by historical standards; meanwhile, the personal saving rate has swung from positive to negative.

Furthermore, two important academic studies of the 2003 dividend tax cut found evidence that cutting taxes on dividends does *not* improve economic efficiency. One study, by Harvard Professor Mihir Desai and University of Chicago Professor Austan Goolsbee, concluded, “[T]he dividend tax cut, despite its high revenue cost, had minimal, if any, impact on marginal investment incentives.”⁷

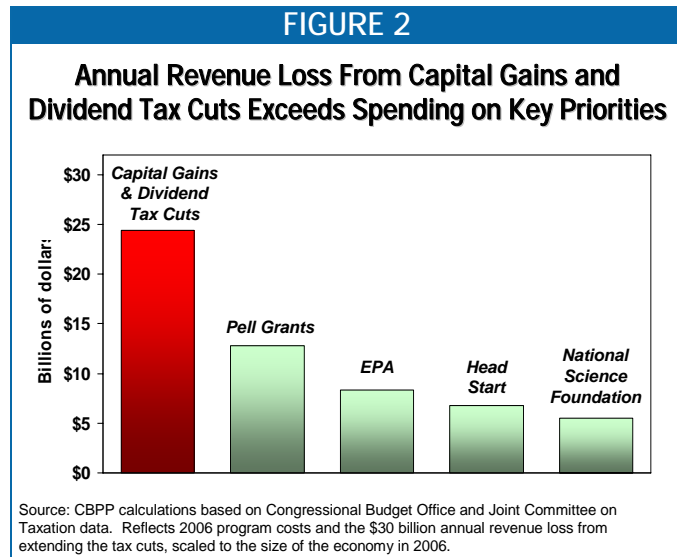
- Unless the cost of the capital gains and dividend tax cuts is offset by cuts in services or increases in other taxes, extending these tax cuts will add to deficits, thereby reducing both

⁶ Gene Amromin, Paul Harrison, and Steven Sharpe, “How Did the 2003 Dividend Tax Cut Affect Stock Prices?” Federal Reserve Board Discussion Paper, December 2005, <http://www.federalreserve.gov/pubs/feds/2005/200561/200561pap.pdf>.

⁷ Mihir A. Desai and Austan D. Goolsbee, “Investment, Overhang, and Tax Policy,” *Brookings Papers on Economic Activity*, 2004.

national saving and future national income. The non-partisan Congressional Research Service concluded that, under most plausible assumptions, the dividend tax cut “would harm long-run growth as long as it is based on deficit finance[ing].”⁸

- The Joint Tax Committee projects that making the capital gains and dividend tax cuts permanent would reduce revenues by about \$30 billion a year, or about \$25 billion a year in 2006 terms. This amounts to about twice what the federal government spent last year on Pell Grants to help low-income students attend college and more than twice what it spent on the Environmental Protection Agency, the Head Start Program, or the National Science Foundation. (See Figure 2.)



Tax-cut supporters have challenged the Joint Tax Committee cost estimates, arguing that extending the capital gains and dividend tax cuts would produce such large economic gains that it would more than pay for itself and would actually raise revenue. But as discussed above, it is not clear that extending the tax cuts would yield *any* significant economic benefits over the long run, much less economic gains large enough to fully offset the cost.

The remainder of this analysis examines the evidence in more detail, first regarding the capital gains and dividend tax cuts and the economy, and then regarding these tax cuts and revenues.

The Capital Gains and Dividend Tax Cuts and the Economy

The simplest way of evaluating the tax cuts’ economic effects is to examine how the economy has performed during the current business cycle, with its large tax cuts, as compared with previous post-World War II business cycles. These types of comparisons do not provide conclusive evidence: even if the economy performs well relative to historical norms, it might have done so for other reasons. Similarly, even if growth is weak, it might have been weaker without tax cuts. Still, comparing the current expansion with others does help establish whether it is a standout that requires special explanation or whether it fits within the range of a typical business cycle.

The current period’s performance with respect to key indicators has been well within the range — in fact, at the low end — of ordinary performance during the business cycle. GDP, non-residential investment, wages and salaries, and employment growth all have been below average relative to comparable periods of other post-World War II business cycles. (See Figure 1 on page 2.)

⁸ Jane Gravelle, “Dividend Tax Relief: Effects on Economic Recovery, Long-Term Growth, and the Stock Market,” Congressional Research Service, updated February 14, 2005.

The Economy's Improvement in 2003

Those who argue that the capital gains and dividend tax cuts had powerful economic effects often discount the first two years of the current expansion (2001-2003) and focus on the fact that the economy's performance improved around the time of the 2003 tax cut.

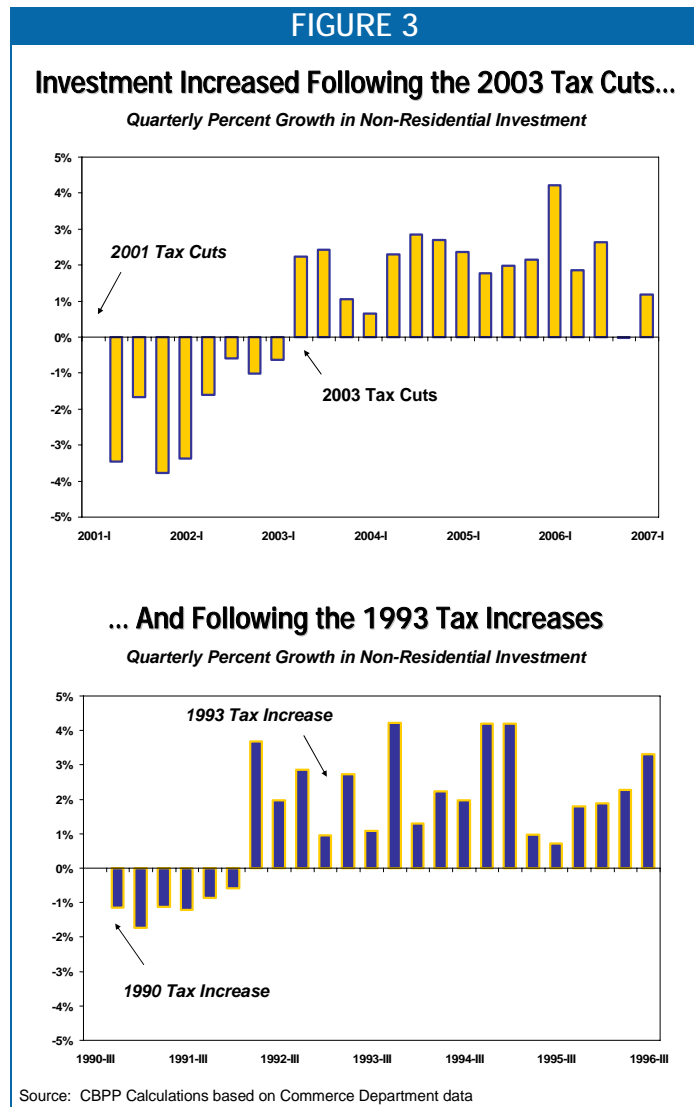
To see that this superficial *correlation* does not prove that the tax cuts *caused* the economy's improvement, one need only consider the case of the 1990s business cycle. That business cycle followed a pattern strikingly similar to the current one, especially with respect to growth in non-residential investment. Figure 3 displays the data for both periods. In both the 1990s and the current period, investment declined through the recession and the first eighteen months or so of the recovery. And in both the 1990s and the current recovery, investment growth then resumed. In the current recovery, that improvement coincided with a tax cut. In the 1990s, investment growth recommenced without tax changes of any kind, and then strengthened modestly following a tax *increase*.

Determining whether the capital gains and dividend tax cuts were *responsible* for the 2003 improvement in the economy clearly requires a more careful analysis. Several pieces of evidence suggest they were not.

The Economy Was Expected to Improve With or Without Tax Cuts

The claim that the tax cuts caused the economy's improvement in 2003 implies that, without the tax cuts, the economy would not have improved, or would have improved markedly less. But there are solid reasons to think that an upturn was likely regardless.

- Already in January 2003, before the capital gains and dividend tax cuts were even proposed, the *Wall Street Journal's* survey of economists found that most thought, "a modest economic recovery should take firmer root in 2003, led by businesses expected to pour their recuperating



profits into investment.”⁹

- Similarly, in February 2003, then-Federal Reserve Board Governor and current Federal Reserve Board Chairman Ben Bernanke predicted “an increasingly robust economic recovery during this year and next” because of firms’ need to replace old capital, improvements in business cash flows, and diminishing uncertainty about geopolitical events.¹⁰

- As of February 2003, the President’s own Council of Economic Advisers was predicting that employment growth would accelerate significantly beginning in 2003 *even without a new tax cut*. (It may be noted that, as of the end of 2006, total employment was millions *below* the level that the CEA predicted it would reach *without* the President’s proposed tax cut.)

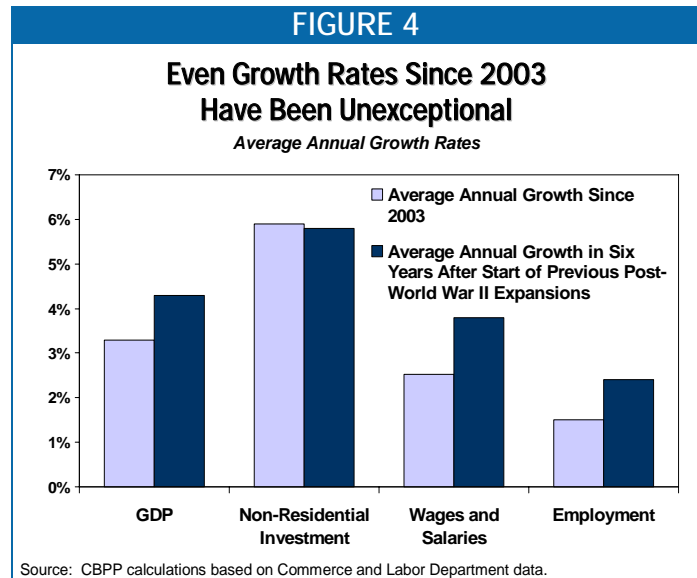
- It certainly was *not* expected that, in the absence of tax cuts, the recovery would remain as weak as it had been in 2001-2003. Had average growth rates remained as low through the first quarter of 2007 as they were during the 2001-2003 period, GDP growth during the current expansion would have been the lowest for *any* previous expansion since the end of World War II. Growth in non-residential investment, employment, and wages and salaries also would have been weaker than in any previous post-World War II recovery.

Nor has the *extent* of the improvement since 2003 been surprising. Had non-residential investment grown at its post-2003 rate since the start of the recovery, overall investment growth in the current period still would have merely matched the historical average. Moreover, GDP, employment, and wage and salary growth still would have been *below* average. (See Figure 4.)

Capital Gains and Dividend Tax Cuts Not Expected to Boost the Economy in the Short Run

Another reason to doubt claims that the 2003 capital gains and dividend tax cuts boosted economic growth immediately following their enactment is that, to the extent that economists believe capital gains and dividend tax cuts help the economy at all (see discussion below), they generally agree that any such effects would appear in the long run, *not* the short run.

Writing about the dividend tax cut, Gary Becker, a Nobel Laureate economist and supporter of the proposal, commented that “this tax cut will not yield immediate benefits;” its purpose is to “boost the economy in the longer run.” Becker continued, “Any short-run stimulus from



⁹ John Hilsenrath and Constance Mitchell Ford, “Economists Expect Spending By Business to Lead Recovery,” *Wall Street Journal*, January 2, 2003.

¹⁰ Remarks by Governor Ben S. Bernanke at the 41st Annual Winter Institute, St. Cloud, Minnesota, February 21, 2003, <http://www.federalreserve.gov/Boarddocs/Speeches/2003/20030221/default.htm>.

eliminating the dividend tax would be too weak to have a significant benefit to the economy.”¹¹ Similarly, a statement by a group of economists, including ten other Nobel Laureates, noted that the dividend tax cut “is not credible as a short-term stimulus.”¹² A Congressional Budget Office study found that the same is true of capital gains tax cuts: “[I]n general... capital gains tax cuts would provide little fiscal stimulus.”¹³

In addition, simulations of the effects of dividend and capital gains tax cuts have found that they are highly ineffective as economic stimulus. An Economy.com study found that reducing the taxation of dividends and capital gains would generate less than a dime of stimulus for each dollar of lost revenue; a Goldman Sachs analysis estimated that the dividend tax cut would provide eight cents of stimulus for each dollar of cost. (For comparison, Economy.com estimated that more efficient stimulus proposals would yield more than a dollar of stimulus per dollar of revenue loss.)¹⁴

Thus it seems far more likely that other factors, rather than the capital gains and dividend tax cuts, were responsible for the economy’s improvement in 2003.

Other Factors Were at Work in the Economy’s Improvement

In a recent informal poll, the *New York Times* asked 49 prominent mainstream economists to name the most significant factor behind 2003-2006 economic growth.¹⁵ Only five named the 2003 tax cuts; the rest focused on other factors. Several, including former Federal Reserve Vice-Chairman Alan Blinder, cited “superlow interest rates caused by the Federal Reserve.” Economist Robert Gordon of Northwestern commented that, “the most obvious cause [of the improved growth was] an unprecedented period of negative short-run interest rates that fueled spending on housing, made possible consumer cash-outs through mortgage refinance, and also supported consumer spending more generally.”

A few of those interviewed stressed the point that the improvement in 2003 was very much in line with the usual ups and downs of a typical business cycle. Economist Robert Hall of the Hoover Institution commented, “[T]he U.S. economy recovered from every single recession it ever had, so the growth in 2003-2006 was generally part of the normal cyclical recovery.” Erik Hurst of the University of Chicago pointed out, “[T]he growth in 2003-2006 was not that different from 1996-2000 (which had nothing to do with tax cuts or pent-up demand).”

¹¹ Gary S. Becker, “The Dividend Tax Cut Will Get Better With Time,” *Business Week*, February 10, 2003, http://www.businessweek.com/magazine/content/03_06/b3819038.htm.

¹² Economists’ Statement Opposing the Bush Tax Cuts.” Available at http://www.epinet.org/stmt/2003/statement_signed.pdf.

¹³ Congressional Budget Office, “Economic Stimulus: Evaluating Proposed Changes in Tax Policy,” January 2002, <http://www.cbo.gov/ftpdocs/32xx/doc3251/FiscalStimulus.pdf>.

¹⁴ Mark M. Zandi, “Assessing President Bush’s Fiscal Policies,” Economy.com, July 2004 and Goldman Sachs, “Fiscal Policy — In Search of Balance, Creativity and Grit,” May 2, 2003.

¹⁵ Daniel Altman, “Pop Quiz: Did the Tax Cuts Bolster Growth?” *New York Times*, May 13, 2007, <http://www.nytimes.com/2007/05/13/business/yourmoney/13view.html?ex=1336708800&en=5b14a30788f7df80&ei=5124&partner=permalink&expnod=permalink>.

The Capital Gains and Dividend Tax Cuts' Long-Run Effects

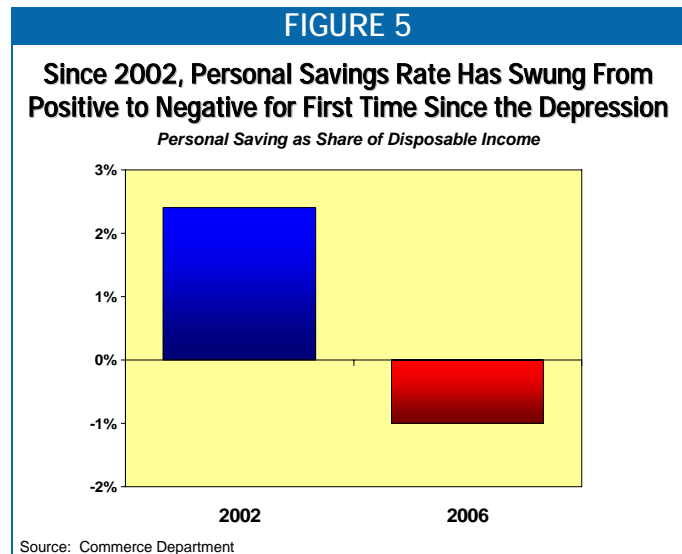
As discussed above, the available evidence indicates — and various noted economists agree — that the 2003 tax cuts had little or no effect on the economy in the short run. Nonetheless, supporters of these tax cuts may argue that making the tax cuts permanent would yield substantial *long-run* economic benefits by increasing private saving or making the allocation of investment more efficient.

The available evidence raises significant doubts about whether the tax cuts would have either of these beneficial effects. Moreover, even if making the tax cuts permanent did help the economy through one or both of these channels, its overall economic impact would depend critically on how it was financed. If the tax cuts' extension were financed by borrowing (like the original 2003 tax cuts and their 2006 extension), then it would probably be at least as likely to *reduce* economic growth as to increase it.

Capital Gains and Dividend Tax Cuts and Private Saving

Promoting private saving is one of the key mechanisms by which proponents of the 2003 tax cuts claimed they would boost economic growth. Advocates argued that the tax cuts would translate into an increase in personal saving, which would translate into an increase in national saving and national investment (the total investment made by Americans) and thereby into increased future national income. (In fact, even if tax cuts increase *private* saving, they may still reduce *national* saving and long-run national income if they are deficit financed, as discussed below.)

In theory, tax cuts for capital gains and dividends could encourage households to save more by increasing the after-tax return to saving. In practice, according to the non-partisan Congressional Research Service, “most empirical evidence seems to point to little savings response. The savings rate has been relatively constant during most of the post war period and attempts to formally estimate the savings response, while problematic, have found small effects of varying sign.”¹⁶ While economists still debate what drives savings decisions, some evidence suggests that individuals approach savings choices in ways that make them relatively insensitive to the after-tax rate of return. In particular, it appears that many people decide how much to save on the basis of simple rules of thumb, like saving a target dollar amount or a target percentage of their incomes, or saving whatever amount of current income is not required to attain some specified level of consumption. Since these rules of thumb do not reference the after-tax rate of return, the saving behavior of individuals who rely on them will be largely independent of the rate of return.



¹⁶ Jane G. Gravelle, “Distributional Effects of Taxes on Corporate Profits, Investment Income, and Estates,” Congressional Research Service, updated May 7, 2007.

It is also worth noting that, since the capital gains and dividend tax cuts were enacted, the personal saving rate has turned negative for the first time since the Great Depression. (See Figure 5.) It is possible of course that the saving rate would have turned even more negative without the tax cuts. But these data still should be troubling to those who hope tax cuts for investment income can solve the problem of low national saving.

Capital Gains and Dividend Tax Cuts and the Allocation of Investment

The key rationale for the dividend tax cut, however — and to a lesser extent for the capital gains tax cut as well — was not that it would increase *aggregate* saving and investment but that it would improve the *allocation* of investment, making it more efficient. The argument was that earnings on corporate investment were “double taxed:” once by the corporate income tax and once when paid out to investors as dividends or capital gains. As a result, too much investment was being directed to non-corporate businesses and too little to corporations.¹⁷ The theory was that the dividend tax cut would significantly reduce these distortions — as well as distortions that cause corporations to rely too heavily on debt financing — and would thereby enhance the efficiency of investment decisions.

Economists disagree, however, about the extent to which lowering dividend taxes actually improves the efficiency of investment decisions, rather than simply or primarily providing windfall gains to shareholders. The outcome depends on how firms finance their investment,¹⁸ and the evidence on this issue remains murky. Interestingly, though, two academic studies that used the 2003 dividend tax cut to examine this question concluded that the new data support the view that dividend tax cuts are primarily windfalls for current shareholders. Economist Kevin Hassett, co-author of one of the studies and a prominent supporter of the 2003 tax cut, commented that his findings implied it was “not likely that tinkering with the dividend tax rate will have much effect on investment.”¹⁹ Similarly, a study by Harvard Professor Mihir Desai and University of Chicago Professor Austan Goolsbee, concluded, “[T]he dividend tax cut, despite its high revenue cost, had minimal, if any, impact on marginal investment incentives.”²⁰

¹⁷ Strangely, some supporters of the dividend tax cut have claimed that its benefits were disproportionately targeted to “small” businesses. (See, e.g. Senate Republican Policy Committee, “Marking the 4th Anniversary of the 2003 Tax Relief Law: A Boon to Taxpayers, Tax Receipts, and the Economy,” May 15, 2007.) In fact, one of the principal economic justifications for the tax cut was to redirect investment *away* from noncorporate businesses and toward corporations that would yield higher rates of return.

¹⁸ More specifically, it depends on whether most “marginal” investment is financed through new share issues or retained earnings. For an explanation of these issues, see Jane Gravelle, “Dividend Tax Relief: Effects on Economic Recovery, Long-Term Growth, and the Stock Market,” Congressional Research Service, updated February 14, 2005.

¹⁹ Kevin A. Hassett, Presentation at American Enterprise Institute Forum, “How Did Firms Respond to the Dividend Tax Cuts?” November 8, 2005 and Alan J. Auerbach and Kevin A. Hassett, “The 2003 Dividend Tax Cuts and the Value of the Firm: An Event Study,” National Bureau of Economic Research Working Paper No. 11449, June 2005.

²⁰ Mihir A. Desai and Austan D. Goolsbee, “Investment, Overhang, and Tax Policy,” *Brookings Papers on Economic Activity*, 2004.

Reduced Tax Rates for Capital Gains Can Have Negative Economic Effects

Supporters of capital gains tax cuts typically emphasize their potential economic benefits, such as the possibility that cutting capital gains tax rates will make investors more willing to sell unproductive investments (see discussion on page 12). But as various experts have noted, preferential tax rates for capital gains are also “the lynchpin of many tax sheltering schemes,” since tax shelters often hinge on opportunities to recharacterize ordinary income as capital gains and take advantage of the lower tax rates.* (The recent revelations of how hedge fund managers are converting their fees into capital gains to take advantage of the differential rate is just one example of the type of manipulation and gaming that the large rate differential induces.)

Tax shelters do not just reduce revenues; they also divert resources to unproductive activities, a development undesirable for the economy. As noted economist and Urban-Brookings Tax Policy Center Director Leonard Burman explained in a commentary on the 2003 capital gains tax cut, “shelter investments are invariably lousy, unproductive ventures that would never exist but for tax benefits. And money poured down these sinkholes isn’t available for more productive activities. What’s more, the creative energy devoted to cooking up tax shelters could otherwise be channeled into something productive... Bottom line: low rates for capital gains are as likely to depress the economy as to stimulate it.”**

One key feature of the 2003 capital gains tax cut seems to positively invite unproductive tax avoidance. From 2008-2010, the long-term capital gains tax rate will be *zero* for taxpayers who are in the 15 percent tax bracket or below for purposes of the regular income tax. This creates a very large incentive for high-income investors to employ schemes that allow them to take advantage of the lower rate, which was intended for middle- and low-income households. For example, one recent article suggested that wealthy investors could consider transferring stocks to elderly parents with low current incomes, who would then pay no capital gains tax when they sold the assets.***

* Leonard E. Burman, William G. Gale, and Jeffrey Rohaly, “The Expanding Reach of the Alternative Minimum Tax,” *Journal of Economic Perspectives*, Spring 2003.

** Leonard E. Burman, “Under the Sheltering Lie,” *Marketplace* Commentary, December 20, 2005, <http://www.taxpolicycenter.org/publications/template.cfm?PubID=900918>.

*** Sandra Block, “2008 Drop in Capital Gains Rate Won’t Be For Everyone,” *USA Today*, June 15, 2007.

Even economists who believe that dividend tax cuts enhance efficiency typically estimate that the resulting effect on economic growth would be small. Former Council of Economic Advisers Chair Glenn Hubbard, a prominent supporter of the dividend tax cut, suggested in a speech at the American Economic Association in January 2004 that gains resulting from the dividend tax cut’s effect on the allocation of investment would raise the long-term level of GDP by only 0.2 percentage points.²¹ (If it took 30 years for that “long run” effect to materialize, this would amount to bumping up the average annual growth rate from, for instance, 3.0 percent to 3.007 percent.) Moreover, that statement was made in reference to an earlier version of the President’s proposal, which likely would have had a *larger* impact on the economy than the proposal ultimately enacted.²²

²¹ Cited in William G. Gale and Peter R. Orszag, “Bush Administration Tax Policy: Effects on Long-Term Growth,” *Tax Notes*, October 18, 2004, http://www.urban.org/UploadedPDF/1000698_Tax_Break_10-18-04.pdf.

²² The President’s proposal would have fully eliminated the tax on dividends, but only in the case of dividends paid out of corporate earnings subject to the corporate income tax. (About half of all corporate earnings are not taxed by the

In the case of the capital gains tax cut, proponents argued that the tax cut would improve the efficiency with which capital is allocated to different purposes through an “unlocking effect.” Their argument was that investors sometimes hold onto stocks and other assets that it would be more efficient to sell, simply because they want to defer capital gains taxes; reducing the tax rate would reduce this distortion. But considerable evidence suggests that the impact of tax rates on capital gains realizations is relatively weak. For example, growth in realizations of individual capital gains has closely tracked growth in realizations of corporate capital gains, even when individual and corporate capital gains have been subject to very different tax changes.

In addition, it is worth noting that capital gains tax cuts can make the allocation of resources *less* efficient. By increasing the tax differential between income paid out in the form of capital gains and other forms of income, they may have the effect of diverting resources into tax shelters — economically unproductive schemes designed to convert ordinary income into more lightly taxed capital gains. (See box on page 11.)

Small Potential Economic Gains From Tax Cut Could Be Outweighed By Negative Impact of Financing

The 2003 capital gains and dividend tax cuts, as well as their subsequent extension through 2010 and most proposals to make them permanent, have relied on deficit financing. This means that any increase in private saving or investment efficiency must be counterbalanced against the negative economic consequences of higher deficits. By reducing government saving, increases in deficits reduce national saving and thus tend to lower long-run national income.²³

The Congressional Research Service evaluated the 2003 dividend tax cut under various assumptions and concluded that “the dividend relief proposal would harm long-run growth as long as it is deficit financed.”²⁴ Similarly, Brookings Institution economist William Gale and former Brookings Institution economist (now CBO director) Peter Orszag found that even given optimistic assumptions about the dividend tax cut’s impact on private saving and the allocation of capital, the tax cut would have “roughly a zero [net] effect on long-term growth” if financed by borrowing.²⁵

The Capital Gains and Dividend Tax Cuts and Revenues

In addition to claiming that the capital gains and dividend tax cuts have yielded or will yield large benefits for the economy, proponents often argue that the tax cuts have unleashed a “surge” of federal revenues.

corporate income tax.) Because the original proposal would have provided a larger individual-level tax reduction, but only to earnings that had been taxed at the corporate level, it would have done more to level the tax treatment of different forms of investment than the tax cut ultimately enacted. Thus, the economic benefits of the enacted tax cut would presumably be even smaller.

²³ For further discussion, see Aviva Aron-Dine and Robert Greenstein, “Economic Effects of the Pay-As-You-Go Rule,” Center on Budget and Policy Priorities, March 19, 2007, <http://www.cbpp.org/3-19-07bud.htm>.

²⁴ Jane Gravelle, “Dividend Tax Relief: Effects on Economic Recovery, Long-Term Growth, and the Stock Market,” Congressional Research Service, updated February 14, 2005.

²⁵ William G. Gale and Peter R. Orszag, “An Economic Assessment of Tax Policy in the Bush Administration, 2000-2004,” Boston College Law Review, vol. 45, no. 4, 2004. http://www.bc.edu/schools/law/lawreviews/meta-elements/journals/bclawr/45_5/05_FMS.htm.

Evidence for these claims, however, is lacking. Overall revenue growth during the current business cycle has been exceptionally weak, exactly as one would expect in the aftermath of two large tax cuts. The new Office of Management and Budget Projections indicate that at the end of 2007, revenues will be only 3.1 percent above where they were at the start of the current business cycle in March 2001, after adjusting for inflation and population growth. In contrast, in previous post-World War II business cycles, real per-person revenues had grown by an average of 12.0 percent by the same stage of the business cycle. (See Table 1.)²⁶

Table 1: Total Real Per-Capita Revenue Growth in 26 Quarters after the Last Business Cycle Peak	
Current Business Cycle	3.1%
Average for Previous Post-World War II Business Cycles	12.0%
1990s Business Cycle (following tax increases)	16.2%

Some proponents of the tax cuts acknowledge the weak performance of revenues from 2001-2004 but credit the stronger revenue growth in 2005 and 2006, and the growth now projected for 2007, to the 2003 capital gains and dividend tax cuts. To assess such claims, one must start with a basic fact. To have increased revenues, these tax cuts would either have had to: (1) cause the economy to grow more rapidly than it otherwise would have, or (2) cause revenues to grow as a *share* of the economy more than they otherwise would have. As discussed above, the evidence indicates the capital gains and dividend tax cuts did *not* significantly boost the economy. Hence, they could not have significantly increased revenues through this mechanism. Thus, to have increased revenues, the tax cuts would have had to cause revenues to be higher as a share of the economy than they otherwise would have been.

Following enactment of the tax cuts, revenues fell in 2004 to their lowest level as a share of GDP in more than 40 years. Since then, revenues have rebounded to approximately their 40-year historical average as a share of the economy. But the evidence indicates that this bounce-back is the result of factors unrelated to the capital gains and dividend (or other) tax cuts.

Major Factors Behind Growth in Revenues As a Share of GDP Appear to Include Surging Corporate Profits and Increasing Income Concentration

A new analysis by the Congressional Budget Office decomposes the growth in revenues as a share of GDP since 2003 among various sources. The single largest factor that the CBO analysis identifies — accounting for more than a quarter of the increase in revenues as a share of GDP — is an increase in *corporate profits as a share of GDP*.²⁷

²⁶ In order to avoid distortions that could result from the fact that different business cycles begin at different points in the fiscal year, we compare revenue growth across business cycles by constructing quarterly revenue figures as weighted averages. For example, we estimate revenues in the second quarter of fiscal year 2001 to be (1/2) x revenues in fiscal year 2000 plus (1/2) x revenues in fiscal year 2001. We then compare growth over the 26 quarters following the business cycle peak. Had we instead compared revenue growth over the six fiscal years following the year of each business cycle peak (without constructing quarterly revenue figures), this would not have changed our qualitative conclusions.

²⁷ Letter from Congressional Budget Office Director Peter R. Orszag to Senate Budget Committee Chairman Kent Conrad, May 18, 2007, <http://cbo.gov/ftpdocs/81xx/doc8116/05-18-TaxRevenues.pdf>.

Between mid-2003 and the end of 2006, corporate profits grew at an average annual rate of 14 percent, after adjusting for inflation. Because that pace was about four times the rate of GDP growth, corporate profits increased substantially as a share of GDP. At the same time, employee compensation grew much more *slowly* than GDP and *declined* as a share of GDP.

This increase in corporate profits as a share of GDP — and the corresponding decline in employee compensation as a share of GDP — boosted corporate tax revenues as a share of GDP while reducing individual income tax revenues as a share of GDP. The result has been a net increase in federal revenues as a share of GDP of 0.5 percentage points. (There has been a net increase because some of the increase in taxable corporate profits came at the expense of compensation that is not subject to tax or is more lightly taxed than corporate profits.)

The Significance of this Shift in National Income

This shift in the distribution of national income from employees to corporate profits has been large. In 2006, the share of national income going to wages and salaries was at its lowest level on record, with data going back to 1929. The share going to total employee compensation was at its second lowest level since 1968.

If the economy had grown very strongly, it would have been possible for wages and salaries and employee compensation to fall as a share of the economy but still grow at a robust pace. As discussed above, however, the economy has grown at a below-average pace in the current expansion. As a consequence, the exceptionally strong growth in corporate profits came at the expense of strong growth in wages and salaries and other employee compensation. This is reflected in the fact that wages and salaries have grown more slowly during the current expansion than in *any previous expansion since World War II*, and total employee compensation has grown at a below average rate as well.

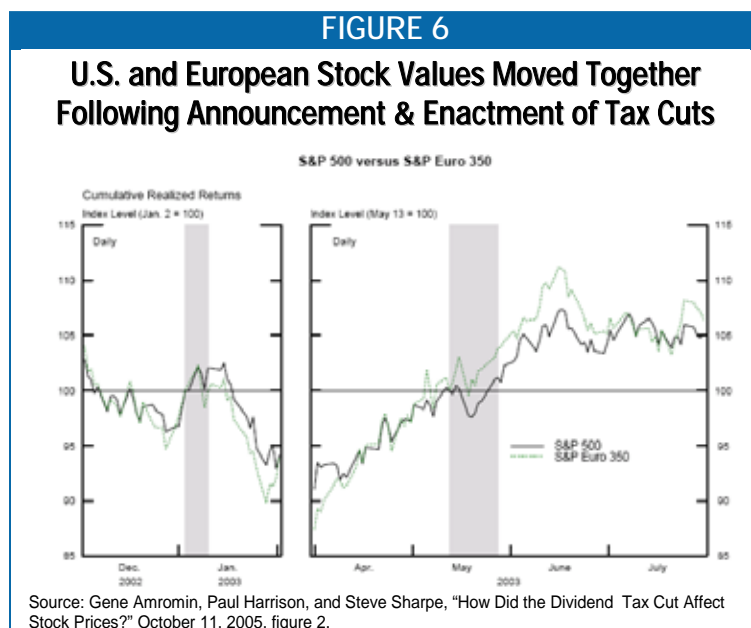
To be sure, these trends in the distribution of economic gains appear to be due to a variety of changes in the national and global economies; they are not due to the 2003 tax cuts. But if tax-cut proponents claim the capital gains and dividend tax cuts *have* somehow been responsible for the shift in national income from wages and salaries to corporate profits and thus for the increase in revenues attributable to this shift, they will implicitly be arguing that the tax cuts also have caused the drop in the share of national income going to workers in the form of wages and salaries. This is a trend for which tax-cut proponents probably do not wish to claim credit.

The Remaining Growth in Revenues as a Share of GDP

The Congressional Budget Office reports that most of the remaining growth in revenues as a share of GDP since 2003 (i.e., the share not due to the growth in corporate profits as a share of GDP) is due to miscellaneous other factors, which likely include rising income inequality. New data from economists Thomas Piketty and Emmanuel Saez (widely regarded as among the leading experts on trends in inequality) show that the share of the nation's pre-tax income going to the top 1 percent of households increased a full 3 percentage points between 2003 and 2005, the largest two-year increase since the 1920s. (Note: 2005 is the latest year for which these data are available. Three percentage points of personal income amounted to more than \$200 billion in 2005.) Piketty and Saez also found that between 2004 and 2005 alone, the average pre-tax income of the top one

percent of Americans rose by an average of \$102,000, after adjusting for inflation, while the average pre-tax income of the bottom 90 percent of Americans rose by only \$250.

Since high-income taxpayers pay taxes at higher rates, an increase in the share of the nation's income that goes to high-income households leads to an increase in revenues as a share of the economy. Analysts at Goldman Sachs, as well as other analysts and economists, have suggested that the rise in income inequality may be an important part of the explanation for recent revenue growth.²⁸



If tax-cut supporters were to argue that the tax cuts increased revenues through the mechanism of increased inequality, they would also be arguing that the tax cuts decreased the share of the nation's income flowing to the bottom 99 percent of American households. This is another development for which they do not appear eager to claim responsibility.

Small Role Played by Capital Gains Realizations Does Not Show 2003 Tax Cut "Paid for Itself"

CBO attributes a little less than a sixth of the increase in revenues as a share of GDP since 2003 to increased capital gains realizations. The growth in capital gains realizations reflects in large part the growth in the stock market since 2003. Advocates of the capital gains and dividend tax cuts frequently imply that because the increase in the market's value followed the capital gains and dividend tax cuts, it was caused by those tax cuts. However, a careful study by three Federal Reserve economists persuasively refutes the contention that the capital gains and dividend tax cuts caused the stock-market increase. The study compared the performance of taxable stocks in the United States to the performance of European stocks, which did not benefit from the tax cuts. It found that European markets, which were *unaffected* by the U.S. capital gains and dividend tax cuts, behaved similarly to the U.S. market, casting serious doubt on the claim that the tax cuts were a crucial factor behind the improvement in the U.S. market.²⁹ (See Figure 6.)

The same result emerges from more recent data on European stock markets compiled by the Congressional Budget Office, which CBO Director Peter Orszag presented at a recent conference of the National Tax Association. In his address, Orszag also noted that even though the 2003 tax cut

²⁸ Goldman Sachs, "The Macro Effects of Rising Income Inequality," June 30, 2006.

²⁹ Gene Amromin, Paul Harrison, and Steven Sharpe, "How Did the 2003 Dividend Tax Cut Affect Stock Prices?" Federal Reserve Board Discussion Paper, December 2005, <http://www.federalreserve.gov/pubs/feds/2005/200561/200561pap.pdf>.

applied to long-term but *not* short-term capital gains — and to individual but *not* corporate capital gains — “you don’t see a very substantial difference in realizations or behavior between short- and long-term gains over the last few years,” nor a substantial difference between individual and corporate realizations. Orszag observed that this “raises questions about whether it was long-term capital gains tax changes that were driving a lot of behavior.”³⁰

It is true that temporary cuts in capital gains tax rates, such as those enacted in 2003, are well known to lead to substantial *temporary* increases in capital gains realizations (i.e. temporary increases in taxpayers selling assets such as stocks) as investors act to take advantage of a capital gains rate cut before it is scheduled to expire. But the Joint Committee on Taxation takes this effect into account in its estimates and still projected that the 2003 capital gains tax cut would lose revenue: the effects of the lower rate would overwhelm the effects of higher realizations.

In short, the data do not support claims that the capital gains tax cut is responsible for a large share of the recent increase in revenues as a share of GDP.

Conclusion: Making the Capital Gains and Dividend Tax Cuts Permanent Would *Lose* Revenue

The argument that the capital gains and dividend tax cuts have “paid for themselves” or raised revenue hinges on the claim that these tax cuts had large positive effects on the economy and/or have significantly increased revenues as a share of GDP. As discussed above, the best evidence does not support these contentions and in fact indicates that they are not correct.

The best estimates of the cost of extending the capital gains and dividend tax cuts consequently remain those from the Joint Committee on Taxation, which show that making these tax cuts permanent would reduce revenues by about \$215 billion between 2011 and 2017.

In coming decades, the nation faces huge fiscal challenges as a result of rising health care costs and the baby boomers’ impending retirement. Among the first steps toward facing up to these challenges would be to abandon Pollyannaish claims that various tax cuts are a free lunch.

³⁰ Quoted in Heidi Glenn, “Carroll Defends White House Health Care Proposal,” *Tax Notes*, May 18, 2007.